# NATIONAL REPORT

OFFICE

2Q/24

Marcus & Millichap

## Office Performance Remains Fragmented, Driven by a Variety of Company Approaches to Office Usage

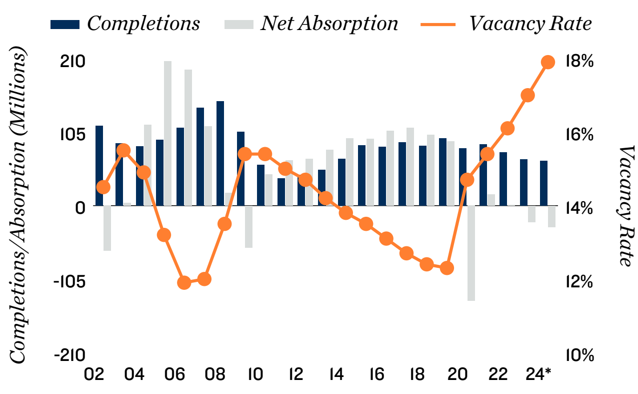
**Metros report mixed net absorption trend in the first quarter.** The fourth quarter of 2023 marked positive office net absorption across most major U.S. markets, resulting in the greatest three-month total since late 2021. Yet, some of this positive momentum ebbed in the first three months of 2024. Net absorption shifted back into the red nationally; however, only 11 markets had reductions over 500,000 square feet. The markets with increasing vacancy logged minimal quarter-over-quarter adjustments that rarely crested 50 basis points. Of the 50 major markets tracked, 18 noted falling or flat vacancy in the first quarter. San Jose led this group with a 90-basis-point drop, the metro's most significant decline since late 2021. It is still too early to tell whether the office landscape is settling, but multiple indicators suggest the sector is at least slowing its previously rapid descent.

**Supply creates minor complications in select markets.** Only 25 out of 50 major markets are slated to receive more than 1 million square feet this year, and tertiary markets make up a scant portion of this total. Half of all the new square footage scheduled for 2024 completion is concentrated in eight markets. Boston, New York City, Dallas-Fort Worth and Austin alone expect 28 percent of the country's total completions. As the cost of construction elevates with rising labor and material expenses, and office vacancy stays at record highs in many markets, some project proposals could be tabled. This would further moderate supply pressure in most major metros, painting a clearer picture of company demand for existing space.

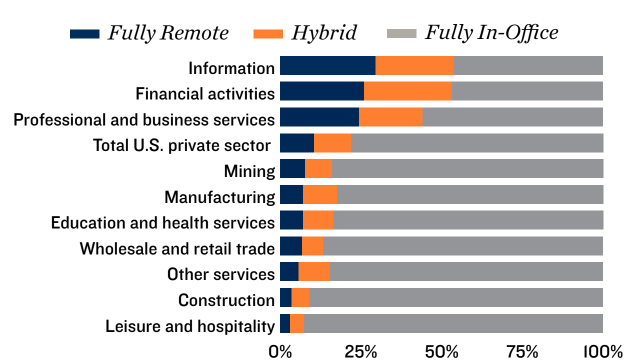
**Construction skews some asking rent averages.** The national average asking rent fell year-over-year, and now sits 1 percent lower than the early 2023 peak. Still, more than 10 million square feet of new space came online in March, and this new supply assisted in the mean inching up quarterly. New stock in markets that generally have higher asking rents is propping up the measure. For instance, Boston logged the greatest volume of deliveries over the last 12 months ended in March, equaling more than 6.6 million square feet. This coincided with the metro's mean asking rent surging more than 15 percent year-over-year.

**Growing number of firms commit to in-person work.** There is no overarching approach that companies are taking to in-person office work; however, there are some emerging trends. The end of 2023 and the opening months of 2024 saw tech companies, which were the first to embrace remote work during the pandemic, sign a flurry of leases. Specifically, growing companies focused on developing artificial intelligence programs are moving back toward collaborative office formats. Nvidia and OpenAI each signed 100,000-plus-square-foot office leases in the Bay Area, in addition to acquiring real estate. Other larger tech companies have announced their intention to simplify operations and slim payrolls, leading firms like Google, Salesforce, Meta and Slack to cut leased office space. In other industries, office demand has been fragmented. While companies like FedEx shrink some regional footprints, other firms like Walmart and Kroger have committed to in-office work policies that can even require remote employees to relocate.

### National Supply and Demand




### Prevalence of Telework Differs Across Industries




*Percent of Employees Working Remote, Hybrid or In-Office ***

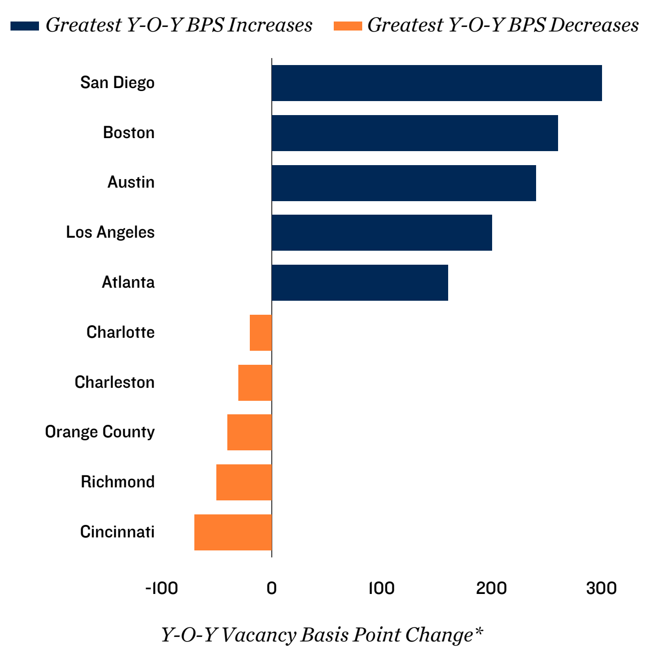
** Forecast; ** As of May 2024*

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

## Supply Challenges Persist in Many Markets; Newly Built Space Outperforms

- **Primary, secondary markets feel supply impact.** Although supply pressures have eased in most of the major markets, some are still vulnerable to this complication. Of the 15 major U.S. markets that expect jumps of at least 100 basis points this year, nine expect at least 1 million square feet of space. San Diego, Boston and Austin will record the largest jumps, coinciding with these three markets expecting nearly one-fourth of all new square footage this year. Few tertiary markets will exceed 1 million square feet of new space, accounting for most of these markets expecting vacancy changes that are flat or less than 100 basis points.

### Secondary, Primary Metros Hold Vacancy Extremes

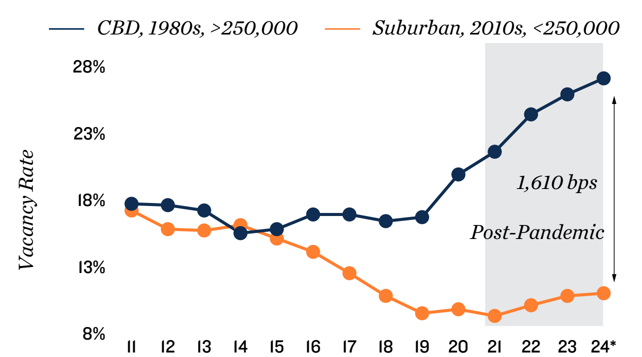


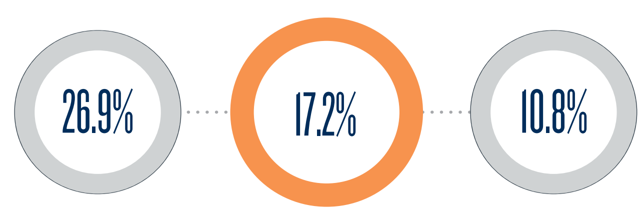

| Metros With the Highest Y-O-Y BPS | 2024 Completions (square feet) | Metros With the Lowest Y-O-Y BPS | 2024 Completions (square feet) |
|---|---|---|---|
| **San Diego** | 3.1 million | **Cincinnati** | 40,000 |
| **Boston** | 7.0 million | **Richmond** | 190,000 |
| **Austin** | 3.75 million | **Orange County** | 142,000 |
| **Los Angeles** | 1.6 million | **Charleston** | 143,000 |
| **Atlanta** | 2.1 million | **Charlotte** | 1.7 million |

- **Smaller, low construction markets boast vacancy decreases.** Of the five markets with the largest vacancy jumps expected this year, three are primary markets. Among the five markets with the greatest vacancy decline, four are secondary or tertiary. All but one of those smaller markets are expected to have a vacancy rate of 13 percent or lower by the end of the year. Primary markets claim 13 of the 20 highest vacancy rates in the country, with secondary markets making up most of the others.

- **Demand builds for smaller, newer suburban space.** After positive net absorption in the second half of 2023, the CBD metric was negative and a net 9 million square feet was relinquished in the first three months of 2024. The divide between suburban and urban demand is likely to widen further. While the suburbs also witnessed negative net absorption in the first quarter, the 1.3 million-square-foot slide was more minimal, leaving vacancy in these properties lower than in the CBD. Tenants right-sizing their footprints have exhibited a preference for highly-amenitized space, particularly in buildings constructed post-2010 with smaller floor plans.

### Newer, Smaller Suburban Assets Outperform




*1Q2024 vacancy in pre-1980 builds larger than 250,000 square feet located in urban cores*

*Overall 1Q2024 vacancy for all offices*

*1Q2024 vacancy in post-2010 builds smaller than 250,000 square feet located in suburbs*

** 2024 Forecast; ** As of 1Q*

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

## 2024 Forecast

### EMPLOYMENT

**1.3%** increase Y-O-Y

- The opening months of the year saw substantial employment gains. While hiring will slow going forward, total employment will expand by 2 million jobs, aided by gains in the office-using sector.

### CONSTRUCTION

**64** million square feet completed

- Deliveries fall below 70 million square feet for the second time in the last decade, reaching their lowest level in 11 years. Completions this year will expand inventory by just 0.7 percent, matching 2023's increase.

### VACANCY

**90** basis point increase Y-O-Y

- Vacancy will rise by the same margin as 2023, with net absorption remaining negative for a second straight year. The rate will subsequently reach a national record high since at least 2000 at 17.9 percent in 2024.

### ASKING RENT

**1.0%** decrease Y-O-Y

- The average national asking rent will decrease to $28.75 per square foot this year. This figure is skewed by new construction and varies heavily by market as demand for existing space remains subdued in many areas.

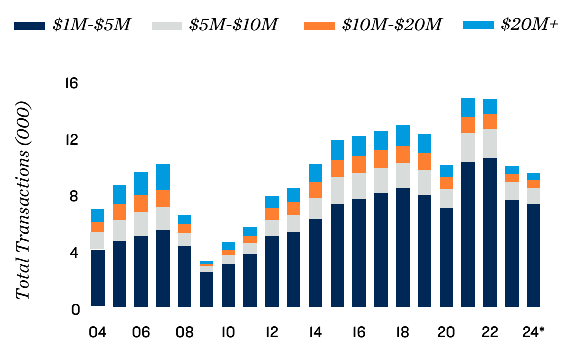
## 2024 INVESTMENT OUTLOOK

- **Investors stay active in smaller, lower-basis markets.** In half of all U.S. major markets, deal flow fell by at least 35 percent year-over-year in March. Baltimore, Portland, Sacramento, Cincinnati, Charleston and Pittsburgh were the only areas that logged a downward adjustment of less than 20 percent. All of these secondary and tertiary markets offered regionally low entry costs, and all but Portland and Pittsburgh had relatively limited vacancy adjustments over the last year. San Jose was the only office market to log an increase in transactions over the trailing 12 months ended in March, coinciding with the metro recording the largest positive net absorption in the U.S. during the first quarter.

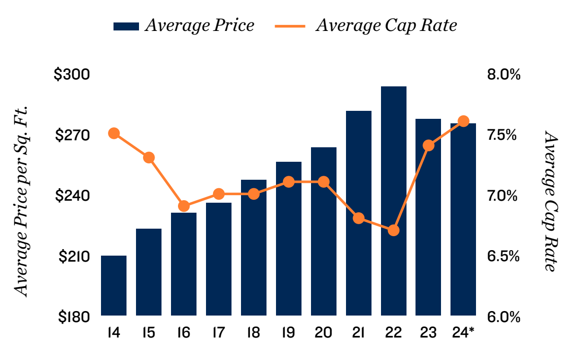
- **Tenant purchases gain some momentum.** Owner-user sales have steadily increased in prevalence following the pandemic. Acer and Nvidia are examples of tenants purchasing their space in Silicon Valley. Other companies may follow suit as high-quality space across the country can be obtained below the market's historical average sale price per square foot.

- **Private buyers seize opportunities, while institutions stay cautious.** As interest rates stay elevated and office vacancies increase, most transactions in the past yearlong period were under $10 million. Some institutions have cautiously signaled a willingness to invest in office properties that meet certain specifications, but private buyers currently make up most of the buyer pool. This will likely persist as lower entry costs for high-quality builds present themselves.

### Office Transactions By Price Tranche




### Investment Sales Trends




* Trailing 12 months through 1Q

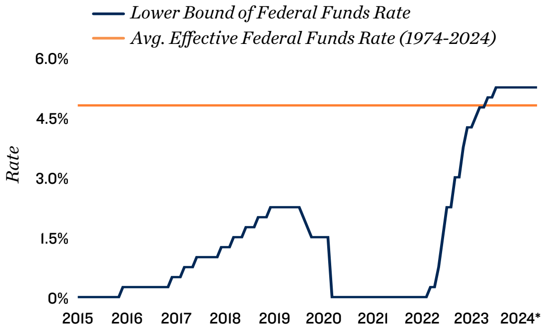
Sources: CoStar Group, Inc.; Real Capital Analytics

# Interest Rates Remain Unchanged in May; Financing Comes From Nontraditional Avenues

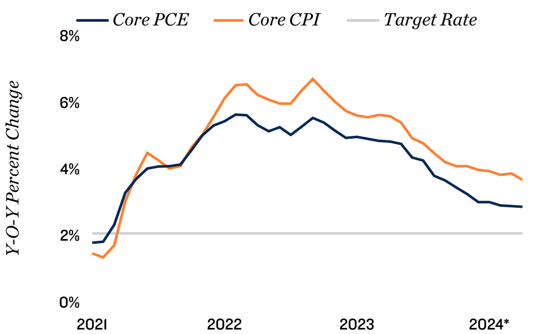
**Fed takes a higher-for-longer stance on rates as inflation stays elevated.** In June, the Federal Reserve left the federal funds rate unchanged at a lower bound of 5.25 percent for the seventh straight meeting. While markets began the year hopeful for several 2024 rate cuts, the Fed recently indicated it is willing to take a “higher-for-longer” stance if inflation remains sticky. Core PCE, the Fed’s preferred inflation reading, was up 2.8 percent year-over-year in April. This marked an improvement from a year prior, but is still persistently higher than the committee’s 2 percent target. Federal Reserve Chairman Jerome Powell has indicated the Federal Open Market Committee (FOMC) will wait to cut rates until the body has concrete evidence that inflation is consistently coming down toward the 2 percent mark. While the FOMC seems to be concentrating less on employment readings, the slowing labor market offers an upside. Hiring slowed in May, reassuring the Fed that labor side pressures are easing.

**Office investors seek alternative financing or utilize 1031 exchanges.** As the office sector continues to face scrutiny, lenders have approached underwriting with caution. To be considered, loans generally need to be at very low leverage or tied to borrowers with well-established relationships. This has led to an increase in all-cash deals, seller financing and 1031 exchanges. As larger institutional investors look to reduce their office exposure until more clarity emerges in the sector, local and regional banks have also claimed a greater share of office loans. Owner-user deals have and will likely continue to rise as businesses find opportunities to acquire top-tier assets for entry costs below recent levels. As with other types of transactions, the financial health of the buyer is of top consideration for the lender. In the coming months, investors are likely to continue seeking alternative financing options; however, more traditional opportunities could return if interest rate cuts happen later this year. Distress sales could also emerge as an opportunity for investors to acquire assets at lower price points. Sales of distressed properties — including auction, high-vacancy, short, foreclosed and bankruptcy sales — reached a 10-year high in the first quarter, with office accounting for the second-highest average among property types. Generally speaking, mid- to large-size properties face more risk, while smaller stabilized traditional or medical offices are less impacted.

## Federal Funds Rate Over Time




## Core Inflation Stays Above Fed’s Target Rate




** Through May*

*Sources: Bureau of Labor Statistics; Federal Reserve*

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*Price: $1,500*





*Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; Federal Reserve Bank of St. Louis; Federal Reserve Bank of New York; Moody’s Analytics; Real Capital Analytics; U.S. Census Bureau*