McCALL/ALMY

ASSESSING THE BOSTON OFFICE MARKET DURING COVID-19.

The uncertainty surrounding Governor Charlie Baker's plan to re-open the Massachusetts economy in four phases is a reminder that establishing a timetable for a return to work may be nearly impossible for many businesses. Despite the uncertainty, however, there are encouraging signs that the Greater Boston real estate market can successfully weather the storm created by the pandemic and adapt to a new normal more quickly than other markets.

On a national level, a stock market that had seen all of its gains since 2017 wiped out in mid-March rebounded forcefully (including Boston headquartered firms Wayfair, Boston Beer, and Vertex Pharmaceuticals), although the past week indicated there could be a return to volatility. And while the COVID-19 pandemic has devastated some CRE sectors – particularly retail, restaurants and hotels – others remain strong, particularly industrial, as ecommerce plays an increasingly important role in helping consumers meet their needs while helping them to stay safe.

As for Greater Boston, the diversification of its economy should prove to be its saving grace. The healthcare and education sectors, despite current challenges, will continue to serve as anchors for the economy in the long run, although the delivery systems for both may undergo radical change. The life sciences, which have created huge demand for both lab and office space in Greater Boston in recent years, should continue to thrive – particularly with an increased focus on devising a vaccine and treatments for COVID-19 in addition to their ongoing research and development.

The State of Office Today

The office market, because it represents such a large percentage of commercial real estate, will bear close watching as the impact of the coronavirus continues to unfold. Of immediate concern is the ability of tenants to pay rent and the ripple effects that will be felt throughout the real estate ecosystem. As we are still in the early stages of the crisis, we are advising tenants to have honest conversations with their landlords about their financial situations so that if warranted, a deal that is amenable to both parties can be worked out. In some cases, that means landlords extending free rent for the near term, typically with the understanding that it will be made up on the back end of the lease, and may include extensions. Not all landlords have the financial flexibility to do so however, which could result in a cascading effect as tenants delay rent, landlords default on mortgage payments, and lenders and investors in mortgage-backed securities are adversely impacted.

For tenants currently in the market for space, there has been a pronounced slowdown in lease deals of late, as any tenant that doesn't have to make a decision in this uncertain market is not going to. Those with more immediate needs hoping to gain rent reductions or other concessions from landlords in this market today may be disappointed, however. Unlike previous downturns, much of the Class A office space in the Boston CBD is owned by well-capitalized landlords such as Oxford, Boston Properties, Rockpoint, Norges Bank, and Prudential – which typically take a long-term view.

If the lockdown continues for a prolonged period, however, landlords may no longer be holding all the cards, as the amount of sublet space being released back into the market could be substantial, driving down rents. This may take some time to become reality, but every day we are seeing more and more sublease opportunities becoming available. We could potentially see the vacancy rate in the CBD go from 6.5% to 13%-15% and the suburbs increase from 12% to as high as 20%-23%, in certain markets. Even the well-capitalized landlords mentioned above will eventually need to respond with lower rents.

Currently, tenants with immediate space needs are adjusting their real estate strategies. In one case, a company with plans to take 50,000-plus square feet prior to the coronavirus re-assessed and opted for a deal for two-thirds of the space, benefitting both the tenant and landlord in the short term. A second tenant planning to renew for five years worked out a deal with the landlord to reduce the commitment to two years, but paid a premium for the shorter term.

What's Next?

When office buildings do open their doors, the way that office space has been used will undoubtedly change. For starters, the coronavirus has created a massive test case for the viability of work-at-home strategies for both companies and employees. While there will almost certainly be an uptick in the amount of people working from home for at least some portion of the work week, it appears there is a significant portion of the workforce who feel they can be more productive in a structured work environment.

While there is much speculation as to what the future of the post-coronavirus workspace will look like, the trend towards work benches is likely to go away and the current 110-180 square foot per person allotments are going to increase. Business is becoming increasingly global and health experts are predicting that epidemics of infectious diseases are expected to become more prevalent. With this in mind, many of the larger requirements in play today are re-assessing their space needs and are now planning to increase the ratio from an average of 130 square feet per person to a minimum of 200 square feet and up to 300 square feet. So while work from home strategies may reduce the daily headcount in the office, the need for spacing should keep office space requirements from contracting too dramatically. This may also spur the need for companies to take lower-cost space in the suburbs, particularly for support functions.

The move to the suburbs is a trend that may occur regardless of COVID-19, as millennials having children begin to consider moving to the suburbs seeking less expensive and larger living space for their growing families. A prolonged COVID-19 situation in a congested city with less access to nightlife and cultural events may hasten the move to the suburbs.

While the City of Boston has not announced a firm date for nonessential construction to resume, speculative office construction will largely come to a halt. This includes projects such as Boston Properties' Back Bay Station as well as South Station, although Hines and co-investors Dutch pension fund APG Asset Management U.S. Inc. and New York-based Dune Real Estate Partners may have the deep pockets and long term vision to proceed with South Station. Projects with a tenant already in tow – including the 1.1 million square foot Bulfinch Crossing, which pre-leased over half of the office space to State Street – should continue, as will multifamily projects throughout the city. Demand for startup spaces could be affected, as the pandemic is presenting challenges for a number of startups. Venture capital is becoming scarce, although funding for some biotech and cybersecurity firms will continue.

McCALL/ALMY

The Good News

As with the Great Recession, Boston is in a much stronger position to rebound than other markets, beginning with its solid “meds and eds” foundation. Colleges will transition to a teleconferencing model for the short term as the virus continues to take its toll on our people and institutions, but will ultimately survive. The high density of world-class educational institutions creates a fertile talent pipeline as well as fueling tech and life science startups that may become the next Facebook or Biogen. There is also a pent-up demand for medical services (including elective surgeries, a vital moneymaker for hospitals), so the healthcare industry should come back strong once the healthcare settings are deemed safe enough to return to.

Boston’s diversified economy, fueled by its growing tech and life science industries and anchored by traditional businesses such as financial services and law firms, will survive. When we emerge from this pandemic, the world will be a different place, but Boston will continue to be a hub of culture and innovation.

LENNY OWENS
Executive Vice President/Partner
+1 617.838.9191
lowens@mccallalmy.com

DAVE RICHARDSON
Executive Vice President/Partner
+1 617.838.9343
drichardson@mccallalmy.com

SANDY TIERNEY
Executive Vice President/Partner
+1 617.838.9474
stierney@mccallalmy.com