COSTAR INSIGHT

Stabilizing office demand shows resilience — and a few cracks

After five quarters of declines, tenants start holding onto more space

New York's recent demand surge has contributed to a national stabilization in office occupancy. (Paul Winner/CoStar)

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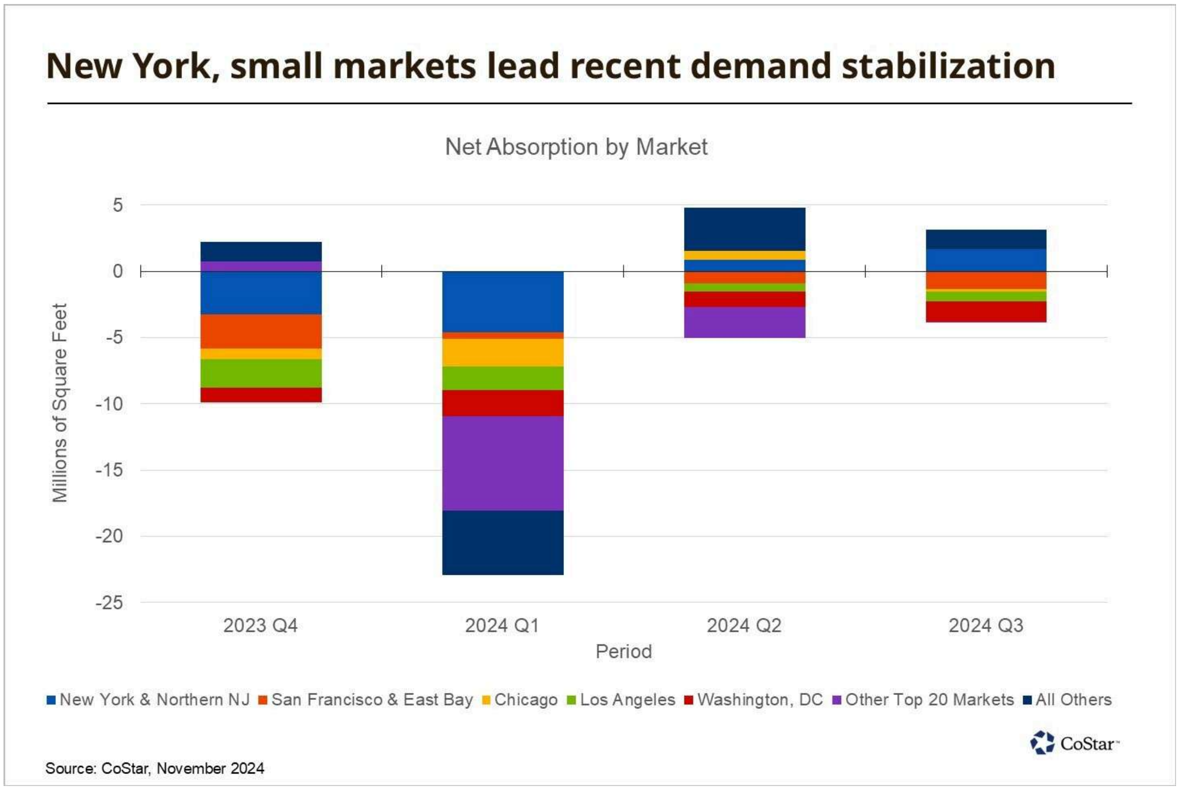
Earlier this year, office occupiers suddenly started holding onto more space, dramatically slowing five quarters of sharply declining demand. Most U.S. markets had an increase in total office occupancy in the second and third quarters, a clear change in momentum. Still, a deeper look reveals that the office recovery is likely to be long and bumpy.

Tenants gave back about 1 million square feet of office space in the second and third quarters, a negligible amount after almost 23 million square feet was returned in the first quarter alone. A combined 86 million square feet of office space was returned since the beginning of 2023.

This flattening demand occurred despite an ongoing slump in leasing volume, suggesting that a number of occupiers have abruptly paused what had become a pattern of substantial shrinking of their office footprint. Instead, more office tenants have recently chosen to hold onto space for their employees to use with increasing frequency.



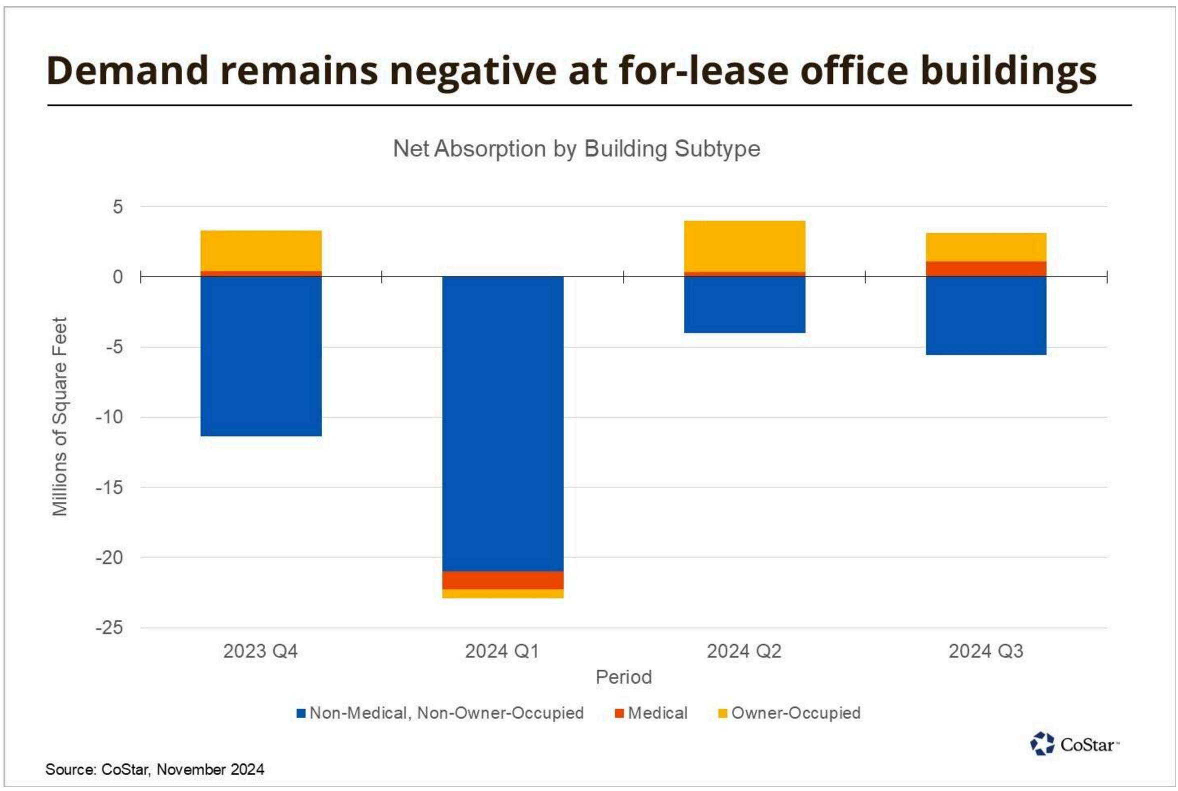
The shift in office demand has been broad-based. In the second and third quarters, more than half the country's office markets posted positive net absorption, the change in occupied space over time, compared to barely a third in the first quarter.

Perhaps most interesting, New York City has led the charge with 2.5 million square feet of positive absorption between April and September of this year. Financial firms, in particular, have driven a resurgence of office demand in the nation's largest city.

Office demand has also increased in secondary and tertiary markets, those outside the largest 20 markets. The group collectively posted 4.8 million square feet in positive absorption over the same time. Even Chicago's beleaguered office market experienced positive absorption to the tune of over 400,000 square feet since the beginning of the second quarter.

Other markets, however, are still waiting for the rising tide to arrive. Office absorption has remained decidedly negative in some of the cities that have been hit hardest by shrinking demand in the past five years, including the San Francisco Bay Area, Los Angeles, and Washington, D.C. In the aggregate, other top 20 markets have also yet to see absorption turn positive.

This geographic unevenness indicates that the recent pause in office move-outs across numerous markets may not yet signal a general recovery. Another is that absorption has continued decline in traditional, for-lease buildings, albeit to a lesser extent.



Non-medical office buildings that are not owner-occupied lost about 9.5 million square feet in occupancy during the second and third quarters. While this was well short of the 21 million square feet lost in the first quarter and the 11.4 million square feet lost in the fourth quarter of last year, it exhibits the leasing market’s overall softness. While office tenants may have slowed their move-out behavior, there were not enough new move-ins to offset the amount of move-outs that still occurred.

Aside from medical office buildings, which rely on fundamentally different demand drivers, recent absorption trends have been supported by owner-occupiers. They moved into nearly 8 million square feet in the past year, including 5.7 million square feet in the second and third quarters of this year. Office owner-users have shown consistent demand throughout the post-pandemic era and now account for an increasing share of office building buyers.

Fewer move-outs are a welcome sign for office owners who have had difficulty backfilling vacated space and face a future of structurally slower growth in the knowledge workforce that their buildings serve. They will be hoping the recent stabilization in office demand marks an inflection point and the beginning of a wider recovery.