

RESEARCH

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Author

Kevin Fagan
Head of CRE Economic Analysis

Xiaodi Li, PhD
Assistant Director - Thought Leadership

Contact Us

General Questions
+1.800.366.7347
info@reis.com

Sales Information:
+1.646.346.5400
sales@reis.com

Customer Success
+1.212.901.1932
info@reis.com

Q4 2021: Office First Glance

Performance Metrics Continue to Buck Expectations

We had continued to project rising vacancy rates for the office sector through 2021, given uncertainty about return-to-office plans and ongoing concerns about the pandemic. This flew in the face of economic projections that called for economic growth of over 5.5% in 2021 – the highest rate of growth for US GDP since 1984. We evinced surprise when office vacancies began falling faster than many expected. They dropped in the third quarter by 30 basis points and again in the fourth quarter by 10 basis points, to end the year at 18.1%. The national vacancy rate is now 40 basis points lower than what may well be (in retrospect) the pandemic peak of 18.5%, recorded in the second quarter of 2021.

Asking and effective rents were basically unchanged at the national level, ending the fourth quarter at \$34.46 PSF and \$27.74 PSF, respectively. Year-over-year asking and effective rent growth rates of -0.2% and -0.8% paint the picture of a tumultuous period, with both types of rent posting positive (if marginal) increases in the middle of the year.

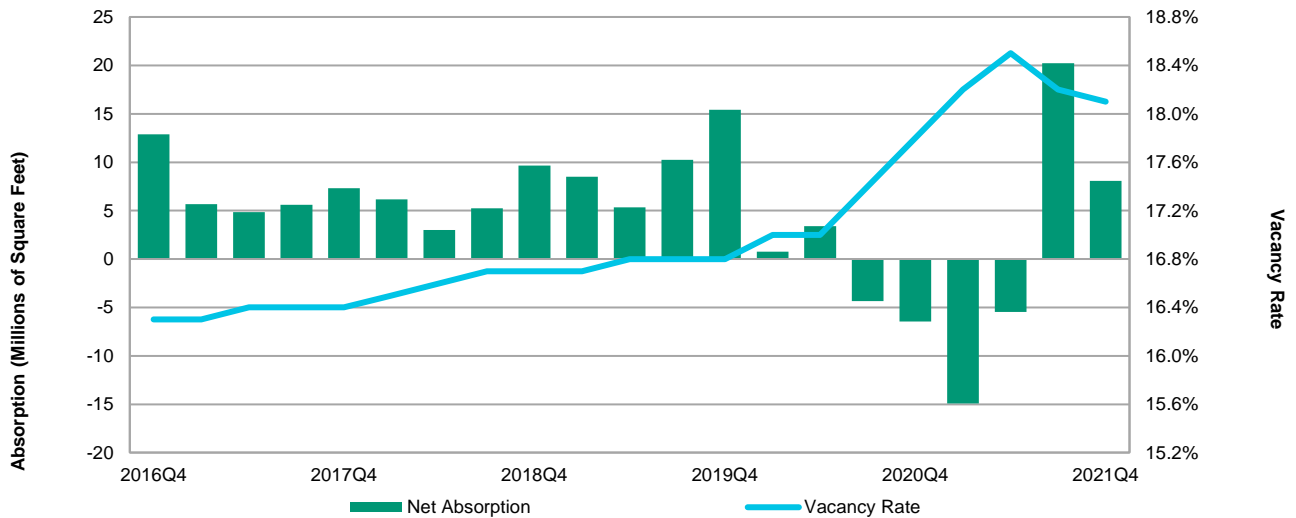
Where, Oh Where, Is That Distress?

To be fair, vacancies did continue rising through the middle of 2021, and remain elevated at slightly over 18%, up about 30 basis points on the year. The most recent pre-COVID three-year average (2016-2018) was 16.6%. Measures of distress were magnified at the market level, with more pronounced vacancy spikes in urban centers (+210 basis points versus end-2019, versus +150 basis points). But by most counts, pandemic-induced distress did not reach anywhere near what the market originally expected during March through June of 2020, the time of peak uncertainty. This mirrors how the most negative of forecasts for GDP growth in 2020 and 2021 were cut by approximately half: at its worst (in mid-2020), the IMF was projecting that US GDP would fall by 8.0% over the course of the year. The actual number is closer to 3.5%.

But perhaps the wolf that the boy cried about is still coming: last quarter we wrote about the Delta variant and related issues like supply chain and labor shortage disruptions depressed economic activity (US GDP growth fell from the high 6's through mid-2021 at an annualized rate, to just above 2% q/q in the third quarter). With the Omicron variant on the rise, employers have once again postponed return-to-office plans, prompting the New York Times to call for an 'end of a return-to-office date.'¹ Budgets are being drawn up for 2022, with considerations regarding physical occupancy likely playing a part in terms of whether employers large and small will renew their existing lease with the same amount of space – or less. One immediate effect we've recorded (and about which we will expand upon further in an upcoming research piece) is the marked increase in very short lease terms (one year or less) being signed: the percentage of very short leases increased from 14.8% in 2019 to 32.2% in 2021. Since the onset of COVID in early 2020, the median office lease term signed by tenants has fallen from 5 years to 3 years. Though largely driven by tenants occupying small spaces, it is still indicative of how firms are thinking through (or rethinking) commitments for the next few years.

As such, our near-term projections suggest that the office sector will continue to face uncertainty, reflected in rising vacancy rates. Vacancies *did* rise throughout 2021 on the net: from 17.8% to 18.1%. We are expecting vacancies to crest over the next couple of years, though we have retreated from our worst projections. We continue to hold that the office sector is unlikely to experience a record-breaking positive recovery (in stark contrast to the apartment sector) in the near future.

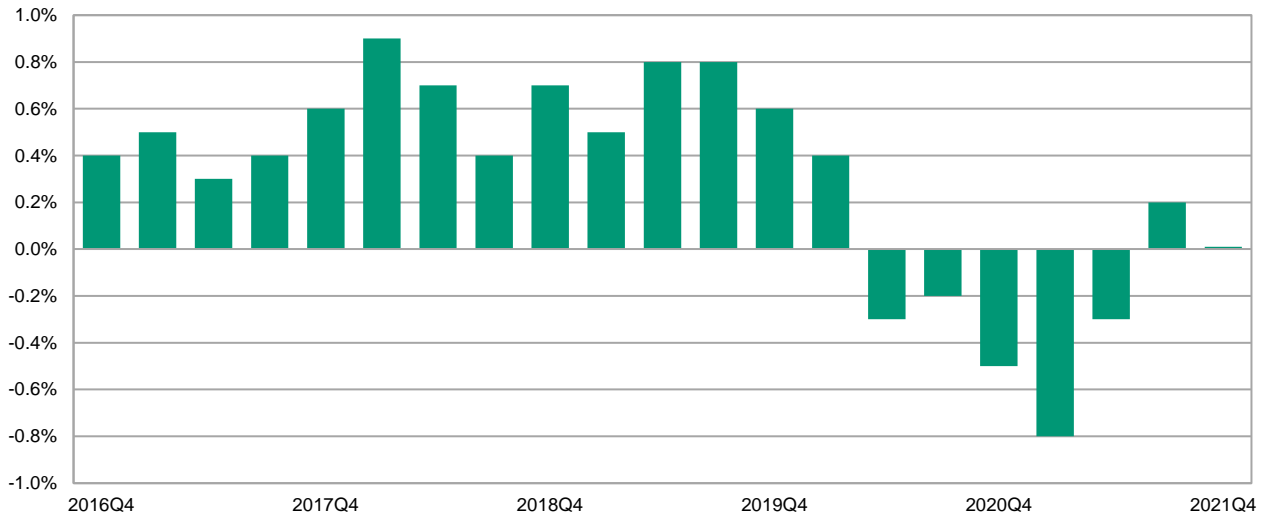
Figure 1 Office Net Absorption and Vacancy



Source: Moody's Analytics REIS

¹ "The End of a Return-to-Office Date. More and more companies are saying: 'We'll get back to you.'" *New York Times*, December 11, 2021.

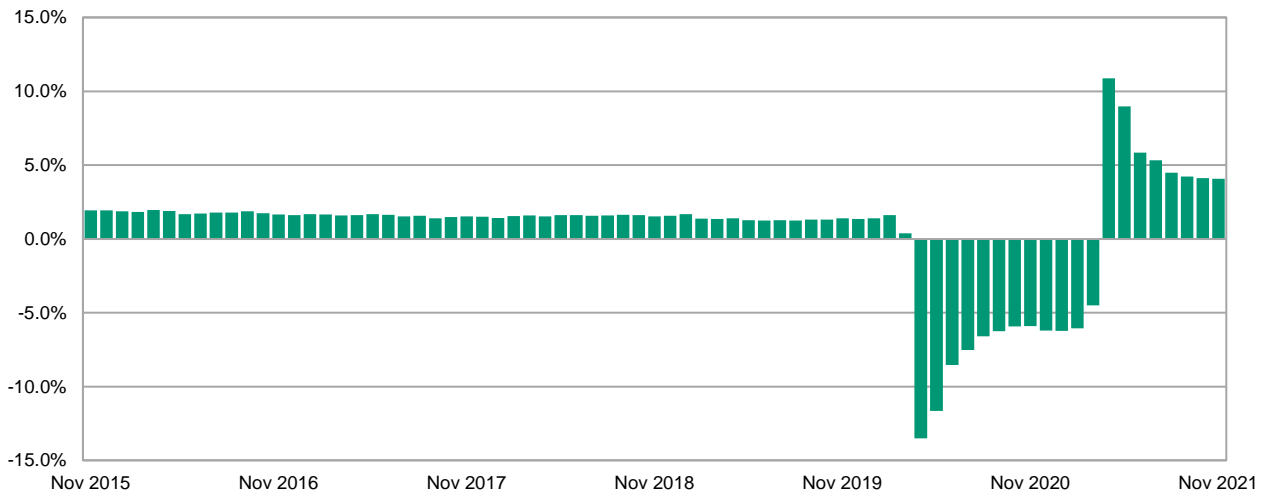
Figure 2 Office Effective Rent Growth



Source: Moody's Analytics REIS

Figures 1 and 2 above provide a visual depiction of what we have been discussing. There *has* been distress in the office sector, with vacancies rising through the middle of 2021, and five straight quarters of negative effective rent growth. Performance metrics are probably best characterized as 'having stabilized' in the latter half of 2021, though pessimists are still waiting for the so-called other shoe to drop, when they would argue that employers will decide to shed substantial office space because of continually low physical utilization percentages.

Figure 3 12-Month Change in Employment



Source: Bureau of Labor Statistics

Table 1 Office Fundamentals (# of markets)

YEAR	QUARTER	POSITIVE ABSORPTION	NEGATIVE ABSORPTION	POSITIVE OCCUPANCY	NEGATIVE OCCUPANCY	POSITIVE EFFECTIVE RENT GROWTH	NEGATIVE EFFECTIVE RENT GROWTH
2021	4	59	23	53	29	61	21
2021	3	70	12	64	18	63	19
2021	2	37	45	24	58	45	37
2021	1	20	62	17	65	29	53
2020	4	32	50	16	66	40	42

Source: Moody's Analytics REIS

Office Outlook

There will likely be a retraction of some of our most negative rent growth projections, across markets, once we finalize our forecast series – this is consistent with prior quarterly trends, and is driven this period by flat (to slightly improving) performance metrics. Figure 3 above, however, suggests that employment growth has been slowing down; the effect of the Omicron variant has yet to be determined: will it peak in a few weeks and barely cause a disturbance in economic activity? Or will it weigh down first and second quarter figures for overall GDP growth? With uncertainty around boosts from fiscal policy, like whether or not (and in what form) the Build Back Better program will be approved, 2022 US GDP growth forecasts are likely to be lowered as well.

Table 1 above gives a sense of how mixed signals have been about whether or not it's time to call for a (consistent) recovery for the office sector. National averages for vacancy change and rent growth were flat, but the mix of markets posting positive versus negative results (for absorption, occupancy, and effective rent change) has leaned towards the negative, between the third and fourth quarters. Expect more conflicting signals over the next couple of years as the evolution of the office sector proceeds.



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General Questions
+1.800.366.7347
info@reis.com

Sales Information:
+1.646.346.5400
sales@reis.com

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+1.212.901.1932
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