BRIDGE INVESTMENT GROUP

OCTOBER 2020

# Hub and Spoke:

## Wheels Continue to Turn Towards Prime Suburban Office

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## Executive Summary

The COVID-19 ("CV-19") crisis has affected myriad aspects of social and professional life, and many have called it the great disruptor that will change the face of ____. One could insert anything in that blank space, from retail to hotels to sports to outdoor recreation. So, what happens when we insert commercial office into that blank space?

Bridge Investment Group ("Bridge") believes that CV-19 will be the great equalizer for the desirability of the prime suburbs relative to the gateway markets. Throughout the cycle preceding CV-19, Bridge's investment thesis focused on the prime suburbs of high-growth, knowledge-rich metros, though admittedly we refrained from calling out "Suburban Office" given its perceived lack of appeal compared to the glitzy central business districts of gateway cities. Now that the suburbs have, as Justin Timberlake once put it, gotten their sexy back, we examine why this investment thesis has continued to be right and why we believe CV-19 will accelerate office trends that were already in place, while generating significant investment opportunities.

It would be erroneous to believe that the cultural trends related to how and where the workforce wishes to work have emerged solely as a response to the crisis, though CV-19 has accelerated them. Bridge wrote about these trends in its Q3 2019 white paper, *Investing in the Path of Progress*, namely:

1. Knowledge-based growth markets have overtaken the gateway markets in attractiveness and stability;
2. Office space needs to be amenitized inside and out as cities and employers engage in a war for talent;
3. Durable yield is king in a low to negative global interest rate environment; and
4. Well located, best-in-class prime suburban offices are attractive for an owner-operator such as Bridge due to 50%+ discounts to replacement costs, supply constraints and plenty of potential to capture upside through hands-on operations.

Today, not only do these macro and investment themes ring true, but CV-19 has made them come to fruition even faster than we could have expected.

As in any good drama, there are three acts to this play. In Act I, we see how CV-19 has changed the perception of commercial office space, from its location and accessibility to the perils of disrupting culture and creativity. In Act II, there are several characteristics and innovations that have challenged commercial office space, and we introduce our perspectives on how these will play out in a post-CV-19 world. In Act III, we examine how this great rebalancing presents a tactical investment opportunity for prime suburban office. The epilogue, naturally, clarifies what this means for investors and future asset allocation decisions.

## Creative Destruction of the Modern Office

### *Location, Location, Location*

While Bridge has long sung the praises of the prime suburbs, few would have predicted that the adage "location, location, location" would now so poignantly describe the high growth suburban locations. We have consistently seen over the past decade that growth in the US economy has been concentrated in the knowledge-based growth markets, what we call "Bridge Target Markets." Both employers and employees have increasingly preferred to locate in higher quality of life, lower cost of living metro areas, in which there is dynamic activity, an educated workforce and the ability to successfully compete in the war for talent. Since 2009, net in-migration into Bridge Target Markets has totaled 6.8 million people, while gateway markets have lost 1.0 million. During the same period, Bridge Target Markets experienced 2.5 times the growth in office-using jobs compared to the gateway markets: 1.65 million jobs created versus 658,000 in the gateway markets.[i] This made the Bridge Target Markets highly attractive places to invest capital, particularly as these markets' replacement rents had not yet caught up to levels needed to justify new supply. Amid today's backdrop of social unrest, the prospect of higher taxes to cover local revenue shortfalls, and the increased appeal of space over density, the flow of human capital towards Bridge Target Markets has only accelerated. We have seen a mass exodus out of the cities towards prime suburban areas, family-friendly markets as workers migrate away from inflated and prohibitively expensive residential real estate, while companies are already there, attracted to the robust, well-educated and eager labor force. In our view, prime suburban office will be the great beneficiary of the human capital migration curve steepening post CV-19.

### *Media Versus Reality: The Death of Office*

CV-19 instilled the fear that the greater density of gateway central business districts epitomizes the epicenter for transmission, and that firms would combat this great obstacle with remote working, potentially permanently. But this short-term response to a crisis overlooks the longer-term impact to creativity and culture borne from working in cross-functional teams and engaging in real-time and often unscripted idea formation as opposed to a scheduled virtual environment.

Jonathan Gray, President of Blackstone, adeptly put it, "We're much more efficient when we're together."[ii] Bridge believes the next normal will encompass the individual's desire to stay safe, yet alongside that concern exists the perfectly rational and human desire for community, collaboration, and self-fulfillment in a professional setting. According to a recent Gensler survey, "only 12% of U.S. workers want to work from home full-time. Most want to return to the workplace, but with critical changes."[iii]

Regardless whether to the suburbs or to central business districts, most workers are expected to return to offices. We have already seen this play out in the rest of the world, which is mostly back to the office. But what they will return to in the US is an important question, and those who do return will likely, if not certainly, need more space to accommodate social distancing. This trend of "de-densification" provides an immediate advantage to suburban property given its lower starting density and more diverse transit options.

This explains why in the Bridge portfolio, 80-100% of assets are reoccupied at some level as of the publishing of this paper, yet in Manhattan, only 10% of workers are back. Furthermore, of the 104 leases representing 733,590 square feet Bridge has signed since work from home orders began, the square footage per lease is *up* 10% since pre-COVID levels. Of these leases, 38% were new rather than extensions or renewals, suggesting continued activity in the prime suburbs.

Contrary to the portrayal in the media, commercial office space has remained extremely resilient during the CV-19 pandemic. Across Bridge's 14 million square feet of office, we have experienced 99.0%+ rent collections. In contrast, NCREIF had 91.8% rent collections in September (slight decrease from 92.5% in August).[iv] While the market number is still high as the vast majority of tenants have continued to pay rent during the crisis, Bridge Target Markets have outperformed due to a higher concentration of knowledge-based workers, re-occupancy and absorption. Defaults in the knowledge-based markets have been extremely limited, with only 0.38% in default by square foot and 0.14% of tenants in the Bridge portfolio requiring workouts. Meanwhile, rents of newly executed leases have remained flat to up, with a number of Bridge Target Markets showing rent growth through mid-year as their influx of jobs and employees heavily outpaced supply during the previous growth cycle. Absorption in the prime suburbs, while still negative collectively during CV-19, has greatly exceeded that of the gateway markets. Bridge's office assets have experienced only 1.2% of negative absorption during this period, due to a few CV-19-impacted businesses closing in the third quarter as both Q1 and Q2 had positive absorption. A number of our submarkets continue to demonstrate positive absorption throughout the crisis, which explains why, for example, a large office park in Minneapolis in our portfolio is currently executing new leases about $1.00 per square foot above pro forma. Q4 2020-to-date is demonstrating strength and a tepid recovery, with portfolio absorption once again turning positive. Given the diversified makeup of our 1,000+ tenants, we believe these positive absorption trends are indicative of the fundamental strength in the knowledge-based economy and speaks to the possible magnitude of the recovery that will shape up post the CV-19 crisis.

The reality is businesses today need to make decisions for 3, 5, 7+ years into the future, and what Bridge has seen on the front lines is companies are treating CV-19 as a moment in time rather than a permanent reality. Companies' most pressing priority has been to procure safe, amenitized, competitive office space for their knowledge-based workers that allows them to preserve their unique cultures.

## To What Will We Return

### *Densification and The Evolution of How Closely People Are Working*

For the last 20+ years, the density of office space per office-using job has steadily compressed. New office supply has not kept pace with this growth, and users have effectively densified their space utilization with open floor plans to allow more people to work in the same amount of space. In the gateway markets, pre-crisis, the ratio of office-using jobs to total office space was approximately 8 users to each 1,000 square feet of space. In contrast, in the prime suburbs, and taking the Bridge nationwide portfolio as a proxy, average density was only 4.5 users per 1,000 square feet of space, or about half. Social distancing requirements as laid out by public health officials suggest 4.0 users per 1,000 square feet of space. It is not difficult to see how the prime suburbs can meet this need far more easily than the highly dense gateway markets. Even in dense New York, re-occupancy rates in its suburbs are more than three times that of Manhattan.

We believe CV-19 has accelerated the already decade-long demand increase for prime suburban office, ranging from the need to relocate critical office functions to firms looking to maintain continuity and satellite locations in times of uncertainty. For example, we are beginning to see increased demand from firms to open satellite offices, especially in transit-dependent markets such as Chicago where employees are wary of riding public transit. The dispersed "hub and spoke" model, which Bridge employs in its own operational footprint, is a rational go-forward expectation for medium to large-sized firms.

### *Flexibility and The Evolution of How People Are Working*

Prior to the pandemic, approximately two to three percent of office-using jobs were fulltime work from home jobs, and another four to five percent of jobs were out of coworking facilities[v]. Since the global financial crisis, we have seen an increase in the utilization of flexible offices for companies that require significant travel and the use of "hoteling" where employees effectively book an office for the time they are going to be in that location related to travel or a specific project. There was already a trend towards an increase of short-term tenants occupying periods of one to three years at a rent premium, though this previously accounted for less than ten percent of our portfolio's rent roll.

Of the leases Bridge has signed or negotiated since the early stages of CV-19 in April 2020, 41% have a component of flexibility to them. Our view is that there will be an enhanced desire and premium for flexibility of term, where a company can sign, for example, a three-year lease with a renewal option rather than a 10-year lease, but at a higher rent. While as an office operator, this could initially decrease the weighted average lease term of the portfolio, it does so in the context of accretive leased occupancy collecting higher rent and re-mark to market. The reality, in our view, is the majority of tenants will still continue to seek the typical five to ten-year lease terms.

There is another benefit of an enhanced desire for flexibility: the ability to capitalize on the new coworking managed model. Coworking had been all the rage, until it stopped being so, with the precipitous fall of high-flyers such as WeWork due to their flawed business model. Previous models assumed you could create space and lease it from a landlord for X and then sublease it out on a short-term basis for two-to-three times X with great amenities and generate significant revenues and profits in extremely dense and public facilities. In the post CV-19 reality, we expect we will see an increase of the managed model, in which coworking firms manage the space as service providers, reallocating the upside of the space to the landlord and effectively swapping a short-term lease obligation into a permanent capitalization model. The prime suburbs' density of coworking has been only 1.5% compared to 4 to 5% in the gateway markets, and we expect to see an increase in this type of coworking, capitalized by, and with upside to, the landlord.

It is important to recognize that while some may call the newly configured office the "new normal," the increase in space and shift towards enhanced flexibility, remote working and coworking represents a continuation of what engaged landlords were already doing at their assets.

## Why Office Now, Part Three

This white paper represents the third time Bridge answers the question: "*Why Office Now?*" Today, the case for investing in commercial office is a tactical combination of opportunity and distress. As it relates to opportunity, knowledge-based office space generally continues to outperform all other real estate asset classes in cash flows (often in the double-digits), which have consistently been generated throughout the pandemic. As we laid out in previous white papers, one of the fundamental appeals of commercial office space is the ability to operate through cycles, collecting durable cash flows that look outstanding in a low interest rate environment, regardless of which way the cycle turns.

A cycle in office has to do with supply and liquidity. This crisis has further depleted an already significantly reduced supply pipeline in Bridge Target Markets, and liquidity, while impacted in the short-term, is only of importance if someone is a forced seller and not able to operate and drive stable cash flows through difficult times.

In our view, there is a tremendous opportunity for well-capitalized, vertically integrated owner-operators to innovate and reconceptualize office space in the prime suburbs of knowledge-based growth markets. Assets can be acquired at 50-60% discounts to replacement cost, locking in a supportive basis, and with a stable tenant profile of an educated workforce. Buying the best-located assets that are 85% leased in high-growth markets enables an operator to amenitize and modernize the property to meet the needs of the post CV-19 tenant, driving rent growth and NOI without having to compete with new supply or with the gateway markets that offer a completely different (and for many, lesser) value proposition. Bridge views this opportunity as a more tactical one today; given the short-term liquidity squeeze that accompanies most economic downturns, including CV-19, not all commercial office space is created equal. Bridge is specifically focused on transit-oriented, well-leased, Class A prime suburban office buildings, which underwrite to double-digit cash-on-cash and present what we believe to be one of the strongest opportunistic return generators in the post CV-19 reality.

As it relates to distress, the near-100 percent rent collections for our office properties and general collection strength in the industry has masked the dislocation we expect to materialize in the coming quarters. Office operators, unless they had a high degree of retail, food service or hospitality-focused tenants, have performed with exceptional resilience throughout CV-19. To date, there has been limited transaction activity as office managers have chosen to clip cash flows rather than sell into an illiquid market. However, many office buildings are owned by REITs or local operators who have historically been more passive, unable to meet the evolving active management needs and capex required to optimize a building to amenitization and flexibility requirements. Private equity managers may also hold significant office inventory but often are not able to make valued improvements due to end of fund life concerns. While most office transactions post CV-19 have traded at a moderate discount, Bridge believes there will be significant opportunity to buy the highest-quality assets at outstanding prices in the prime suburbs. We believe market liquidity will return with conventional acquisition transactions, and we expect to see significant distressed and strategic buying opportunities from undercapitalized owners without access to financing or the operational wherewithal to meet the demands of the next normal.

The commercial office market generally responds to the imbalance of persistent demand amidst a supply slowdown, and we expect this will translate to growing rental rates later next year. If sentiment in US commercial office space remains subdued and continues to lag global office trends for a much longer period than expected, even transit-hub Class A prime suburban office will be negatively impacted by those headwinds. However, we expect well-operated prime suburban office to outperform and to continue to drive double-digit cash-on-cash, while providing a strong tactical investment opportunity out of the recovery.

This highlights two points: 1) long-term ownership of the right assets in the right locations allows one to weather the storm and drive great performance and cash flows; and 2) the ability to buy opportunistically during periods of distress with a longer-term trend view is a tactical, attractive source of value creation.

## Epilogue: Why Invest in Suburban Commercial Office Now

Bridge continues to see a robust opportunity for value-add suburban office in high-growth, knowledge-based markets. Prior to CV-19 in Q3 2019, we highlighted two macro themes and two investment themes in our commercial office outlook in *Investing in the Path of Progress*. We believe what we wrote continues to be true, if not even more improved. We have updated our macro and investment themes considering the next normal arising from CV-19 as follows:

1) Cash is King! Better buyers and operators will thrive in times of distress.
2) "Suburban will win." We believe there will be a distinctly different path in the recovery of markets because fundamentals already were, and continue to be, stronger in Bridge Target markets.

Bridge expects these macro and investments themes will perform well as the economy weathers the recession. The combination of a disciplined asset selection process with well-conceived improvements that meet tenant needs in knowledge-based markets represent a highly attractive investment thesis. We expect this to be a tactical strategy whose durable cash flows will help investors weather the ebbs and flows of the macroeconomy, while driving returns that compare highly favorably to other global asset classes.

## Disclosures and Disclaimers

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[i] Bridge Investment Group Research. Source: Moody's Analytics; U.S. Census Bureau; U.S. Bureau of Labor Statistics, Current Employment Statistics (CES), Quarterly Census of Employment and Wages (QCEW). As of September 2020.
[ii] https://www.bisnow.com/london/news/capital-markets/blackstones-coronavirus-playbook-104109?utm_source=CopyShare&utm_medium=Browser
[iii] Gensler. 2020. U.S. WORK FROM HOME SURVEY 2020. Briefing #1: Back to the Office.
[iv] NCREIF NFI-OE (all Open-end Fund Index) *August 2020 Rent Analysis* (released August 25, 2020) and September 2020 Rent Analysis (released September 24, 2020).
[v] CBRE Research Client Survey, June 2020. https://www.cbre.com/-/media/files/future%20of%20work/future-of-the-office-v2.pdf