Insights
Strategy
Analysis

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Rebalancing past and present

What past periods of occupier market dislocation tell us about the property outlook today

October 2024

Investing today. For tomorrow.

Rebalancing past and present

1 **A framework for resolving property market imbalances** p. 3

We lay out a framework for understanding the wide variety of forces that combine to rebalance oversupplied property markets over time, including cyclical market forces and structural policy changes

2 **Case studies of historical market rebalancing** p. 10

Case studies from historical and ongoing periods of market rebalancing are examined and placed in the context of our rebalancing framework

3 **Office market rebalancing outlook** p. 19

Updating our March 2023 *Revisiting the future of office* report, we apply lessons from the rebalancing framework and case studies to the oversupplied portions of office markets globally

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A framework for resolving property market imbalances

We regularly receive questions seeking to compare patterns of market rebalancing

Example, indicative client questions:

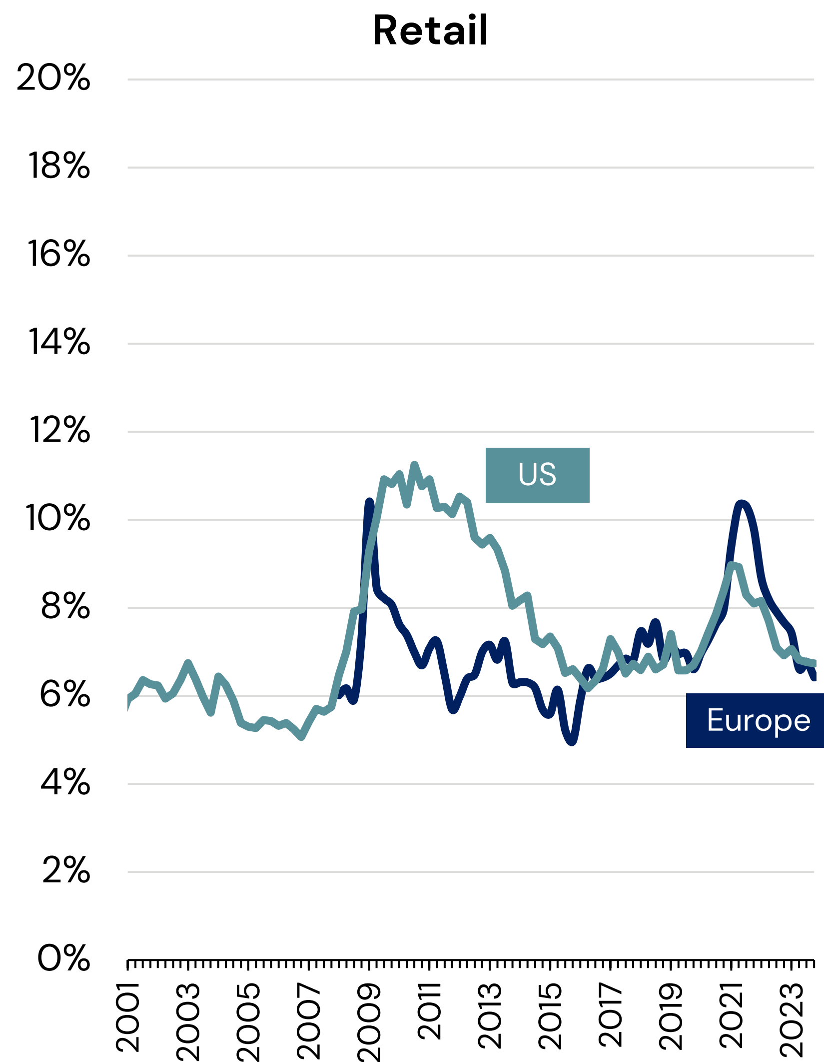
"Is **office** the **new retail**?"

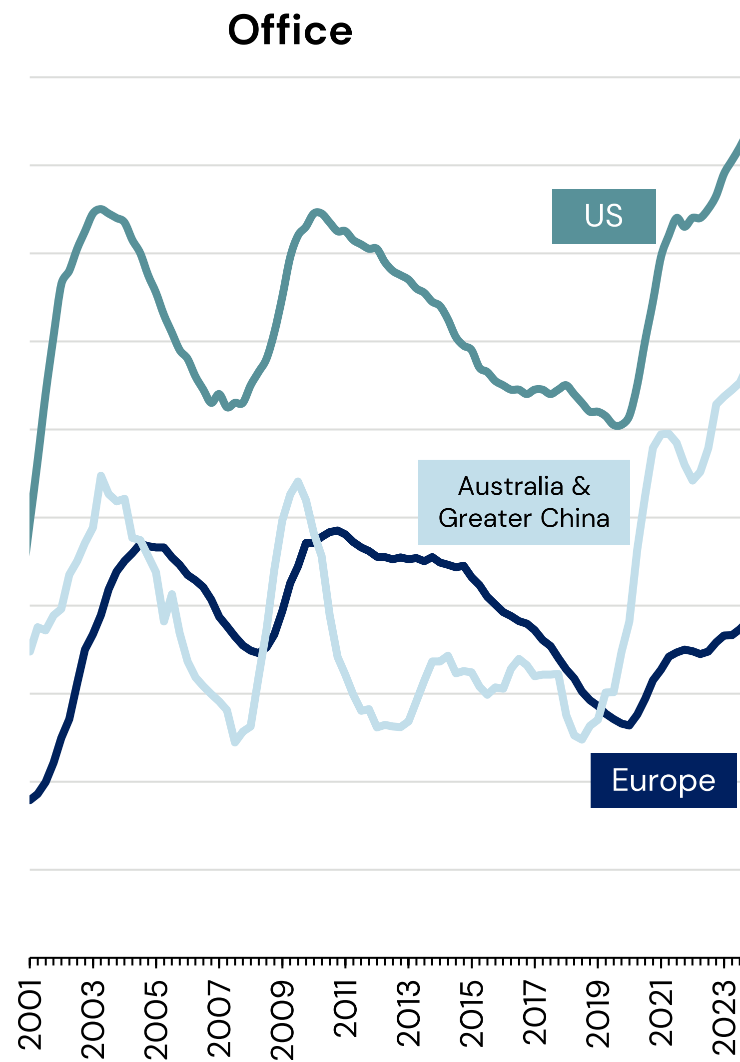
"Is the **7-10 years** it took to rebalance the retail market a relevant precedent for **office**?"

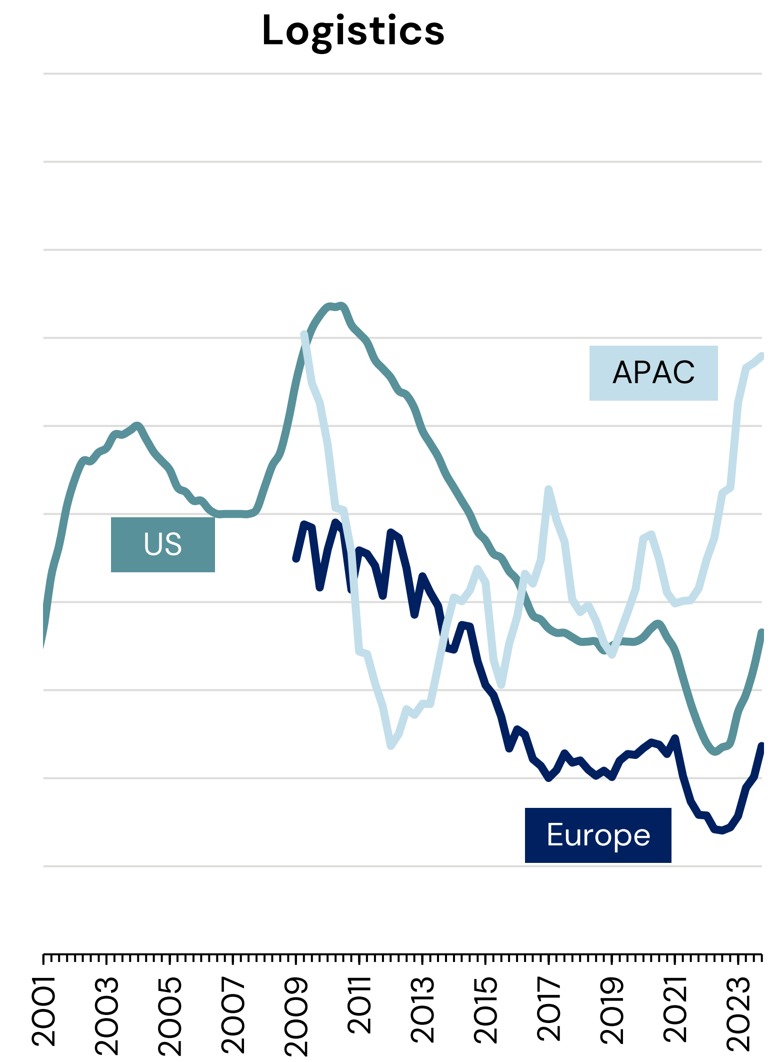
"Should we be worried about **rising cyclical vacancy** in the **global logistics** and **US apartments** markets?"

Data context: Rising office and logistics vacancy rates, falling retail vacancy

Vacancy/availability rates by sector and region







Retail vacancy is falling steadily across most markets and sub-types.

Office vacancy spiking in some markets, notably the US, Australia, Greater China, and commodity segments in Europe.

After years of declines and/or stability, **logistics** vacancy spiking as a supply wave delivers.

*Availability shown for industrial and retail.

Source: The Association for Real Estate Securitization (Japan multifamily), as of Q4 2023; Ichigo Real Estate Services (Japan logistics), as of Q1 2024; JLL REIS (all other markets except Japan logistics and multifamily), as of Q1 2024. NCREIF Property Index (Retail: Strip and Retail: Mall subtypes), data through 2Q 2024. CBRE-EA (Sum of Markets), RealPage Analytics, LaSalle, JLL (Europe office and industrial), MSCI (Europe residential and retail). Data through Q3 2023 (US) and Q1 2024 (Europe and APAC). No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

A framework for occupier market rebalancing

Cyclical rebalancing and structural rebalancing often work hand-in-hand

Cyclical rebalancing

The math of replacement cost rents causes demand to exceed supply, allowing the market to rebalance over time

Factors:
(more discussion on next page)

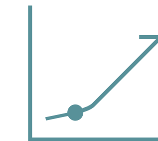
New supply slowdown

Demand recovery

Structural rebalancing

Discontinuous breaks in the fundamental nature of the market, such as demand drivers and the "rules of the road," help the market heal

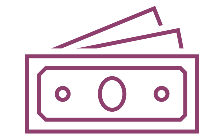
Factors:
(more discussion on next page)



Structural demand shift

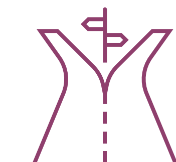
Stock deletions

Planning / zoning changes



Subsidies, incentives, tax

Sustainability factors



Infrastructure change

Market forces

Policy catalysts

The scope of this report:

This report **focuses on markets unbalanced in favor of tenants** (oversupply).

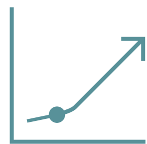
There are, of course, examples of markets with structural imbalances in favor of landlords (undersupply), such as is often the case in regulated residential markets. These situations are out of scope for purposes of this report.

A taxonomy of factors that may drive the rebalancing of property markets

Market forces

Demand recovery

- **Cyclical upswing** in occupier demand
- Owes to changes in position in the economic cycle



Structural demand shift

- **Structural breaks** in demand patterns
- Can be caused by technological or policy changes (see catalysts at right) that alter level and locational dynamics of demand

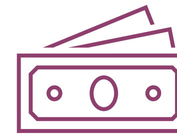
New supply slowdown

- Reduction in pace of delivery of new competitive supply
- Can be **normal reaction to weakening NOI outlook**—i.e., cash flow prospects worsen development economics, making it less profitable to deliver new space
- Can also be the result of **capital markets issues** that limit flow of capital to developers or cause them to require a higher return

Stock deletions

- Refers to any removal of real estate stock from the market
- Could be due to **demolitions**, **conversion** (use change), or such severe obsolescence that the stock for all intents and purposes is not competitive and does not significantly influence market dynamics (**irrelevance**)

Policy catalysts

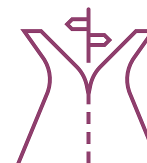


Subsidies, incentives, tax

- Government policy that **alters the economics** of providing or occupying real estate, potentially **tipping the scales** of market forces
- Examples include changes that impact tenant occupancy cost, landlord operating cost, development/redevelopment costs, etc.
- Can be direct or indirect; can take the form of net negative (tax) or net positive (subsidy)

Planning / zoning

- **Prohibition** or **encouragement** of certain land uses
- Examples include changes to permitted land use categories, site coverage/massing, minimum design standards, streamlined or tightened approval processes, etc.



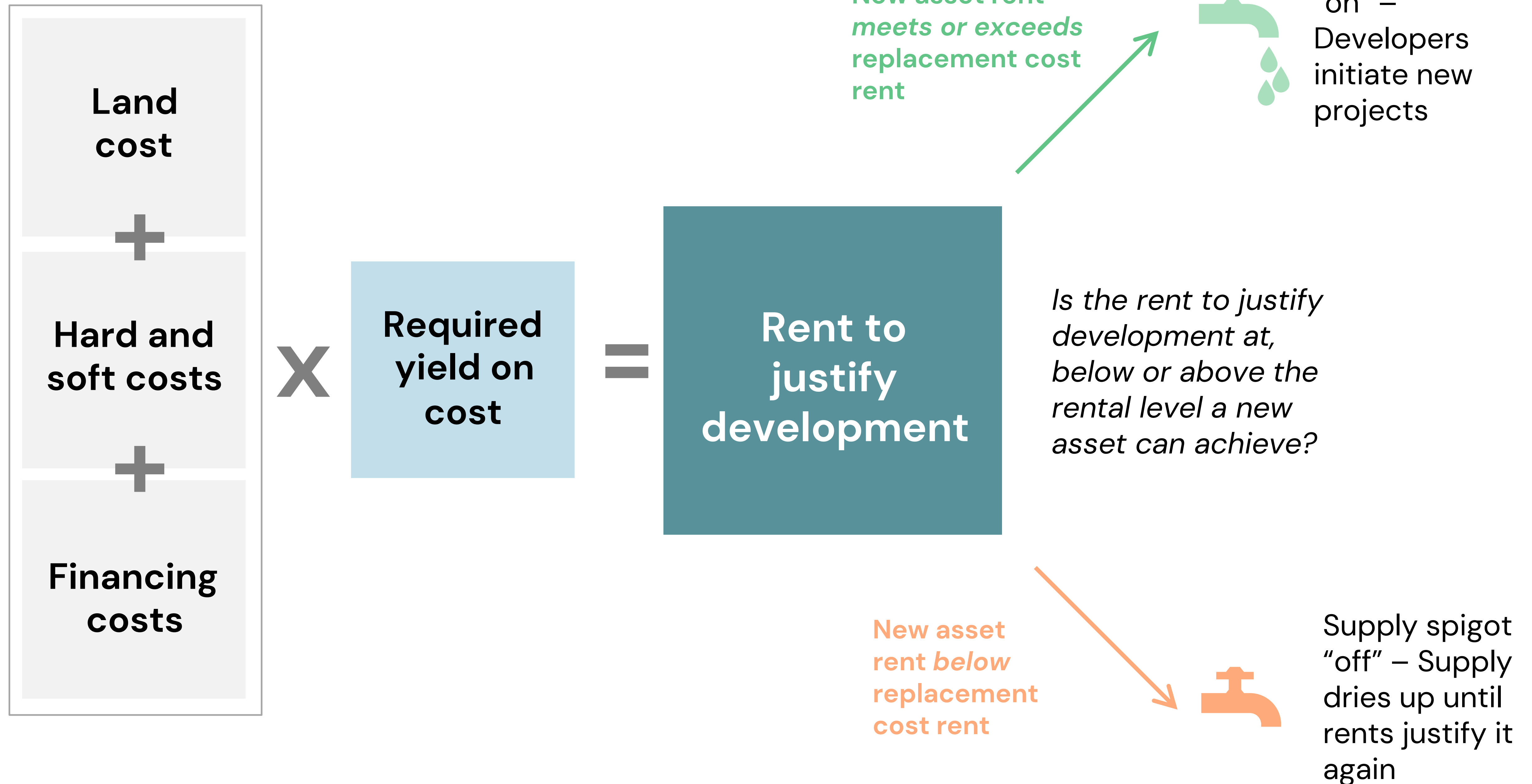
Infrastructure change

- Existing stock may be **demolished to make way for infrastructure improvements**
- Changes to the provision of transport, power or other infrastructure can also consolidate demand by reshaping market and submarket dynamics
- Land reclamation and opening of new accessible micro-locations can lead to stock additions

Sustainability factors

- Regulations such as minimum standards and carbon taxes can alter the viability of properties based on their sustainability characteristics
- Potential driver of **accelerated obsolescence**

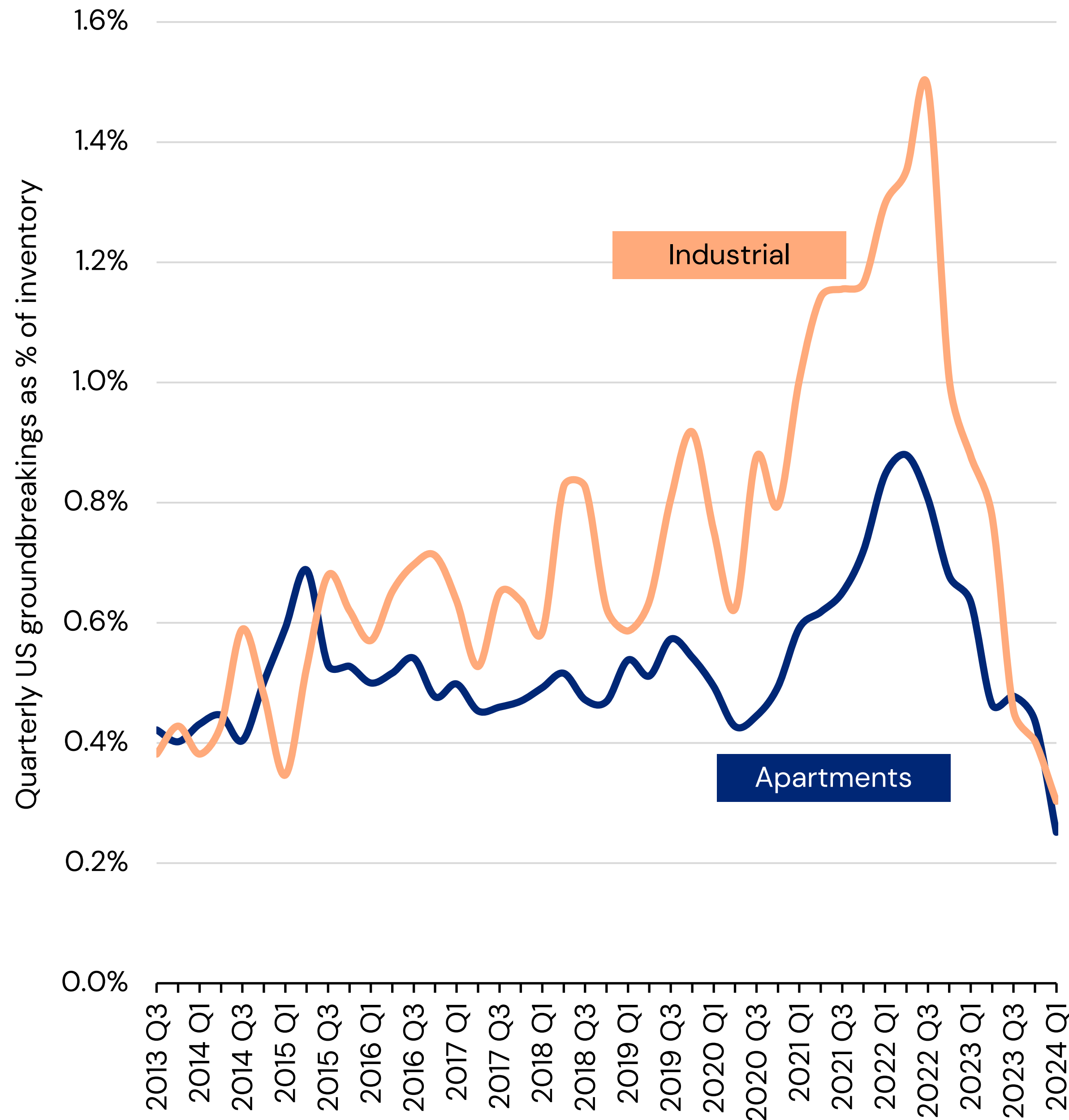
Cyclical rebalancing: Replacement cost rents key driver in turning supply spigot on/off



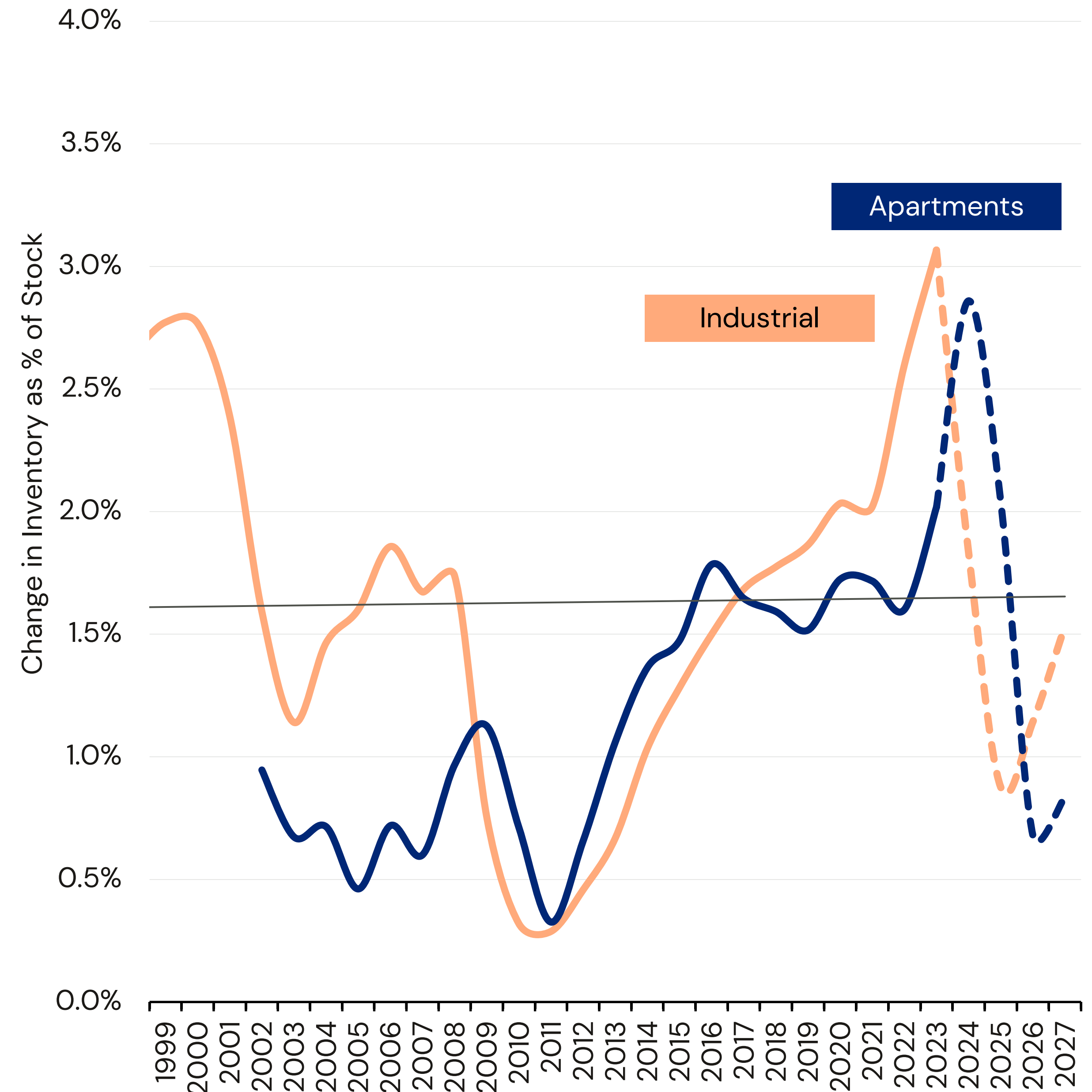
[1]Source: LaSalle Investment Management
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Cyclical rebalancing: Rental math suggests today's supply waves likely to be temporary

New starts (groundbreakings)



Completions (deliveries)



Source: LaSalle analysis of CoStar, NMHC, and RealPage data as of 20 May 2024
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

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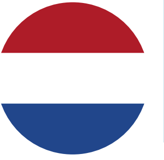
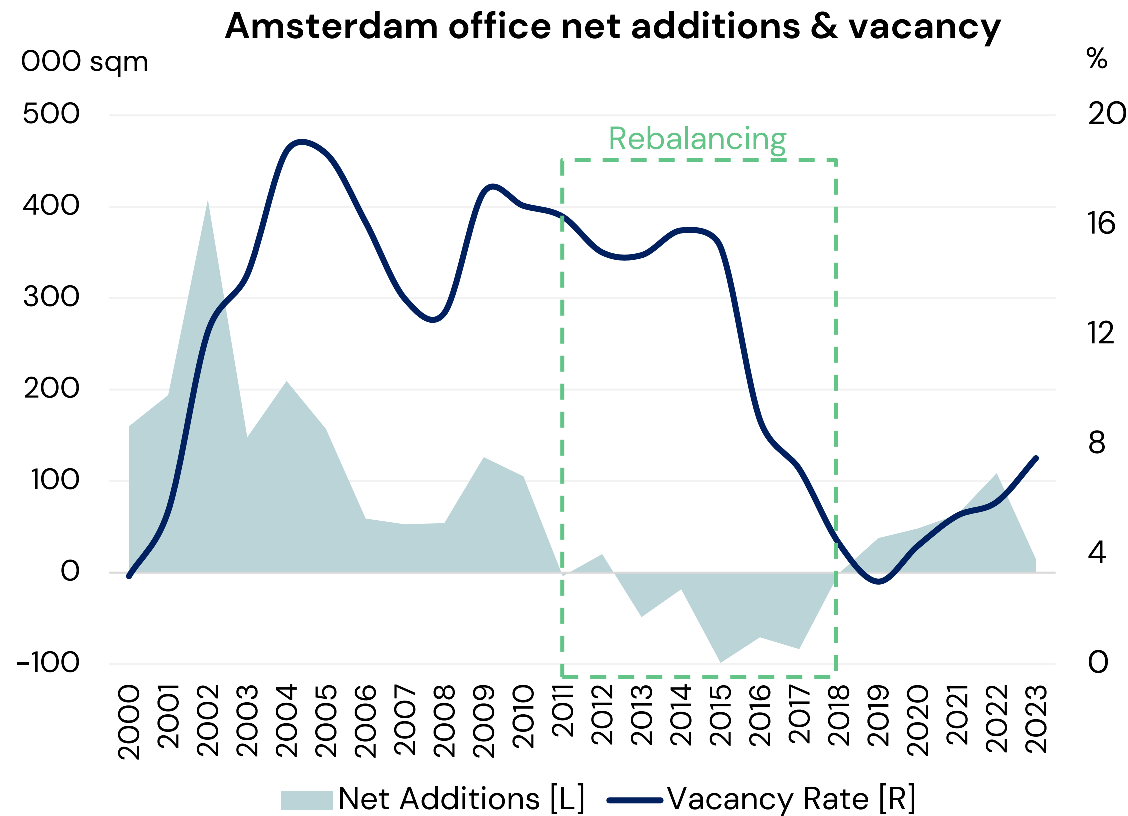
Case studies of historical market rebalancing

Amsterdam planning drives office conversions



Case study: Amsterdam office, 2011-2018



Conversion of former ING office buildings (51,000 sqm) to a neighbourhood of over 900 homes, Haarlemmerweg/Westerpark West, Amsterdam West

Origins of imbalance

- During the economic boom in the 1990s and 2000s, favorable financing conditions and accelerating demand encouraged **widespread office development** throughout Amsterdam.
- This resulted in a steep rise in vacancy and **oversupply** of office space as demand eventually weakened. Older buildings were vacated for new ones, leading to persistently high vacancy concentrated in older stock, speeding up the **obsolescence** process. By 2011, half the vacant office space had been empty for three or more years, pointing to **structural vacancy** in the market.

Resolution

- The municipality implemented **new regulations** that came into force in 2011 to combat the problem of pronounced and persistent vacant office space:

  - **Speculative office construction was severely restricted;** developers were obligated to have a certain degree of pre-letting prior to starting construction.
  - Owners of empty offices were required to report buildings that had been vacant for longer than six months to the municipality.

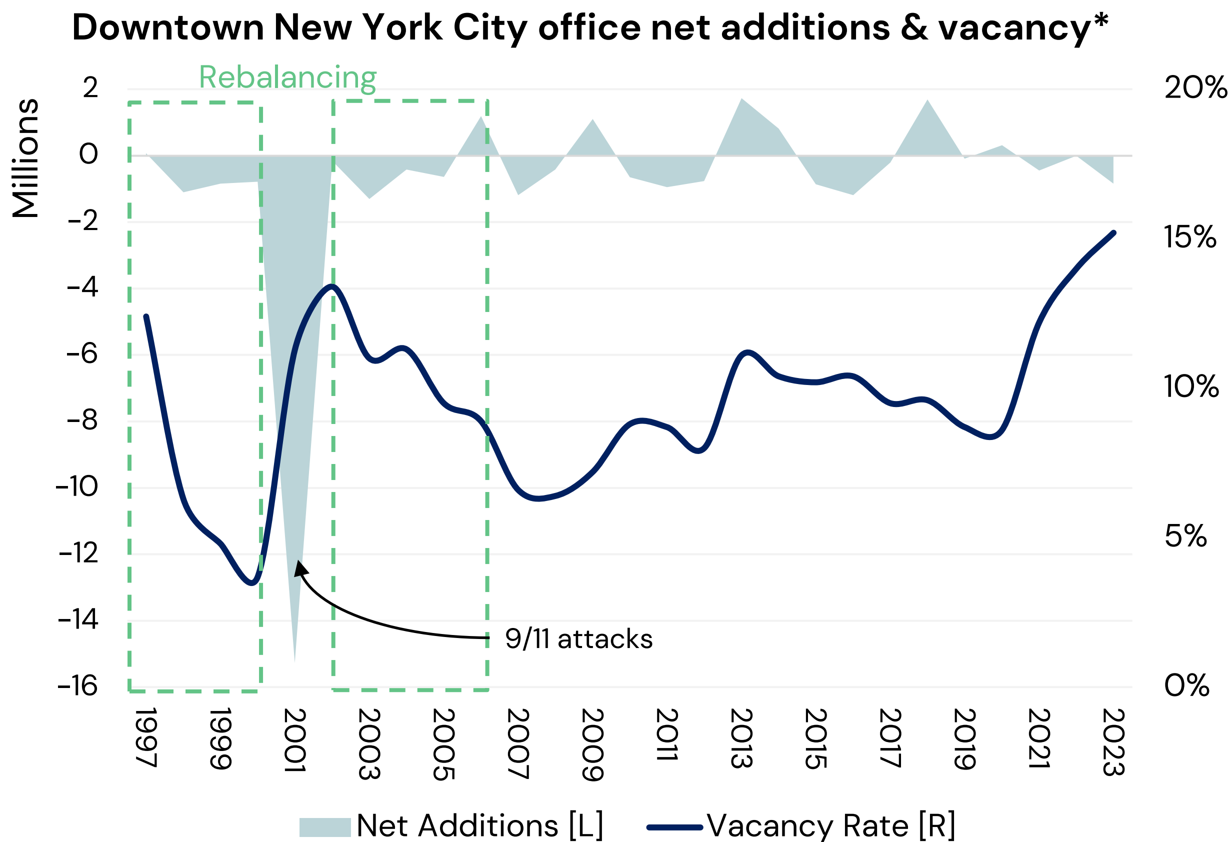
  - Regulations made it **easier to convert empty office buildings to alternative uses** (residential, hotels and student accommodation). 2015 marked a record high for conversions, with 124,000 sqm of office removed, and in the following two years the volume of conversions was only slightly lower.
- These measures led to **several years of negative net additions and vacancy fell to a low of 3%** by 2019. As vacancy dropped, the city of Amsterdam started to relax planning rules, including the suspension of pre-let requirements, allowing more room for office development in strategically selected growth areas. This resulted in increased building starts and lower demolitions, with net additions turning positive after 2018.

Resolution timeline: ~8 years after a decade of weakness

Source: LaSalle (03/24), JLL, PMA, Google Maps
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Incentives drive office-to-resi in NYC

Case study: Downtown NYC office, 1996-2006



25 Broad St (521,767 SF into 345 condo units, 1994) and 3 Hanover (240,000 SF into 202 rental apartments in 1998) conversions

Origins of imbalance

- Following the 1987 stock market crash, office vacancy in New York City increased, particularly Downtown. Vacancy rates rose from 9.6% in Q2 1988 to 17.2% in Q2 1991, with vacancy Downtown rising from 11.8% in Q1 1988 to 21.4% in Q2 1991.
- Downtown vacancy continued to rise, peaking at 23.5% in Q4 1993. **Vacancy was primarily concentrated in older obsolete office buildings**.
- Simultaneously, the population in the city continued to grow, exacerbating the **shortage of available housing options.**

Resolution

- The **421-g tax incentive program for converting commercial buildings in Downtown Manhattan** to residential use was introduced in 1995. The program involved a 12-year real estate tax increase exemption and a 14-year abatement of approximately 80% of the real estate taxes paid on the property before conversion.

- As a result of this program, Downtown Manhattan experienced **more office conversions than other areas of the city** in the period between its implementation in 1995 and expiration in 2006.
- It would be remiss not to mention that the 9/11 attacks happened in the middle of this process. They removed a large amount of office stock, but also proceeded a severely negative demand shock. This tragic event can thus be considered more of an interruption of rebalancing than an accelerant.

- With over **5 million square feet of office space converted** into residential units from 1996-2006 and an increase in office demand, the Downtown vacancy rate decreased to below 10% in the mid-2000s.
- Currently, vacancy rates are increasing, surpassing historical levels, prompting consideration of new tax incentives.

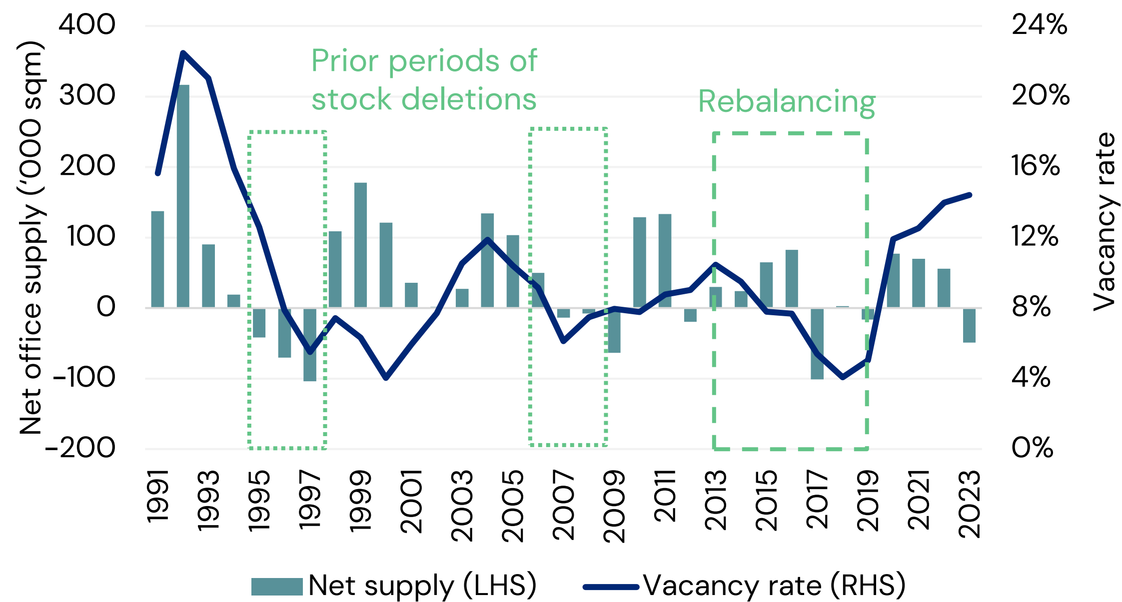
Resolution timeline: roughly a decade, interrupted by the 9/11 attacks

Source: LaSalle (03/24), JLL, CoStar, CBRE, CBRE-EA. Data as of 2023. *a large amount of negative net additions was due to the loss of buildings in the WTC

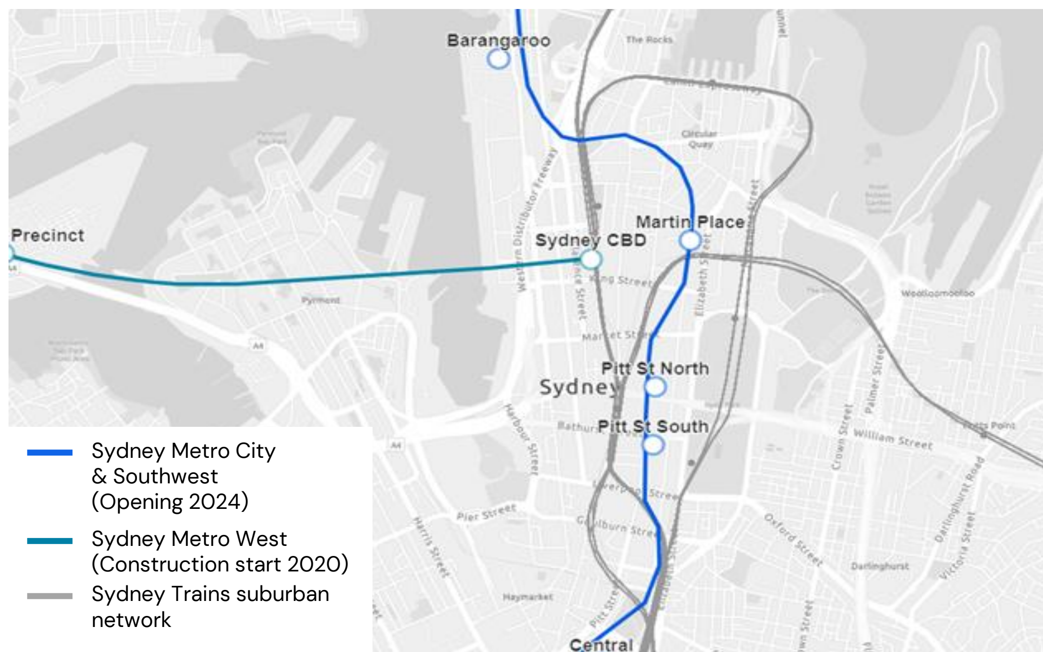
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected. |

Sydney stock deletions historically common, Metro construction a recent but one-off factor

Case study: Sydney office, 2013-2019



Sydney Metro line development map

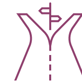


Origins of imbalance

- Despite weak tenant demand following the Global Financial Crisis (GFC), cumulative net office supply in the Sydney CBD office submarket was 177,849 sqm (or 3.7% of 2007 stock) from 2007 to 2011. As a result, office vacancy rates in Sydney CBD rose from a cyclical low of 6.1% in 2007 to a peak of 10.5% in 2013. Office vacancies were primarily concentrated in secondary-grade offices.

Resolution

- **Above-average stock withdrawals** over the period 2013-19 contributed to the rebalancing process. The vacancy rate in the Sydney CBD declined from 10.5% in 2013 to 5.0% in 2019.



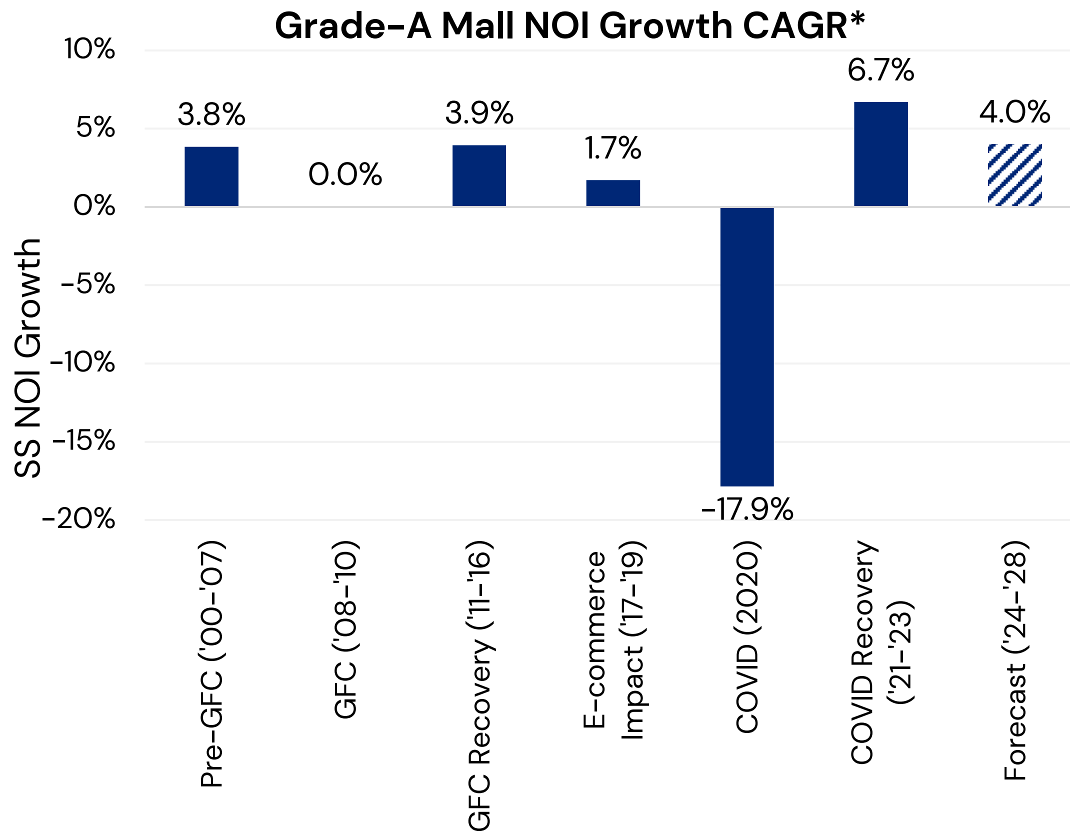
  - Due to the **construction of the Sydney Metro** through the Sydney CBD office submarket, the New South Wales government acquired and withdrew approximately 52,000 sqm (or 1.0% of 2015 stock) in 2016-17, mostly secondary-grade offices for new metro stations, meaning that a quarter of the vacancy decline between 2015-18 was directly attributed to demolitions for the new metro.
  - The new CBD segment of the Metro, which opened on August 19, 2024, is also likely to drive tenants to the most prime micro-locations around newly enhanced transport nodes at the expense of older offices and offices in CBD fringe locations.
  - In addition, approximately 370,000 sqm (or 7.3% of 2015 stock) of existing office stock was **withdrawn to accommodate new office and residential development** over the period of 2016-19.
- Conditions in the Sydney CBD office markets are weakening again given elevated supply and sluggish demand.

Resolution timeline: episodic 3-5 year rebalancing periods, weakening again

Source: JLL REIS (Sydney CBD office net supply and vacancy rate), as of 2023; the Transport for New South Wales, as of 2023
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Confluence of forces rebalanced US malls

Case study: US mall sector, 2017-Present



100 Oaks is a property in Nashville, TN owned by a LaSalle fund. It was converted from a traditional mall to a mix of medical office and Power Center retail.

Origins of imbalance

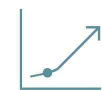
- Shifting consumer preferences away from department stores and the rise of e-commerce accelerated in the 2010s, contributing to a scenario sometimes labeled the "retail apocalypse".
- Pre-COVID, Mall YoY NOI growth declined from a peak of ~5% in 2013 to ~1% in 2019 and plummeted to an all-time low of -18% as the pandemic hit in 2020. NOI growth rebounded in 2021 and has stabilized slightly above the long-term average.
- The COVID-19 pandemic in 2020 triggered a spike in the e-commerce market share. Mall NOI growth and foot traffic declined sharply, catalyzing a surge in retail bankruptcies and store closures concentrated heavily in malls.

Resolution

- Since 2021, retailer bankruptcies have been more muted, and the e-commerce share of retail sales has normalized and remains below the pandemic high. As a result, the **tenant base is leaner but healthier and more stable**, as store openings have outpaced closures, and there have been more minimal department store closures since 2021 (<30 per year).

- From 2016-2020, 1,050 mall-based department stores and **71 malls closed.** Since the pandemic recovery, **54 malls have closed**, predominantly impacting the struggling C mall subset. Many shuttered anchor boxes and entire malls remain untouched, while others have been redeveloped, most of which have retained a retail component. There was an early focus on redeveloping the space into open-air retail, but trends have shifted towards mixed-use concepts, including retail, residential, office, and medical office space.

- Negative supply growth has occurred since 2009, ramping up starting in 2017, averaging -1% y/y from 2017-2023. **Minimal new construction** is expected near-to-medium as rents do not justify construction costs. This dynamic is a tailwind to mall fundamentals.



- Recent anchor backfilling activity has introduced more **non-traditional mall tenants**, such as sporting goods retailer Dick's Sporting Goods, which has been and is expected to continue to be a significant back-filler of mall anchors.

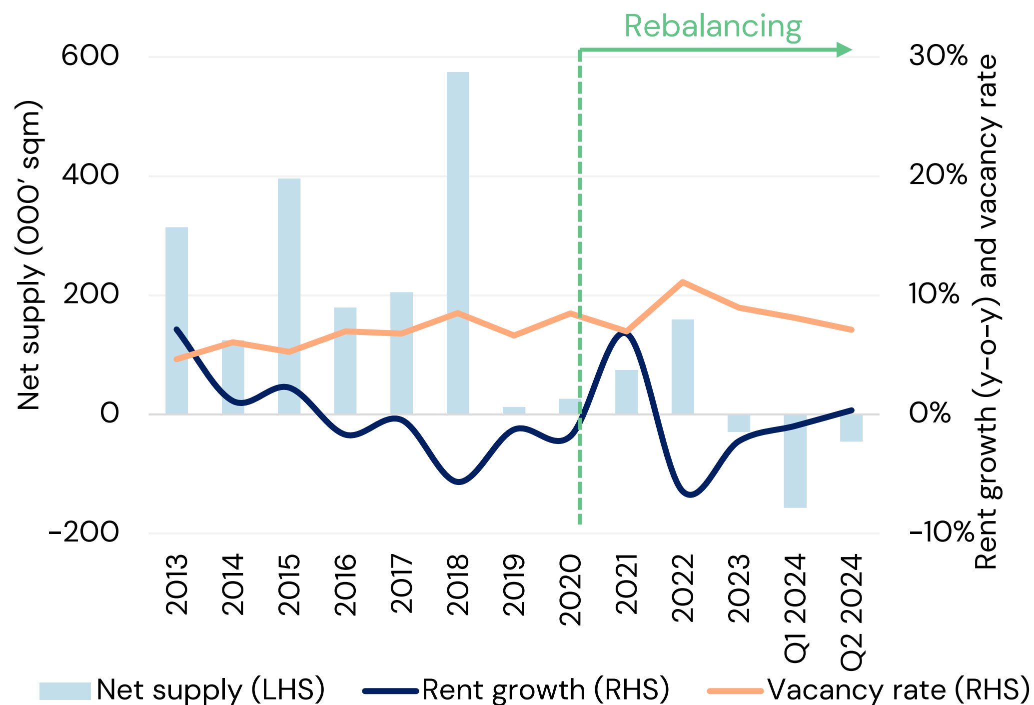
Resolution timeline: 5-7 years

Source: LaSalle (10/24), JLL, Green Street, ICSC.
*Green Street's same store NOI growth data is value weighted and therefore primarily pertains to malls that are 'A' grade or superior.
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

China retail's incomplete, bumpy rebalancing

Case study: Shanghai retail, 2021-present

Shanghai retail net supply, rent growth and vacancy rate[1]

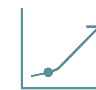


LaSalle multifamily project: COZI in Hongqiao Business District, West Shanghai. A conversion project from retail & hotel to multifamily.

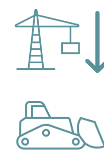
Origins of imbalance

- In 2010, the Chinese government introduced strict nationwide regulations on residential property to curb speculation. Consequently, **major traditional residential developers began to expand into the retail sector**, resulting in high supply levels in 2013-2018.
- From 2013 onwards, **the rapid growth of e-commerce** led to intense competition against offline retail in China.
- The result was a prolonged period of softening and even negative rent growth, which lasted for seven consecutive years in 2014-2020, as new completions struggled to gain traction and landlords traded rent for occupancy.

Resolution



- Changes in demand drivers contributed to the beginning of the rebalancing process:
  - **The growth of domestic brands**. Popular domestic brands in fashion, food & beverage, new energy vehicles, sports, etc. secured funding from PE/VCs/IPOs in 2019-2021, creating new demand forces for retail.
  - **The transition towards omnichannel retail.** Large brands (e.g., new energy vehicles, electronics) transformed their physical shops into experiential centers and many online brands set up physical stores to enhance all-channel sales. This has supported demand for retail.
  - **The relaxation of family planning policies.** The introduction of the two-child policy in 2016 and the three-child policy in 2021 led to the growth of children's education and entertainment brands.[2]



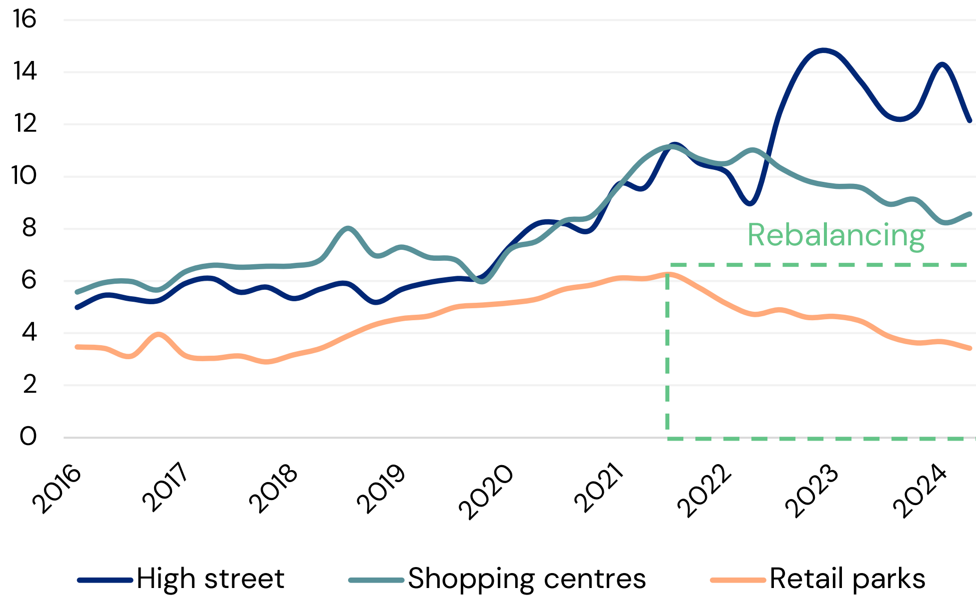
- **Limited new supply in 2019-2021** also contributed to the beginning of the rebalancing process**.** New supply moderated in 2019 and remained low in 2020-2021. In recent years, there are **examples of conversions** of challenged malls to other uses, but the overall impact on the market has been limited.
- The occupier market began to rebalance in 2021. The process was interrupted by the Shanghai lockdown in 2022. **The future path of rebalancing is uncertain,** as weak consumer confidence will take time to recover, the consumption downgrade trend is likely to continue, and the new demand drivers mentioned above are providing decreasing support. In addition, a large amount of new supply is projected to hit the market in 2025-2027.

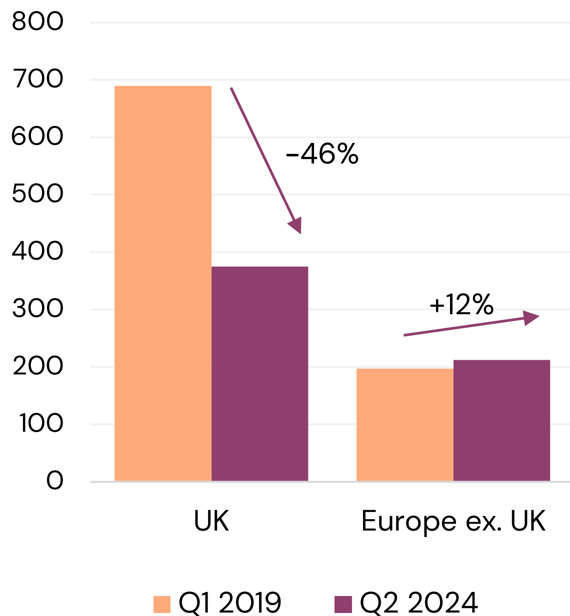
Resolution timeline: incomplete, trending the wrong way

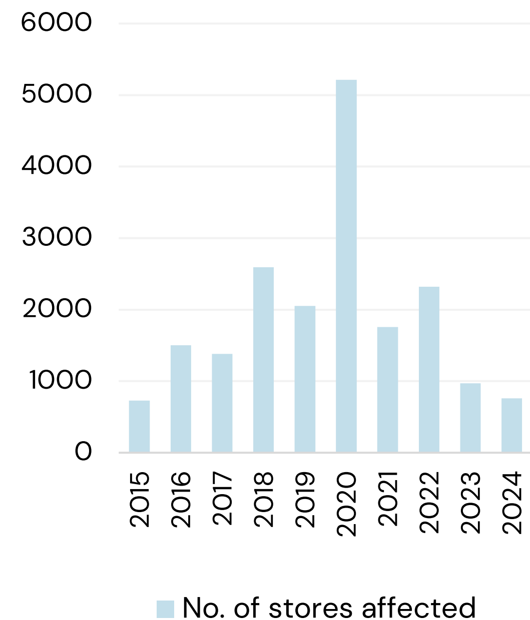
Notes: (1) Shanghai retail net supply, net absorption and vacancy rate data include all prime retail assets in JLL REIS database and the retail net effective rent growth is based on JLL REIS Shanghai prime retail en-bloc net effective rents. (2) The two-child policy allows a family to have up to two children, the three-child policy allows a family to have up to three children.
Source: JLL REIS (Shanghai retail net supply, rent growth and vacancy rate), as of Q2 2024
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

UK retail parks repositioned; rents rebased

Case study: UK retail parks, 2019-present







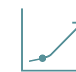
Origins of imbalance

- Recent weakness in the UK retail park sector can be **traced back to its prior strength.** Between 1985 and 1990, average annual rental growth in the sector was 11.3% per annum. By early 2019, retail park rents in the UK had become unsustainable, surpassing average rents in Continental Europe by more than three times. Retailers took up more space than was operationally efficient, leaving them exposed when faced with tight trading conditions and high debt burdens.
- The UK's **"upwards-only" rent review system** further fueled the distress as commercial rents are typically prevented from decreasing, even in an economically challenging environment.
- A combination of overexpansion from retail occupiers, **failure to embrace e-commerce**, and significant rental increases ultimately led to a sharp occupier fall-out, particularly in 2018. A surge in **administrations and consolidation programmes** saw many retail park occupiers permanently ceased trading. These included Toys 'R Us, Maplin Electronics, Poundworld, and Mothercare.

Resolution

- **CVAs,** or Company Voluntary Arrangements, are a legal process in the UK that allow struggling companies to reach an agreement with their creditors to repay the debts over time. One aspect of CVAs is the ability to override upwards-only rent review clauses, which means that rents can be reduced if approved by the creditors. This has led to a significant decline in prime rents in the retail park sector. Between **2019 and 2020, prime rents in retail parks decreased by -46%** and have remained flat since.

- This rental rebasing was a challenging change for retail park landlords to accept. However, it was viewed as a necessary step to ensure the sustainability of the segment. By reducing rents, **retail parks became more affordable** for tenants, which helped attract and retain occupiers.



- With the transition towards omnichannel strategy, retail parks have reinvented themselves as an **affordable, accessible, and adaptable** retail format, making them a preferred choice for retailers due to their ability to **facilitate a seamless omnichannel experience**.

- This transition, along with competitive tensions, limited supply, and a restricted development pipeline, has resulted in **the lowest space availability in over 15 years**. The net positive openings in retail parks in 2023 (+0.3%) reflect the continued consumer demand for this retail format.

Resolution timeline: ~5 years

Source: LaSalle (10/24), MSCI (06/24), JLL (06/24), and CRR (08/24).
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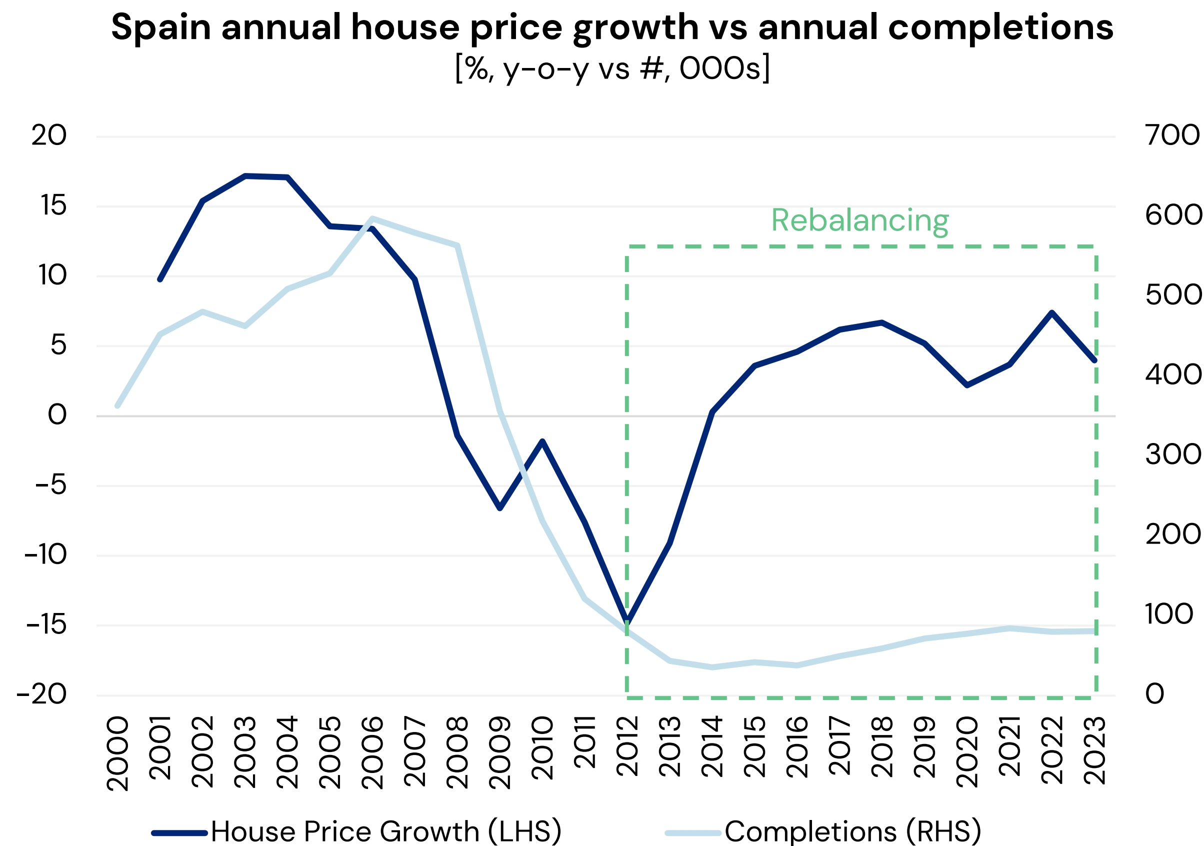
Spain resi supply collapse, demand recovery

Case study: Spain residential, 2001-present



Abandoned housing development in Zaragoza (Markel Redondo, 2010)

Origins of imbalance

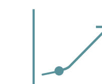
- A major expansion in credit following the introduction of the euro in Spain allowed for increased mortgage borrowing and a major expansion of the construction sector in the early 2000s.
- The number of new homes built increased from ~200k units per year in the 1990s to c.500k per year between 2000-2008.
- In Spain, the GFC led to a major economic contraction, higher unemployment, mortgage delinquencies, developer bankruptcies, all of which combined to hit both demand for homes and construction activity.
- House prices fell as a result, with house price growth negative for six consecutive years from 2008, a ~35% peak-to-trough fall.

Resolution

- The years following the GFC and Euro-crisis (2012-2023) saw completions average only ~60k homes annually.

- A rebalanced demand and supply dynamic accompanied by **recovery in Spain's economy** and several years of low interest rates following the GFC supported demand for house purchases, meaning house price growth has averaged 4.4% p.a. since 2014.
- Despite the impact of rising base rates more recently, Spain continued to see positive house price growth in 2023, in contrast to other major European economies which saw house price contractions.

- The **lack of supply following the GFC,** combined with strong population growth (compared to the Eurozone average) and the relative affordability of Spanish house prices following the crash has supported demand, despite tightening monetary conditions.



- Another notable trend has been the **increased proportion of Spanish households that rent,** standing at 24.7% in 2023, up from 21.2% in 2014. This can be partially attributed to the emergence of the Build-to-Rent sector in Spain, as well as the country becoming increasingly popular as a destination for international students and young professionals. A subset of the overhang of unsold housing units were converted to for-rent dwellings.

Resolution timeline: ~5 years

Source: LaSalle (03/24), INE, Eurostat.

Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Lessons from case studies

Implications for current market debates

- While it is possible that some challenged markets may never rebalance—as in the case of total obsolescence of a property type or location—the case studies suggest that **even very challenged markets typically heal with time.** The "death of _" has been proclaimed many times, usually prematurely.
- The rebalancing process is **complex** – there are usually many factors driving the process at the same time.
- It can take a **long time for market imbalances to resolve** – up to a decade or even more. Even if net supply is zero, vacancy can (by definition) only fall by the rate of net absorption.
- **Stock deletions** by demolition and conversion receive a lot of attention but are generally a less prevalent factor in rebalancing markets than the media attention received would suggest.
- Policy matters. Resolving persistent imbalances can sometimes **require a catalyst**, such as a policy change. The impact of such policies can be both intentional and unintentional.
- **Change happens at varying speeds** depending on sector and location. For example, the synergies of co-tenancy in a retail center can go into reverse and accelerate failure when occupancy falls below a certain level, as the property quickly acquires a "dead" vibe. Similar forces do not operate in most other property types, which can keep them failed assets in the competitive stock for longer.
- **A rebalanced state is not a permanent condition.** For several of the markets and sectors covered by the case studies, conditions are again weakening as they are impacted by local, national and global trends.

3

Office market rebalancing outlook

2024 update: *Re*-revisiting the future of office

Views mostly remain consistent with report, yet a few bright spots are emerging in the US

In March 2023, we published our *ISA Focus: Revisiting the Future of Office*. We examined the prospects for the office sector, addressing key questions while highlighting differences and similarities among global markets. **Our assessment of risk factors remains largely unchanged** from the 2023 report, with US markets showing the most significant risk, Asia Pacific the least (apart from Australia), and Europe in between. We maintain our views that:

- Office demand risk and investor perception of office risk relative to other sectors have increased but **vary globally.**
- **Office quality, micro-location and amenities remain critical.** Since the 2023 report, top-tier office properties have recovered at a considerably faster pace than commodity product.
- There is **increasing divergence in performance between high-quality assets and older buildings,** which will require significant capital investment to meet changing tenant requirements and regulations.
- Markets leading in regulation and awareness of sustainability factors are likely to see earlier **investable brown-to-green strategies.**
- Distressed office pricing is beginning to appeal to select risk-tolerant investors, especially in the US. Since 2023, US office transactions have increased but remain depressed.

Market segment / Risk factors (Description)	Return to office (Employees return to office)	Health of fundamentals (Vacancy rates relative to long-term average)	Investor risk (Investor view of office risk relative to other sectors)	Debt availability (Pricing and availability of debt on offices*)
US major CBDs	(↑) Neutral	Negative	Negative	Negative
US sunbelt suburban	Neutral	Negative	Negative	Negative
London	(↑) Positive	Positive / Neutral	Neutral	Neutral
Cont. Europe	Positive	Positive	Neutral	Neutral
Australia major CBDs	Neutral	Negative	Negative	Neutral
Tokyo 5-Kus	Positive	Neutral	Neutral	Positive
Shanghai CBD	Positive	Negative	Negative	Negative

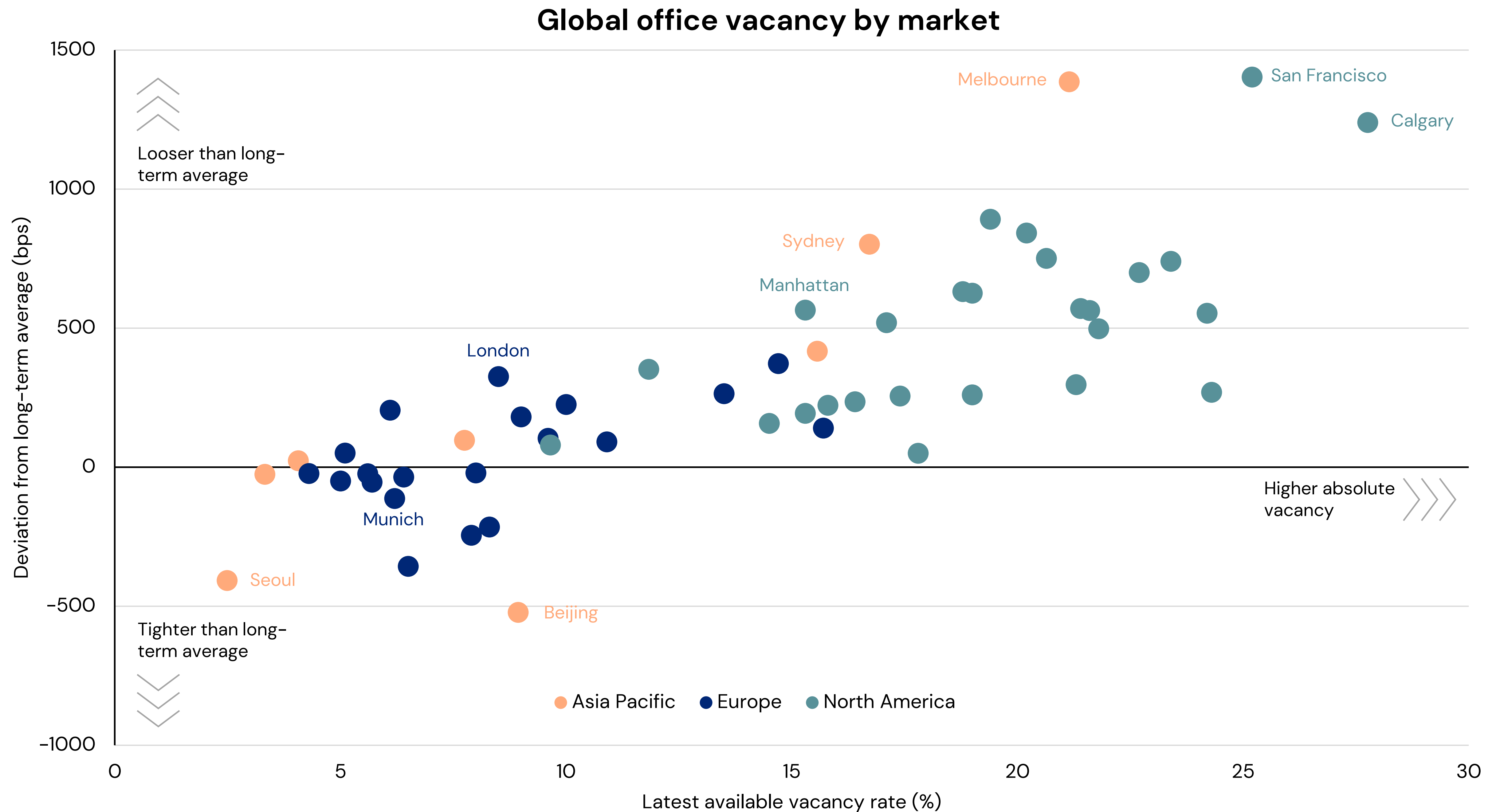
↑ Change from 2023 report

Assessment of risk factors: Positive, Neutral, Negative

Source: LaSalle (9/2024), JLL (8/2024), CBRE-EA (8/24). *Attractive pricing for top-tier office properties in the US is moving towards a neutral rating.

Office conditions “all over the map”

Market conditions vary considerably by market, with conditions in North America relatively weakest



The current vacancy rate refers to the latest available data point for each location and these dates range between Q1 and Q3 of 2024. Similarly, the measurement period of the long-term average will depend on data availability but represents the longest period available for each series.
Sources: JLL, CBRE-EA, CBRE, Real Page, MSCI, NCREIF, Canada Mortgage and Housing Corporation, company reports and LaSalle Research and Strategy as of October 2024.

US office demand recovery coming (slowly)

Eventually, office job growth will take up demand slack created by remote work impact

Office Employment & Occupied Stock

Office Employment and Occupied Stock Index=2003

1.50
1.40
1.30
1.20
1.10
1.00
0.90

2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 2031 2032 2033 2034

Occupied office stock

Office-using jobs

1 Historically, office-using jobs and the occupied office space exhibited a strong correlation

2 A gap between occupied stock and office jobs opened up due to remote working

3 By 2025, five years after the pandemic, the remote working adjustment is forecast to be out-weighed by job growth; office occupied stock will start to recover

4 By 2030, office-using jobs are forecast to be 14% higher than in 2019

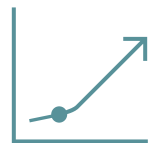
5 **But:** In 2030, occupied office stock is forecast to be back only to its 2019 peak

Source: CBRE-EA (Sum of Markets), Oxford Economics. Q2 2024, LaSalle Research & Strategy forecasts
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Surveying the factors impacting the prospects for office market rebalancing

Demand recovery

Demand is recovering for high-quality office space as firms seek more collaborative space and period of adjustment to hybrid work completes



Structural demand shift

Some have argued that artificial intelligence-related demand may drive a demand rebound in some innovative cities, but AI equally poses a risk if it drives automation

New supply slowdown

New office supply has fallen dramatically in most markets and is likely to remain depressed for quite some time

Stock deletions

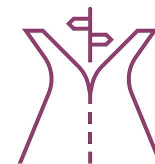
Demolitions, conversions and irrelevance of obsolete stock is growing, but remains small relative to vacancy levels **(see following pages)**

Subsidies, incentives, tax

Tax incentives for the conversion of office space into other uses, or even subsidies for its outright demolition, are being introduced in some places **(see following pages)**

Planning / zoning

Some governments are introducing planning changes that will make a larger share of obsolete office buildings candidates for conversion **(see following pages)**



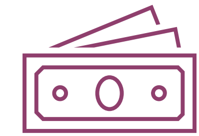
Infrastructure change

New transport infrastructure in some markets has the potential to clarify or redefine what is considered a prime office location, helping demand consolidate around it

Sustainability factors

In some geographies, sustainability regulations and green-sensitive demand change are likely to accelerate the obsolescence of a large portion of the office stock

US policy catalysts for use conversion



Incentive programs focused on office-to-residential conversions

Widespread oversupply of offices, alongside housing affordability issues in major cities in the US, have given rise to new or expanded incentives for the conversion of offices to residential. Among the 20 largest CBD office markets, 11 have created new incentives since 2020 or expanded existing ones to cover conversions, four more have proposed new legislation to do the same, and two are performing assessments of the feasibility and benefits of conversions programs. Federal incentive programs have been introduced to provide more attractive economics in solving market imbalances.

HUD* Community Development Block Grant Program (CDBG)

- Provides grant funding that can be used to support acquisition and costs associated with the conversion of commercial properties to residential uses.
- $85 million in grants to states and local governments and multijurisdictional entities to remove barriers to affordable housing production, and includes the development of adaptive reuse strategies and the financing of conversions as eligible activities.

Below-market loans that make the numbers work

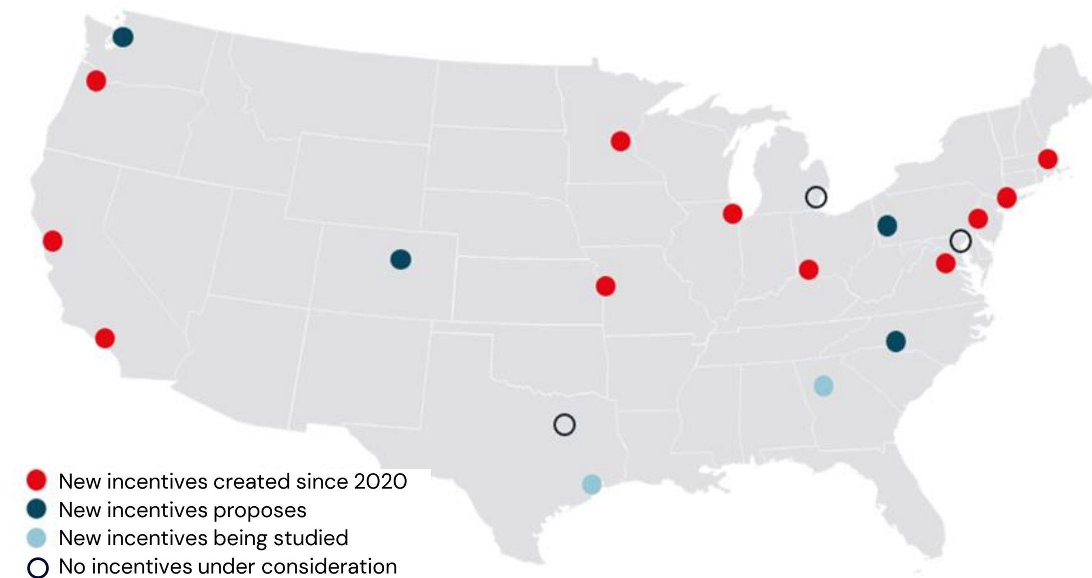
- The Department of Transportation's (DOT) Transportation Infrastructure Finance and Innovation Act (TIFIA) and Railroad Rehabilitation & Improvement Financing (RRIF) programs offer over $35 billion in lending capacity, which provide large-scale below-market loans that can be used to finance conversions near transportation.

Land dispositions that make deals possible and can reduce development costs

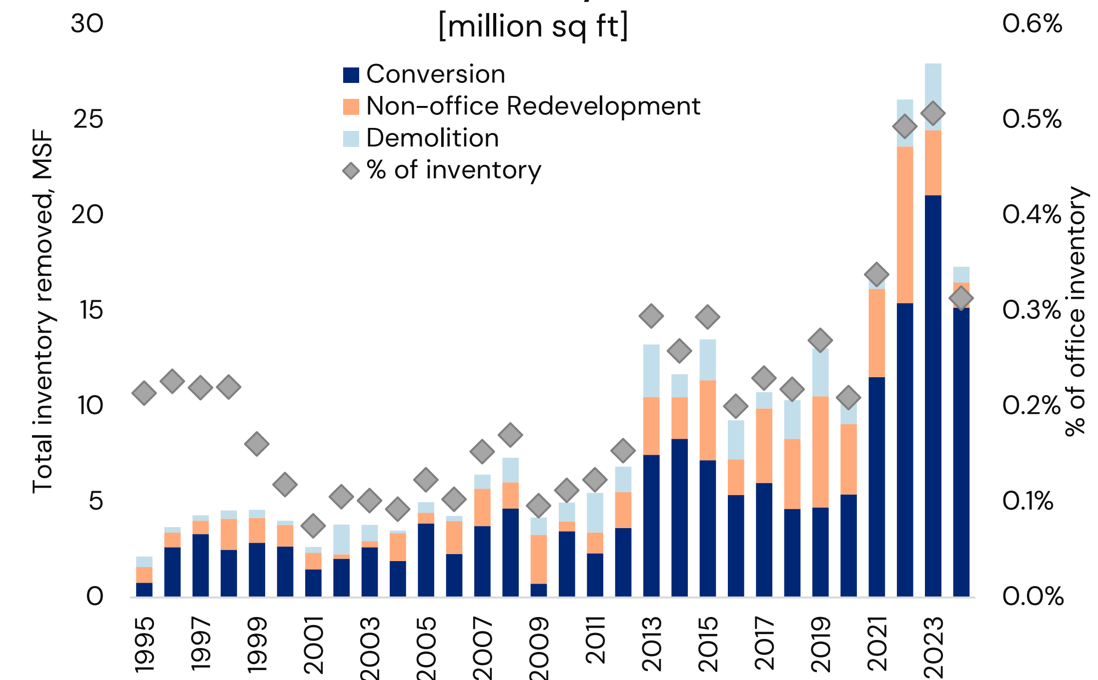
- DOT is permitting transit agencies to transfer properties to local governments or affordable housing developers at no cost, some of which could have existing commercial uses that can be converted to affordable housing.

In addition, local city-led incentives such as the LaSalle Street Reimagined initiative in Chicago aim to create more vibrant and diverse neighborhoods by adding mixed-use amenities and providing funds to facilitate the conversion of office buildings into apartments.

Incentives for conversions programs in 20 largest US office markets



US office inventory removed*
[million sq ft]

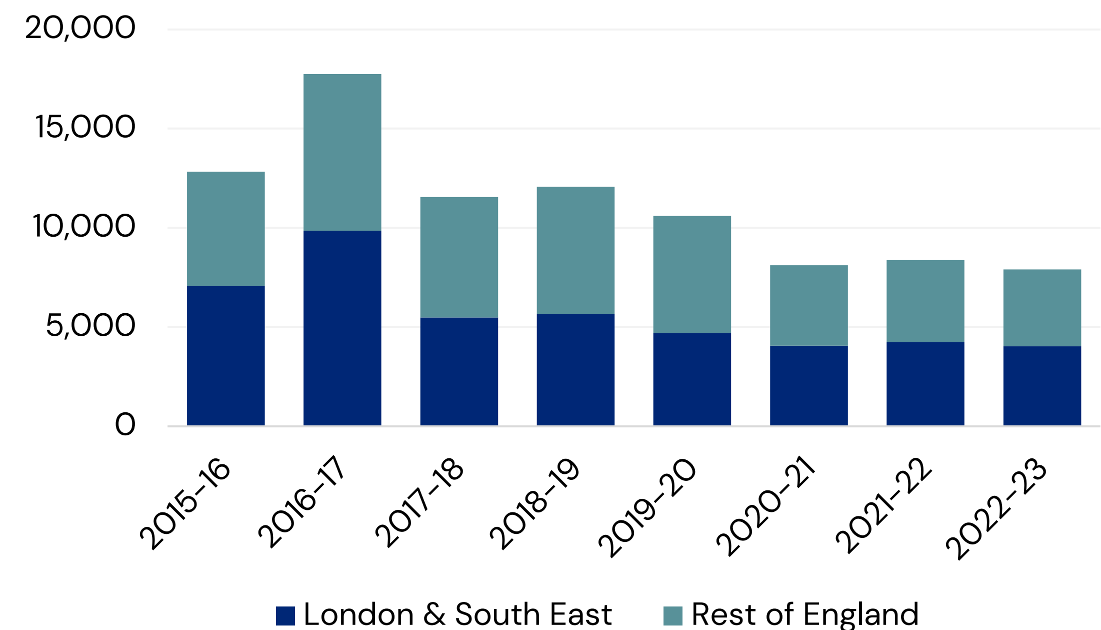


Sources: LaSalle (06/24), JLL (04/24/8/2024), LSH (06/24). *Note: Includes buildings above 80,000 s.f. RBA. Demolition = tear-down of existing office building with no imminent plans for new development. Conversion = change in the use of all or a portion of the asset, while retaining all or a portion of existing structure. Redevelopment = capital improvement project which changes the use of a site by demolition and ground-up new development. Non-office redevelopment excludes office demolitions replaced with new traditional office ground-up development. No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.
*HUD = U.S. Department of Housing and Urban Development, https://www.whitehouse.gov/wp-content/uploads/2023/10/Commercial-to-Residential-Conversions-Guidebook.pdf

UK planning changes enable and encourage office-to-residential

- UK office stock has declined 7% since 2014, largely driven by a new type of **Permitted Development Right** (PDR Class O) introduced in 2013 that allowed office-to-residential conversions without planning permission. Conversions peaked at almost 18,000 new dwellings in 2016-17, but have since lessened. One challenge was a lack of sufficient provisions to safeguard the quality of converted space.
- Class O rights were amended in 2020 to include an adequate natural light requirement and again in 2021 to include national space standards. In 2021, Class O was replaced by Class MA permitted development rights, which allowed for the conversion of commercial buildings to residential, but with size and vacancy requirements.
- In March 2024, amendments to Class MA were introduced that **relax the eligibility criteria to support the conversion of commercial buildings to residential.** The previously enforced qualifying criteria that have been removed are:
  - **The need for a vacancy test** – the requirement for a building to have been vacant for a continuous period of at least three months
  - **Size limit of development** – the cumulative floor space of the existing building was not to exceed 1,500 square metres.
- This new legislation will **open up new and larger opportunities for conversion** of obsolete office stock to residential, which remains undersupplied across major cities.
- However, space standards and rights to natural light still apply and both remain a significant constraint on office-to-residential conversions, with the size, shape and orientation of some buildings making them unfit for conversion.

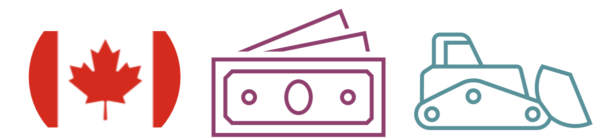
Net additional dwellings under permitted development rights: office to residential



In Q1 2024, a private investor purchased the former GSK building, Brentford with vacant possession for £69m, with plans to convert to residential.

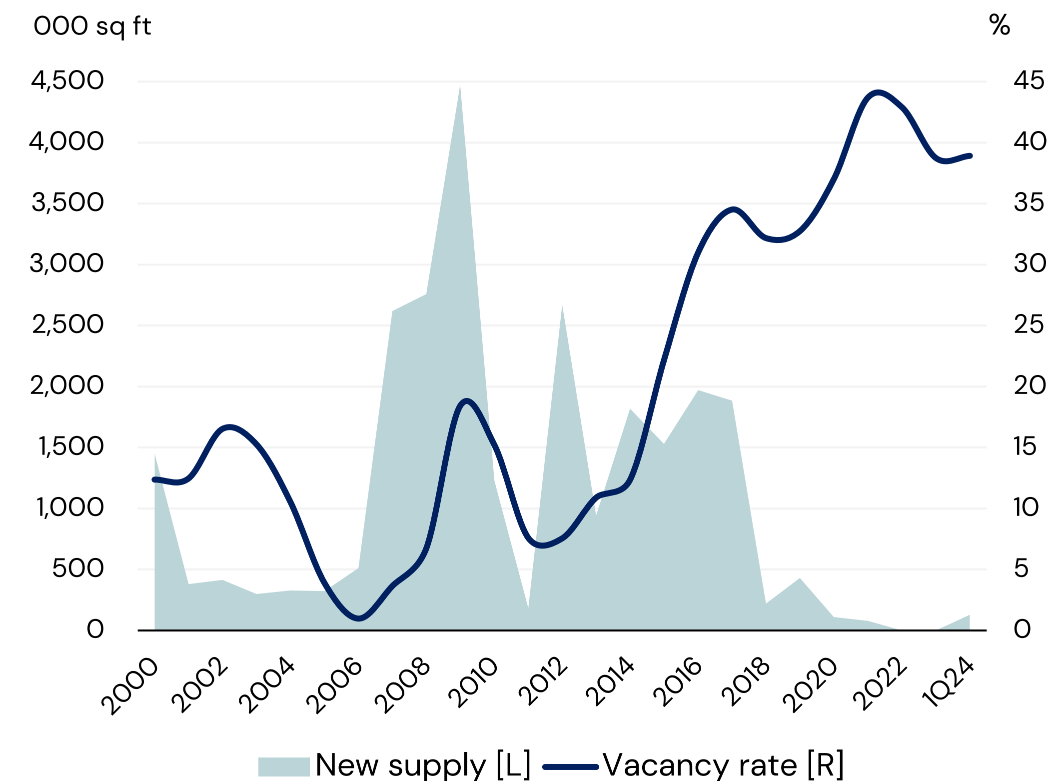
Sources: LaSalle (06/24), LSH (06/24), Department for Levelling Up, Housing and Communities

Canada case study: Calgary office demolition incentives

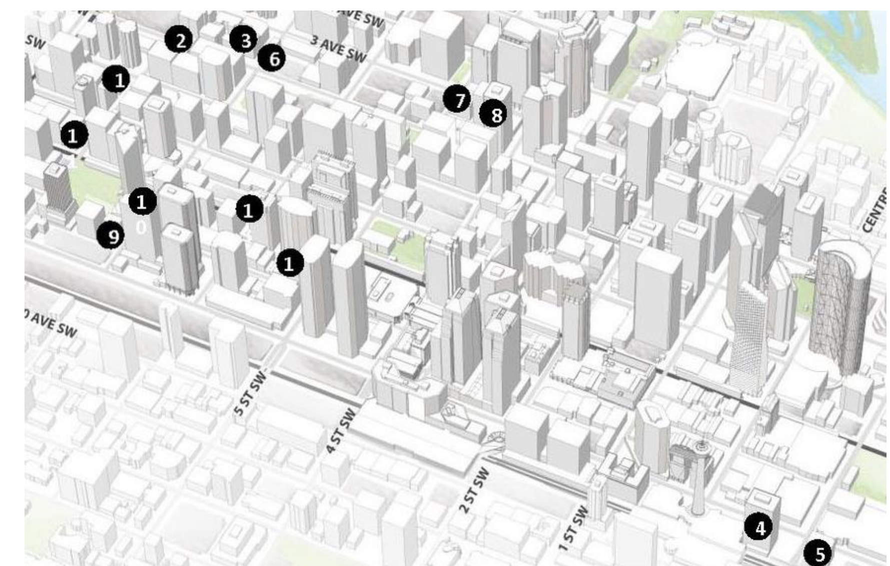


The City of Calgary has three main incentive programs available to office developers and owners. **The goal is to remove six million square feet of vacant office space in Calgary's CBD.** To date, C$567 million of partner investments have been secured; for every $1 the City invests, they leverage $3 in private investment. Thus far ~2,300 new residential units have been created as a result of these programs.

- **Downtown post-secondary institution incentive program –** Provides incentives for office space conversions to post-secondary institutions to establish a greater presence in the CBD. The City is also exploring ways to invest in student housing and/or student-focused housing.
- **Downtown office demolition incentive program –** Supports the demolition of end-of-life office buildings that are unsuitable for office conversions.
- **Plus 15 Fund offset program –** The City is providing C$2.0 million in incentives to developers who initiate residential projects in the CBD core to offset any required *Plus 15 Fund* contribution (Plus 15 is an indoor, elevated walkway system connecting CBD buildings). This removes a potential barrier for new residential development and additions to existing buildings to accommodate new residential use.



Conversion of older Class B/C office buildings in Calgary includes 13 current, approved projects in the CBD, with four more under review



Sources: LaSalle (06/24), JLL, https://www.calgary.ca/development/downtown-incentive.html

Office-to-residential is challenging and by no means a panacea

The conversion of office space to residential use often requires significant structural changes which leads to high costs that can approach or exceed the cost of new development in some cases.

While incentive programs can positively tilt the economics to enable conversion of office to residential or other uses, the characteristics of the location and physical specifications of the building are critical considerations to assess the suitability of a conversion project. **Only a small subset of the currently challenged office stock is of sufficient quality for conversion.**

Conversion suitability checklist (JLL)

Location considerations

- Good public transport connections / close to workplaces
- Local amenities such as retail, restaurants, schools, entertainment and leisure facilities
- Proximity to green spaces
- Limited noise pollution

Building considerations

- Natural light exposure and unobstructed views are of greater importance in residential dwellings than in office buildings
- Floor plates should allow for sufficient light exposure and ventilation of dwellings (smaller floor plates preferable; 15-20k sqft)
- Building structure impacts layout of units with central core or rectangular side core most compatible for residential conversion
- Ease of remodelling distribution of utilities such as HVAC and plumbing systems to individual units

Downtown Chicago example:

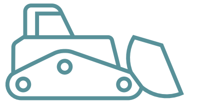
30 N LaSalle Street
Chicago, IL

CBD office → **Apartments**

Golub & Company, with American General Life Insurance, plans a $130 million office conversion project at 30 N. LaSalle Street. The project aims to convert the existing 900,000 square foot office space into 349 residential units, with 105 units designated as affordable housing. The plans call for ground-floor retail and green space. To support this project, they have requested a $57 million subsidy from the LaSalle Street Reimagined initiative.

Sources: LaSalle (06/24), JLL (08/23, 04/24)

More suburban examples of stock deletions



In areas with persistently high vacancy, low rents and declining values, offices becoming land deals

Three examples from Chicago area suburbs:

Former **Walgreens** HQ
Deerfield, IL

Office → **Single-family**

Pulte Group, a homebuilding company, plans to acquire an 18-acre portion of Walgreens' headquarters in Deerfield, a suburb of Chicago. They intend to replace 261,820 sf of office space, a daycare, and 800 parking spaces with 42 single-family homes. This acquisition is taking place amidst the village's consideration of a ban on development of warehouse/ distribution facilities.

Former **Allstate** HQ
Northbrook, IL

Office → **Logistics**

In October 2022, Allstate sold its 1.9 MSF corporate campus in Northbrook, a north suburban area of Chicago, for $232 million to Dermody Properties. Dermody Properties is in the process of converting the 232-acre property into a 10-building industrial park known as The Logistics Campus. The project, including land acquisition, is estimated to cost over $500 million.

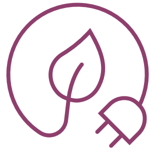
Former **Sears** HQ
Hoffman Estates, IL

Office → **Data center**

In 2023, Compass Datacenters acquired Sears' 194-acre headquarters in Hoffman Estates, in northwest Chicago, for $194 million. The existing 2.4 MSF of interconnected buildings will be demolished and replaced with data centers. The village recently amended zoning regulations to allow for data centers, whereas other uses, such as a distribution center, would have required a zoning change.

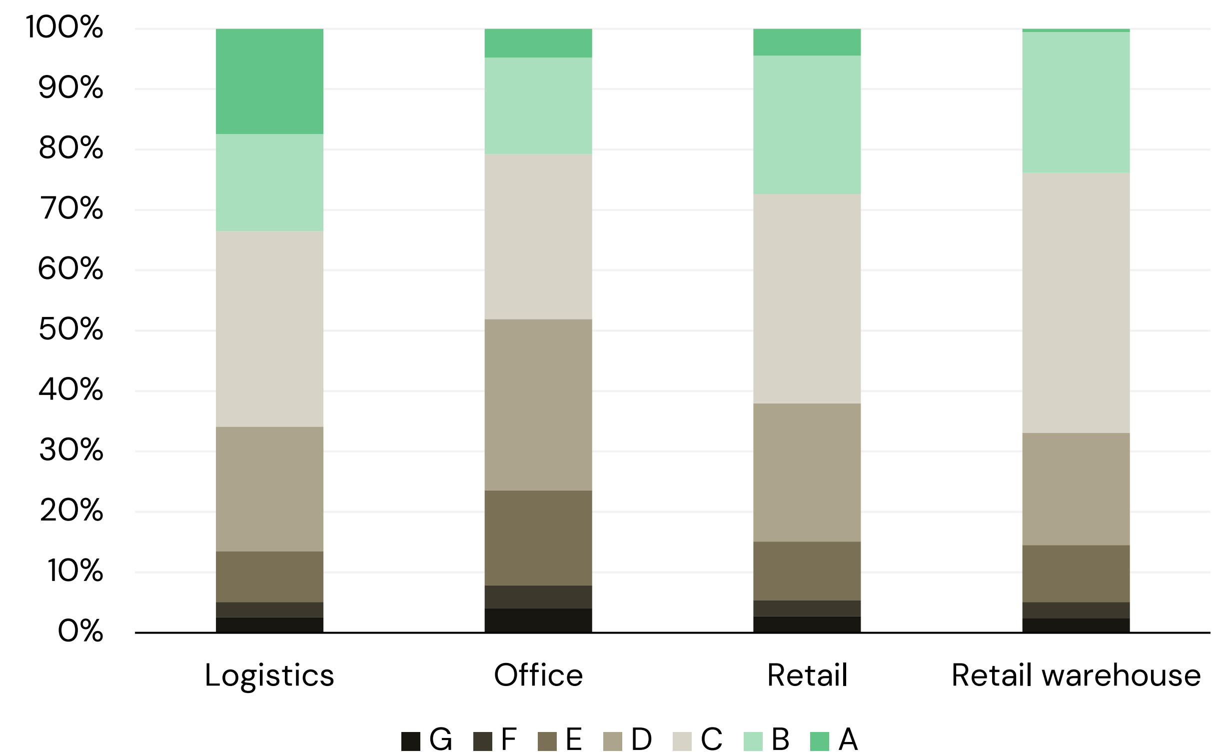
Source: CoStar and numerous news articles from 2022-2024.

Sustainability factors likely to become increasingly widespread obsolescence drivers



- Looking ahead, regulations such as **minimum standards** and **carbon taxes** will alter the viability of properties based on their sustainability characteristics, and act as a potential driver of accelerated obsolescence.
- **Government regulations** combined with **market forces** in the shape of corporate occupier commitments towards high sustainability criteria to meet their own sustainability targets, attract and retain talent and promote the well-being of employees are likely to drive demand for sustainable buildings.
- Market change driven by transition risk is likely to be **greatest in markets with more stringent regulations** and slow improvement in stock. That said, variations in sustainability characteristics between markets and buildings will also create opportunities for targeted strategies in improving the sustainability and energy efficiency of buildings.

UK EPC rating % of overall stock by property type



Example green regulations driving obsolescence

- In the UK, **minimum energy efficiency standards (MEES)** regulations made it unlawful to let a property with an Energy Performance Certificate (EPC) rating below 'E' from 1 April 2023 and the government intends to raise the minimum to 'C' by April 2027 and 'B' by 2030. Currently, less than 30% of UK stock is compliant with the 2030 minimum, and so will either need to be upgraded in terms of energy performance or will become stranded.
- **New York City enacted Local Law 97** in 2019 to drive emissions cuts from buildings, which are responsible for more than two-thirds of NYC's greenhouse gas emissions. The law places increasingly stringent carbon caps on the amount of emissions over the course of five-year intervals beginning this year on most buildings larger than 25,000 square feet — covering nearly 50,000 properties across NYC.

Source: JLL; Department for Levelling Up, Housing & Communities as of 2023.

Investment implications of office market rebalancing prospects

LOOKING AHEAD

- Occupier market rebalancing typically involves a **complex confluence of factors** and often **requires a long period of time** to complete. This is especially likely to be the case for the office sector in markets where it is oversupplied.
- The **media loves to focus on demolition and use conversion** as a road to solving office market challenges, but a demand recovery alongside an extended period of very low supply is more likely to be the primary drivers of rebalancing.
- Despite widespread challenges, there inevitably will be **specific investment opportunities** to convert obsolete office stock to other uses, or to upgrade office buildings subject to stranding risk into a higher quality product.
- We also anticipate selective opportunities to acquire **mispriced standing stock** that is well positioned to benefit from the rebalancing of the sector.
- Be aware and **ahead of policy changes** and future government initiatives that may “change the math” of sector economics, potentially creating investment opportunities

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