MOODY'S ANALYTICS | CRE

RESEARCH
OCTOBER 15, 2021

Author
Victor Calanog PhD
Head of Commercial Real Estate Economics

Contact Us
General Questions
(800) 366-7347
info@reis.com
Sales Information:
(646) 346-5400
sales@reis.com
Customer Success
(212) 901-1932
info@reis.com

Q3 2021: Office First Glance

Performance Metrics Hold Steady – and Improve

While we were projecting rising vacancy rates given continuing uncertainty about the fate of the office sector, third quarter numbers suggest that the most negative forecasts proclaiming the death of office space may need to be approached with some skepticism. The national vacancy rate fell by 30 basis points in the third quarter, ending the period at 18.2%. Asking rents held steady at $34.44 PSF, unchanged relative to the second quarter.

Effective rents actually rose in the third quarter, increasing by 0.1% after five straight quarters of declines, to end the period at $27.49 PSF. Absorption went positive – with occupied stock increasing by 18.4 million SF. While this does not make up for the 31.6 million SF of negative absorption from the second quarter of 2020 to the second quarter of 2021, it does make one wonder whether or not extreme pessimism about the office sector is still warranted.

Evolutionary Forces Still Likely to "Disrupt" the Sector

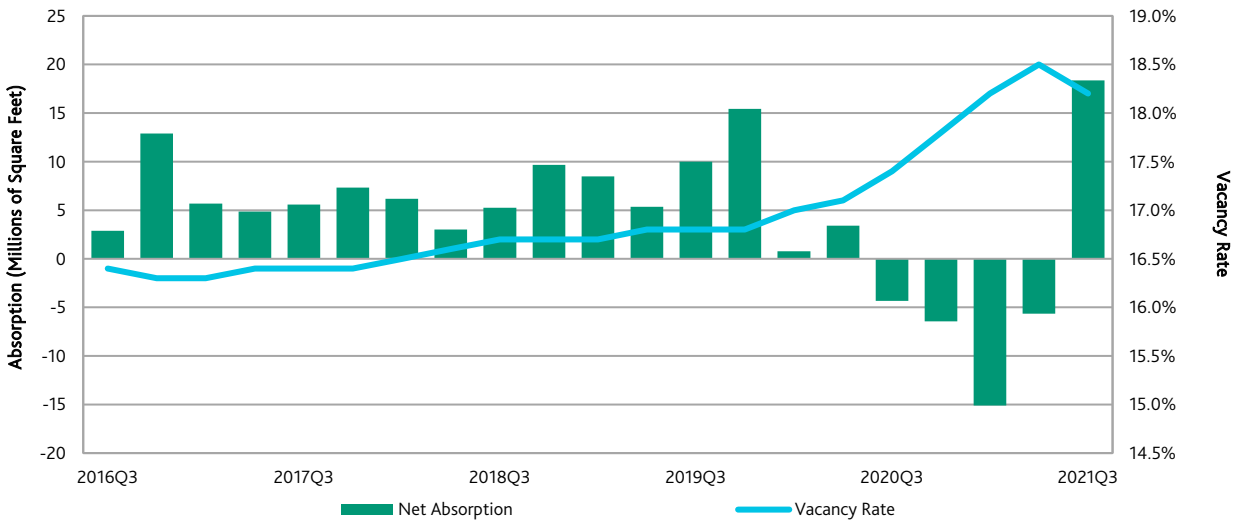
'Disruption' is a term that Clayton Christensen popularized in his work 'The Innovator's Dilemma' (1997), and today it is used as a catch-all phrase to suggest that a sector or industry may be facing significant change. We expect that the office sector will continue to be buffeted by forces stemming from the current pandemic: 'return to office' policies of many firms were postponed to 2022, owing to the rise of the Delta variant. Some large companies like PriceWaterhouseCoopers even announced recently that it would allow tens of thousands of its employees to work from home permanently. Surely these are disruptive forces that will result in higher vacancy rates and a sustained decline in rents, right?

We are still projecting a rough intermediate term for the office sector, with vacancies rising from its current 18.2% to perhaps the mid- to high-18s over the next two years. As employers and employees figure out the optimal office-or-remote blend, office sector fundamentals are unlikely to experience a massive recovery (which is happening at the moment in the apartment sector). As such, we are forecasting asking and effective rent growth to be negative for 2021 as a whole – but it should be noted that we are not recording nearly as much distress as we initially expected at the start of this year; and certainly not relative to how bad we thought things might get during the height of COVID.

Furthermore, there is historical evidence that office *values* have in fact held relatively steady over the last 40 years, despite some major ups and downs during the S&L crisis in the early 1990s, the tech crash of 2001, and the Great Financial Crisis of 2008-2009. Investors continued to find value in the asset class, even as office *usage* per office-using employee declined precipitously: from 250 to 260 square feet per employee in the 1980s, we are down to about half that number leading up to 2020.

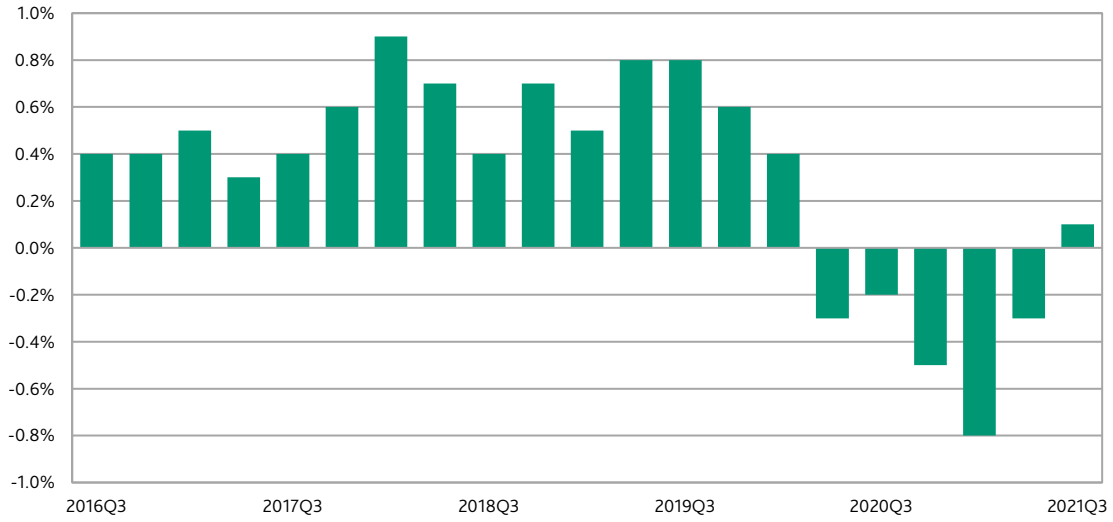
What this means for the office sector is that while there is a case to be made about employers shedding space, as they use the current crisis to minimize real estate costs, this trend might be offset by other companies wanting to lease or own space (like growing tech firms). How this will all shake out may resemble more of a gradual *evolutionary* process, versus a cataclysmic disruptive event that lays the sector low.

Figure 1 Office Net Absorption and Vacancy



Source: Moody's Analytics REIS

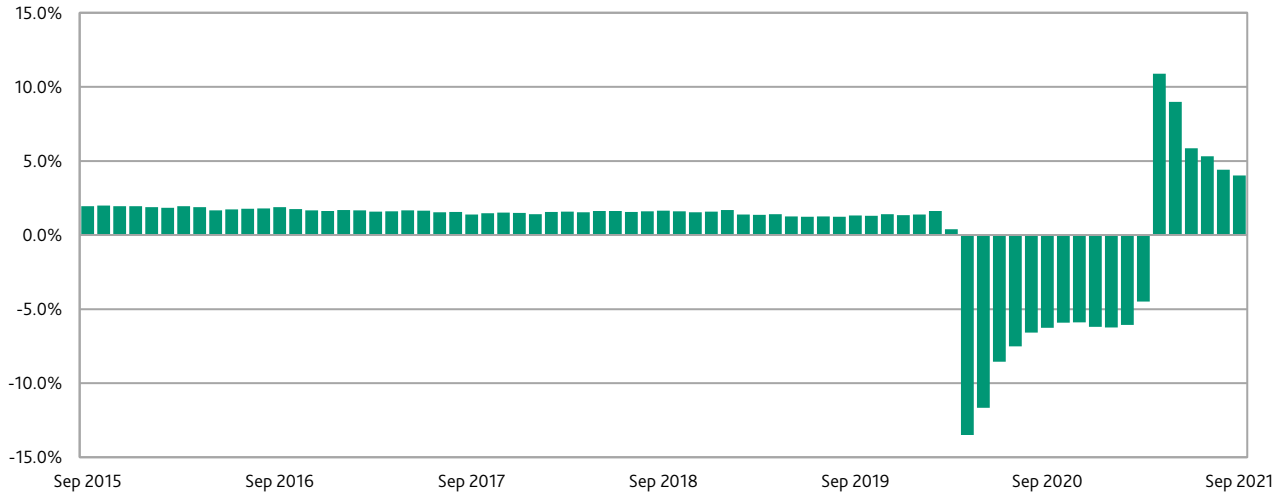
Figure 2 Office Effective Rent Growth



Source: Moody's Analytics REIS

Figures 1 and 2 above depict the trends we've been discussing, visually. After rising slowly over the last four years, national vacancies spiked to a high of 18.5% because of the COVID-19 crisis. The fact that it fell by 30 basis points this quarter might offer optimism to some, but we are decidedly reserved when it comes to issuing proclamations of a sustained turnaround. Effective rent growth turned positive, albeit marginally so, this period, after five straight quarters of declines.

Figure 3 12-Month Change in Employment



Source: Bureau of Labor Statistics

Table 1 Office Fundamentals

YEAR	QUARTER	POSITIVE ABSORPTION	NEGATIVE ABSORPTION	POSITIVE OCCUPANCY	NEGATIVE OCCUPANCY	POSITIVE EFFECTIVE RENT GROWTH	NEGATIVE EFFECTIVE RENT GROWTH
2021	3	68	14	64	18	63	19
2021	2	36	46	24	58	45	37
2021	1	19	63	17	65	29	53
2020	4	32	50	16	66	40	42
2020	3	28	54	10	72	28	54

Source: Moody's Analytics REIS

Office Outlook

Consistent with prior quarterly trends, expect for projections of declines in occupancy and rent growth to be moderated this period, given positive signals from the third quarter. Figure 3 above suggests that employment growth has been slowing down; concerns about Delta and other upcoming variants continue to weigh down expectations of economic activity for the latter half of 2021. Our Predictive Analytics group has accordingly lowered 2021 GDP growth forecasts from 6.7% six months ago to 5.8% as of our October vintage: we're still expecting the highest figure for GDP growth since 1984, but it is to be less robust than originally predicted.

The office sector will likely go through convulsions over the next 12-24 months, though it would be unfair to characterize these as 'death throes.' Expect conflicting data points as we go through this evolutionary period: we will continue to see announcements of firms letting go of office space. However, we will need to weigh that against news of billion-dollar transactions and investments flowing into the office sector, like Google's recent $2.1 billion purchase of an office building in New York City, announced in late September.

LEARN MORE

Find out more information about Moody's Analytics award winning products and solutions.

reis.com

General Questions
(800) 366-7347
info@reis.com

Sales Information:
(646) 346-5400
sales@reis.com

Customer Success
(212) 901-1932
info@reis.com