NATIONAL REPORT
OFFICE

IPA | INSTITUTIONAL PROPERTY ADVISORS

2Q/23

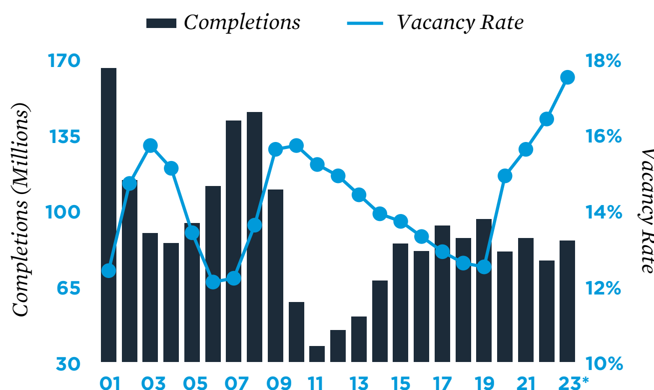
Office Users Face Diverging Paths as Needs Vary; Persisting Hybrid Work Clouds Long-Term View

Fundamentals remain challenged near-term. While health concerns have largely dissipated, ongoing hybrid work practices continue to impact the office sector. As leases end, companies are re-evaluating space commitments. In some cases, this is leading to office closures or consolidations. Asset and location-specific features are major influences on these decisions. National availability rose to 16.8 percent in March 2023, the fifth consecutive quarterly increase, and will likely stay on an upward track for the near future. The property type can be expected to stabilize over time, however, as developers respond to weakening fundamentals by curtailing development. Major office projects have begun to stall amid uncertainty and other proposals could be sidelined, reducing completions in the coming years.

Property performance heavily influenced by region. Office fundamentals vary dramatically across the country. In some areas, metro vacancy has surged above 20 percent, while others still sit below 10 percent. Areas of high net in-migration over the last three years have noted the strongest office performance. A plethora of companies relocated to Southeast Florida following the pandemic, aiding fundamentals in markets like Miami-Dade and West Palm Beach. Smaller, tertiary markets are also in stable condition as metros, such as Louisville and Charleston, claim sparse construction pipelines and boast growing populations. Heftier completion totals are more common among primary markets, where this supply pressure, along with greater business costs, are leading to higher availability.

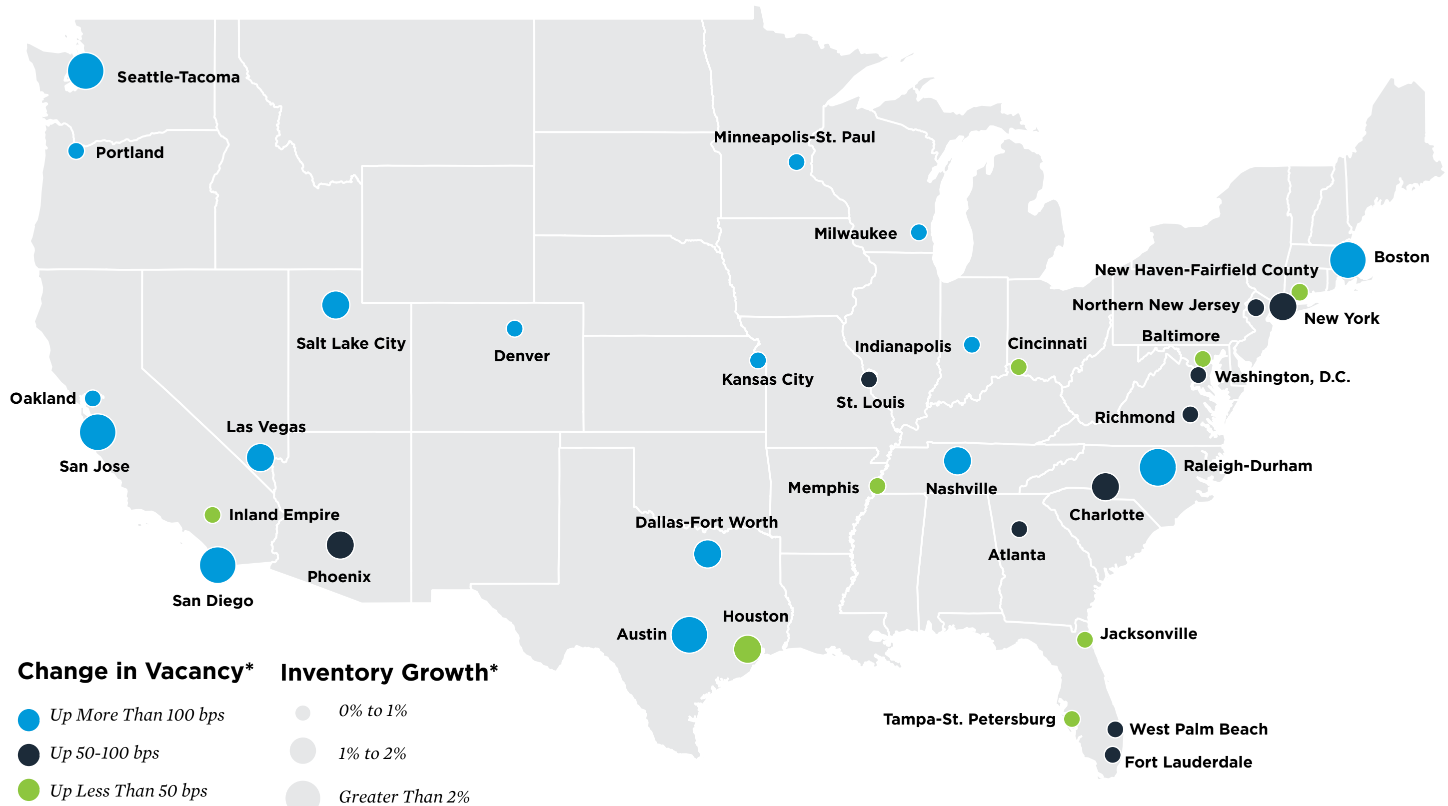
Office usage varies based on company needs and industry. Firms have taken a variety of approaches to in-person work. Some prominent companies, such as Netflix or Goldman Sachs, have reinforced commitments to working in the office. Others have indicated that hybrid work is the new company normal. Office space utilization in 10 of the largest U.S. metros has generally plateaued at around 60 percent, which may cause some companies to consider eliminating excess space. Tech-dominant markets generally have softer demand, due in part to anticipatory space over-commitment. Still, many industries, such as law or financial services, that require face-to-face interaction or confidentiality have less room for hybrid models. Pockets of demand exist in most metros where these industries are concentrated.

Hybrid work complicates long-term outlook. Companies' preferences have generally shifted toward suburban areas, aligning with the migration of the aging millennial generation. Urban properties face mounting headwinds, particularly in less commuter-friendly markets. Millennials are emerging as the next generation of business leaders, drawing employers to them. Suburban offices have noted lower availability than urban properties for three consecutive years. Macroeconomic uncertainty has also led many companies to cut costs. In March, the gap between vacancy for Class A and Class B/C space reached its greatest point as mid-tier vacancy was 910 basis points below the high-tier rate. While top trophy space holds appeal as a destination unto itself, broadly, demand for budget space may be more consistent.



* Forecast ** As of 1Q
Sources: IPA Research Services; CoStar Group, Inc.

Supply and Demand Realign in Smaller Metros; Development Headwinds Persist in Most Primary Markets



Selection of Markets by Expected Completions in 2023

TRADITIONAL OFFICE SUPPLY TRENDS

- While the national construction pipeline is moderating, it is unlikely to alleviate upward vacancy pressure. Some larger markets, such as San Jose, will still face supply challenges this year, exacerbating existing demand headwinds. Nine metros account for over half of the existing national pipeline, and four of these markets will end the year with availability over 20 percent.
- Secondary and tertiary markets — such as Cincinnati and Memphis — with limited pipelines are generally positioned to record more favorable changes in availability. Those expecting less than 1 million square feet project a 90-basis-point vacancy rise on average, compared to areas delivering more than 1 million square feet increasing vacancy by nearly 150 basis points.
- Compared to the national average, Midwest CBDs are performing well. Seven of the 10 lowest downtown vacancy rates in the U.S. are held by Midwest or just South markets, all with vacancy rates of 13.6 percent or lower in March. Going forward, commuter-friendly metros like these may fare better than densely-populated areas as companies hope to reduce employees' travel times.

MEDICAL OFFICE SUPPLY TRENDS

- Of the space slated to come online in the U.S. during 2023, approximately 14 percent is categorized as medical office. While only a fraction of the pipeline, strong demand for specialized space will help backstop availability in the office sector amid headwinds.
- In metros with medical office-heavy pipelines, robust demand for these spaces may offset vacancy challenges caused by traditional offices. Riverside-San Bernardino, for instance, expects to maintain the lowest traditional office vacancy rate among major U.S. markets in 2023. This can partially be attributed to strong medical office fundamentals. Medical office vacancy here was at 6.8 percent in March, and over 90 percent of 2023 deliveries fall in this category.
- In both medical and traditional office sectors, delivery delays began to crop up in the first half of the year. Projects have stalled or scaled back as builders assess the cost of construction, the current lending environment and ongoing labor shortages. Complications stretching through the first half of the year could mean many project proposals fail to come to fruition. This would aid the long-term supply risk as companies look to existing properties for space.

** Forecast*
Sources: IPA Research Services; CoStar Group, Inc.

Investors Cautious as Fundamentals Continue to Stabilize

2023 Forecast

U.S. EMPLOYMENT

1.2% increase Y-O-Y

- By the end of 2023, total employment will be 3.3 million jobs higher than ever before. Despite unemployment entering the year at a multi-decade low, approximately 1.8 million positions will be added.

U.S. CONSTRUCTION

86 million square feet completed

- Supply additions will surpass last year's 76.7 million-square-foot completion total. Inventory will, however, expand slower than the long-term average of 1.2 percent, reaching only 1.0 percent year-over-year.

U.S. VACANCY

110 basis point increase Y-O-Y

- Availability will reach a record high mark in 2023, elevating to 17.5 percent. Nevertheless, the annual basis point change will be lower than the 250 basis point surge noted in 2020.

U.S. ASKING RENT

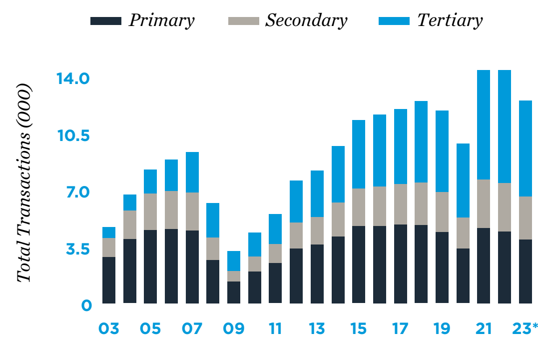
0.5% increase Y-O-Y

- This year will be the fourth period with a moderate asking rent increase as new and high-tier space becomes available, influencing the mean rate. The average asking rent will land at $29.13 per square foot.

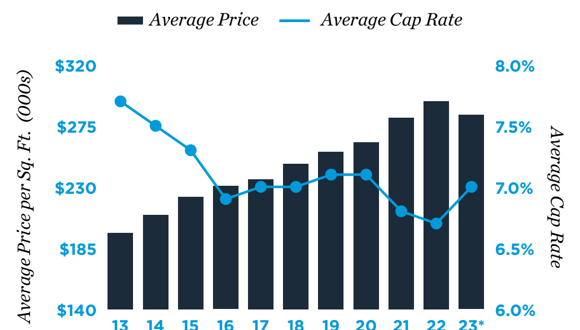
2023 INVESTMENT OUTLOOK

- **Sales activity tempered by aggressive monetary policy.** The Federal Reserve's interest rate hikes contributed to a slowdown in trading during the trailing 12 months ended in March. Transactions tapered in the first quarter, a trend that is likely to carry through at least the first half of the year. The softer transaction environment has affected sale metrics over the yearlong period. Preliminary data suggests further pricing adjustments going forward, paired with rising cap rates.
- **Tertiary markets continue to garner investor interest.** Higher yields and lower vacancy rates have highlighted smaller markets, drawing investors from under-performing primary markets that were commonly targeted pre-pandemic. Over 47 percent of transactions in the yearlong span ended in March took place in tertiary markets, up from the 2019 count of 42 percent.
- **Medical offices facing fewer headwinds.** As with traditional office properties, transactions involving medical office assets slowed going into the first half of 2023. Still, the deal flow drop-off was less pronounced than in traditional office space. While most medical office tenants have incorporated some degree of virtual work, hybrid interactions supplement in-person visits rather than replace. Clarity on the future of telehealth has boosted investor confidence in the segment and aided leasing activity. Fundamentals in these assets have been aided by tenants' need for space, particularly as the aging population grows across the country, backstopping long-term space demand.

Office Transactions By Market Type



Investment Sales Trends



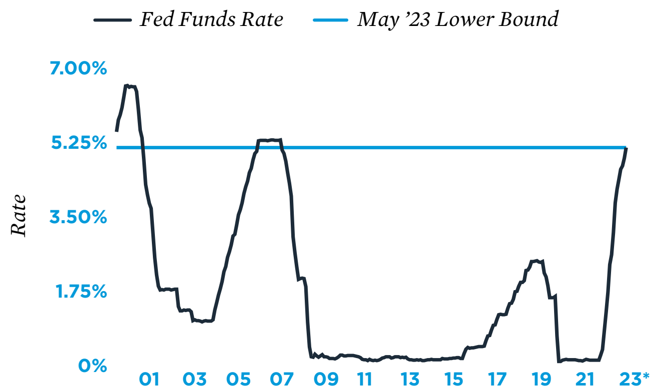
* Through 1Q; trailing 12 months through 1Q for transaction activity
Sources: CoStar Group, Inc.; Real Capital Analytics

Easing Inflationary Pressures and Banking Disruptions Soften Fed Stance; Lenders Keep Criteria Tight

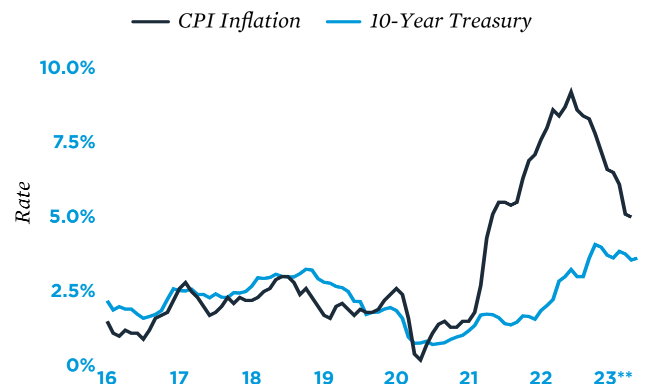
Fed signals less aggressive policy going forward, after pushing the federal funds rate to a 16-year high in May. The Federal Open Market Committee lifted the overnight lending rate 25 basis points to the lower bound of 5.0 percent in May, the 10th consecutive rate hike since the onset of 2022. However, as inflationary pressures ease and the banking system contends with disruption effects, the FOMC has signaled a future preference for taking a meeting-by-meeting approach to any further monetary policy tightening. The recent bank failures will have their own cooling economic influences and have already led to tighter lending conditions. Should inflation pressures continue to ease, the Fed may opt to keep the rate flat, leading to the long-run outlook improving. If the FOMC holds interest rates steady and additional strain on the banking system can be avoided, buyer/seller expectations could have time to realign, and consistency will allow financiers and investors to adjust their underwriting accordingly.

Lending conditions tighten as financiers become increasingly risk-averse. Building on challenges from a higher interest rate environment, uncertainty surrounding the future of office space and increased regulator scrutiny have led many banks to be highly selective on what transactions they consider. In many cases, lenders have gravitated toward single-tenant credit-leased buildings with stable rent rolls. The appetite for value-add properties has largely evaporated as banks seek to mitigate risk. As lending conditions remain tight, investors have often sought out alternative financing sources. These challenges are likely to persist near-term, complicating deal flow and making capital more costly to borrowers. However, these forces have placed upward pressure on cap rates, which helps compensate for higher quoted rates. As time advances and more clarity emerges on the outlooks for both office utilization and financial market health, more buyers and sellers should be able to align on terms and discover a capital solution to advance some trades.

Federal Funds Rate Over Time



Inflation and Interest Rate Trends



** Federal Funds Rate through May 5; ** CPI through April; 10-Year Treasury through May 8*
Sources: IPA Research Services; Bureau of Labor Statistics; Federal Reserve

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Sources: IPA 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