SPECIAL REPORT

Marcus & Millichap

POSITIVE INDICATORS IN THE OFFICE SECTOR

APRIL 2024

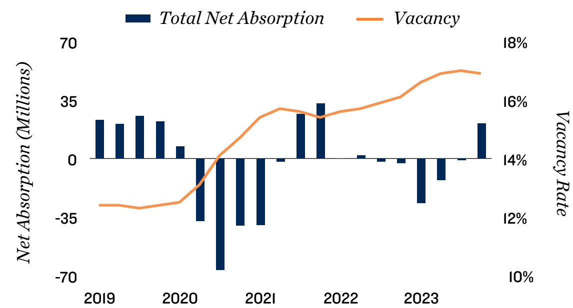
Early Signs Point to Improving Office Sector; Investment Trends Begin to Reflect Changes

Most metros logged positive net absorption at the close of 2023. During the fourth quarter of last year, office net absorption exited the red for the first time in 15 months, pulling nationwide vacancy down 10 basis points. Over 21 million square feet on net was newly occupied between October and December, comparable to an average quarter in 2019. Nearly three-fourths of all major U.S. markets recorded positive net absorption during the span, with Houston, St. Louis and Chicago claiming the largest positive totals. This illustrates that while some larger markets, like San Francisco, are still facing unique challenges resulting in negative net absorption, positive signals in the sector are widespread across the country. Class A properties and buildings located in suburban areas accounted for most of the positive absorption. Space in denser suburban areas and main streets has become increasingly sought out by tenants as they draw retailers, claim walkability and are often proximate to residential areas.

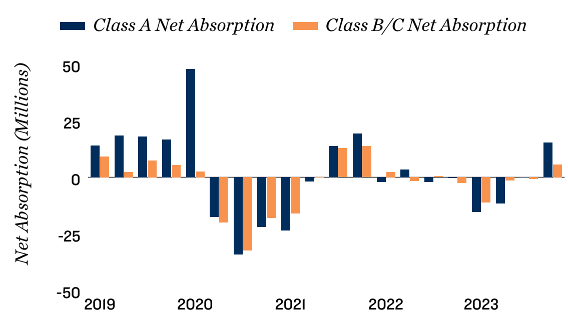
New wave of return-to-office plans comes to fruition. In the years since lockdown restrictions eased, companies have grappled with balancing in-person and remote work. Return-to-office plans have grabbed headlines as companies continue to adapt policies to health and economic conditions. Many employees and employers have found a hybrid balance that allows for some in-person collaboration, combined with remote work flexibility. As the labor market cools, however, employees may find an increased value of being in the office, particularly in traditionally office-using sectors. This year opened with a slew of Fortune 100 companies announcing strict hybrid work policies that often include at least three to four days present in the office, and even lay out timelines for employees to relocate closer to corporate hubs. UPS, Kroger, IBM, Dell, Amazon, Ford and GM are just a few such companies.

Stricter attendance policies could further aid space demand. Depending on the success of increasingly stringent return-to-office policies in 2024 and whether weakness continues to emerge in the labor market, demand for office space could see increasingly positive signs this year. Tech companies — which were often the first to embrace the flexibility of remote work — are now leading the charge toward stricter policies as cybersecurity concerns grow. Dell has established that remote employees who do not return to in-person work could forfeit promotion opportunities. Meanwhile, IBM suggested that employees should relocate near a corporate hub or separate from the company. IBM signed a 774,000-square-foot lease in Durham late last year, along with other companies spearheading in-person work, like Bank of America in Jersey City and OpenAI in San Francisco. In denser suburban areas, Class A properties are likely to benefit the most as companies seek space in highly-amenitized locations, including near dining, retail options and residential areas, as well as places with better walkability.

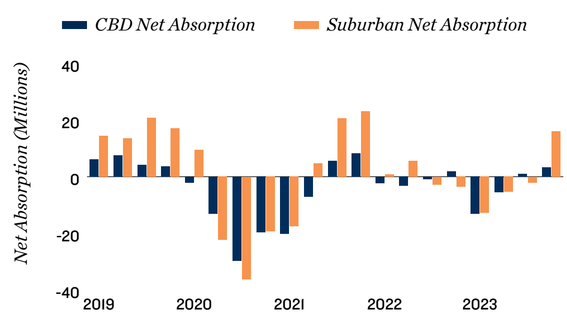
Net Absorption Reaches a Five-Quarter High



Class A Properties Lead in Net Absorption

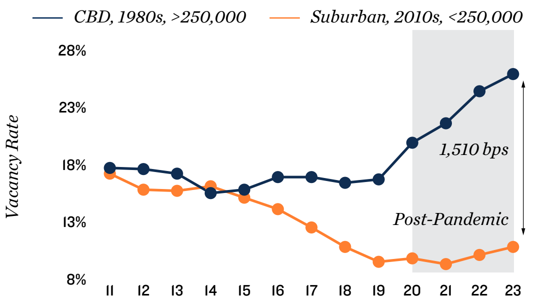


Suburban Assets Highly Sought Out

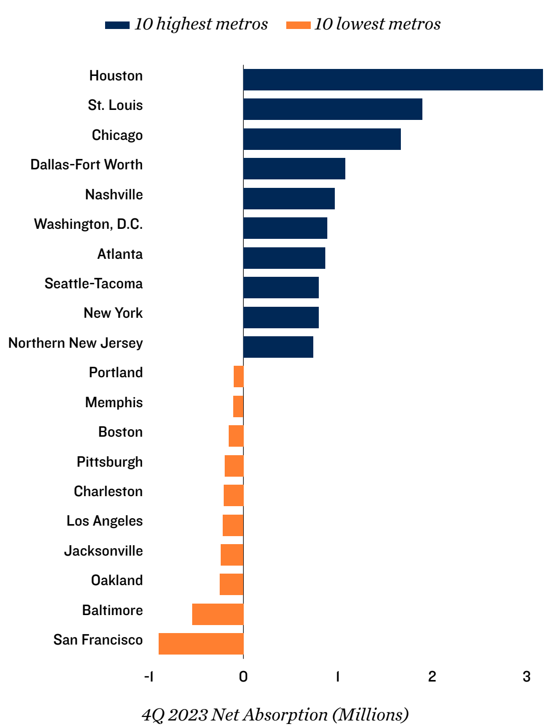


Sources: Marcus & Millichap Research Services; CoStar Group, Inc.

Newer, Smaller Suburban Assets Outperform



Positive Net Absorption Trend Widespread



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

Tenant demand dependent on specific characteristics. Age, location and size still play a large role in leasing activity. Most new leases signed late last year were in suburban areas, accounting for nearly 15.5 million square feet of total net absorption. Central business districts have also shown signs of strengthening, as both the third and fourth quarters of 2023 logged positive absorption, but on a much smaller scale. While office performance varies by the location within a metro, so does the metro's location within the country. Of the major metros that saw the greatest net absorption in the fourth quarter, all had average, or above the U.S. average, weekly office attendance compared to pre-pandemic — including Houston, Chicago, Dallas-Fort Worth, Washington, D.C. and New York. The other markets with elevated absorption were either mid-sized, commutable markets like St. Louis, or areas of high in-migration like Nashville. Property class also plays an important role as Class A assets were highly sought out by tenants in the fourth quarter, with 15.4 million square feet occupied on net. Class B/C properties performed better for the year overall, but saw a much smaller 5.6 million square feet absorbed in the last quarter. Highly-amenitized assets in suburban locations are most commonly sought after, especially as tenants look to rightsize their footprints. This can sometimes mean occupying less space, benefiting buildings with smaller floor plans.

As pre-2020 leases roll off, hints of future complications arise. It is still too early to confirm whether the sector has completed its readjustment cycle. Some clouds are still on the horizon, even as companies reaffirm commitments to in-person work. Firms are in the process of determining space needs, and leases signed before the pandemic are expiring, leaving companies with the choice to renew or vacate their spaces. Bank of America, for instance, recently announced it will move out of 316,700 square feet of space at 201 N. Tryon St. in Uptown Charlotte before its lease expiration in 2025. The company cited that it was not renewing the lease, in favor of assigning workers to office buildings the bank itself owns. Leasing velocity for spaces over 100,000 square feet also fell last year, suggesting that companies prefer flexibility and favor smaller floor plans. Still, the average lease term for these larger spaces is roughly in line with the half-decade preceding the pandemic, signaling that companies targeting large floor plans intend to commit to space long term.

The investment landscape is still fragmented. The office sector has multiple stories unfolding. On one hand, lower quality assets in urban areas are plagued by high vacancy and faltering tenant demand. Meanwhile, investment in good quality office space in suburban areas was consistent exiting 2023. Trades involving the top, highly occupied office assets will support investment sales going forward, but troubled properties are likely to have serious markdowns. Additionally, institutional buyers have largely stayed on the sidelines as uncertainty surrounds office properties and interest rates remain elevated. This has made room for private and owner-user buyers. Owner-users began to make up an increasingly large portion of office sales in late 2023, accounting for roughly 23 percent of trades last year. This trend could increase in prevalence while the year progresses as companies move toward ownership and institutional buyers remain wary of office assets, allowing opportunities to emerge.

Prepared and edited by:
Jessica Henn
Research Analyst | Research Services

For information on national commercial real estate trends, contact:
John Chang
Senior Vice President, Director | Research & Advisory Services
Tel: (602) 707-9700
john.chang@marcusmillichap.com
Price: $1,000