VIEWPOINT

ONE YEAR IN

TRANSWESTERN

Why Transwestern Is More Optimistic About Dallas Than Ever

75%

of executives expect revenues to return to pre-COVID levels by 2022

Federal Reserve Bank of Dallas
(includes firms already at/above pre-COVID levels)

15+ million

square feet of pent-up office demand that will return

Transwestern Research

7+ million

square feet of office demand from out-of-market relocations

Transwestern Research

Since the pandemic began one year ago, Main Street has faced its toughest year since The Great Depression. While Dallas' economic resiliency has come through, Transwestern is thinking deeply about strategic moves business leaders can make to be well-positioned for success in the coming years.

In this white paper, Transwestern offers concise analysis and practical tips that business leaders can use **today** to take advantage of unique opportunities over the next six months.

- **Business Conditions**
  Urban density is here to stay as Dallas is expected to become as big as Chicago by 2035. Dallas remains well-positioned and could experience growth dynamics similar to the 1980s energy boom. Read more »
- **The "New Normal" For Office Space Isn't So New**
  Transwestern has closely monitored research and business feedback about potential changes to the office. Not surprisingly, most office trends discussed in gateway markets will not be as applicable to Dallas. Read more »
- **Now Is The Time To Make Space Decisions**
  Pent-up demand for office space and growing expectations of inflation are occurring simultaneously, creating a uniquely challenging time for tenants who need to make budget-conscious space decisions. Making those decisions **sooner rather than later** could result in valuable savings. Read more »
- **How The "New" Normal Will Impact The Office Market**
  Dallas will outperform and recover faster than other markets. Transwestern has created two forecasts for effective rents and vacancy rates using granular data from past recessions and recoveries. Read more »

CLIENT CONTACT
Paul Wittorf
Executive Managing Director
214.446.4512
paul.wittorf@transwestern.com

RESEARCH CONTACT
Andrew Matheny
Research Manager
972.774.2529
andrew.matheny@transwestern.com

MEDIA CONTACT
Collin Burwinkel
Marketing & PR Specialist
972.774.2531
collin.burwinkel@transwestern.com

Business Conditions

A Fresh Perspective

As many peers have stated over the last 12 months, Dallas remains well-positioned to recover from this downturn. Day-to-day conversations with business leaders are saturated with cautious optimism that the region will write another great comeback story and grow to new heights, as it did 10 years ago after the greatest financial crisis and recession in decades.

Instead of rehashing the same growth story witnessed first-hand over the last 10 years, Transwestern is considering how the pandemic may have altered Dallas' trajectory over the next 10 years and beyond.

- **Dallas-Fort Worth will be as big as Chicago by 2035**
  DFW will be home to more than **10.1 million people** compared to Chicago's 10.0 million according to latest forecasts from the Texas state demographer and regional planning agencies.
- **Urban life is here to stay**
  Dallas' most walkable districts are also car-friendly, allowing the city to quickly pivot to new norms during and after COVID. One little known fact is that the M-LINE Trolley's ridership was **up 2% in 2020** despite the pandemic, signaling that attitudes toward urban life have not changed in Dallas' densest neighborhoods.
- **Dallas will build upward, not just outward**
  Escalating land and development costs will continue shifting the development pipeline away from low-rise and mid-rise construction. As a result, high-rise development in the Uptown, Arts District, Deep Ellum, Knox District, and Oak Lawn/Turtle Creek neighborhoods will continue transforming the Dallas skyline. A dozen new towers are already under construction and **more than two dozen** are in the pipeline.
- **Legacy/Frisco is DFW's third central business district**
  The Dallas North Tollway will remain the top destination for relocating companies due to its accessibility to a rapidly growing white collar workforce. As land becomes scarce and low-rise construction becomes difficult to underwrite, office buildings will likely become more vertical. In the long run, these former suburbs could employ as many people as the Dallas urban core.
- **Flexible work schedules will improve commute times**
  Many employees plan to spend 10-40% of work hours at home while schedules at the office become more flexible. This will likely shorten rush hour commutes and accommodate more growth on existing infrastructure. Urban locations could become more accessible to the rapidly growing suburban workforce, spurring future waves of densification.
- **"Inflation" may re-enter our national vocabulary, but Dallas will outperform**
  Dallas will likely see above-average job growth as it did after The Great Recession. If corporate relocations accelerate, Dallas real estate could experience similar growth dynamics as the energy boom of the '70s and '80s. The region's exceptional industry diversity and modest levels of office construction will make growth more sustainable, decreasing the probability of experiencing another bust as Dallas did in the late 1980s.

Historical Perspective

Robert Duncan, the Chairman and Founder of Transwestern, shared these thoughts with *The Dallas Morning News* during the 1981 recession. The vision of Dallas presented here is just as true 40 years later.

Transwestern Property takes aggressive stance

Transwestern Property Company will start 1,000,000 square feet of office space in Dallas this year — an aggressive stance for any developer but especially for this investment building firm which took its first breath of life in early 1978.

Why this optimistic surge in an environment characterized by an economic recession, unruly financial markets and what could be a soft office building market? "Because the right product can still be very effectively marketed in Dallas, Texas," answered Robert Duncan, president of the Houston-based development firm.

"First of all, Dallas is in robust health economically and will require a good deal of space. In fact, I think Dallas' real strengths as a major urban center are just now emerging. This community, with its matrix of desirables, could have the greatest growth potential of any city in the country, including Houston.

Source: NewsBank/Dallas Morning News

Tenant Perspectives

The 'New Normal' For Office Space Isn't New

Since the first week of lockdowns in early March 2020, speculation has been rampant about how office will change in the "new normal."

After factoring in unique aspects of the Dallas market—and more importantly, reading surveys closely to ensure they are correctly interpreted—Transwestern believes the mainstream narrative around office space will be most applicable to gateway markets. Sunbelt markets such as Dallas will likely outperform national trends for several reasons:

- **Dallas did not densify as much as gateway markets.**
  Floorplans approached 7-8 employees per 1,000 SF in ultra-dense markets, but densification was significantly less intense in Dallas. The simplest explanation is that Dallas is a car-oriented city, so office density is constrained by parking that can only support 4 or 5 employees per 1,000 SF.
- **Most employees want flexibility, not an either/or choice between home or the office.**
  Surveys indicate most employees want to come back to the office with a hybrid work schedule that allows them to work from home 10-40% of the week, whether through 1-2 full days, partial days, or some combination of the two.
- **Employees have realistic expectations.**
  Employees are candid when asked about their "ideal" or "preferred" workplace environments. When asked what they expect employers to *actually change*, the vast majority offer practical and easy-to-achieve solutions.
- **Most employees want cultural changes, not physical changes to floorplans.**
  In fact, the ***only*** three items that received majority support in Gensler's *U.S. Work From Home Survey* were "stricter policies against coming in sick," "increased opportunities to work from home," and "increased office cleaning." These are operational changes requiring no modifications to space. Employees who desired physical changes were mostly located in 'totally open' floorplans or had shared desk arrangements, which are present in Dallas but not common.

*The bottom line: Most change will not occur **to** the work place, but **in** the workplace as flexibility and collaboration become more common.*

At the same time, qualitative improvements ***cannot*** be overlooked. "Comfort" is consistently the main reason employees want to continue working from home long-term, yet "comfort" rarely influenced office finish-out before the pandemic. This is an area where most small and mid-size office users can make a little investment go a long way with targeted improvements to shared spaces and spartan break rooms.

The good news: Leaders of closely held businesses have a unique advantage by maintaining a direct connection with the people they lead every day.

Fortune 500 companies are hiring teams of consultants to make sense of conflicting opinions of thousands of employees across sprawling real estate portfolios. Local business leaders can directly ask employees, or better yet, empower their respected colleagues to figure out what changes would have the greatest impact on employee experience and productivity. This level of ownership and transparency will also increase confidence that leadership's later plans to return to the office are guided by a desire to return to a better workplace and a better work culture.

More insight and perspective can be found in Transwestern's recent posts:

- 6 Strategies to Make A Long-Term Decision in an Uncertain Market
- The 'New Normal' For Office Space is More Familiar Than We Think

Tenant Perspectives

Navigating Through The Next 12-24 Months

As a general rule, the business cycle determines the relative bargaining power between tenants and landlords in lease negotiations. When the economy booms and many businesses expand, multiple tenants compete for space and landlords tend to have more bargaining power. When the economy contracts, demand for office softens and more sublease space becomes available, shifting bargaining power back in tenants' favor. This give-and-take is how many companies make brand-enhancing space decisions during a downturn while simultaneously realizing cost savings and productivity gains.

The unprecedented nature of the pandemic and the historic fiscal and monetary response will likely create unusual features for this recovery. Transwestern believes these factors may lead to a relatively shorter period for businesses to take advantage of cost savings relative to past experience:

Supply and demand factors differ significantly from past recessions

- Transwestern estimates **12-15 million SF of pent-up office demand** will rematerialize when expectations about vaccine distribution solidify and revenues improve for most businesses by Q4 2021.
- PPP loans brought needed relief, but also ensured landlords could maintain rent collections at higher levels compared to a typical recession.
- Tenants usually gain bargaining power when new buildings deliver during a recession with little pre-leasing. Prior to the pandemic, developers were more cautious with speculative development.

These factors indicate that an abnormally high number of tenants will be in the market during this recovery. As landlords enter more negotiations and gain confidence in the market's strength, they will likely begin winding down concessions. Transwestern believes this could begin in as soon as **4-6 months** and perhaps sooner in well-positioned properties with low vacancy.

*Business leaders can stay ahead of the curve by acting on space needs **now**, not in late 2021/early 2022 when many will be acting on them.*

Recovery and inflation

Recent capital market moves suggest expectations for inflation may be building. While it is difficult to distinguish optimism for recovery (higher economic growth) from fears of inflation (higher price growth), Transwestern believes the Dallas office market will likely outperform in either case:

- Dallas will likely recover sooner than metros that experienced greater business failure and/or have less friendly business climates, allowing demand for office to recover sooner in Dallas.
- If the Fed prioritizes labor market recovery over inflation control, monetary policy could lead Dallas into an expansion cycle while *national* employment is still recovering.
- Corporate relocations could accelerate, as lagging recovery or above-average inflation would make Dallas' business climate more attractive to companies in high-cost markets.
- Office rents are sensitive to inflation as the real return for office investments is diluted. Investors will look to bring real returns in-line with actual (or expected) inflation by increasing rents more rapidly and/or reducing concessions.

The likelihood for Dallas to outperform while pent-up demand for office returns underscores the unique opportunity for businesses to achieve cost savings in 2021.

Landlord Perspectives

The "New Normal" For Office And When It Arrives

While the future of office is more hotly debated in gateway markets, sunbelt markets like Dallas have fundamentally different demand drivers and relationships with density. As a result, Transwestern expects sunbelt markets to outperform national trends.

In a typical downturn, researchers in commercial real estate generate short-term forecasts for the office market by using prevailing trends of office density to correlate job loss and recovery with negative and positive net absorption, respectively. So far, forecasting has been challenged by the pandemic, timing of vaccine distribution, and uncertainty around the long-term effects of the unprecedented levels of fiscal, monetary, and regulatory intervention by governments at all levels. Potential shifts in office density also make rule-of-thumb assumptions about job changes and office absorption less reliable.

The good news: we know more than we think.

- **Perspective on "pre-COVID levels" is important.**
  Forecasts of "return to pre-COVID levels by 2025" are often discussed with an uncertain tone, but this lacks context that pre-COVID indicators were outperforming in Dallas after a decade-long expansion cycle. With office activity expected to resume by late 2021, a return to normal by 2025 is the equivalent of **closing a 10-year gap in just 4 years**. This should lead to optimism, not pessimism.
- **The net impact to office demand will not be as extreme as some have predicted.**
  A July report by the Atlanta Fed indicated the bottom-line change to office footprints will likely be marginal (–2.8% to +0.4%). A more recent survey of executives by the Dallas Fed showed **75% expect no permanent change to office footprints** following COVID, while 5% expect an increase. 20% expect a decrease, but this follows pre-pandemic trends of companies moving to denser floorplans for efficiencies and cost savings.
- **Changes will not happen overnight but will be accelerated through pent-up demand.**
  Understanding when and how much pent-up demand returns is critical to understanding how quickly post-COVID changes to space impact office market absorption and vacancy. Transwestern's lease database shows most businesses signed 12- to 36-month extensions at the beginning of the pandemic, which gives the office market a period of several years to work through these changes while the economy picks up steam to return to full employment.
- **Many forecasts do not account for inflation.**
  Effective rents in office properties are sensitive to inflation as investors want to maintain real rates of return. Examples include pension funds where inflation impacts forecasts of future retirement needs or public REITs that seek to maintain a dividend yield that remains competitive with other investment types.

The missing piece of the puzzle: quality datasets that ground forecasts in reality

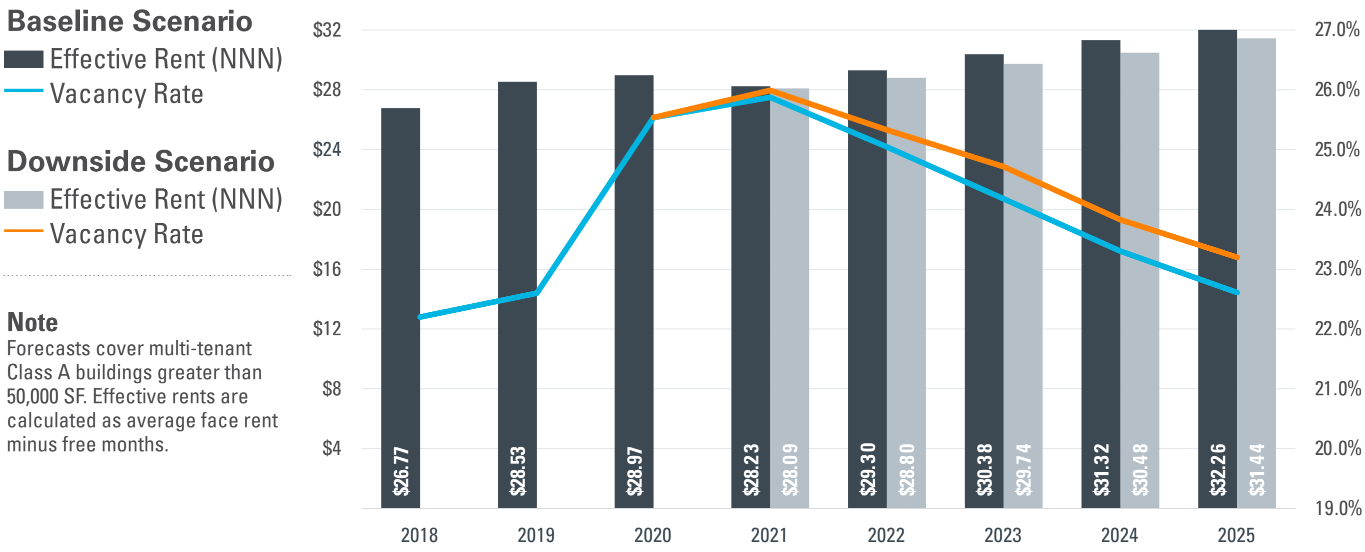
Transwestern is in a unique position to forecast these trends given the large volume of transactional data produced and analyzed in the company's day-to-day business. In the Dallas market alone, Transwestern's resources encompass databases tracking office tenants that occupy 153 MSF, 12,000+ lease transactions spanning more than 20 years, and high frequency data monitoring 9+ MSF of sublease space at the suite level. Granular data at this scale can be mined to provide deep insight into how the Dallas office market behaved during and after the 2001, 2007, and 2020 recessions.

With all these resources, Transwestern has produced two forecast scenarios for the Dallas office market:

- A **Baseline** scenario representing Transwestern's current expectations based on available data, research, and on-the-ground intel.
- A **Downside** scenario that takes a more conservative view about the timing of Fed policy against inflation, the length of economic recovery, and how much work-from-home impacts office demand.

Landlord Perspectives

Transwestern Forecasts For The Dallas Office Market



Note
Forecasts cover multi-tenant Class A buildings greater than 50,000 SF. Effective rents are calculated as average face rent minus free months.

Effective Rents return to pre-pandemic levels as early as 2022.

- Effective rents in Dallas continue to grow despite historically low leasing volumes and concessions increasing at rates similar to the past two recessions. Transwestern's analysis of lease transactions indicates landlords achieved this by holding firm on starting rent/escalations and obtaining longer term.
- Forecasts show a small dip in effective rent in 2021 as historical experience suggests tenants may receive one additional free month in concessions while office demand is soft. Nevertheless, pent-up demand will likely close the window of opportunity for tenants to receive generous concessions faster than previous recoveries.
- The Baseline scenario assumes inflation picks up in 2022, returning rents to pre-pandemic levels in nominal terms. The Downside scenario assumes the Fed hikes rates sooner to snuff out inflation, dampening economic growth and leading to a longer recovery. Nevertheless, effective rents in the Downside scenario return to pre-pandemic levels in 2023.

Vacancy likely peaks in 2021 before returning to pre-pandemic levels by 2025.

- Pent-up demand will likely return market vacancy to pre-recession levels in a shorter time than the past two recoveries.
- Sublease space could be absorbed sooner as floorplans did not densify as much in Dallas, increasing the probability that available stock can fit tenants' needs.
- Pre-pandemic construction keeps market-level vacancy elevated for a few years, but **67% of deliveries** are concentrated in Class AA product in the Uptown/Deep Ellum area with full service rents exceeding $58 PSF. As a result, construction will have an uneven impact across submarkets and asset classes.
- Nevertheless, Class AA properties will lease-up as exceptional quality remains the top motivator of tenants who lease trophy-class space. These properties will also capture out-of-market relocations.
- Well-positioned, highly-amenitized Class A buildings in prime submarkets will likely be less impacted by construction.

Lastly, it is important to note that these forecasts only predict overall market conditions. Transwestern believes the key differentiators between outperforming and underperforming properties will always be inherent attributes, the effectiveness of marketing efforts, location quality, and submarket dynamics.

A copy of the forecast model is available to clients and friends of the firm by contacting Transwestern's local Research team.