Leases are Getting Shorter and Rents are Dropping with U.S. Office Market in Turmoil

Leasing activity dropped 53 percent following shelter-in-place orders, and the path to recovery is as uncertain as ever

By Greg Cornfield July 16, 2020 6:35 pm

The U.S. office market recorded 14.2 million square feet in occupancy losses in the second quarter, bringing year-to-date net absorption to -8.4 million square feet. New York City and San Francisco were responsible for 26.7 percent of all net loss. photo: Wikimedia

The coronavirus pandemic has brought the United States office market to a near halt, and the path to recovery is as uncertain as ever, experts say.

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New data from **JLL** shows leasing in the U.S. dropped by 53.4 percent in the second quarter following shelter-in-place orders, wait-and-see strategies, and additional time spent negotiating. The work-from-home phenomenon obscured future space needs, and stay-at-home mandates effectively ceased tour activity.

JLL also reported this week that the average office lease in the U.S. fell 15 percent in the first five months of 2020, primarily driven by tenants at the end of their lease. It's down to about seven years, and it's "likely to fall farther." Office users are avoiding long-term decisions, according to **Ben Munn**, global flex space leader at JLL. Instead, they're looking for flexibility and taking the "path of least resistance" by extending work-from-home programs.

"Whittling down lease terms is certainly part of that effort," Munn said in a statement.

Marc Landis is managing partner at **Phillips Nizer LLP,** where he co-chairs the real estate practice. He told Commercial Observer there have been two dominant theories about how the pandemic would impact the office market. The first is that occupiers would need more space to spread employees out, and the other is that people can work remotely and need less space.

"I believe the second theory has gone a lot further than the first theory at the moment," he said. "That is a function not only of employer considerations — feeling they need less space and would like to spend less when times are tough — but also the employees who prefer operating remotely more often than not. There are people who have cabin fever or would like to be able to function without kids underfoot, but a lot of people are functioning well."

Indeed, a recent survey of U.S. workers found that Americans who are working remotely during the pandemic have had largely positive experiences. A majority said it has given them more time during the day and improved their health without significantly impacting productivity. Of the workers currently operating remotely, 78 percent said working from home saved them time; 71 percent said they are more comfortable working from home than in an office; and 55 percent said the quality of their work improved.

Additionally, an analysis updated in June by the **National Bureau of Economic Research** showed 37 percent of jobs in the U.S. can be performed entirely at home.

"As we start talking to clients about their needs, and the balance of this year, and deals they want to do in 2021, they're absolutely looking for less space and greater flexibility," Landis said. "I saw hesitancy in the transactions where we were involved. People are more focused on what they could cancel or change as opposed to new deals."

Major firms have also been signaling that their office strategies could permanently change, suggesting they will need significantly less office space. Activist investor **Jonathan Litt**, founder and CIO of **Land & Buildings**, said it was becoming obvious as early as April.

"When **Larry Fink** of **BlackRock**, **James Gorman** at **Morgan Stanley**, and others like **Facebook,** said, 'Hey, this is working pretty well, we're going to keep people working from home,' we said, New York City is going to have a problem," Litt told CO.

Mike Klein, partner at **Benesch**'s Real Estate & Environmental group, also said leases are getting shorter.

"Office space is a big expense for businesses, and the more they're able to have people work from home and cut down on that expense and lease less space, the better off they probably feel they are," Klein said. "I think a lot of people are putting off decisions to lease more space at the moment because they're still trying to figure out — from their own business perspective — what they're gonna want long term."

Landlords and tenants are also still working on rent abatements and deferrals for existing leases, Klein said, and spending more time with collections than on new leases. And rather than searching for new space during a pandemic, corporations are choosing to renew or extend leases. Renewals jumped to 51 percent of leases, up from 29 percent before the pandemic, according to JLL data.

JLL's report said that heading into the second half of 2020 — as federal aid and the **Paycheck Protection Program** dries up — all eyes will be on the ability of states to withstand or contain a second wave of coronavirus, as well as tenants' response to re-entry. Klein said the future of the office market depends heavily on how soon a vaccine or therapy for coronavirus is developed in order for people to feel safe returning to the office. For sure, the survey by **Morning Consult** showed one-third of remote workers won't return until a vaccine is available.

Landis said contract stability and strong relationships with traditional landlords has been vital compared to the coworking models like **WeWork**.

"WeWork participants found that they were not given a great deal of flexibility," he said. "Unlike a traditional commercial landlord, who would take a long view and work with the tenants in the short term, WeWork greeted people with an extended middle finger."

WeWork and coworking firms were the largest consumers of office space in New York City the past few years. WeWork alone occupies 9 million square feet in the city, but it had been dealing with well-documented financial struggles prior to the pandemic. Now, the business model appears untenable, according to Litt. His firm said the social distancing era is likely to dramatically diminish the popularity of coworking space, and the current recession will further reduce demand.

The U.S. office market recorded 14.2 million square feet in occupancy losses in the second quarter, bringing year-to-date net absorption to -8.4 million square feet, according to JLL data. New York and San Francisco were responsible for 26.7 percent of all net loss in the second quarter.

The deals that closed were tied between finance and tech, with larger deals stemming from government, health and health insurance. The largest lease in the U.S. in the second quarter came from **PG&E** consolidating into a new headquarters in Oakland. Without that 900,000-square-foot agreement, the U.S. market would have been down around 56 percent in overall activity. **Microsoft, TikTok** and **Walmart Labs** were some of the other few notable transactions from companies continuing to expand.

Litt said earlier this year that the New York office market is facing an “existential hurricane,” and that landlords across the city are likely to suffer. The firm expects vacancies to hit 20 percent in New York City, and rents to decline between 15 percent and 20 percent. Litt explained this week that the market was already facing headwinds, with firms relocating due to increased taxes, and companies like WeWork imploding.

Development activity in the U.S. was largely unchanged at 134 million square feet as state and local mandates halted construction activity and pushed out time frames into the next quarter at best, and potentially 2021 for some deliveries expected this year. More deliveries will hit in the coming quarters, including **One Vanderbilt** and **425 Park Avenue** in New York; **Bank of America Tower** and **167 North Green Street** in Chicago; **Rainier Square** in Seattle; **Block 162** in Denver, and additional phases of **Sentinel Square** and **Capitol Crossing** in D.C., all of which are more than 500,000 square feet and in many cases still with significant availability.

In New York City alone, another 25 million square feet of new office product is still planned to be delivered between now and 2024, Litt said. In Chicago, the office construction pipeline is currently the most active it has been in several years, according to JLL, with several plans to break ground in the latter half of 2020 and the beginning of 2021. While some plans may be on pause around the country, experts say the pipeline will likely continue to absorb any incremental demand, especially as user needs adapt.

Only suburban Class A space has seen expansion over the course of 2020, at 3.9 million square feet, according to JLL. Klein said companies are again looking at the suburbs and areas with less density.

“At least in Chicago, everybody always wanted to move to The Loop or into downtown Chicago,” Klein said. “Now companies are considering having more space spread out in the suburbs.”

Major cities were already seeing population declines prior to stay-at-home orders, and the trend is likely to pick up speed after the pandemic, according to Land & Buildings.

“This just added fuel to the fire, and I think we’re going to have a very material revaluation of New York City office buildings over the next three to five years,” he said. “We know where the people are going. They were going there before COVID, and they’re going to continue to go there. And that’s the suburbs.”

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