Newsletter (14) - Office Real Estate

(1) Introduction

In this week's edition of our newsletter, we explore the state of the office real estate market. After years of disruption following the pandemic, the asset class is undergoing selective revitalisation. Changing demand along with constrained supply is defining this new market, creating both risks and opportunities for investors re-entering the market.

(2) COVID-market

Over the past five years the office real estate market has experienced significant turbulence. In the pre COVID-19 market, offices were stable and income-producing assets, with relatively low vacancy rates. Across the board, rents were growing steadily especially in core-markets with limited space available and a consistent pressure for urbanization. Europe vacancy was tighter than the U.S., with standout markets like Berlin near 1.6%.

As office use collapsed during the pandemic, occupancy rates plummeted across geographies; both European and American occupancy rates decreased by nearly 200 basis points over a few quarters. Further, as surveys and studies suggested that hybrid work would persist, companies downsized their space and the reletting market froze. When companies tried to get out of long-leases for more space than they had use for, the sublease market ballooned. Consequently, competition decreased for space, which suppressed rents. Valuations, which are by extension a product of rent and vacancy, declined as a result.

Transaction volume rebounded in 2021 because of cheap financing, however when inflation and interest rates rose in 2022 office deal volume fell drastically. Blackstone, among others, explained that capex growth outpaced rent, which created a significant pull on unlevered returns, reducing incentives for new investments. The downturn of the asset fundamentals, coupled with falling multiples due to a more uncertain investment environment, hamstrung transaction volume all together.

(3) Shifting Demand

Following the post-pandemic slump, offices are re-emerging as investable assets with demand fundamentally shifting and tenants prioritizing quality over quantity.

The increase in demand for offices is largely driven by a behavioural change regarding offices. A few years on from the peak of hybrid work, they are seen less as fixed costs and more like tools to attract employees to the office and enhance culture. Moreover, prime offices help attract talent. Such prime offices are usually highly technological, rich in amenities and centrally located. Illustrating this trend, the share of grade A office space leasing is 10% higher than pre-COVID levels. The newly introduced JP Morgan New York office exemplifies this trend, providing 24/7 food-courts, wellness centres and bars, while built to net-zero emissions. In contrast to prime assets, sub-prime offices continue to struggle amid the market dynamics. Companies are no longer interested in office space with few to no amenities, located outside of cities and facing costly renovations to meet proposed government environmental standards.

In Frankfurt, the divide in demand is evident and highlighted in KPMG's relocation from *The Squaire* to the newly refurbished Operturm. While the centrally located and ESG-compliant Opertum is nearly fully occupied, *The Squaire* is half empty, burdened with high maintenance costs and poor location by the airport. While the Opernturm is fetching a sale of c. €900mn at a 4.5% yield (22x), The Squaire has seen its value deteriorate 40% to €517 mn. The example illustrates that even landmark properties are vulnerable to obsolescence without modernization and strong sustainability credentials. This bifurcation in demand, concentrated at the top but absent at lower quality, has profound implications for returns.

(4) Supply Squeeze

Whilst demand for prime offices is booming, such space is currently too scarce in almost all developed markets. The investment market dynamics, characterized by rising interest rates, construction price increases and stricter ESG requirements has made development oftentimes unpalatable - creating a bottleneck. Last quarter, for example, Britain recorded the lowest level of office under construction in over 10 years. With the uncertain economic conditions expected to continue, fueled by high-for-longer rates, certain speculative projects have been stalled or gone insolvent.

On the sub-prime side, there has been a surge in office-to-residential conversion, as a way to capitalize on obsolete office stock. For example, last quarter in New York recorded the highest rate of office conversion activity since the GFC (4.1 million square feet). As demand for housing in large cities is increasing, such conversions, can in theory, be an opportunistic attempt to benefit from tailwinds in other asset classes. In practice, however, physical and regulatory barriers continue to restrict feasibility of conversions. The differences in layout, lighting and water, just to name a few, makes it a structural challenge. Combined with high retrofit costs and still-elevated financing rates, only a small fraction of sub-prime, out-of-favor offices can be viably converted. As a result, much of the outdated stock remains stranded, keeping effective supply tight even as vacancy rates moderate on paper. Until financing conditions ease and regulatory frameworks adapt, the supply imbalance is unlikely to fully correct.

(5) Risks & Opportunities

With office values falling 20-40% in the last five years, owners need to refinance at lower valuations (i.e. higher LTV ratios) and higher interest rates, oftentimes requiring new equity injections. With funds maturing, such injections are sometimes impossible, which increases demand for private credit options to bridge valuation and loan deltas. Nevertheless, banks have been more lenient with such insolvent equity partners, due to their unwillingness to write down assets on their books. Hence, by allowing the restructuring of outstanding loans, this has contributed to the “extend and pretend” ethos in the office market and has made the true extent of repricing opaque.

On the other hand, dire conditions of owners, combined with an increasing drift between demand and supply of prime offices, results in opportunities for capital-rich investors. As funds are forced into distress sales when approaching redemption cycles, acquisitions of prime-located assets can be made at discounts. Patient capital with longer time horizons can capture this discount, provided they can underwrite short-term volatility, and position for rising rents ahead. Kathleen McCarthy of Blackstone echoed this view in a CNBC interview at the start of 2025, noting that “for select assets and select sub-markets, you are really seeing a strengthening in the market.” This reaffirms that Blackstone along with other PE funds with dry powder intend to ramp-up investment into high-quality office assets after a period of restraint.

(6) Conclusion

In conclusion, the office real estate market is being reshaped by bifurcating demand, for which supply is struggling to adapt. Driven by a fundamental shift in how occupiers view workspace, the significant flight-to-quality continues to favor prime office assets, while overall vacancies are rising due to redundant sub-prime assets. Changing dynamics are however presenting opportunities for investors, and capital is increasingly flowing into the market, signaling that to some extent, office is back.