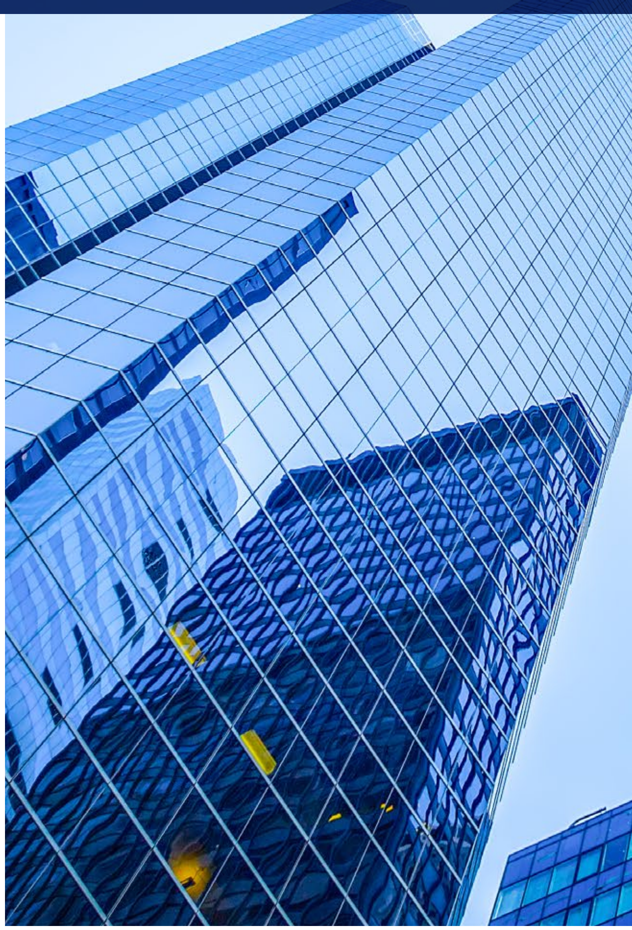
HAS THE US OFFICE MARKET BOTTOMED OUT?

Demand levels off after steep drop in 2022 and 2023.

By Craig Van Pelt



The start of the Covid pandemic is now more than 4 years in our rearview mirror. From a commercial real estate perspective, no sector was more negatively impacted than the office market. Through the second half of 2024, the US office market is down nearly 6.3 percent (or 297 million square feet) in terms of occupied, direct leased space, compared to pre-Covid levels. Additionally, there is another 130.7 million square feet of vacant available sublease space. After this much carnage, is the office market at the bottom of this cycle?

There is evidence that the market is beginning to level. While net absorption has been negative for 16 of the past 17 quarters, the amount of negative absorption in the most recent quarter was at its second lowest level since the start of 2020. Further, the amount of available sublet space has decreased for 4 straight quarters, while overall new supply is dwindling, with new office construction starts at historic lows. However, according to lease data available through CoStar and Cresa, leases signed before the start of 2020 are just over halfway through rolling.

The biggest driver of decreased office demand is remote work. Many companies have instituted different scenarios for addressing hybrid and/or remote work. With approximately 2+ years since many workers returned to the new normal, return-to-the-office has generally been baked into many organization's space planning. These levels are somewhere between 60 and 80 percent of pre-Covid levels. With 3 to 4 more years of pre-Covid signed leases slated to roll, it's likely additional office space will continue to be shed. However, with many companies having a clearer picture of office space needs and several years of post-Covid signed office leases, the stabilization of the office market appears to be taking hold. With little new supply being delivered and underutilized office space being converted to other uses, a better balance of supply and demand will be reached. Nevertheless, there is more room for the office market to drop and office occupiers will have leverage for the foreseeable future.

KEY POINTS

1 REMOTE WORK IMPACT

Office demand remains reduced due to remote/hybrid work, with occupancy levels hovering between 60-80% of pre-COVID levels.

2 LEASE RENEWALS LOOM

Many pre-COVID office leases are halfway through their term, with more space likely to be shed as leases roll over in the next 3-4 years.

3 STABILIZATION EMERGING

Despite room for further declines, reduced new supply and office space conversions to other uses suggest that a better balance of supply and demand is on the horizon.

LEASE EXPIRATIONS

Pre-Covid Signed Leases Continue to Roll

Class A office leases signed before the Covid-19 pandemic are approximately halfway (51.9%) through their roll, with 524.7 million square feet expired through August 2024. Moving forward, there is approximately 485.6 million square feet that is still set to expire through 2034. As occupiers continue to make decisions on strategic real estate plans, it is likely many companies will continue to right-size their space to reflect their current strategy to hybrid work scenarios. Further, new job growth will have a counter effect, especially if occupiers have over-compensated for expected reduced use.

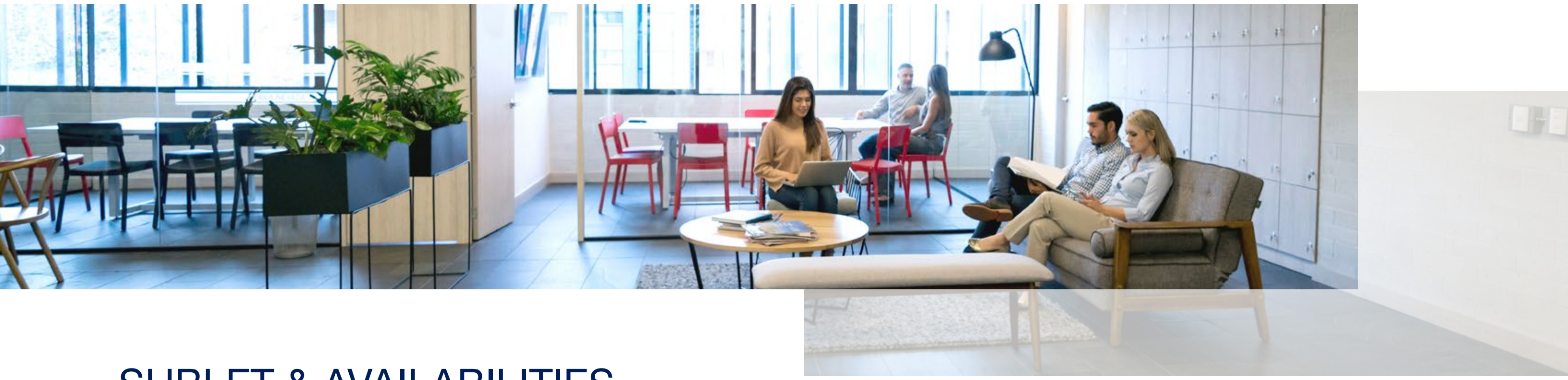
Leases Signed Prior to 2020 and Expirations by Year

Lease data includes Class A office space over 5,000 SF in the US

Source: CoStar and Cresa

Note; 2024 data is displaying before and after September 1, 2024

Visit cresa.com for more information.

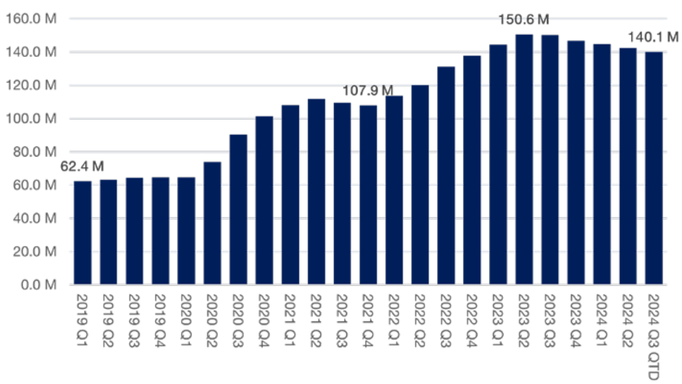


SUBLET & AVAILABILITIES

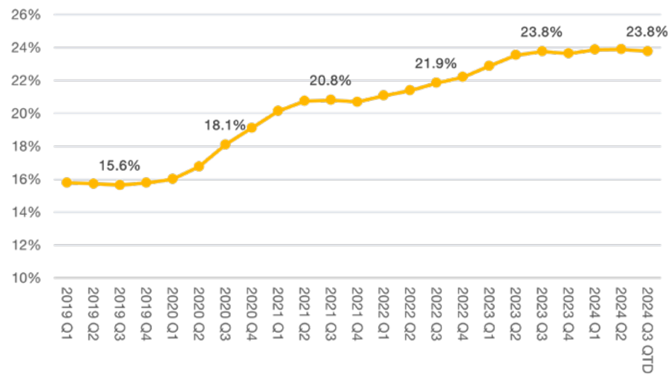
Both Sublet SF Availabilities & the Total Availability Rate Level-Off

Class A sublease space has fallen for four straight quarters, although it is still elevated based on historic levels. The availability rate, which includes the amount of space that is being marketed as available for lease, regardless of whether the space is vacant, occupied, available for sublease or available at a future date, has been at the same level for the past 4 quarters.

Sublet SF Available: United States (Class A)



Total Availability Rate: United States (Class A)



Source: CoStar and Cresa

LEASING TRENDS

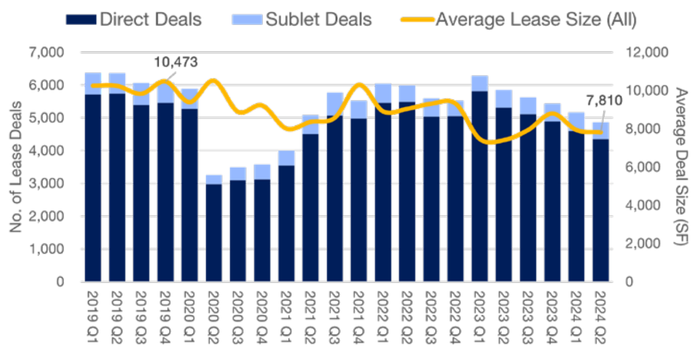
Deals Getting Done But the Number of Deals and Deal Size Shrink

Average lease sizes from 2021 through the second quarter of 2024 were 19.8 percent smaller compared to 2019.

The number of deals completed from 2021 through the second quarter of 2024 decreased by 11.8 percent compared to 2019.

The average lease size is showing signs of stabilization, but the overall number of signed leases has trended lower in the past year. It should be noted that with a cloudy, macro-economic landscape, it is likely many organizations are slower to sign new, direct leases and may be extending leases for a shorter term as they wait for the economy to slightly recover.

Sublet SF Available: United States (Class A)



SUBLEASE SPACE

Largest US Metros: Before & After Announcement of Covid 19

Sublease space has increased dramatically since the Covid-19 pandemic was announced during the first quarter of 2020. Cities that rely heavily on tech have been hit especially hard, such as San Francisco and Seattle, due to their ability to work remotely and job layoffs. Cities with more industry diversification have generally fared better. In the past 12-months, 12 of the 17 of the markets noted in the chart have seen a decrease in sublease space as a percentage of total inventory.

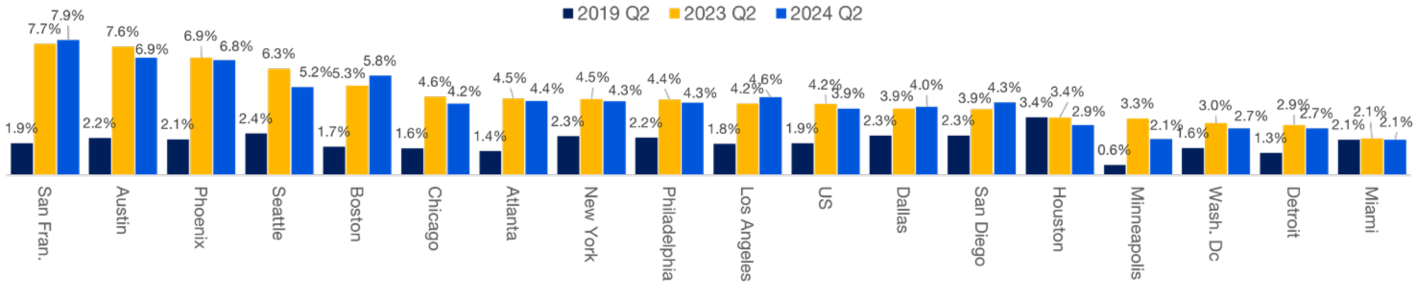
2.15x

Increase in sublease square feet on market between Q2 2019 and Q2 2024 in largest US Metros.

96.6 M

Square feet of sublease space available in largest Metros in June 2024, compared to 45.0 M in 2019.

Office Class A: Sublease Space as a Percentage of Total Inventory

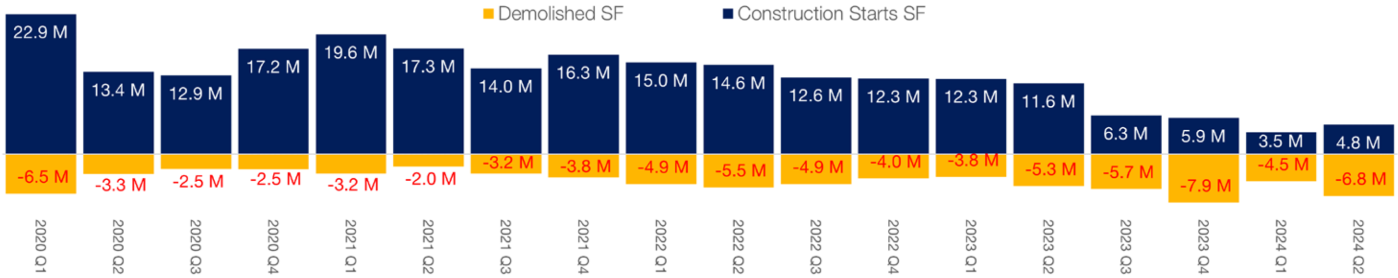


CONSTRUCTION

New Supply Nearly Stops with Demolitions Outpacing New Office Starts

As pre-pandemic office projects deliver, the amount of under-construction space is dropping. Weak demand, increasing construction costs and higher interest rates will likely stall many office projects. During the second quarter, less than 500,000 square feet of office starts got underway, the lowest number in the past quarter century. Since the second quarter of 2023, nearly 25.3 million square feet of office space has been demolished, compared to 20.6 million square feet of office starts over the same period. Pre-pandemic, the ratio of demolished square footage to construction starts square footage was about 21 percent. The ratio in the past year has been about equal, with more square feet demolished in the third quarter of 2023, compared to construction start square footage.

Sublet SF Available: United States (Class A)



Source: CoStar and Cresa

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OFFICE-OCCUPY JOBS

While remote work has fundamentally changed demand, job creation has historically been the driver of office demand. Office-occupying jobs are 6.3 percent higher, or 2.1 additional million jobs, at the close of July, compared to the of end 2020. However, job growth has slowed substantially with Information jobs declining in the past year, while all office-occupying jobs grew only 0.38 percent. Despite strong overall job growth since the start of the pandemic, office demand has sharply dropped.

CONCLUSIONS

The pandemic reset the US office market in the largest shift in a generation. With several years left on the role of many pre-pandemic signed US office leases, organizations will continue to right-size their space to meet current office demands. With overall office volume demand down around 20 percent, future demand will continue to trail pre-2020 levels. However, levels are stabilizing. Limited new supply should further help alleviate lower demand, but slowing office-occupying job creation will put additional pressure on landlords to fill space. While the US office market has been reeling from four years of downward trends, there is additional room for office fundamentals to drop lower.

Tenant Perspective

Trophy and amenity-rich Class A space continues to support the flight-to-quality movement as occupiers downsizing space look to capitalize on cost-savings and provide elevated experiences for employees.

Sublease space is directly competing with direct space as tenants may be attracted by turnkey options and looking to minimize capital expenditures for building out spaces and rising construction costs.

After several years of landlords holding rents, asking rents have started to fall. Concessions continue to be a lever for landlords looking to attract occupiers.

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Craig serves as the Head of Research for Cresa, the leading commercial real estate tenant advisory in the world. The research role provides insight, thought leadership, and trends impacting occupiers of real estate, and supports existing client relationships and business development.

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