



Commercial Insights with Regions Bank

Episode #20

How to Think About Office Space in 2022

What does it mean to have an office *now*? On this episode, we explore the decision-making process for various types of companies as they think about their current or future physical spaces. We cover business needs, employee expectations and the state of the commercial real estate market.

Episode Transcript

Anne Michelle Barnett, SVP, Senior Credit Risk Officer:

The employees are definitely the ones demanding the changes. And so business owners are not going and just seeing what's in the market and grabbing the highest quality product. They're seeing what their employees needs are, and either outfitting that space or finding a landlord that already has that space available.

Chris Blöse, Host:

That's Anne Michelle Barnett, SVP and senior commercial real estate risk officer for Region Bank, describing the state of office space in 2022.

Note that she focuses on employees. There's a good reason for that. Like many other trends, from hiring practices to hybrid workplace models, employee expectations are driving a lot of the changes in the office space market these days.

Welcome to Commercial Insights with Regions Bank. I'm your host, Chris Blöse, and today Barnett and her colleague Todd Jarman, east region executive, are joining us to talk about the world of office space. Each has 23-plus years of experience in real estate banking to draw upon, and they're here to offer their perspective on an unpredictable and ever-evolving market.

Chris:

Todd and Anne Michelle, thank you so much for joining us today. You both have a broad base of experience to compare the current market to. What changes have you seen in commercial real estate in the past few years?

Anne Michelle:

I would say the biggest impact initially in commercial real estate has been the hospitality and the retail sector. You know, those were impacted the most and the quickest.

Todd Jarman, East Region Market Manager:

Yeah. And I'll talk about two industry segments that have actually done quite well during COVID. And that would be apartments and the industrial space. On the apartment or multifamily side, at the onset of COVID, we did see some declining revenue and some delinquencies, particularly as those workers that were in the gig industry, the employees that were in the hotel and hospitality segment, lost their jobs. We saw, a blip and again, some higher delinquencies in the multifamily space, but as soon as the government subsidies kicked in during COVID, and people were able to, replace or subsidize their incomes with the incentives that were out there from the government, multifamily made a very quick turn. And over the last couple of years, we've seen just incredible rise in rental rates at multifamily.

In addition to apartments, the other sector that has had incredible success during COVID is industrial properties. As people shifted away from shopping in brick-and-mortar and doing more online shopping there's just been an incredible need from e-commerce companies to lease more warehouse and industrial space to ship their goods from.



Chris:

So that's interesting; that's digital acceleration obviously changing the way one type of company thinks about its space and what it needs. Let's talk more about office space and what, you know, your average company and maybe another industry might be dealing with now. I know a lot of companies are thinking about remote or hybrid workforce models. How does that change how they're thinking about office space? And what sort of trends are you seeing there?

Anne Michelle:

We've just been following this, looking at articles after articles. And all the surveys are showing a clear trend, where the majority of the workforce strongly still prefers to continue to work from home or adopt that hybrid model that you spoke of. And a lot of the executives still feel the same way. I saw a survey, and it was done in the major metro markets, where they were recording the swipes of cards, where they're going into the office. And if you look at March of 2020, when a hundred percent of those folks that were in the building, they're still below 60%. So clearly folks are still not back in the office full time.

We are seeing that this work from home and this hybrid is just having a longer term impact on the office market. You know, tenant preferences, like you said, are being evaluated —just open space, gyms. Certain buildings are now just functionally obsolescent with the open floor plans that are where you're sitting close, that's just not working. They're trying to come up with maybe some walls, some higher amenities, the HVAC systems and all of that good stuff is what we're starting to see.

Todd:

Yeah. Good point, Anne Michelle. And I'll also back up a little bit. You know, Anne Michelle talked about hotels and how they operate on nightly leases, 24-hour leases. Office is on the exact opposite end of that spectrum. And typically in an office building, the tenants are executing, anywhere from 7-, 10-, 15-year leases. Most of the tenants that were in offices when COVID started were under long term leases, and continue to be under those long term leases. So we haven't yet really seen the impact of COVID on the office space, given the fact that, you know, those tenants were under long term leases. And while their workers were working from home, they were still subject to and paying their rental rates.

But we now are beginning to see, as leases mature post-COVID, companies are beginning to rethink their office needs. And they've seen the success of their employees being able to work from home. And the employees are clearly expressing a desire to continue to work from home, or at least have some level of flexibility under a hybrid model. And we're beginning to see now companies beginning to downsize their space needs and buildings. And so, we've definitely got our fingers on the pulse of what's going on here. We are monitoring our office portfolio, the office buildings that we have loans on here at the bank really digging into those rent rolls, trying to understand which companies are actually physically occupying their space right now, and which companies are, you know, perhaps putting their space up for sublet, which is an early warning sign that they likely will not be renewing their lease when their lease matures.

Chris:

Well, I'm curious, Todd, since you mentioned the option of subletting, what sort of companies are actually looking at those sublet opportunities and looking to take advantage of that existing space now?

Todd:

Sure. So I would say that it's not all bad news, right? We are seeing leasing taking place. And we're primarily seeing that take place in the technology space, technology companies. Here in Atlanta, there's been three recent announcements where large technology firms have taken down very large blocks of space. You know, well, over a million square feet across two buildings here. In Midtown, another large technology firm just announced they're gonna be developing out a 90-acre campus west of Midtown. So we see that it's, you know, those companies that really rely upon that in-person collaboration are wanting to get their employees back into the office, and are out looking for space. You know, as we look at other industries more of the I kind of call it the fire jobs, finance, investments real estate. We're really seeing more of a hybrid work approach for those particular industries.

Chris:



Anne Michelle, you mentioned amenities, you know, that people are really rethinking not only space but amenities. Are there certain types of amenities that may make a space more attractive for a company that does need to have that office space or have that physical presence for their employees?

Anne Michelle:

Yeah. I would say that these property changes are probably gonna include adjusting office layouts to promote the physical distancing and greater privacy. I may have mentioned this before but upgrading the HVAC systems for the fresh air, the indoor air, and providing improved technology to communicate better with the remote workers. I'm seeing some workplace incentives with childcare assistance, transportation reimbursements, big improvements on the cafeteria space, outdoor activity offerings have been big. I envision some major overhauls in these amenities in addition to incentives to come back into the office, because again, a lot of folks, their childcare is closed during COVID, and those are opening back up, and so there's lots of things that business owners need to be thinking about.

Todd:

I would say over the course of the last 10 years, there's been a big push to make buildings energy efficient. There's a designation out there called LEED Certified. It stands for Leadership and Energy and Environmental Design. And many of the new office buildings seek to get their buildings LEED certified or LEED designated as a way to attract tenants to the building — tenants that are conscious about energy efficiency.

Chris:

I think it's interesting you're talking about something that ties into another topic we've covered on this podcast: ESG, or environmental, social, and governance. Are you seeing that sort of framework applied more in terms of driving real estate decisions?

Todd:

Oh yeah. Without a doubt. And not only driving real estate decisions for the tenants themselves, but also from a lending perspective. You know, banks are becoming more and more conscious on the types of properties that we are lending on and making sure that they align with the ESG values of the bank. And again, you know, we're seeing from a company perspective, their employees are demanding it, and they are looking for buildings that have the best systems and the best technologies to really kind of help them fulfill their carbon neutral goals. And they're using it as a recruiting tool to retain the top talent.

Chris:

Beyond LEED or ESG goals, how are companies thinking about the amount and type of space they need?

Todd:

You know, I think what I'm really seeing is a flight to quality.

Anne Michelle:

Mm-hmm.

Todd:

People are taking this opportunity when their leases mature to rethink their office needs: how much space we need, but also where are we gonna be located moving forward, and what type of building are we gonna be in? And again, I see tenants really choosing newer buildings that fit those environmental and healthy needs. And they're looking for the newest and best space that can help attract employees back to the office. So it's not only the building amenities themselves that they're interested in, but it's also the amenities surrounding the building. Walkability to restaurants and nightlife. Walkability to mass transportation.

And as we see this flight to quality, there's gonna be a lot of older office buildings that are out there that are going to become functionally obsolete. And those building owners are gonna need to make a decision what they want to do with that asset moving forward. And it's interesting, we're beginning to see in some of our major markets where sixties, seventy, eighties vintage office



building is getting completely repurposed to, say, multifamily going forward. And even seeing some instances where office buildings are getting converted to industrial use for e-commerce.

Chris:

Is quality more accessible now, as well, just due to the nature of the market?

Anne Michelle:

It is. I mean, with the price for square foot coming down, you can get more bang for your buck. If you were in a B quality asset, you can probably get into a higher quality A asset for the same price that you were paying before. So you're seeing a lot more of that space available.

Chris:

Do these needs and trends vary a lot by industry or type of business? Think about a business that contracts with the government versus a private tech firm, for example.

Anne Michelle:

Yes, completely different. The government, they're typically in the office, very secured sites, completely outfitted, they're in those buildings, and there's not really a reason or a need to leave those leases to move to a different space. They are completely outfitted for them specifically. And so in Huntsville, near where I live, you're not seeing the movement like you are in the Atlantas of the world.

Todd:

Back to the earlier comment I made regarding tech, you know, they view their industry as being very collaborative. And they want to have their employees back in the office, because they kind of view them as their innovators, right? They kind of thrive in that teamwork environment where they are able to collaborate and innovate. And we've seen a significant amount of leasing activity here, not only in the Atlanta market where I work, but we're seeing it there in DC, in National Landing a lot of technology companies are moving into that space. And we're seeing a tremendous amount of build out and investment taking place there.

However, as we look at some of the other industries the financial space, the investment space, the real estate space, we're seeing those companies move to a more hybrid work model, and cutting back the amount of space that they lease in buildings, and having their teams in more of a hoteling type environment, where you've got, an A team and a B team. You know, A team is in the office on Mondays and Wednesdays. And the B team is in the office on Tuesdays and Thursdays. As such companies were able to cut back on their space needs and enjoy some significant savings.

Chris:

I'm curious about the perspective of the folks on the real estate side of this as well. How are building owners responding to all this change?

Todd:

They're trying to create environments that are attracting the employers and employees back to the office. So, you know, outside of the physical space that a tenant leases in a building, the building owners are trying to build out the amenities and the common areas. I was up in Chicago about a month ago visiting our team up there. And it's the first time I've been back to our office building in Chicago since the pandemic. And I walked into the downstairs lobby, which is a common lobby for all the tenants there in the building. And it had been completely redesigned over the course of the last two years and it looked like I was in a high end hotel or a fancy club.

So again, really just putting money into the buildings and the common areas and the amenities to be attractive so employees want to go to work, they want to go to the office.

Chris:



If you're a decision-maker at a business, how can you stay informed about trends, both in real estate and in office design? What resources are out there?

Anne Michelle:

You know, there's a lot of resources available to you, but I think the biggest thing is to get in front of your tenants early, before those leases come due, see what they need. They've got their ear to the ground on what their employers want.

Todd:

Yeah. In regards to, you know, other resources that are out there, there are a number of real estate organizations that are great sources of information for trends and what's going on in the industry. Two that come to mind that our bank is closely involved with, the Urban Land Institute, ULI. And then even more specific to the office space is an organization called NAIOP, which is the National Association of Office in Industrial Properties. You know, both great organizations that have chapters across all of the major markets in the United States and are constantly putting on programs, both in person and online to keep their members and the public up to date as to what's going on in the real estate market.

Chris:

If you are a business owner and you're reconsidering your lease, or you're thinking about what's coming here in the next few years, what new questions are you asking that you might not have been asking in that situation, five, six years ago?

Todd:

I would say back to the point of employees demanding kind of healthy spaces. If I'm examining my lease and looking at various building options that are out there, I'm asking a lot more questions about ventilation in the building, air quality in the building, water quality in the building, what sort of attributes does this building have that can provide a healthy workspace for my employees?

Anne Michelle:

I would say, be close to your employees, understand their needs, understand where they are in their life cycle. If the need to be at home is important, if coming into a safe workplace is important, transportation if you're in the big city. Just understanding your employees and where they are I think is very important.

Chris:

That really goes into thinking about employee expectations, which is something that has come up a lot on this podcast regarding different topics. How else do those expectations play a part in real estate and office space? Are employers listening to what employees want and need more now?

Anne Michelle:

Yes. The employees are definitely the ones demanding the changes. I've seen some businesses try to force back to work, and it's imploded, and they've lost significant workforce. And they've had to go back and send out surveys on what it would take for the employees to come back into the office. And so these business owners are not going and just seeing what's in the market and grabbing the highest quality product. They're seeing what their employees needs are, and either outfitting that space or finding a landlord that already has that space available.

Todd:

Yeah. I would agree. If you're a smaller company and you have less than, you know, maybe 50 employees, it's a lot easier to tell them, all right, guys, it's time to come back to work, right? But if you're a larger company, you've got thousands of employees that are scattered around the country, it's a lot more difficult to throw down a mandate and demand those employees to get into the office. You're just gonna find that those employees are likely gonna revolt and leave.

I've heard the expression said that, you know, we've been working from home for two years now, and it's gonna be hard to put that genie back in the bottle. And I think companies are aware of that. So, like Anne Michelle said, you know, we're starting to see surveys go out to employees asking them, what will it take to get you back in the office? What type of environment do you need



and want, that's going to, again, sort of incentivize you to come back to the office. And it's a really interesting time that we're in right now.

Chris:

Interesting might be an understatement when describing the world of office real estate at the moment.

There are a lot of unknowns, but our guests today have provided some clear takeaways for business decision-makers: Listen to your employee needs and expectations. Think about the amenities that draw people to a physical space, whether that's a focus on health or auxiliary support such as child care. Ultimately, assess the space you need compared with the spaces available in a changing market.

Thanks to Todd Jarman and Anne Michelle Barnett for joining us today and thank you for listening. Get related resources for your business and listen to future episodes at regions.com/commercialpodcast. And subscribe to this podcast on your favorite podcast service.

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