

## New Habits Change the Landscape for Offices; Recovery Likely to Extend into Next Economic Cycle

**Future of office space demand still evolving.** The COVID-19 pandemic has fundamentally altered how many people interact with the office. The rapid, widespread adoption of remote work has now given way to a nuanced workplace return. While some large firms, such as Tesla and Goldman Sachs, have pushed for full in-office work weeks, other major companies — including Microsoft, Apple and Target — have formalized hybrid schedules. Some organizations, like Amazon, are leaving the decisions up to individual teams, or are embracing virtual environments, as Allstate has done. Overall, businesses are pursuing a broad spectrum of strategies, many of which are still in flux, that will have nuanced, long-lasting impacts on office space demand.

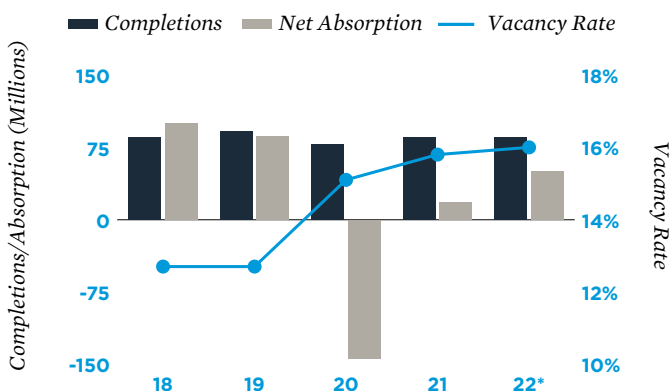
### Return to pre-2020 occupation requires new company creation.

While there is no one strategy for adjusting their workplace policies, an overarching connection is that, for most firms, especially local or regional organizations, offices continue to play a central role. Offices provide a secure location to store sensitive information and critical infrastructure, as well as serve as a hub for team collaboration and training. However, with more employees working remotely more often, less space is needed. Occupied square feet was short 126 million of pre-pandemic levels entering this year, and net absorption has been modest since. While this is keeping vacancy elevated for now, over time, demand from new companies will backfill some of the vacated space. Staff counts have already risen above pre-2020 levels, which will help compensate for less space needed per employee.

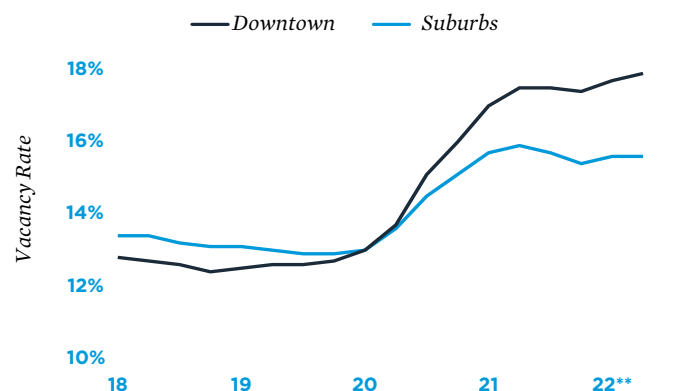
**Migration patterns buttress suburban offices.** Since the pandemic, suburban properties have proven more resilient than their downtown counterparts, due heavily to demographics. Millennials are advancing into their mid- to late-30s, correlating with a preference for more space and homeownership, prompting relocations to more residential neighborhoods. Many households have migrated to less dense cities, where suburbs represent a larger share of property inventories. By locating in these settings, employers are able to be closer to their staff, reducing commutes and aiding retention, while also potentially lowering overhead. Across all major U.S. markets at midyear, asking rents in the suburbs were on average about two-thirds the cost of space in central business districts. These factors have helped the absorption of about half of the space that was relinquished during lockdowns.

**Urban office dynamics still balancing.** Floorplans in downtown areas continue to come up for lease. While briefly positive in the second half of 2021, omicron-induced delays to workplace return plans set net absorption back on a negative path this year. After more than two years of waiting, some companies are finally executing on lease terminations. This is especially true of mid- and low-tier space in the nation's largest central business districts. Even in high-cost metros, such as New York, there is demand for Class A trophy space, as quality amenities and small living spaces can entice staff into the office. Overall though, CBD office properties face a structural downshift in demand that will take time to replenish as the next business cycle brings new companies.

### Supply and Demand



### Suburban Vacancy Holding Below CBD

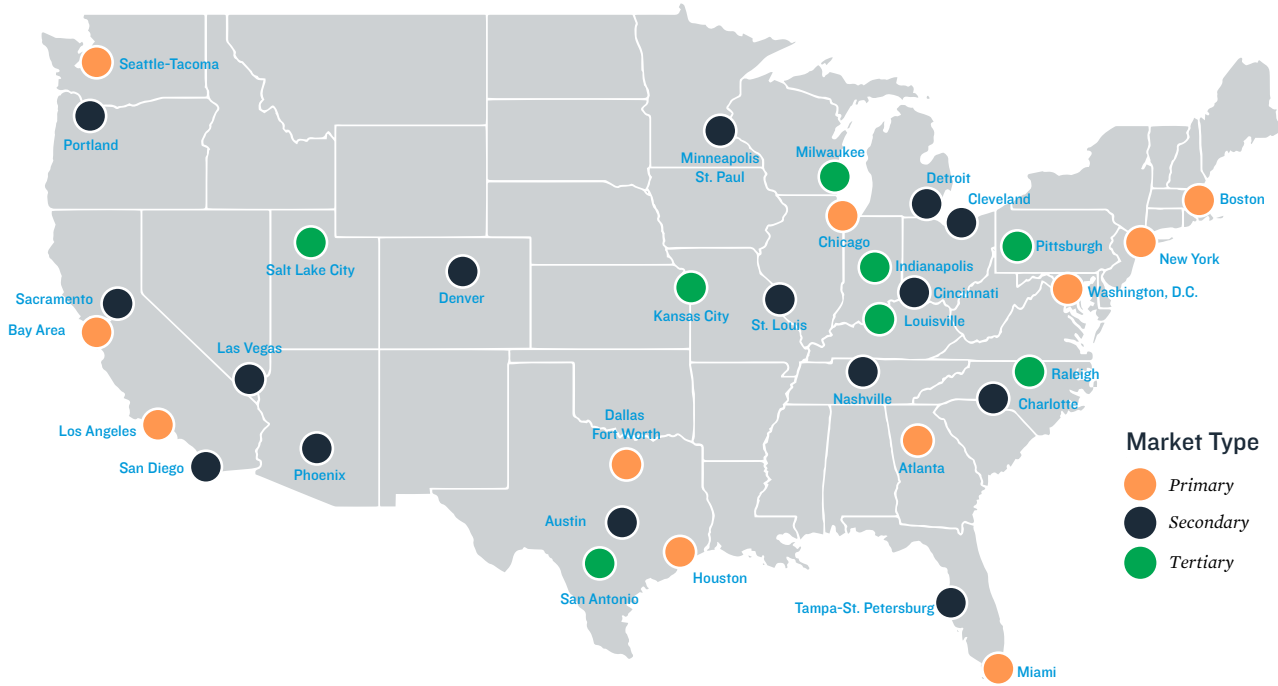


\* Forecast \*\* As of 2Q

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

Tertiary Markets Report Lower Vacancies as Secondary Metros Pull Ahead in Rent Growth

Selection of Major Markets by Type:



Market Type Performance: 2Q 2022 – T-12 Month Period

PRIMARY	SECONDARY	TERTIARY
17.6% Vacancy 0 Basis Points Y-O-Y	15.1% Vacancy 0 Basis Points Y-O-Y	13.2% Vacancy +20 Basis Points Y-O-Y
\$34.23 Per Square Foot +1.0 Percent Y-O-Y	\$23.18 Per Square Foot +2.4 Percent Y-O-Y	\$20.39 Per Square Foot +0.9 Percent Y-O-Y

- Offices in the central business districts of primary metros, where space per employee is at a premium and commutes can be long, were unsurprisingly some of the most heavily-impacted locations by the pandemic. After climbing 550 basis points between the end of 2019 and June 2021, vacancy across the country’s primary CBDs has advanced more slowly, up 30 basis points to 18.6 percent.
- Suburban primary offices experienced a smaller availability shock, peaking in June 2021 at 17.1 percent. Modest improvement in the suburbs against lagging core areas has kept overall vacancy flat.

- Vacancy in secondary metro suburbs has declined 30 basis points year-over-year, in contrast to most other areas, facilitating rent growth of 2.9 percent, outdistancing both larger and smaller metros. Secondary markets may offer the right combination of population size and living cost that appeal to both residents and employers.
- Tertiary metros, which have historically reported tighter vacancies than larger cities, may be poised to see additional tailwinds. As secondary cities grow, nearby tertiary, satellite markets may welcome new residents and employers seeking more space at less expense.

Markets displayed above are not a complete list of all primary, secondary and tertiary markets, performance data based on a wider sample of major markets  
Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

**Stabilizing Fundamentals Bring More Investors Back to the Table**

**2022 Forecast**

**U.S. EMPLOYMENT**

**2.9% increase Y-O-Y**

- Hiring for 2022 is expected to reach 4.3 million new jobs, with around 1 million of those roles with traditionally office-using firms. Headcounts in the segment are already 4 percent above pre-pandemic.

**U.S. CONSTRUCTION**

**86 million square feet completed**

- Total deliveries will just exceed the 85.7 million square feet deposited in 2021. Yearly construction activity continues to lag the 100 million-square-foot threshold routinely surpassed in the 2000-2009 period.

**U.S. VACANCY**

**20 basis point increase Y-O-Y**

- After climbing 310 basis points in 2020 and 2021, office operations are beginning to stabilize. The national vacancy rate will inch up to 16.0 percent this year, as more companies make decisions on their space needs.

**U.S. EFFECTIVE RENT**

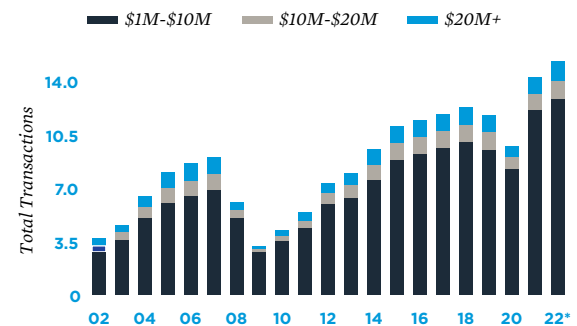
**1.1% increase Y-O-Y**

- After two years of negligible movement, the national average asking rent will advance modestly to \$29.13 per square foot this year. Rent growth is focused among direct leases in suburban settings.

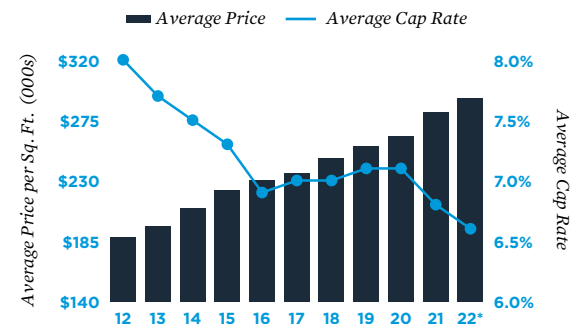
**2022 INVESTMENT OUTLOOK**

- **Sales activity historically high through midyear.** Despite the sector’s recent challenges, office trading achieved a new record over the 12-month period ended in June. Sales activity was up nearly 25 percent compared to the previous high set in 2018. Transaction velocity peaked in the final quarter of 2021, however, as aggressive monetary tightening by the Federal Reserve has added hurdles to the investment landscape this year. While down quarter-over-quarter, the number of assets that changed hands in the April to June span was nevertheless higher than normal for that time of year.
- **Higher yields, changing workplace habits highlight smaller metros.** A demographic migration trend favoring the Sun Belt and tighter yields in larger cities has sustained an ongoing shift in investment activity from primary markets to secondary and tertiary metros. Compared to 2019, the share of office trades over the past four quarters located in tertiary cities increased 4 percent to 47 percent, while the primary market metric dropped by a similar margin to 32 percent. In 2010, about 44 percent of trades were for offices in primary locations relative to 35 percent in tertiary settings.
- **Fewer near-term hurdles underpin medical office sales.** While down from late 2021 peaks, transactions for medical offices continued at a historically elevated pace in the second quarter. Given the health needs of an aging population, medical offices offer a favorable long-term demand outlook at comparable entry costs to traditional offices, which have more near-term hurdles.

**Office Transactions By Price Category**



**Investment Sales Trends**



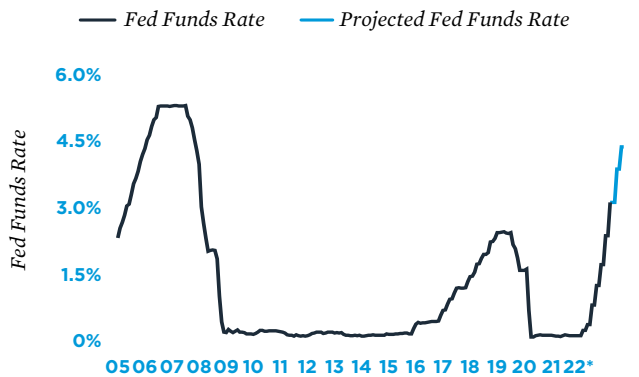
\* Through 2Q; trailing 12 months through 2Q for transaction activity  
Sources: CoStar Group, Inc.; Real Capital Analytics

## Fed Intent on Steering Economy onto Slower Trajectory; Lenders Tighten Criteria in Response

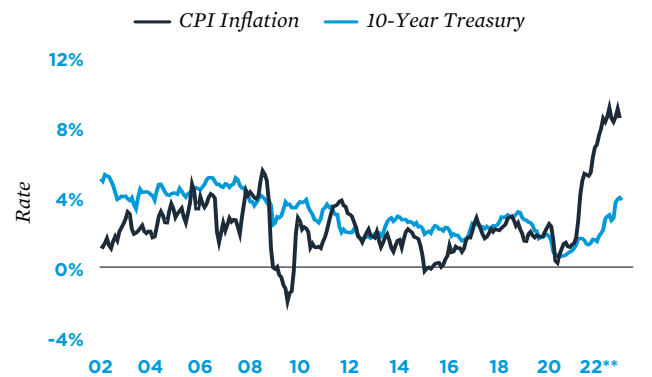
**Demand/supply imbalances push the Federal Reserve to extend aggressive rate hike schedule.** Persistently elevated inflation, driven by structural shortages of housing, goods and labor, which lack quick solutions, is pushing the Federal Open Market Committee to substantially tighten monetary policy. In order to bring the target range of the federal funds rate above 4 percent before the start of 2023, the Federal Reserve has raised the overnight lending rate a collective 300 basis points so far this year, with additional hikes anticipated in November and December. These higher borrowing costs have been paired with a quantitative tightening program, as the Fed works to reduce a balance sheet that inflated during the pandemic. The FOMC hopes that the resulting upward pressure on interest rates will help usher in a sustained, slow growth economic environment that will escort inflation metrics back to the central bank’s 2 percent target. To achieve this objective, the FOMC may foster an economic downturn. A recession would likely be much more mild than in 2008-2009, when the financial system was over-levered, or in 2020 when the pandemic forced a broad shutdown.

**Lenders making capital available to borrowers, but with tighter criteria and at greater cost.** The Fed’s ongoing commitment to tempering inflation continues to force lenders to recalibrate quoted rates. In order to compensate for disruptions in the capital market and the slower-growth near-term trajectory of the economy, financiers are also widening spreads on top of the higher base rates. Despite these changes, capital is still available for office investment sales, although financiers are being highly selective on what transactions they consider, even among borrowers with whom they have established relationships. Across both balance sheet and securitization lenders, underwriting criteria are tightening, with a heavy focus on higher debt-service coverage. Overall, capital is available, but it is more costly to borrowers. These forces have begun to exert upward pressure on cap rates.

**Fed Funds Rate**



**Inflation and Interest Rate Trends**



\* Forecast — assumes a 75 bps rate hike and a 50 bps rate hike before end of 2022; \*\* CPI through August; 10-Year Treasury through September 30  
Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; Federal Reserve

**Office Division**

**Al Pontius**

Senior Vice President, Director  
Tel: (415) 963-3000 | al.pontius@marcusmillichap.com

Price: \$1,500

© Marcus & Millichap 2022 | www.MarcusMillichap.com

Prepared and edited by:

**Cody Young**

Publication Manager | Research Services

For information on national retail trends, contact:

**John Chang**

Senior Vice President, Director | Research & Advisory Services

Tel: (602) 707-9700  
john.chang@marcusmillichap.com

The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein. Sales data includes transactions sold for \$1 million or greater unless otherwise noted. This is not intended to be a forecast of future events and this is not a guaranty regarding a future event. This is not intended to provide specific investment advice and should not be considered as investment advice.  
Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve Bank of St. Louis; Federal Reserve Bank of New York; Moody's Analytics; Real Capital Analytics; U.S. Census Bureau