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BOMA NY leadership forum: state of the CRE market, national and NYC

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New York, NY At a BOMA NY hosted leadership forum, experts from Cushman & Wakefield presented a data-packed analysis of the national commercial real estate market and a focus on current CRE conditions in New York City. The presenters forecasted an office sector recovery highlighted by a “flight to quality” product.

Presenters David Smith, head of Americas Insights Global Research, and Reed Hatcher, senior manager Research Services, envisioned a “trajectory to positive macroeconomic trends,” including slowed down inflation and wage growth trending down to a normal range.

Opening with a national overview of the multifamily sector, Smith said, “As we headed into 2021, we saw a lot of household formation. We saw record-setting demand and absorption.” He added, “Today, both multifamily and industrial vacancy levels remain low and well below historical norms.”

Describing the current national office market, Smith said, “We’ve seen vacancy across the U.S. shoot up. We’re now at 19.5% nationwide,” based on the 93 markets that Cushman & Wakefield tracks. “In 2020 and 2021 we got to over 30 million s/f in negative absorption, and then we started to see the fundamentals balance out. And then, in the summer of 2022, we realized that inflation was not going to be transitory.” The Fed made it clear that they were going to raise rates to get that under control.

He said occupiers are now responding to recessionary trends to manage costs. He said, “While the jobs numbers continue to be positive overall, office-using jobs in particular have been relatively flat and even down in some sectors.”

Smith said “a second kind of pop in negative net absorption, over 20 million s/f per quarter in the last three quarters.” Office construction nationwide is at only 50% from peak years. This trend, Smith said, is skewed by outlier markets like Austin, where new construction is adding to inventory, resulting in higher vacancy levels even in high demand markets.

Smith addressed owners’ NOI, or net operating income. He said, “About 7½ % of U.S. office buildings have a vacancy rate over 50%. The other 92½% are much stronger positioned. About 55% of all office buildings have no vacancies right now. So there’s a lot of buildings where their NOI situation, their valuation at this point and their operations are in a much better place today than they were three years ago.”

In addition, Smith said, “You have some buildings that are really pulling the average of vacancy up that are probably not functionally obsolete, but they may be competitively obsolete.”

Regarding remote work, Smith reported that it is “a very North American challenge. English speaking countries have much higher remote work preferences among their employees. We’re not going back to people being in the office five days a week unless their job really requires it – or they personally really like it. (There are) fewer people in the office Fridays; fewer people in the office Mondays, and that’s true pretty much across all cities.” And people’s days in the office are ending earlier, with them finishing their workdays from home.

Addressing the “flight to quality” office demand trend, Smith said, “People are running to that type of product. The challenge is that about 10 to 15% of the market nationwide is top-tier, so there’s not enough of that office space long term for the demand.”

He added, “So either occupiers are going to lower their standards eventually or owners are really going to have to get their buildings into a place where occupiers will use that space, and more importantly, employees will want to come into that space.”

On the upside of this trend, Smith reported that the rents achieved in newer buildings compared with commodity class A buildings has been expanding. The premium has now gone from 5% across all CBD markets to over 40%. In gateway markets like New York, the trend has risen from 10% to almost 40%.

Smith said that financial services firms are “believing in the office as part of their employment strategy, and seeing this as an opportunity to lease space at a really long-term good value.” Law firms also are doubling down on space to enhance their “apprentice style of learning” with face-to-face, in-office interaction.

Smith concluded his national market portion of the presentation by reporting that “we’re going to see negative absorption next year, probably for most of the year; maybe it turns positive in Q4. Maybe its Q1 2025 before we start to see absorption outpace new deliveries.” Smith closed by stating, “We’ll see a vacancy peak in late 2024, probably about 200 basis points higher than we are today. We might end up in the 21-22% range.”

Hatcher opened his New York City market report by stating that the city experienced a fairly strong economic recovery through 2022, recovering to its pre-pandemic peaks. “Coming into this year,” he said, “we hit a new peak in Q2 of about 1.53 million new jobs. Job growth is being restrained by the technology information sector, which alone has lost 26,000 jobs in New York City this year.”

The return to the office trend also is “a major theme here in New York.” He cited research by the Partnership for New York City, which reported in September that 58% of office staff had returned to their buildings on an average weekday, up from about 49% the same time last year. Hatcher said, “It comes as no surprise real estate comes out the highest at about 75%, and then you’ve got the finance and legal sectors each around 65%, and then unsurprisingly, tech down there at 53%.” However, he said, hybrid working “is here to stay.”

According to Hatcher, present-day absorption “paints a more positive picture this year, certainly compared to what we were seeing back during the height of the pandemic, at 20 million s/f of absorption, a little bit better but still negative last year.”

He said, “Properties that have been completed or fully renovated since 2015 are capturing by far the largest portion of what we’re seeing in terms of positive absorption.” The last several quarters experienced about four million square feet of new leasing, down significantly from a pre-pandemic average of about 9.7 million s/f per quarter.

Renewal activity has held up “fairly well,” compared with 2022. He added, “But new leasing really has come down quite a bit. We see that especially in leases in excess of 100,000 s/f.” Hatcher reported that companies were grappling with economic uncertainties, and taking more time to make leasing decisions in the new “hybrid environment.” On the positive side, he said, “We have seen an uptick in large tenants in the market, so we do expect that to improve.”

Hatcher added, “That’s left financial services to carry the office demand this year, representing about 45% percent of leasing activity thus far this year.”

Hatcher also echoed Smith’s observation of a flight to quality office space in Manhattan. He said, “just looking at class A leasing versus B and C, class A was accounting for 65% to 66% of leasing activity pre-pandemic. It now accounts for about 74%. In Midtown though, class A has been accounting for about 85% of leasing activity over the past two years.”

Overall, however, available space has now climbed to just above 93 million s/f, breaking down to 71 million s/f of direct space and 22 million s/f of sublease space. Demand is centered on new development since 2015 and “legacy trophy” properties (about 30 buildings) completed before 2015. Vacancies for these properties are from nine to 11%.

In “commodity class A” buildings, vacancies are 15% for direct space, and classes B and C are “up in the 20% range,” Hatcher said.

Overall, in Manhattan owner concessions such as tenant improvements are at $127 per s/f, and free rent is at 12.4 months. Both have been trending upward. Base rents in Manhattan overall are now down 6% per year compared to last year. Hatcher reported a “growing weakness” in the downtown market, with “not a lot of new product.”

Overall, he cited base rents of $130 for new developments, with legacy trophy buildings “not far behind.” He said, “But then it drops off fairly significantly for commodity class A and B and C. Net effective rents (NER) are now less than $50.”

Hatcher concluded his presentation by predicting “historically new highs of new supply, around nine to 10 million s/f delivered each year.” He said these new properties are commanding new highs in rents. He said, “We just look at 2023 and we’re seeing pre-leasing of over 50% of that space.”

Hatcher closed with, “The trend going forward is we’re going to see less new completions come into the markets. The demand that we’re currently seeing is going to continue to funnel into better quality product. That’s going to leave a growing amount of vacancy in commodity class A; B and C, and that’s going to more heavily, weigh on rents going forward. We’re looking at around a 30% drop.”

In Manhattan, he said, “The challenge is in that lower quality product. I think you know as owners, developers, we’re going to need to look at how to address that going forward.”