NATIONAL REPORT
OFFICE

IPA | INSTITUTIONAL PROPERTY ADVISORS

4Q/23

Office Utilization Begins to Balance, but Hybrid Work Continues to Affect Space Decisions

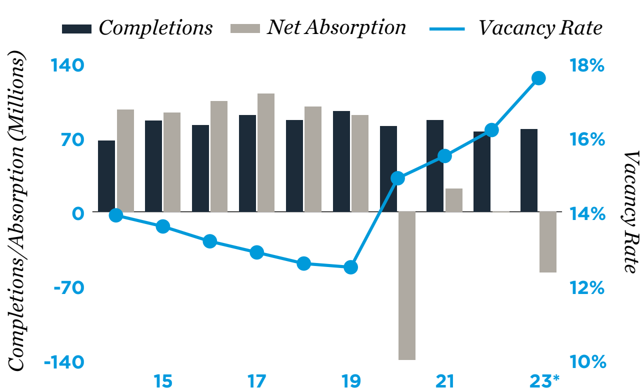
Vacancy on the rise. Office use has structurally changed in the post-pandemic era with hybrid work emerging as the standard practice for many companies. The prevalence of in-person attendance varies by region, industry and company size, but hybrid work models have demonstrated more stickiness than originally expected. A reduction of in-office work hours has complicated companies' long-term space leasing decisions. As leases end, many firms are choosing to reduce their footprints to better align their space with their actual usage levels. The changing utilization, together with the addition of about 78 million square feet in 2023, is contributing to what will be a fourth consecutive year of vacancy increases. Newer buildings often come online with higher asking rents, which has pushed the national mean asking rent nominally upward over the past three years.

Utilization settles near 50 percent. Office utilization in the 10 markets where key card access is tracked by Kastle Systems has migrated toward 50 percent in the post-pandemic era. Metros like Austin that had higher utilization a year ago have witnessed use erosion, while underutilized metros like Chicago and New York have logged gains. Businesses with intellectual property and confidential information, as well as those that face challenges migrating to online platforms, use more office space. Law and financial services firms, in particular, have returned to in-person models at a higher rate than other sectors. Meanwhile, professions in information, insurance and business services have more actively adapted to hybrid or remote schedules.

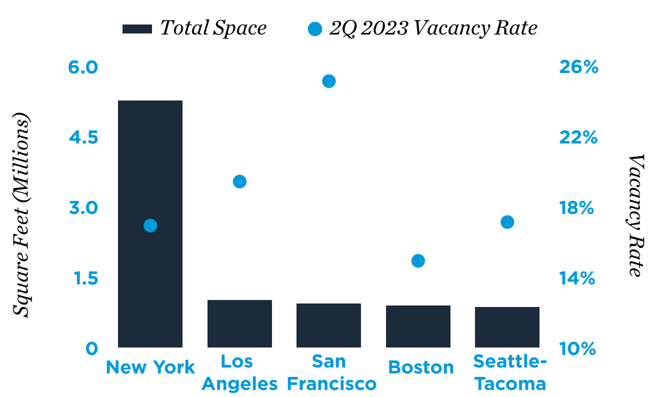
Employers still favor in-person work over hybrid settings. As leases expire, new term lengths have shortened compared to the pre-pandemic norm, reiterating companies' lack of visibility into their future space needs. Still, employers are recruiting for fewer fully remote roles, and entry-level positions are migrating toward being fully on-site to facilitate training. While some companies are reducing office usage — such as Google shedding space in Silicon Valley — others are following through on commitments. Amazon, for instance, is moving forward with plans to occupy an entire 340,300-square-foot office tower in North Austin. This follows a renewed return-to-office movement among several large companies, including Amazon, JPMorgan, Morgan Stanley, Goldman Sachs and BlackRock. As recessionary fears and labor pressures ease, other large companies may begin to solidify future space-usage plans.

The future of co-working space varies. In mid-2023, WeWork sounded the alarm on the company's ability to stay in business amid heightened competition. Compared to its competitors, WeWork is more concentrated in major market CBDs. While headwinds faced by WeWork are not at a scale to move the overall market, certain metros or owners with many of these leases could face challenges if the company renegotiates lease commitments, specifically in New York, Los Angeles, San Francisco, Boston and Seattle-Tacoma. The co-working company had a lease portfolio of 14.9 million square feet in the U.S. by mid-2023, a small portion of national inventory totaling 8.9 billion square feet.

National Supply and Demand



WeWork Leases are Concentrated in New York

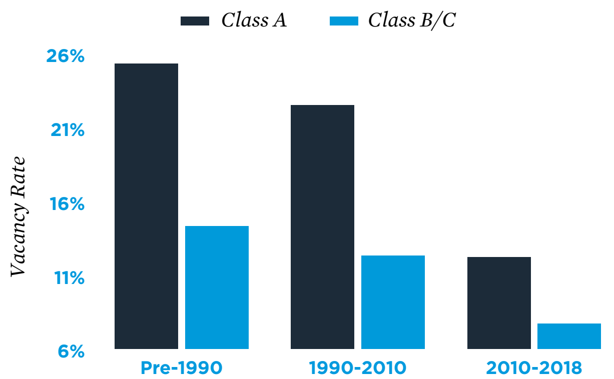


* Forecast

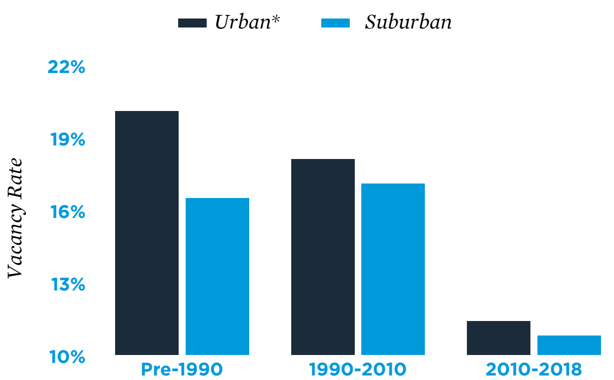
Sources: IPA Research Services; CoStar Group, Inc.; SWAA; Kastle

Building Age and Location Important Factors in Tenant Demand

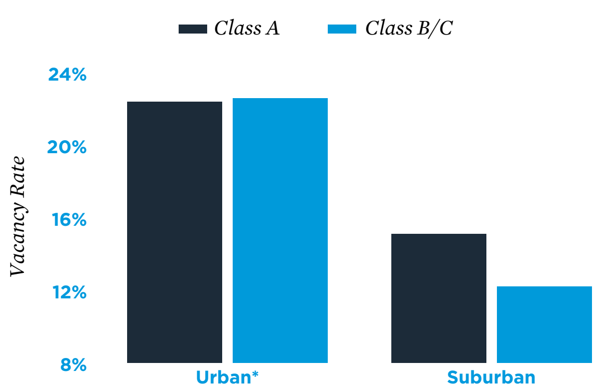
Class A Vacancy is Lower in Newer Properties



Recent Builds Excel Regardless of Location



Suburban Assets Perform Better Across Classes



Older Class A assets push up the sector's vacancy rate. The elevated national office vacancy rate misrepresents the performance of the sector. Characteristics of office property sub-segments significantly impact property performance. Factors like the property age, class and location dramatically influence performance. In June, the vacancy rate of Class A properties was 22.7 percent, well above the Class B/C metric of 13.1 percent. This record-high measure is, however, heavily skewed by a large volume of available space in older Class A assets, particularly older properties located in urban areas of major markets. When seeking space in high-density areas, companies have shown a clear preference for the newest, highly-amenitized spaces.

The urban core records consistently higher vacancy. Regardless of an asset's age or class type, vacancy is higher in urban areas than in suburban counterparts. This can be attributed, in part, to employee migration patterns as many aging millennials favor lower-cost, suburban housing to meet new space needs. Some companies have responded by relocating to suburban offices, limiting lengthy commutes. Many firms occupying space downtown tend to be larger, and they are prone to having more hybrid workers than smaller businesses. Employers with fewer in-person workers may decide to either cut costs and reduce footprints or, alternatively, use top-tier space as an incentive to work in person. Going forward, some CBDs could also face strain from WeWork re-negotiating lease terms at underperforming locations.

Companies display a preference for suburban assets. Just as the migration of employees to the suburbs has hindered demand for urban space, this factor has also raised the prospects of modern suburban offices, which have been sought after since the pandemic. In 2020, suburban vacancy was lower than the CBD for the first time on record. Suburban floor plans typically cost less than their urban counterparts. Major markets with dense urban cores and inconvenient commutes have had the greatest exodus from business districts in favor of the suburbs. San Francisco embodies this trend as vacancy downtown was at 30.3 percent in June, compared to a tighter 16.7 percent in the suburbs, aided by new leases signed by companies like Waymo and Roblox.

Mid-tier vacancy stays below 14 percent. Unlike the volatility logged in the Class A sector, especially older Class A properties in the urban core, Class B/C properties have witnessed a more moderate vacancy climb. While vacancy in Class B/C properties has risen from the record low of 10.6 percent reported in 2019, the sector was just 250 basis points above that metric entering the third quarter of this year. Demand for these office locations has largely been driven by small- to mid-sized firms seeking lower rent alternatives.

** Urban includes properties from high-density submarkets in and outside of CBDs; Vacancy rates are as of 2Q 2023*
Includes office buildings 10,000 square feet and greater
Sources: IPA Research Services; CoStar Group, Inc.; McKinsey & Company

2023 Forecast

EMPLOYMENT

1.6% increase Y-O-Y

- In August, the national unemployment rate rose from a multi-decade low to 3.8 percent. Most of this loosening came from the information sector, which lost roughly 69,000 jobs from December 2022 to August 2023.

CONSTRUCTION

78 million square feet completed

- During the first two quarters, 31.9 million square feet of space came online nationwide. Boston, New York City, Dallas-Fort Worth and Seattle-Tacoma alone will account for roughly 30 percent of annual deliveries.

VACANCY

140 basis point increase Y-O-Y

- Climbing for the fourth consecutive year, vacancy will advance to 17.6 percent. This will be the highest rate on record, heavily influenced by over 57.5 million square feet being relinquished on net.

ASKING RENT

0.2% increase Y-O-Y

- The mean asking rent, supported by new property additions, will grow by less than 1 percent for the fourth consecutive year, leaving the metric relatively stable at $29.23 per square foot.

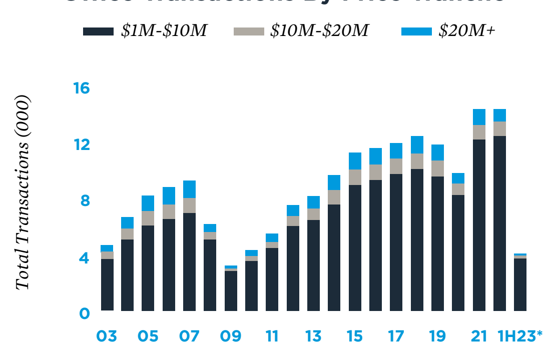
2023 INVESTMENT OUTLOOK

- In the first half of 2023, transaction activity outside of the $1 to $10 million price tranche was scarce. Institutional investors were largely regulated to the sidelines as lending standards tightened and $10 million-plus deals became difficult to finance. Overall, more transactions took place in the first six months of the year than in the entirety of 2009 during the Global Financial Crisis. Private buyers were cautiously active as opportunities emerged to acquire assets at lower price points.

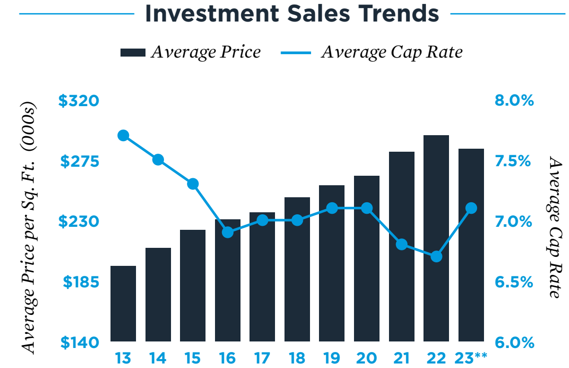
- Due to limited deal flow, price discovery has been complicated, but there were some signs of price softening during the trailing year ended in June. For the first time since 2010, the mean price per square foot decreased, paired with a rising cap rate. Investors have been more active in tertiary metros that have lower entry costs, higher yields and limited construction. Vacancy has also been rising at a slower pace in these settings. Trades in tertiary markets made up 46 percent of all deals conducted in the first half, up 10 percent from the same period in 2013.

- Companies are often negotiating for shorter lease terms as they assess current and future space needs. More volatility with tenants could hinder property values going forward and encourage buyers to target buildings that are not only highly occupied, but also have longer leases and multiple tenants.

Office Transactions By Price Tranche



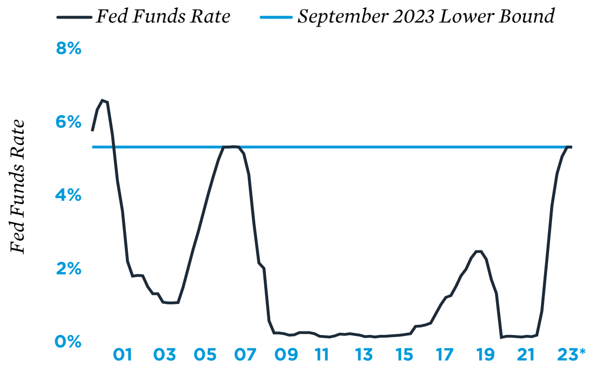
Investment Sales Trends



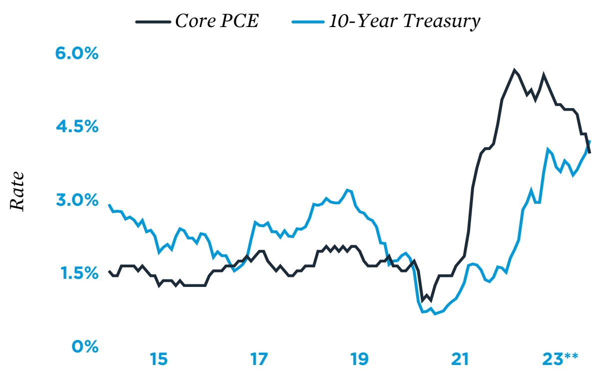
** Preliminary estimate ; ** Trailing 12-months through 2Q*

Sources: CoStar Group, Inc.; Real Capital Analytics

Federal Funds Rate Over Time



Inflation and Interest Rate Trends



** Federal Funds Rate through September; ** Through August*
Sources: IPA Research Services; Bureau of Labor Statistics; Federal Reserve

Federal Funds Rate Remains Unchanged in September; Lenders Limit Office Exposure

September's rate hike pause comes amid softening labor market. After a 25-basis-point rate hike in July, the Federal Open Market Committee decided to hold the federal funds rate steady at its September meeting amid signs of softening in parts of the economy. They opted to keep the rate between 5.25 and 5.50 percent. This is the highest level seen in 22 years, but the Federal Reserve has signaled a more measured approach to monetary policy going forward, while waiting for more data to understand how previous rate hikes are affecting the economy. In August, excluding food and energy, the personal consumption expenditures (PCE) index increased 3.9 percent from one year ago, still above the Fed's target rate of 2 percent. Meanwhile, hiring in August showed signs of slowing. Fewer than 200,000 positions were added and the unemployment rate rose to 3.8 percent, returning to pre-pandemic dynamics, which characterizes a growing, but loosening, labor market. These signs of softening conditions could mitigate the need for additional rate hikes and provide greater stability in financial markets moving forward.

Banks pull back on office loans, reducing overall sector origination volumes. In the first seven months of 2023, lenders were hesitant to engage in office financing. Banks and other financial institutions sought to limit portfolio exposure to office assets amid greater scrutiny from regulators, and capital for these properties has become scarce. Difficulty securing capital has limited investment transactions in the sector entering the second half, apart from medical offices. Of the deals that were completed, lenders favored buildings with long-term leases in place, staggered lease rolls or credit tenant leases, for the stability they provide to cash flows. Owner-occupied purchases are also favorably looked upon by lenders, given the buyer's own commitment to the space. Highly-occupied and amenitized Class A assets in desirable locations have also been able to stand up against lender scrutiny. Going forward, these newer assets in top metros are more likely to pencil out over Class B/C buildings with high vacancy or tenant risks.

Office Division

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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