COVID-19 RECOVERY OUTLOOK

OFFICE & INDUSTRIAL COMMERCIAL REAL ESTATE

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This report examines the potential impacts of COVID-19 on the office and industrial commercial real estate (CRE) market. This report aims to assist County policy makers promote business in the emerging post-COVID-19 business climate consistent with the Council's Economic Development Platform – Business Development Pillar.

KEY TAKEAWAYS

- The current pandemic crisis will accelerate pre-COVID-19 trends of increased e-commerce and teleworking.
- In turn these changes may accelerate decreasing demand for office space in the County as more business turn to telework and look for opportunities to reduce operating costs. However, this may be offset as businesses look to add space to accommodate social distancing of employees.
- While the County has a limited supply of land zoned for industrial use , potential opportunity exists to respond to growing demand for storage, distribution and other logistical commercial facilities through adaptive reuse of commercial properties.

Additional OLO research on COVID-19 recovery is available here: www.montgomerycountymd.gov/olo

MONTGOMERY COUNTY OFFICE & INDUSTRIAL COMMERICAL REAL ESTATE TRENDS (2019)

The Planning Department reports that commercial real estate in the County has grown by 22 million sq. ft. since 1990, however the average rate of growth has slowed over the last 10 years . Between 1990 and 2017, office space grew from just under 55.0 million square feet to 72.7 million square feet and industrial space grew from just over 12.5 million square feet to nearly 15.0 million square feet.[1] Key findings from the Planning Department's 2019 report are below.

OFFICE

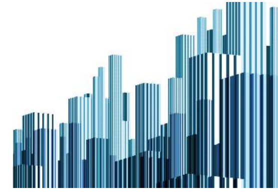
- Planning staff noted demand declined for the following reasons:
  - Federal spending cuts and reduced federal demand for space;
  - Job growth since 2010 in non-office-based sectors like retail; and
  - Changes in technologies, office design and telework reduced demand for space.
- Adaptive re-use or alternative redevelopment present opportunities to reinvigorate market.[2]

INDUSTRIAL

- The County's dwindling undeveloped land supply resulted in a scarcity of suitable industrial plots, high land values, and industrial activity pushed outside of the County.
- County data sources do not distinguish between logistics and industrial markets, making it hard to track needs in rising e-commerce.
- Redevelopment or use of existing office space for industrial is a potential solution, however retrofitting office space requires regulatory support, including amendments to the County's Zoning Ordinance.[3]

What is the National Impact of COVID-19 on the Office and Industrial Sectors?

The COVID-19 pandemic has the potential to significantly impact the commercial real estate sector. This page presents current and projected future commercial real estate trends as well as forecasted vacancy rates.



OFFICE[4]

March-May 2020 National Trends

- More than one-half of office tenants asked for rent relief by the end of March.
- Pre-Covid-19, only 4% of employees teleworked on a regular basis; with mandated closures, 34% of office jobs are working at home as of April.
- Office jobs weathered initial layoffs in March, but the second round of layoffs in April and May occurred hit the sector in greater proportion.
- Pre-COVID-19 number of job openings outnumbered job seekers, but between March and April openings declined 22%, with decreases in openings for engineering, IT, and marketing positions.
- Office leasing activity declined 21% in the 1st Quarter of 2020.

Est. Vacancy Rate (2020-2021 est.)

12 to 28%

Depending on Location

Source: Moody Analytics

POTENTIAL SECTOR TRENDS (SUMMER 2020 AND BEYOND)

DEMAND

- The sector may experience a drop in office space usage as businesses realize cost savings and effectiveness of telework arrangements.
- An April survey of NYC businesses reported 69% of companies plan to shrink office footprint and 74% plan to reduce employees coming to the office.
- Moody’s notes office space demand may shift from central business districts to suburban office parks.
- Businesses may shift from long-term leases to short, flexible leases.

HEALTH

- Reversal or slowing of open office trends and co-working spaces due to health risks.
- Enhanced guidelines for office cleaning with increased maintenance costs may occur.
- Employers may require staggered start times, fewer days in the office, and masks.
- Employers may provide private shuttles as long as public transit is deemed high-risk.

DESIGN

- Safety and social distancing (6 ft.) may increase space needs and influence office design.
- Employers may move to buildings with better air circulation or other health benefits.
- Companies may conduct a cost benefit analysis to weigh costs of outfitting a new space versus savings gained from making telework permanent.

INDUSTRIAL[5]

April-May 2020 National Trends

- This sector experienced supply chain disruptions.

Est. Vacancy Rate (2020-2021 est.)

12 to 15%

Depending on Location

Source: Moody Analytics

POTENTIAL SECTOR TRENDS (SUMMER 2020 AND BEYOND)

DEMAND

- Defaults may occur in the Fall, as annual land lease payments are due.
- Adoption of e-grocery shopping may increase need for cold storage and impact grocery store design to blend retail and industrial uses.
- Acceleration of e-commerce and telework trends could increase the need for data centers and warehouse and distribution facilities.
- International supply chain disruptions could prompt a return of manufacturers to the U.S.

HEALTH

- Industrial plants may move to less dense areas.
- New OSHA standards recommend social distancing, disinfecting of shared equipment, and staggered shifts.

COMMERCIAL REAL ESTATE OUTLOOK IN THE NATIONAL CAPITAL REGION

The DC region will mirror its peer metro areas, which are typically knowledge-based economies. While the regional economy is expected to contract the last three quarters of 2020, recovery may be faster due to the presence of the Federal government and contractors, less dependence on international manufacturing, and workers better positioned to work remotely.[6]

Note on Industrial Development. In 2019, FedEx opened a distribution center in Gaithersburg (MD).[7] However, OLO notes limited industrial land exists in Montgomery County. Key sectors like data warehouses have experienced steady growth in Northern Virginia with the region being named the largest market for data center space in the U.S., with over 12 million square feet. Most of the development has occurred in Loudoun County, with that region being named "Data Center Alley." [8] The following table focuses on office space trends.

OFFICE SPACE TRENDS (Late 2019 to Post-Covid-19 (2020 and Beyond))

MONTGOMERY COUNTY	
Office	2019: Suburban MD - Office Vacancy Rate 16.0% (Q4); Advertised Rents $27.56 (Q2) (All Classes) In 2019, the value of the County's commercial properties lagged other jurisdictions, contributing to lower commercial tax revenue. Average sales price was $232/sq. ft. countywide but dropped to $170/sq. ft. outside of Bethesda. Northern Virginia averaged $272/sq. ft. for all commercial sales. Moving towards March 2020, reports indicate that the office market experienced similar trends to Northern Virginia. The office market was aided by tenants, including NIH which expanded in North Bethesda. Demand may increase due to Maryland's life sciences and health care sectors.[9]
Recovery	Life sciences and health care sectors – including employers in the I-270 life sciences corridor - are poised to benefit from increased research and development spending,.[10]
DISTRICT OF COLUMBIA	
Office	2019: Office Vacancy Rate 11.6% (Q4); Advertised Rents $55.25 (Q2) (All Classes) Market was struggling before COVID-19 with high vacancy and stagnant demand. Co-working is particularly vulnerable. Office vacancy rate could hit 15% in 2020 as leasing activity declines in Q1 and activity is expected to drop through Q3.[11]
Recovery	The construction pipeline is slowing which may help cover loss in demand. The Federal Government occupies a significant portion of office stock in DC and is better able to weather the downturn. Law firms concentrated in DC could see an increase in business to assist businesses in navigating the crisis and obtaining federal funding.[12]
NORTHERN VIRGINIA	
Office	2019: Office Vacancy Rate 14.9% (Q4); Advertised Rents $33.14 (Q4) (All Classes) In the past year Northern Virginia has experienced 71% of new job growth in the DC region for reasons including availability of land and perceived business climate. The Dulles corridor has 37% of federal technology contracts, making it a strong choice as tech companies expanded into cloud computing and cyber technology. Northern Virginia has almost 70% of the 28 million square feet of occupied technology office space in the Washington, D.C.-Maryland-Northern Virginia market. Q1 2020 showed an increase in demand due to government contractor activity as well as the technology, advertising, media and information sectors. Office vacancy rate was dropping before the COVID-19 crisis and experts see this trend continuing.[13]
Recovery	Sectors driving Northern Virginia's growth are government contracts and technology companies like Amazon, which are better able to weather the crisis.[14]

Understanding COVID-19 Impact
OFFICE AND INDUSTRIAL COMMERCIAL REAL ESTATE TAKEWAYS

As discussed, both sectors are impacted by stay-at-home orders and social distancing. Key short- and long-term impacts include:

SHORT-TERM NATIONAL TRENDS *States slowly re-open with social distancing, contract tracing, and virus containment*	LONG-TERM NATIONAL TRENDS *States have re-opened and activity is resumed*
OFFICE • Telework remains in place; staggered return of office professionals; focus on health and safety • Shift to reduce space needs to cut costs **INDUSTRIAL** • Supply chain disruptions may occur as e-commerce trends grow • Businesses may look to increase space – data centers, cold storage, logistics	**OFFICE** • Telework trend continues; shift to shorter, flexible leases, smaller office footprints • Relocation to buildings with better safety features, like air filtration, and in less dense areas **INDUSTRIAL** • E-commerce trend accelerated; need for logistics increases • Move to less dense areas for health and safety

Key questions for Montgomery County

- How will pre-COVID-19 downward trend in demand for office space be impacted as the telework trends accelerate?
- What are the implications of short-term flexible leases on the County's commercial real estate valuation?
- What will be the impact to traffic and public transit as jobs move to telework, e-commerce rises, and companies may offer private transit solutions?
- How will new health and safety standards impact building maintenance costs, which may be borne by landlords, and how could this impact maintenance workers?
- What are potential areas State and local government regulations related to office and industrial buildings?
- What could be the impacts of a shift in demand from central business districts to suburban office parks and/or to buildings with updated health and safety features (e.g., 6ft office trends, air filtration, etc.)?
- Where are there opportunities to explore adaptive reuse of commercial properties to mirror upcoming industrial sector trends in cold storage, particularly near population centers?

Practical next steps for County consideration

- Measure the impact of office and industrial market trends on property taxes and vacancy rates
- Review County codes to allow for adaptive reuse of commercial properties to mirror upcoming trends in telework, social distancing, particularly in the suburbs where valuation and price per sq. ft. are lower
- Evaluate relevant codes and building inspections to meet new requirements for safe and healthy workplaces
- Evaluate opportunities to track data related to logistics and manufacturing to optimize ability to respond to growing logistics trends
- Review County codes and zoning laws to help businesses adapt to trend of blended retail and industrial uses

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