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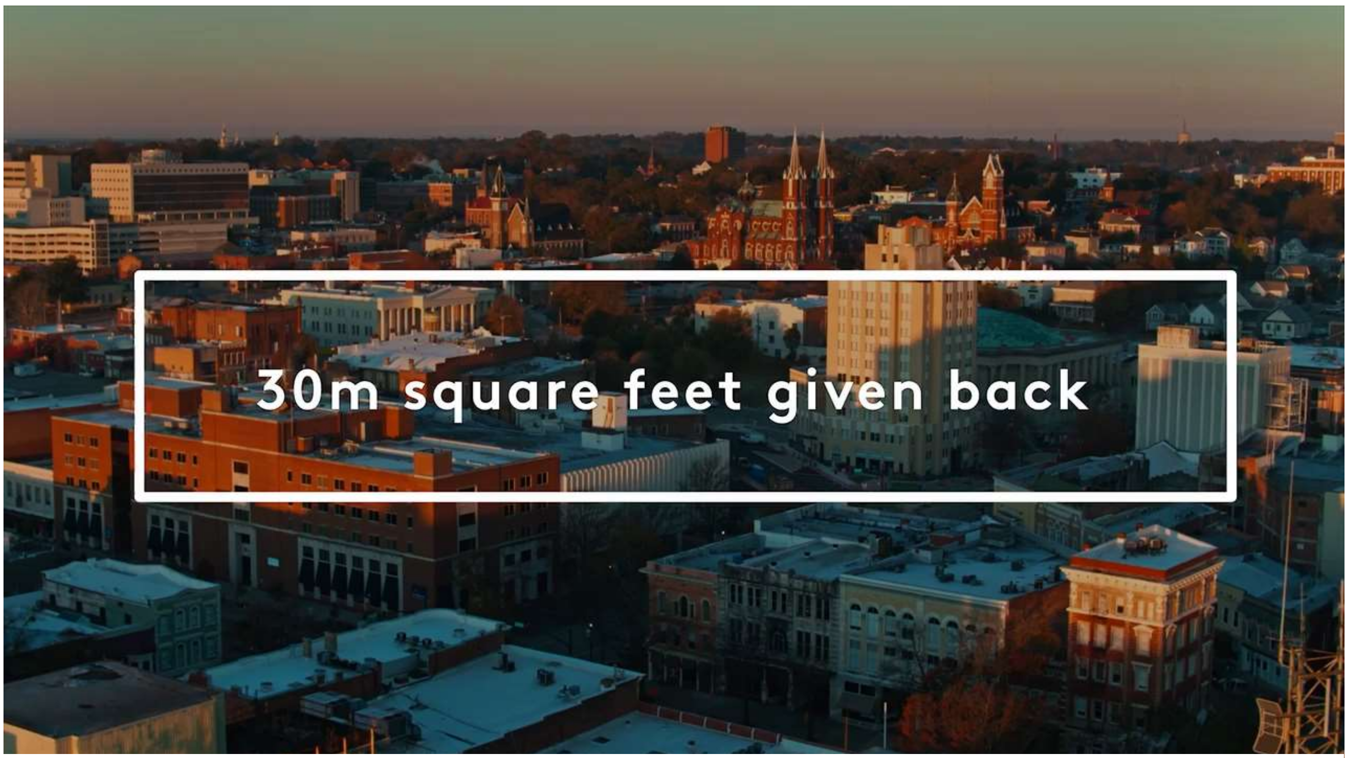
With a Recession in the Forecast, Office Faces a Long Recovery

Slow Leasing and Rising Availability Highlight Market Softness



By Phil Mobley
Market Analyst

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The year is off to an uneasy start for the skyline-defining office sector. So far in 2023, tenants have already returned more than seven times as much square footage to the market as they did in all of 2022.

Meanwhile, the national vacancy rate has risen to a record at just under 13%, surpassing its Great Recession-era peak. And with more than 66 million new square feet of space set to be completed this year — the most since 2008 — it looks set to go even higher.

The weakness in leasing activity comes even as job growth has remained surprisingly strong. Despite headline-grabbing layoffs at tech and financial services firms in recent months, overall employment in office-using industries is still growing and is now where pre-pandemic trends suggested. The disconnect is another signal that space requirements per worker are still in flux.

Things aren't expected to improve in the coming months. Turbulence in the banking sector may alter the Federal Reserve's timeline for more interest rate increases, but many economists are still anticipating a recession within the next year.

Because of this, a growing number of office occupiers are scaling back their office footprints. After rebounding in 2021 and early 2022, new leasing volume fell almost 20% below its long-term average in the fourth quarter. At the same time, sublease availability resumed its rise, ending 2022 up nearly 25% for the year and more than 100% since 2019. The combination of slowing leasing volume and rising sublease availability suggests corporations are looking to trim costs, even as most of them have yet to trim payrolls.

If rising interest rates have cooled the economy and chilled office leasing, then they have frozen capital markets. At just under $25 billion, investment sales of office property in 2022's fourth quarter were lower than in any fourth quarter since 2009. With uncertainty surrounding the future value of offices, the bid-ask spread has widened. A recent spate of loan default announcements could be an ominous sign that not all sellers will be able to weather the storm.

Amid all the various forces at play, the impact on landlords has been anything but uniform. Demand has stayed resilient in buildings delivered since 2015, with tenants taking up an average of nearly 60 million square feet in each of the past three years. At that same time, tenants have shed almost 100 million square feet per year in older buildings.

The divergence is so severe that over half of all currently vacant office space is housed in about 20,000 buildings. While vacancy has nearly doubled in these buildings since the beginning of 2020, in all others, the vacancy has returned to where it was.

The shock to office demand delivered by the COVID-19 pandemic created clear winners and losers in the office market, and the gap between them is widening. There is a real prospect that the highest and best use for many older, high-vacancy buildings could be something other than office.

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