MOODY'S ANALYTICS

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# Q2 2021: Office First Glance

## Distress on the Occupancy Side – But Not So Much on the Rent Side

The national vacancy rate increased by 30 basis points in the second quarter of 2021, ending the period at 18.5%. As an historical note, vacancies peaked at 17.6% in 2010, in the aftermath of the Great Recession. At its current level, the US vacancy rate is now only 120 basis points below the record high of 19.7% from 1991, during the Savings and Loan crisis.

However, we should also put this in perspective. The national vacancy rate remained elevated throughout the past decade, never really declining below 16.3%. As such, from its cyclical trough in 2016 of 16.3% to its current level of 18.5%, the office vacancy rate has 'only' risen by 220 basis points. Since office vacancies were at 17.0% in the first quarter of 2020, 'only' 150 basis points could properly be attributed to the current crisis. By contrast, vacancies rose by 12.5% in the third quarter of 2007 to 17.6% by the end of 2010 – a 510 basis point spike attributable to the Great Recession.

As a further sop to office optimists, while effective rents declined by 0.3% in the second quarter, asking rents actually stayed flat.

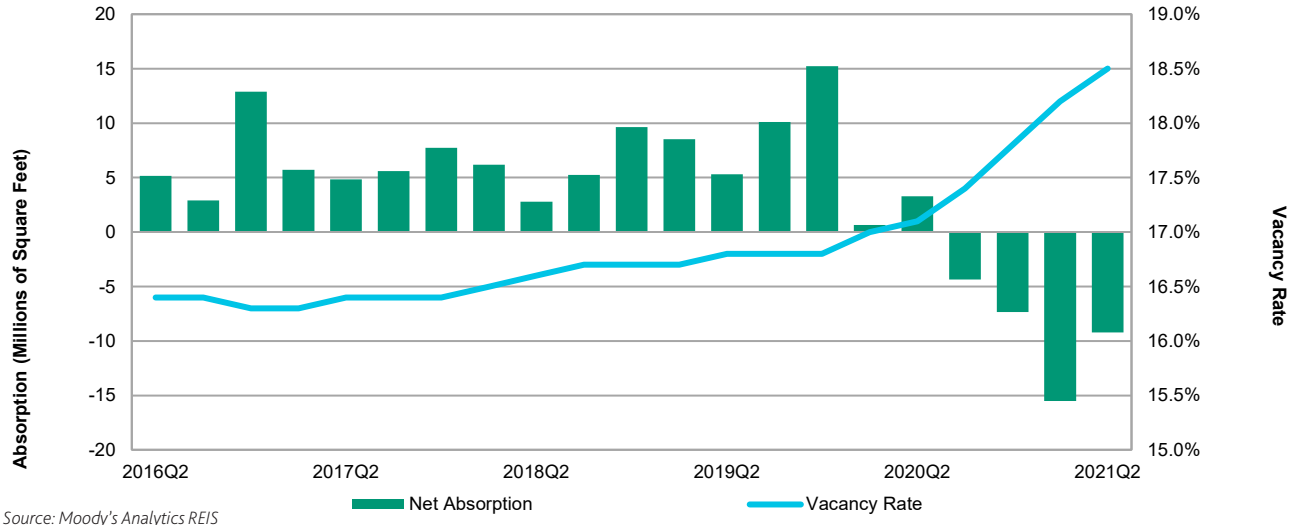
## Continuing Uncertainty Constrains Relative Optimism

The prior section might lead the reader to believe that we are, therefore, optimistic about the prospects of the office sector. That is not altogether true, although we are nowhere near as pessimistic as pundits who are pronouncing a massive decline in both demand for office space as well as values per square foot because of the so-called hybrid revolution.

There is continuing uncertainty about what the 'world of work' looks like, post-COVID. Some have welcomed the return to office space; other employers have received significant backlash from their employees when they tried to codify what 'flexible working' means. Many are wondering whether recent trends pointing to record high resignation rates are connected to this transition period, with the crisis prompting employees to figure out what they really want from their jobs.

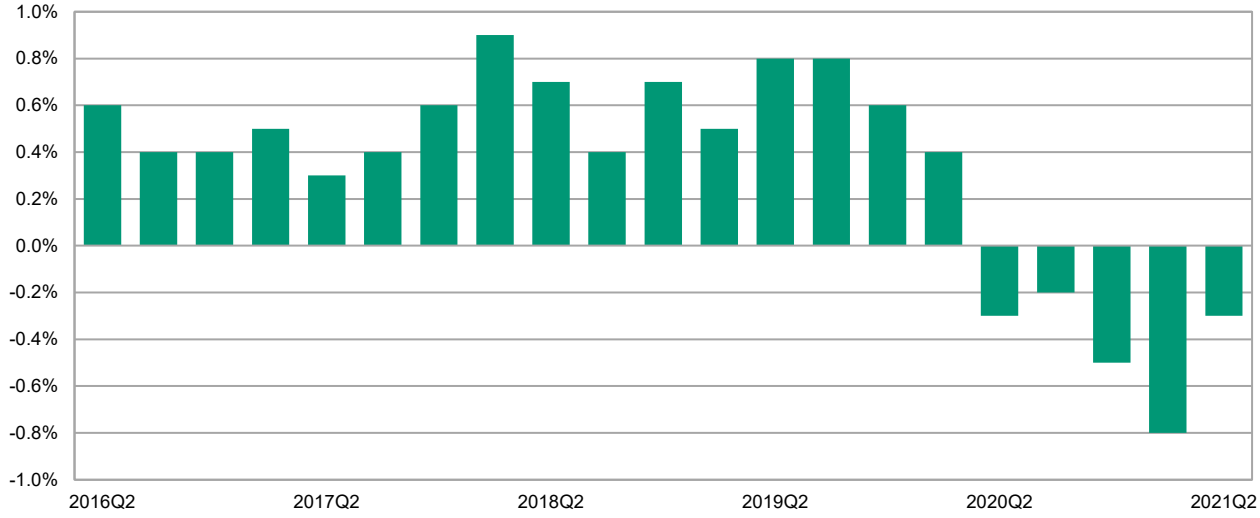
As such, we expect vacancies to continue rising for the next two years as employers and employees figure out the optimal configuration of office space needs. Our current forecasts suggest that national vacancies will continue rising to the mid-19s, a level that *The Economist* recently framed as having 'one-fifth of US offices go vacant.' While that is mathematically true, take note that we aren't very far from the mid-19s given that we are already at 18.5% as of the current period. And note that the national vacancy rate averaged 16.9% from 2011 to 2019 – suggesting that one-sixth of US offices were already vacant over a decade-long expansionary period. We also expect our forecasts of negative rent growth for 2021 to lessen in severity given the lack of current evidence of big rent drops. We cannot rule out the possibility of a longer slide in rents, particularly if employers really do begin shedding 5, 10, 15% or more of their current space. Counterbalancing all that are economic tailwinds from US real GDP expected to grow at rates unseen in four decades, along with office and school reopenings by the Fall that might prompt physical occupancy to rise to levels comparable to pre-COVID trends anyway. Employers might reconfigure their current space for changing needs, but will that truly translate to a secular decline in demand for office, far greater than pre-COVID trends towards lower intensity of office usage (as measured by office-using employees per square foot)?

Figure 1 Office Net Absorption and Vacancy




*Source: Moody's Analytics REIS*

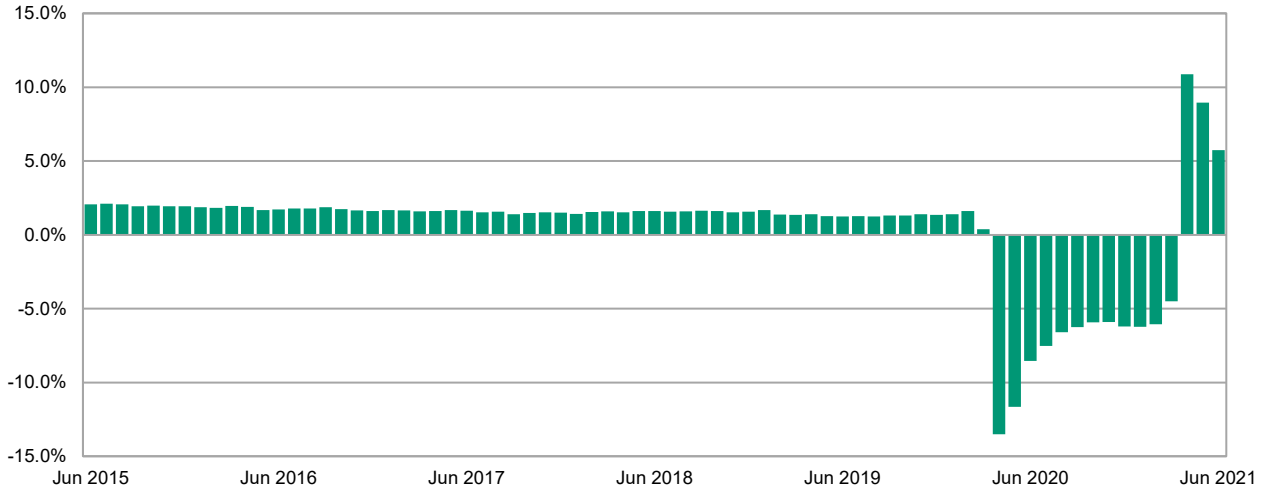
Figure 2 Office Effective Rent Growth




*Source: Moody's Analytics REIS*

The other question is whether or not office *pricing* will truly take a big hit from all of these trends. It is true that we have seen a steady decline in the *usage* of office space: from approximately 250 square feet per employee in the 1980s, to just over 125 square feet per employee at the end of 2019. But that did not translate into a decline in office *values*, particularly for offices located in central business districts. The asset class transitioned towards service industry tenants; suburban office space fell out of favor; central business districts became more vibrant (starting in the mid-1990s). And office values per square foot kept rising.

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 | 2 | 31 | 51 | 24 | 58 | 43 | 39 |
| 2021 | 1 | 19 | 63 | 17 | 65 | 29 | 53 |
| 2020 | 4 | 31 | 51 | 15 | 67 | 40 | 42 |
| 2020 | 3 | 28 | 54 | 11 | 71 | 28 | 54 |
| 2020 | 2 | 48 | 34 | 25 | 57 | 17 | 65 |

*Source: Moody's Analytics REIS*

## Office Outlook

REIS continues to expect that 2021 will be a year of transition for the office sector, but we fully expect to lower our projections for rent declines. We are already observing a lag in terms of how performance metrics continue to slide even as the economy recovers. However, relative to our first quarter numbers we have restated our US GDP growth projections *up* to 6.7% this year (from 5%). That is a big tide that will likely lift many boats – we are already seeing it in equity market valuations, hiring… and inflationary pressures.

Expect idiosyncratic blow-outs and anecdotes on both sides of the argument: news will be replete with employers coaxing their employees back to the office (with employees reacting both positively and negatively). There will also likely be news about employers shedding office space or moving locations. But will *average* occupancies, *net* rent growth, and *actual* pricing trends reflect how office as an asset class is headed towards systemic disfavor? We argue that this is unlikely to be the case.

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