Latest Open Text (TSX:OTEX) Action Highlights the Biggest Risk Facing Office REITs Today

Description

The latest corporate restructuring exercise at tech giant **Open Text** (TSX:OTEX)(NASDAQ:OTEX) announced in the company's quarterly earnings release on Thursday magnifies the biggest market structural risk that faces global office real estate investment trusts (REITs) operators today.

What's Open Text doing?

In response to the COVID-19 pandemic, Open Text announced a comprehensive restructuring exercise that will save significant operating costs and boost earnings for several years to come.

The profitable and cash flo-rich dividend-growth-company is temporarily reducing its payroll expenses for the remainder of this quarter and for fiscal 2021. The CEO's salary, directors fees, executive team, and management salaries will take double-digit cuts. The company is reducing its discretionary spending, too. However, its other permanent move could be a concerning signal for office real estate investors.

"The permanent restructuring programs include, our work from home has been amazingly productive, given this we decided not to reopen approximately 50% of our offices and institute a hybrid model with some employees continuing to work from home," the Open Text's CEO said in an earnings conference call on Thursday.

OTEX will close the offices immediately and permanently. Although this move affects only 15% of its workforce, the sudden discovery that half the offices were not really necessary for the company's smooth operations is a big issue for office space owners.

Why should office REITs care?

Generally, office real estate operators enjoy long-term (five- to 25-year) lease terms. Base rents are usually fixed and periodically adjusted upwards. Tenants usually their proportionate share of operating expenses, common area costs, and property taxes. Office rental expenses are therefore significant for tenants and affordability can be an issue during economic shocks.

Most noteworthy, office occupancy levels may decline during tough financial times, as renewal rates decline on expiring leases. Office REIT investors expect economic recoveries to result in increased corporate hiring rates and improved demand for office space.

There has been a slow trend towards digitization and cloud computing that allowed companies to require fewer offices as employees work remotely. However, office space demand has remained relatively high, and occupancies stable. However, the COVID-19 pandemic could have disrupted the office space market permanently.

The pandemic, associated social-distancing protocols, and national lockdowns required almost everyone to work from home. Suddenly, old traditions and cultural tendencies that made companies resist the migration to remote work arrangements are tested and broken.

I posit that the pandemic has amplified and accelerated an already underway digital migration, where physical offices and printing paper are being squeezed out of the corporate system.

Just like OTEX, many companies could have discovered that not every employee should have an office at company premises for productivity to be controlled.

“Moving to the cloud is contactless for most customers businesses. The edge is as important as the cloud. Remote work is here to stay … (and) working from home is an essential part of the new equilibrium,” Open Text CEO Mark Barrenechea said in an earnings conference on Thursday.

Foolish bottom line

I understand Open Text’s CEO’s position. Over 95% of the company’s staff globally have been working from home during lockdowns, and management could have learned to trust the new low-cost work arrangements.

Many other companies could decide to take the Open Text route. Firms could decide to cut back on their office space requirements as the work-from-home culture gets adopted globally. If this happens, office REITs could battle to maintain occupancy rates in the future, as old leases expire going forward.

That said, OTEX is only a technology firm with vested interests if we all work remotely forever. Further, the tech industry can still function very well with people working remotely. Perhaps we shouldn’t look much into this tech giant’s work model.

Happy investing.

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