The rising interest rate environment has progressively weighed upon office building performance, where required returns have increased as debt and equity components have moved upward. Major headwinds exist for the office markets, most notably the continued acceptance of remote work and hybrid workplace being more structural than cyclical, with no signs of easing in the future. Economic concerns are also high for all real estate sectors as increasing interest rates have slowed growth in many areas of the economy.

Total office returns in Q4 were -4.8%, with the decline attributable to an appreciation return of -5.9%. Income returns remained relatively steady at 1.1%. This was the third consecutive quarter of declining appreciation, resulting in a year-over-year decline of -7.4%. Total returns for the year were -3.4%, with income reported at -3.3%. Pandemic relocations and Life Science’s strong performance in the Suburban markets has disproportionately affected CBD office returns relative to Suburban, with year-over-year appreciation of -9.5% and -4.8%, respectively, and total returns of -5.7% and -0.4%.

Geographically, the South region has performed best over the past year with a slight negative return of -1%. Although the West region fared second best over the past year, it had the greatest decline in Q4 as appreciation was -6.4%, and recently announced tech layoffs in the West region have added risk to office investments. The Pacific Office-CBD office subtype by division illustrates this with the greatest negative appreciation of -7.3%.

Illustrative of the structural shift in office demand due to the remote work trend are figures from Kastle Systems on how much of the leased space is used. Nationally, about 50% of office tenants have returned to the office, indicating that office space utilization is substantially below pre-pandemic levels. In response to changing tenant demand many firms have been downsizing their space with the greatest negative appreciation of -7.3%.

Occupancy increased slightly in Q4 to 87.2% from 87% in Q3, though still below Q419’s 90.1%. Hidden from these figures is the amount of sublease space, which some sources report adds an additional 25% to available space.

The structural changes in office use will not impact all types of office equally, with better quality institutional assets such as those in the NCREIF indexes less impacted. The greatest impact is on lesser quality assets in the B and C class that cannot compete with better positioned, better located, and newly developed properties. These B and C buildings cannot meet ESG requirements and lack the attributes employers need to attract tenants back to the office.

Investors have responded to demand and capital market challenges by increasing office return requirements since the last quarter. The value declines from Q3 to Q4 as a result of narrow bid-ask spread, with the movement toward the bidder as sellers recognize a continuation of weak market conditions and challenging future outlook. Most investors recognize that the market will likely reach bottom as interest rate trends stabilize, which is generally expected to later in 2023.

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