1Q24

United States Office Leasing House View

NEWMARK

Market Observations

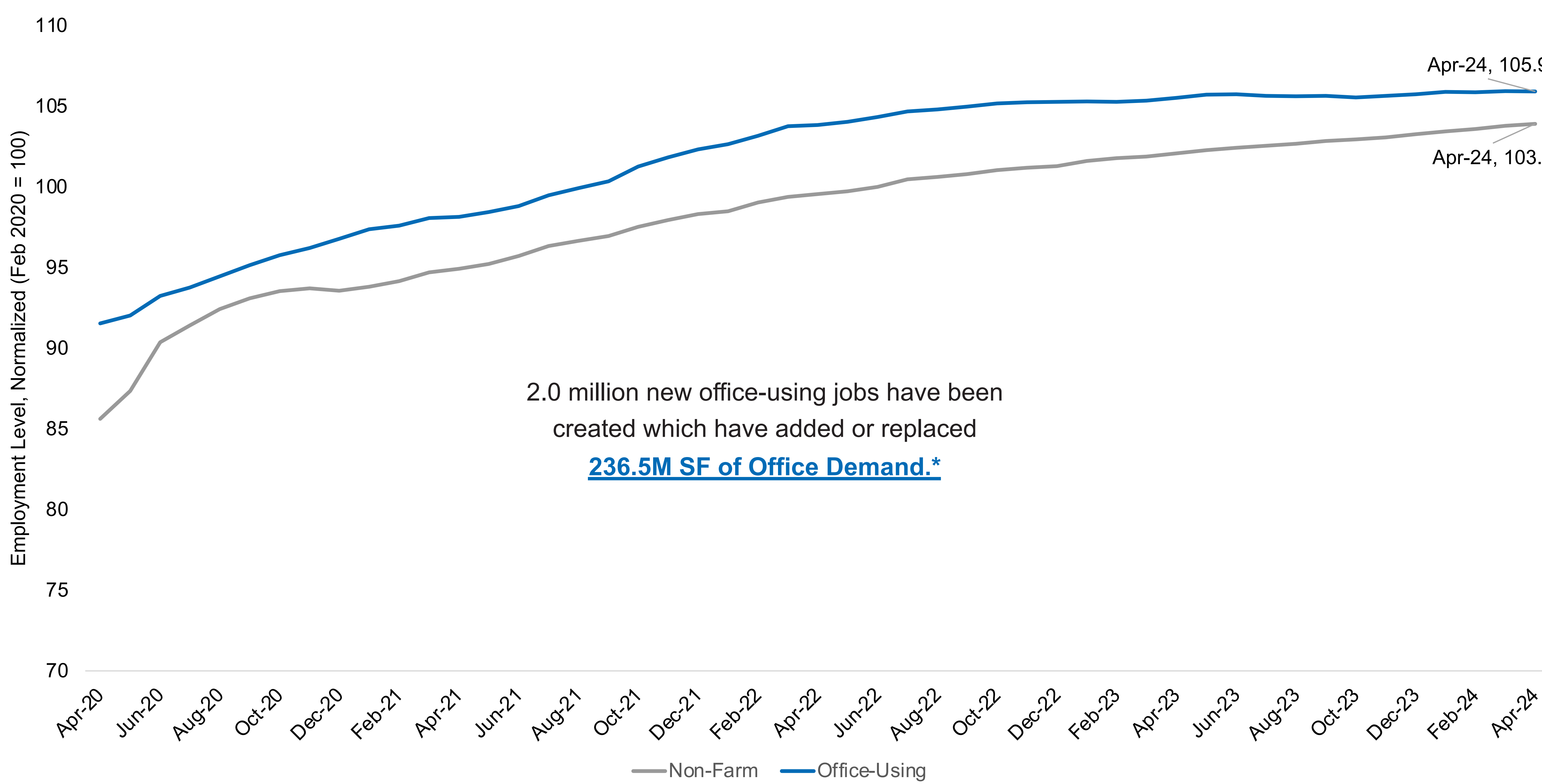
- **Labor Markets:** National office-using employment is now 6.0% above January 2020 levels, with the recovery being led by technology, advertising, media and information companies. These new jobs equate to an estimated 236.5 million SF of office demand, helping to soften the blow the hybrid work office demand shock. However, office-using job growth is now slowing. Indeed, office-using employment contracted in 31 of the top 50 office markets in the last 6 months.
- **Hybrid Work Transition:** Slowing job growth leaves markets more exposed to the ongoing demand adjustment to hybrid work. Newmark estimates that 57% of pre-pandemic leases have yet to come up for renewal, including 1.9 billion SF of renewals in the 2024-2027 period. Average lease size has declined by 13.6% compared to pre-pandemic suggesting further reductions in overall office demand.
- **National Trends:** Leasing activity remained sluggish in most markets in the first quarter of 2024, decelerating nationally to an estimated 0.8% of inventory, compared with the quarterly average of 1.4% realized between 2012 and 2019. Net absorption continued to post losses in 1Q24, but more notably, net absorption decelerated quarter over quarter to -15.5 million SF, breaking its recent upward trend. Negative net absorption was broad-based with occupied space contracting in 40 out of 58 markets tracked by Newmark. National vacancy rose 40 bps to 20.1%. More positively, office inventory under construction declined to 48.2 million SF, a trend expected to continue.
- **Regional Trends:** All regions posted occupancy declines in the first quarter of 2024, led by the East region where occupancy declined by negative 7.6 million SF. Minimal leasing activity as a percent of inventory was relatively ubiquitous across most regions, indicating a slowdown in the momentum that had been gained in the prior two years in some secondary and Sun Belt markets.
- **Market Size Trends:** Gateway markets shed most space in the first quarter of 2024, led by New York, Boston and Chicago. Tertiary markets recorded relatively flat occupancy growth and have continuously outperformed since 1Q21 albeit representing a small share of the national market.
- **Rent Trends:** Asking rents increased 1.1% year over year in 1Q24, led by Tertiary markets in apparent defiance of the law of supply and demand. Concessions packages remain significantly higher than they were pre-pandemic pushing down effective rents. TI allowances are 70% higher than they were pre-pandemic on average based on an analysis of leading office markets.
- **Class Conundrum:** Class performance is more nuanced than the dominant flight to quality narrative suggests. The lowest availability rates are in post-2019 delivered buildings and Class B offices nationally, particularly in suburban markets. The highest rates are in commodity Class A buildings. Asking rent growth is somewhat disconnected from availability rates. Commodity Class A rents have grown 5.2% since 4Q19 in suburban markets, despite having the highest availability for example. Combining metrics as rent per available foot, it becomes clear that legacy trophy assets, commodity Class A and Class B buildings have also suffered reductions in cash flow potential, but commodity Class A has underperformed. There seems to be a free lunch to the owners where they to reduce rents and attract occupiers from Class B buildings. Why has this not happened, and why has there not been a broader adjustment in rents more generally given ongoing high availability? One possibility is that undercapitalized owners face strong incentives to resist adjusting rents, particularly where large incentive packages result in negative cash flows early in a lease.

Demand Drivers

Office-Using Employment Has Outpaced the Overall Labor Recovery

National nonfarm employment recovered to pre-pandemic levels in June 2022 and is up 21.4% from the pandemic low in April 2020. Office-using employment was less impacted during the pandemic and has maintained a consistent pace of recovery, measuring 2.0 million jobs above pre-pandemic levels. This is significant because net-new jobs can provide a counterweight to the negative demand effects from remote work.

Employment Recovery Comparison – Normalized to February 2020

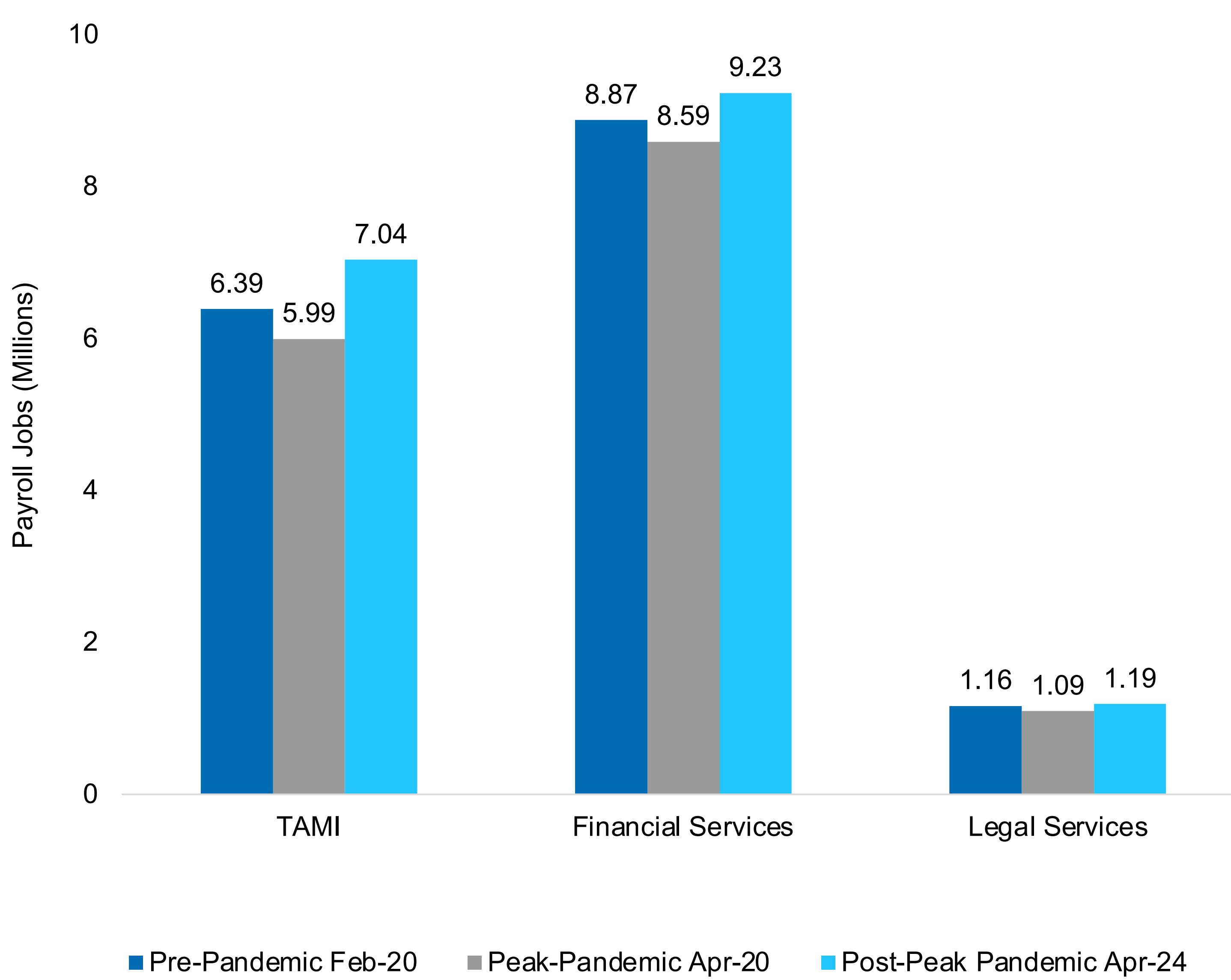


Sources: U.S. Bureau of Labor Statistics, Newmark Research
Seasonally Adjusted
*Assumes estimate of around 120 SF per new office-using job

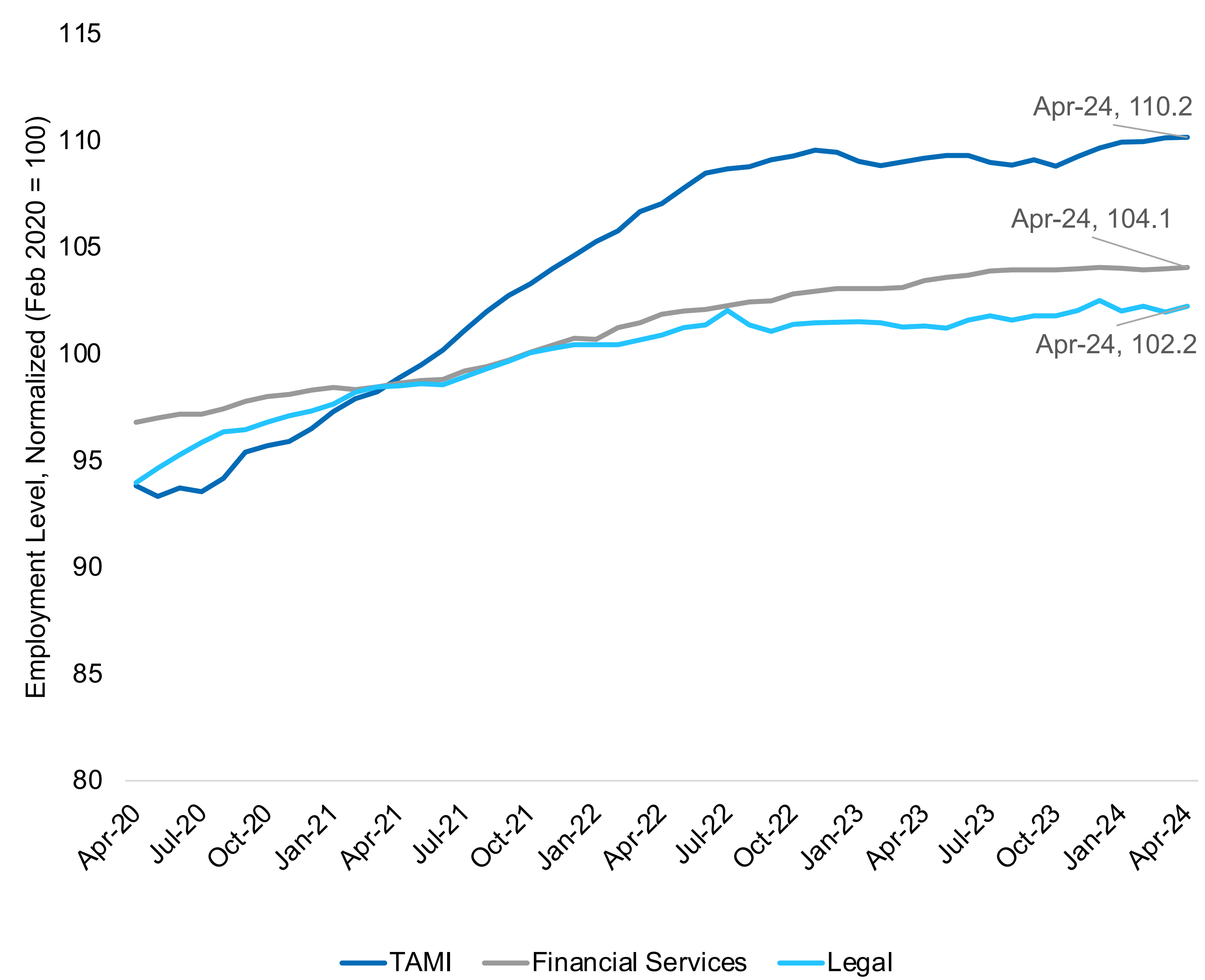
Employment Growth across Office-Using Industries

Employment now exceeds pre-pandemic levels across office-using industries. The recovery in TAMI has been particularly strong, despite significant layoffs in the information sector in 2023, with employment 10.2% above February 2020 levels. Impressive gains have been made across a range of professional and business services, which in the aggregate are up 6.3% from February 2020. Legal services have more than fully recovered as well, but less than these other categories.

Employment by Industry



Employment by Industry (Historical)

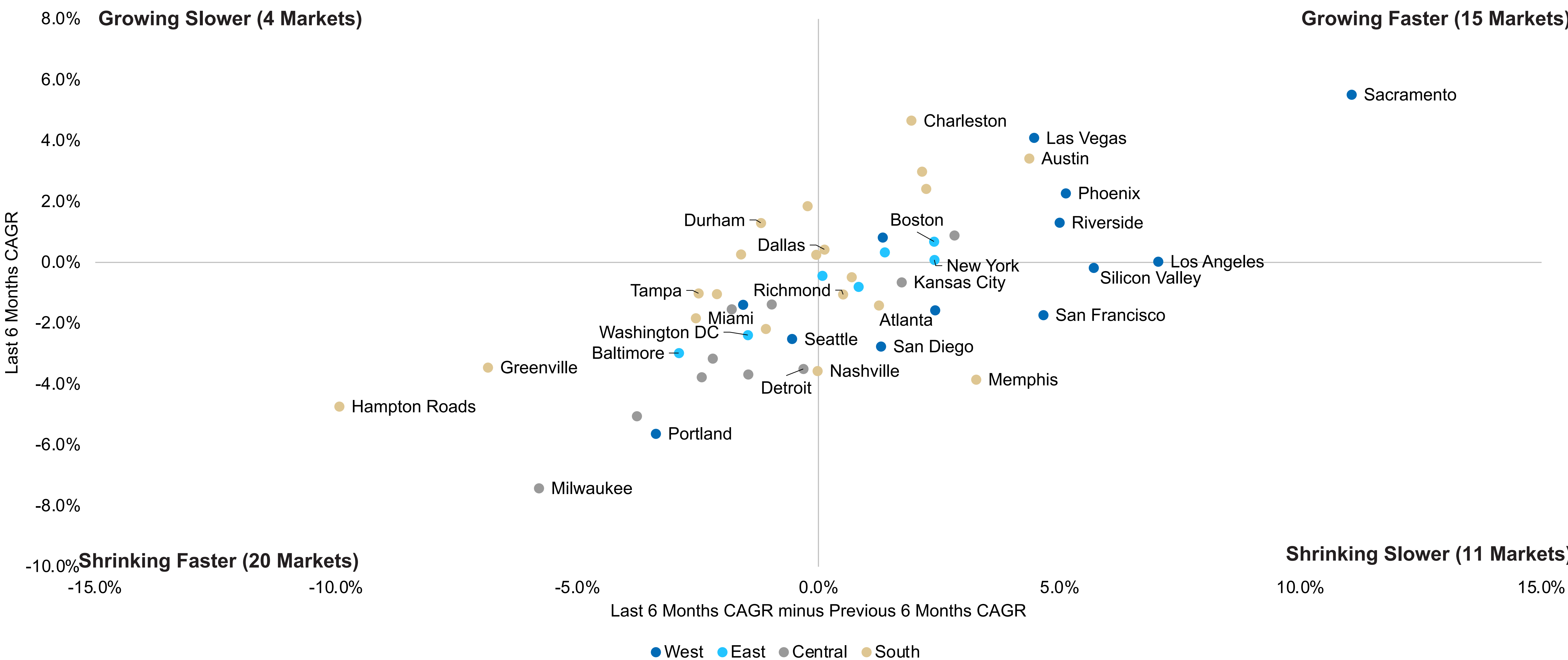


Sources: United States Department of Labor, Newmark Research

Office-Using Employment Growth Decelerating in Most Markets

Employment continued decelerating in 2024, echoing trends seen in 2023; 15 markets saw job growth accelerate from the prior year, while 20 markets, particularly in the Central and South regions, recorded steeper negative growth.

Last 6 Months CAGR vs. 2023-2024 Acceleration

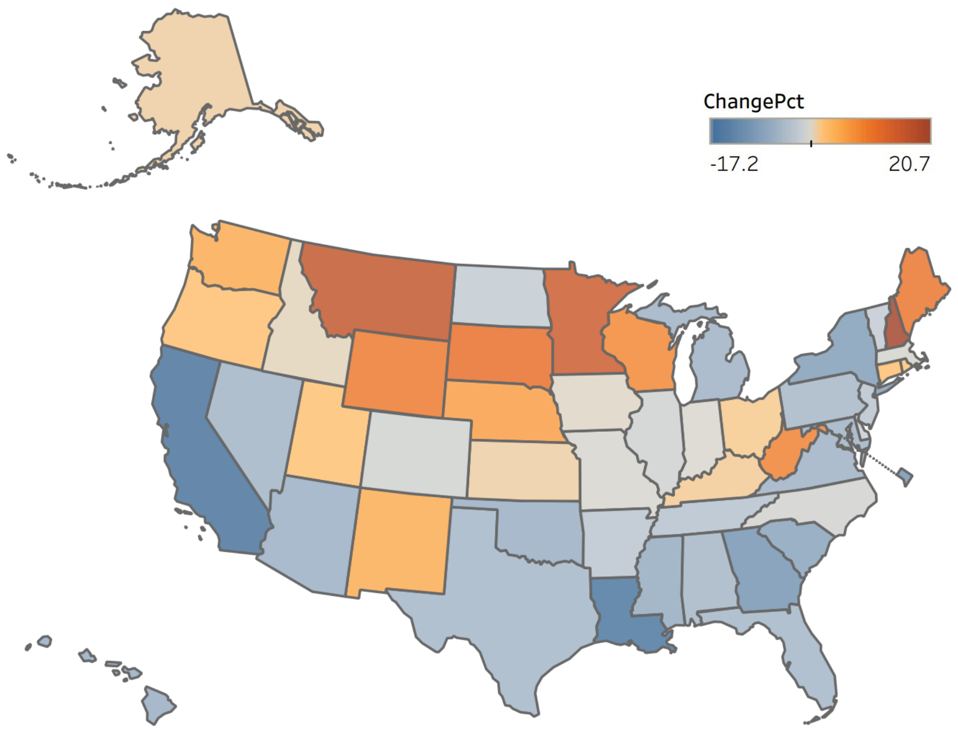


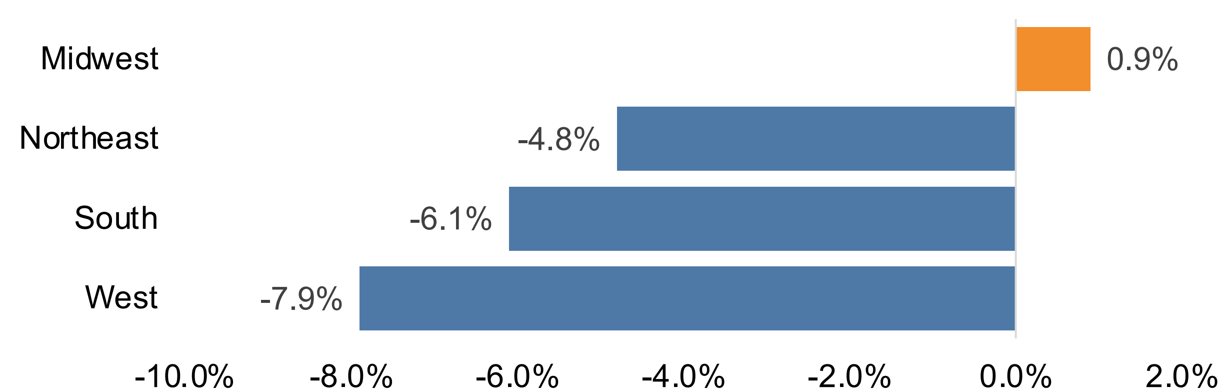
Source: Bureau of Labor Statistics, Newmark Research

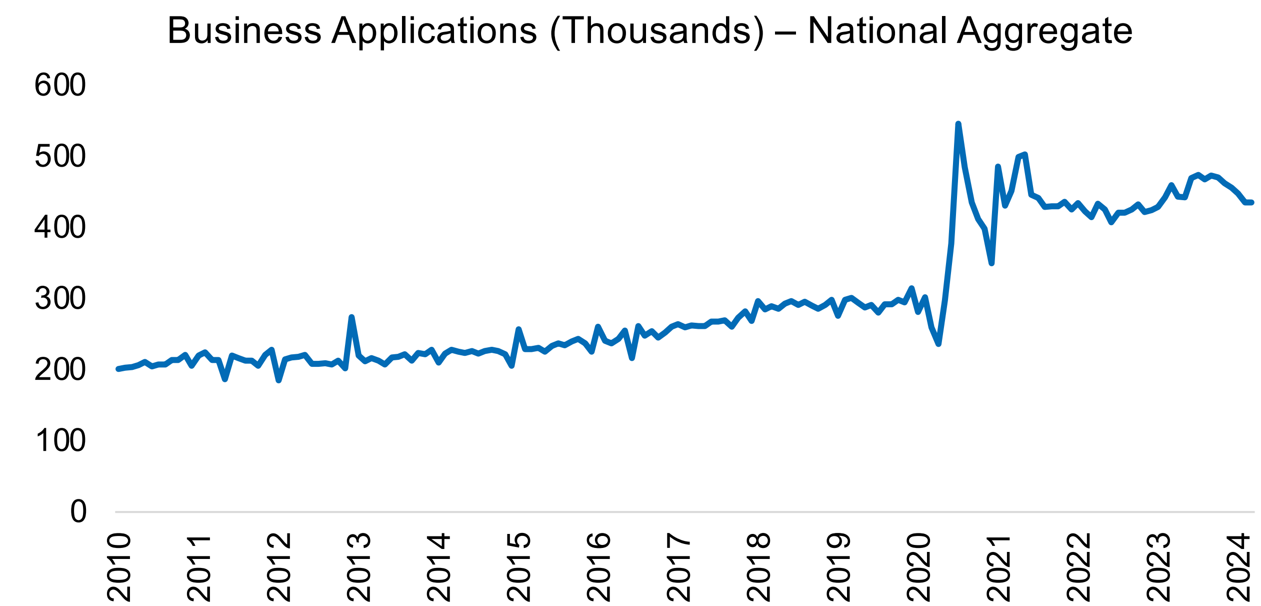
New Business Formation Decelerating but Still above Pre-Pandemic Levels

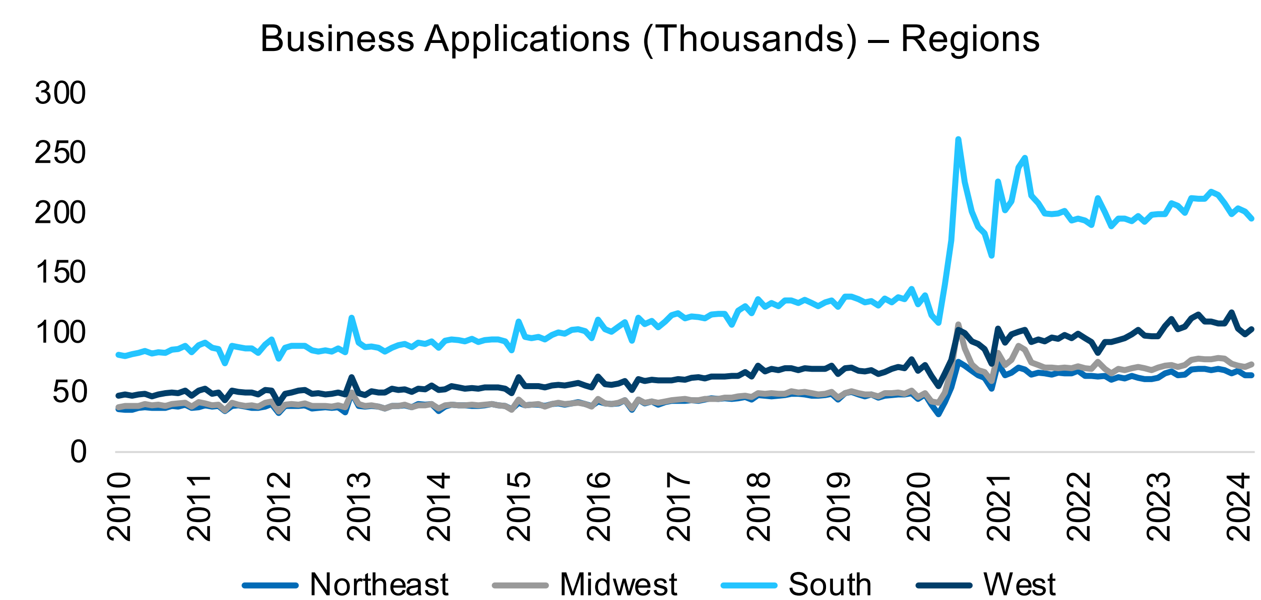
Business formation decelerated in March 2024; 435,629 new business applications were filed, which is down 5.2% from March 2023. This decline was realized in the Northeast, South and West, while the Midwest recorded positive growth to the tune of 0.9% year over year. Overall business creation remains notably higher than pre-pandemic levels in all geographic regions.

Business Applications: Change from March 2023 to March 2024 (Seasonally Adjusted)







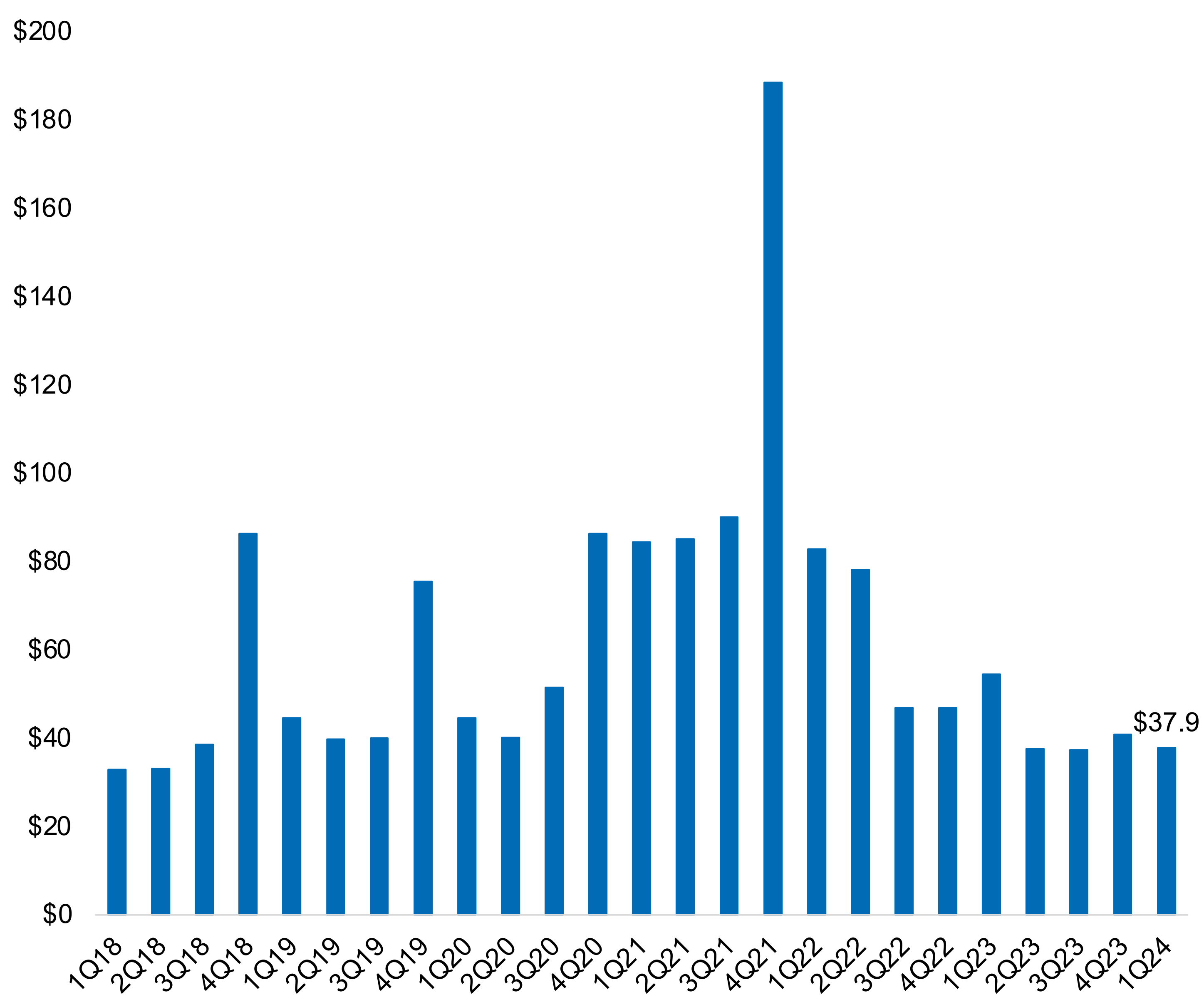


Source: United States Census Bureau, Newmark Research

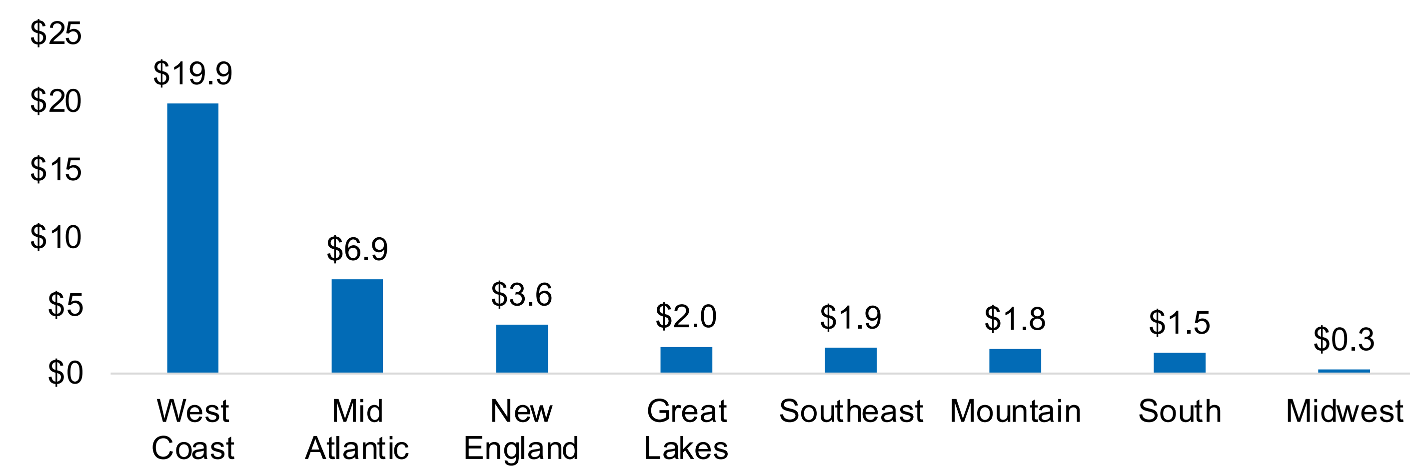
Venture Capital Investment Activity Has Returned to Pre-Pandemic Level

Overall venture capital contracted in the first quarter of 2024 as investors remain cautious. Total investments are down significantly from the cycle's recent peak in 2021, and activity in the past year has returned to a historical equilibrium. Across the range of tracked industry sectors, materials and resources realized the greatest annual gains, to the tune of 105.0% year over year, while information saw the steepest decline, totaling negative 56.2% year over year. The market's largest funds are likely to experience the greatest contraction in activity, but high levels of dry powder should continue to support investment activity among smaller funds.

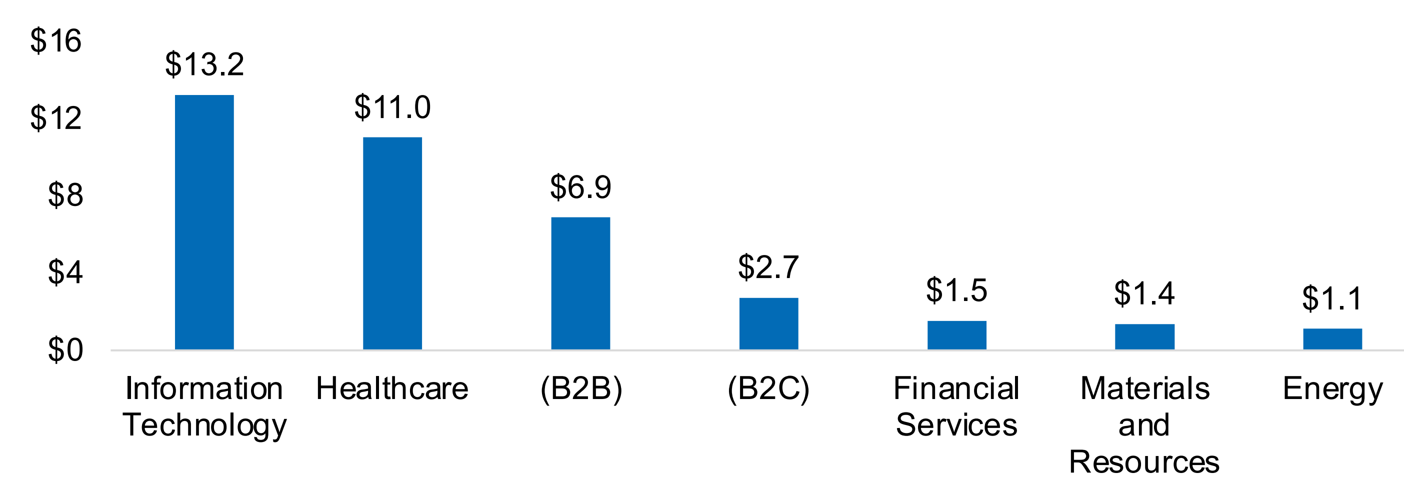
Venture Capital Deal Value ($ billions)



1Q24 VC Funding by Region ($ billions)



1Q24 VC Funding by Industry Sector ($ billions)

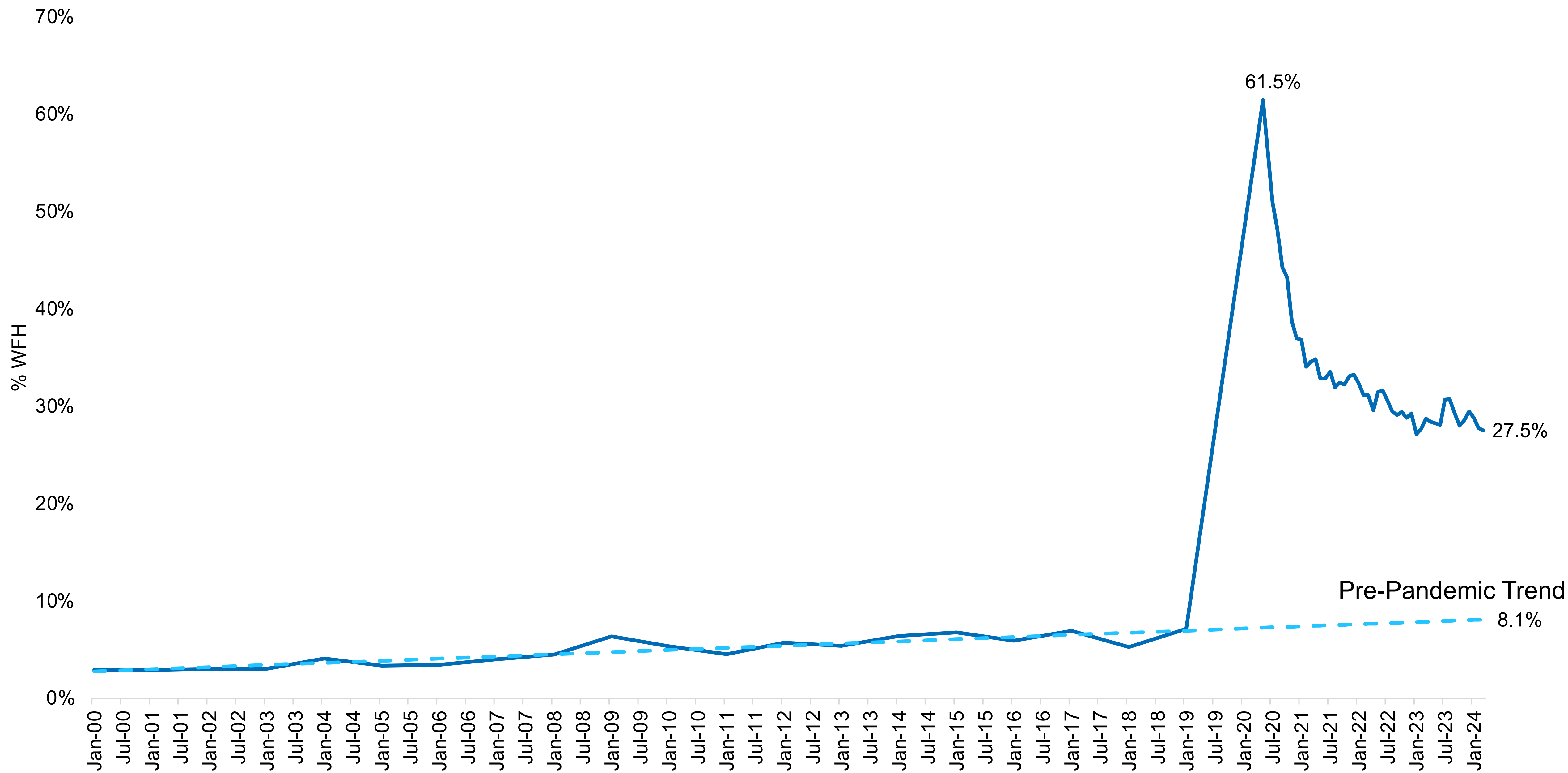


Sources: PitchBook, Newmark Research

The Pandemic Compacted Decades of WFH Transition into Three Years

In the two decades prior to 2020, the full paid days worked from home by all employees averaged 5.2%. This metric grew significantly in the first quarter of 2020, reaching a maximum of 61.5% in May of 2020. Since then, this metric has declined at a decelerating pace and stands at 27.5% as of March 2024.

Share of Full Paid Days Worked From Home



Source: Barrero, Jose Maria, Nicholas Bloom, and Steven J. Davis, 2021. "Why working from home will stick," National Bureau of Economic Research Working Paper 28731.

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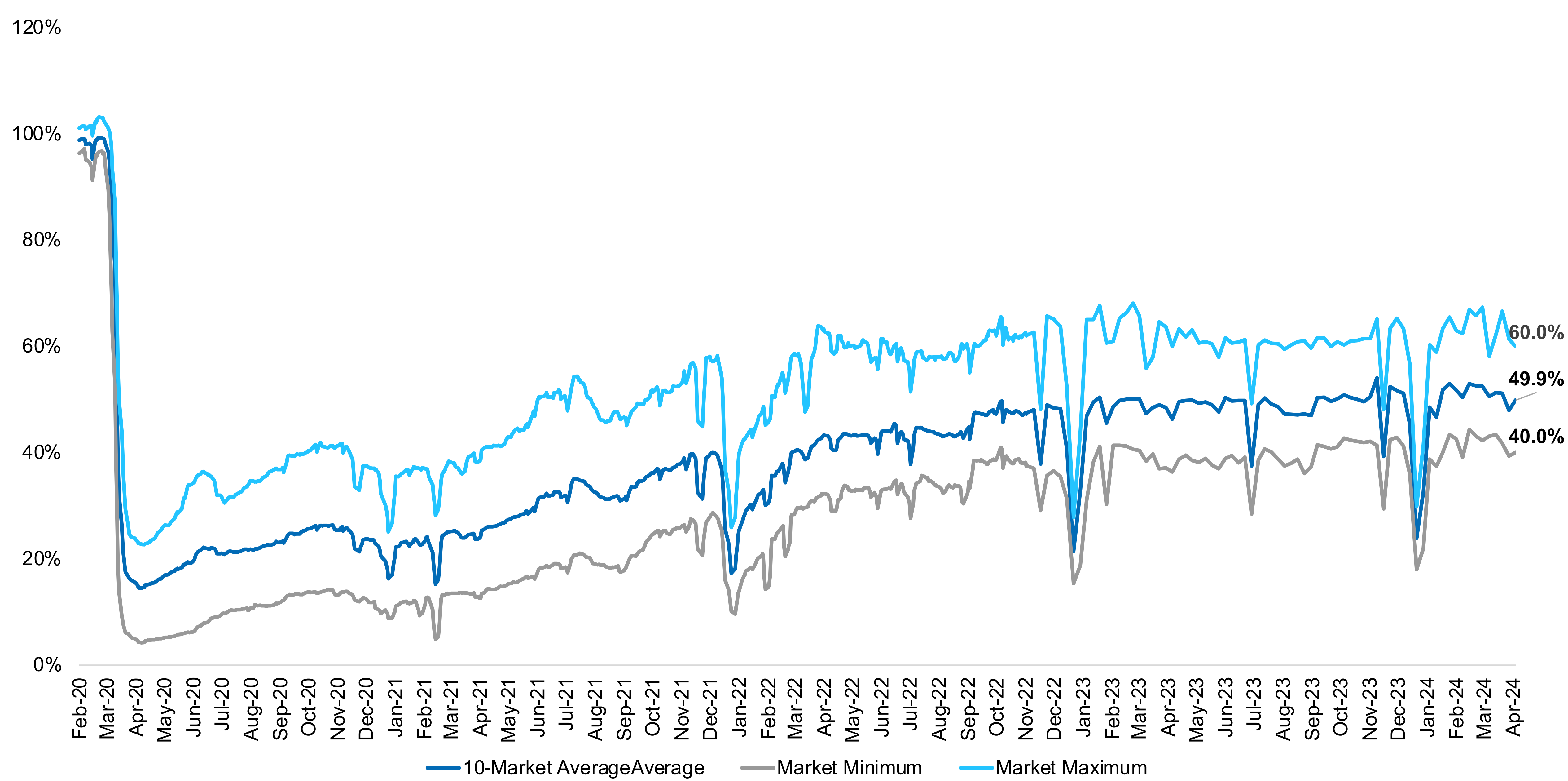
Return to Office Has Stabilized

Kastle Systems' data shows office utilization was relatively static in the first quarter of 2024. The 10-market average reached 54.1% in mid-November of 2023, the highest occupancy levels seen since pre-pandemic, before sliding down again. The 10-market average stood at 49.9% as of April 2024. There continues to be significant variation in daily office attendance during a given week, suggesting that peak office attendance may have been as high as 70% and pushing 80% in the markets with the most robust return to office.

Kastle Systems Daily Office Physical Occupancy Index – 5-Day Trailing Average (Baseline = February 2020)



Source: Kastle Systems, Newmark Research

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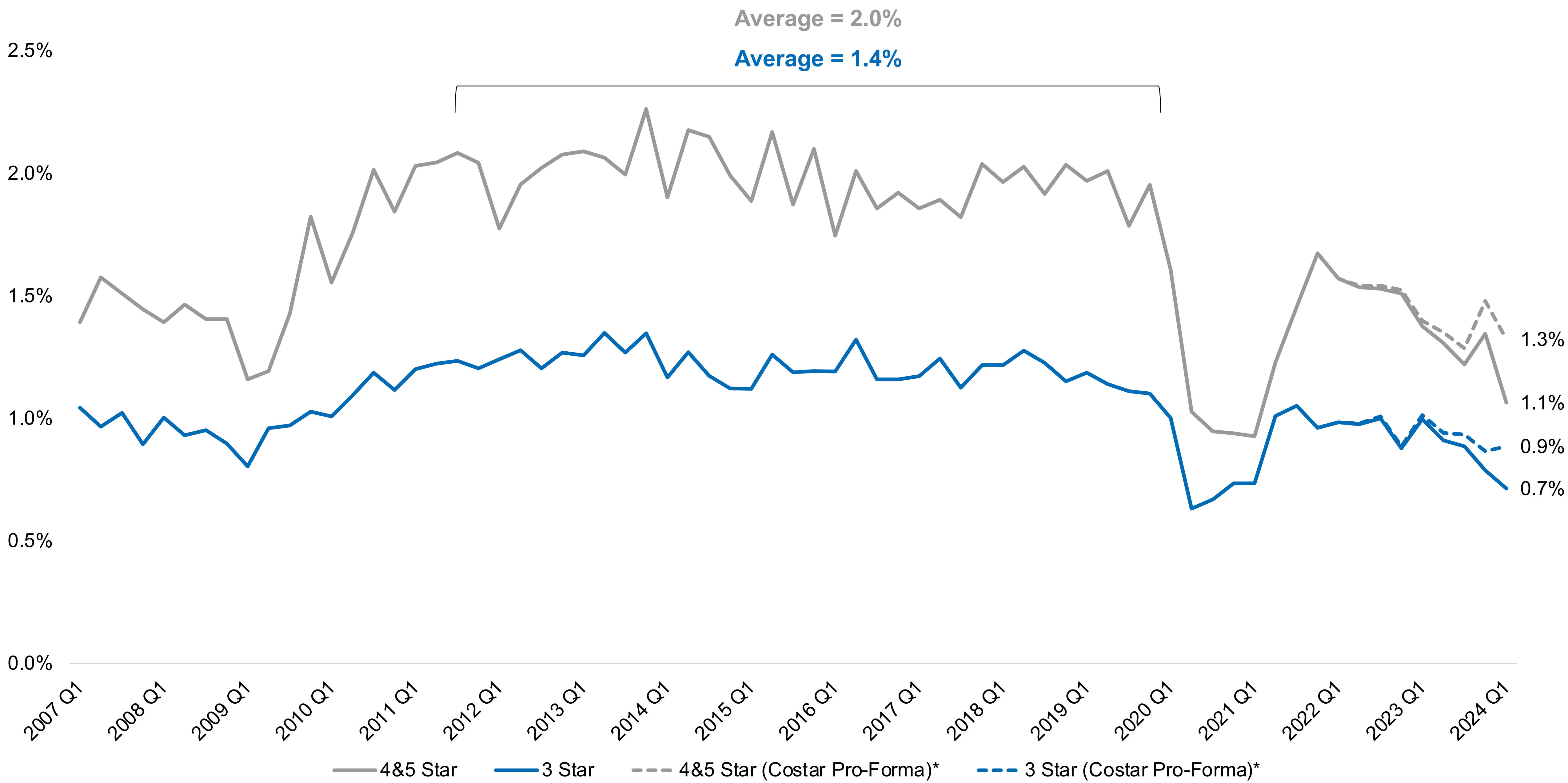
Leasing Market

Office Leasing Lukewarm in 1Q24

Higher-quality buildings continued to outpace the overall market and drove a larger share of leasing activity in the fourth quarter of 2023. Although four- and five-star buildings only account for 38.5% of inventory, these assets captured 51.1% of leasing activity in the first quarter of 2024, a downward trend from the first quarter of 2023.

Leasing Activity as a Share of Inventory



Source: CoStar, Newmark Research as of 4/18/2024
*CoStar pro-forma based on proprietary internal formula that estimates remaining leases not captured based on analysis of historical leasing trends.

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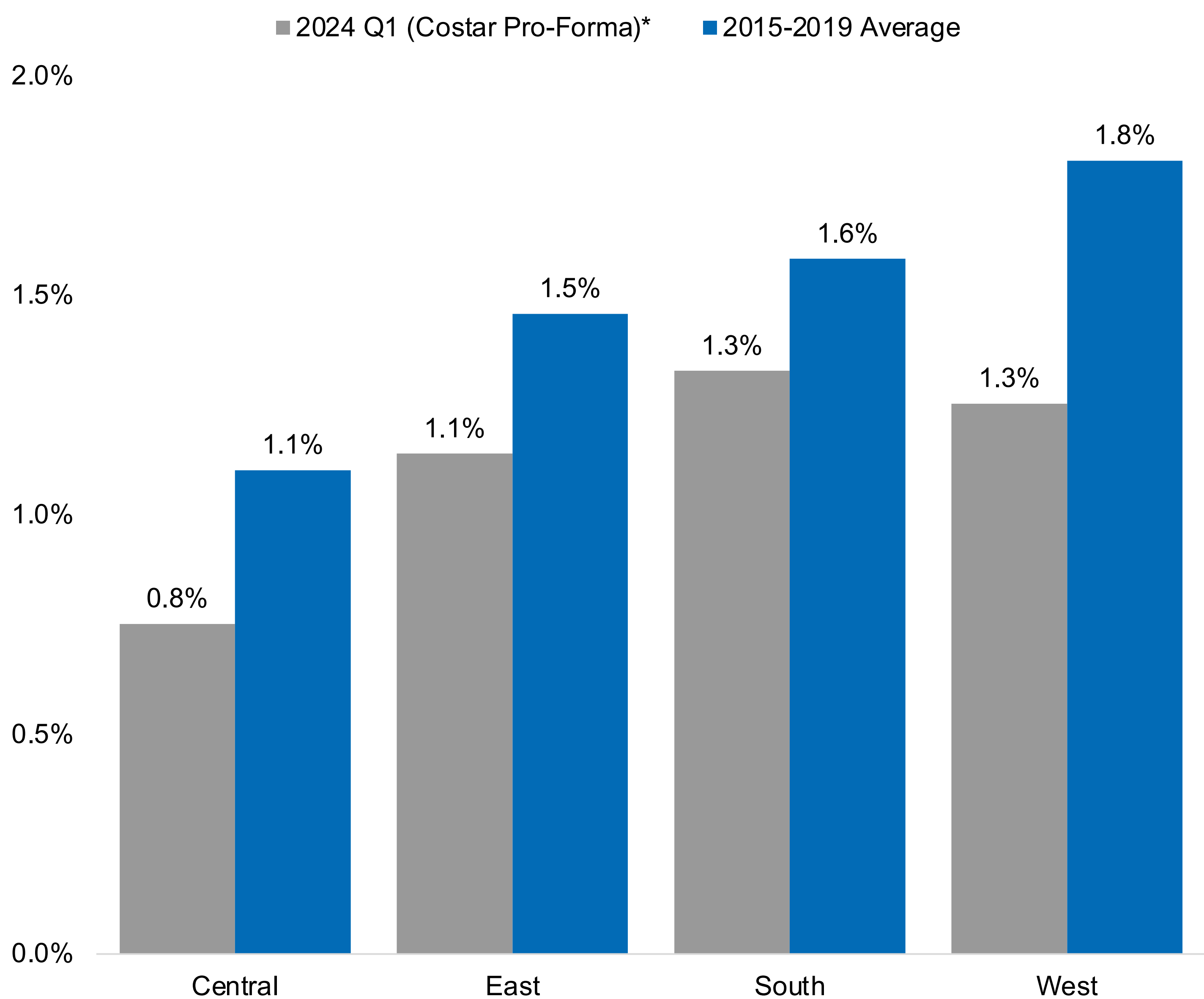
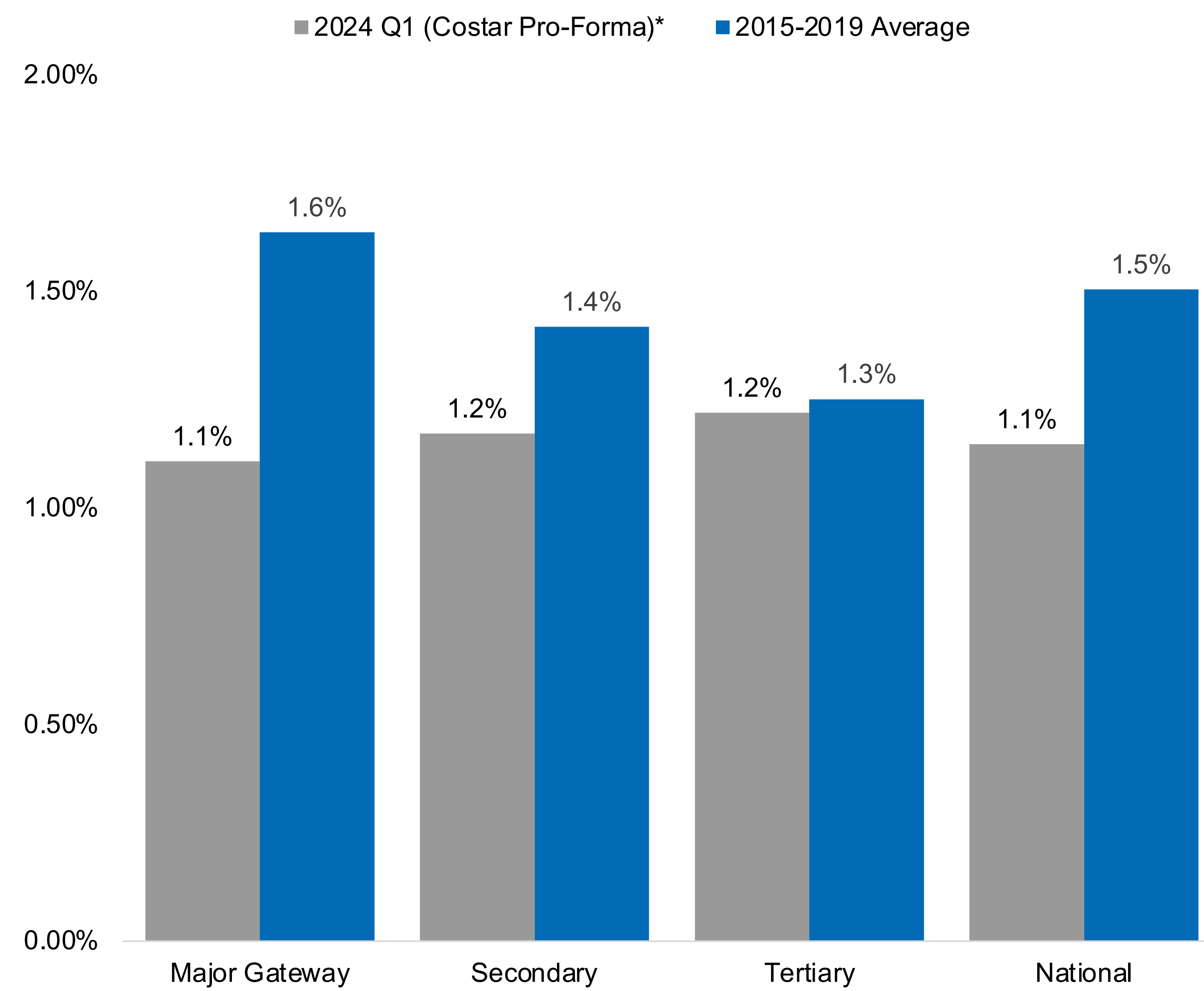
Leasing Activity Lags Pre-Pandemic Baseline

Leasing activity was again sluggish in most markets in the first quarter of 2024. Leasing momentum had been more varied prior to the onset of the pandemic, with Western and major gateway markets commanding a large share of leasing relative to inventory. In the first quarter of 2024, leasing activity as a percent of inventory was relatively even across most regions and market sizes.

Regional Leasing Activity as a Percent of Inventory



Market Size Leasing Activity as a Percent of Inventory

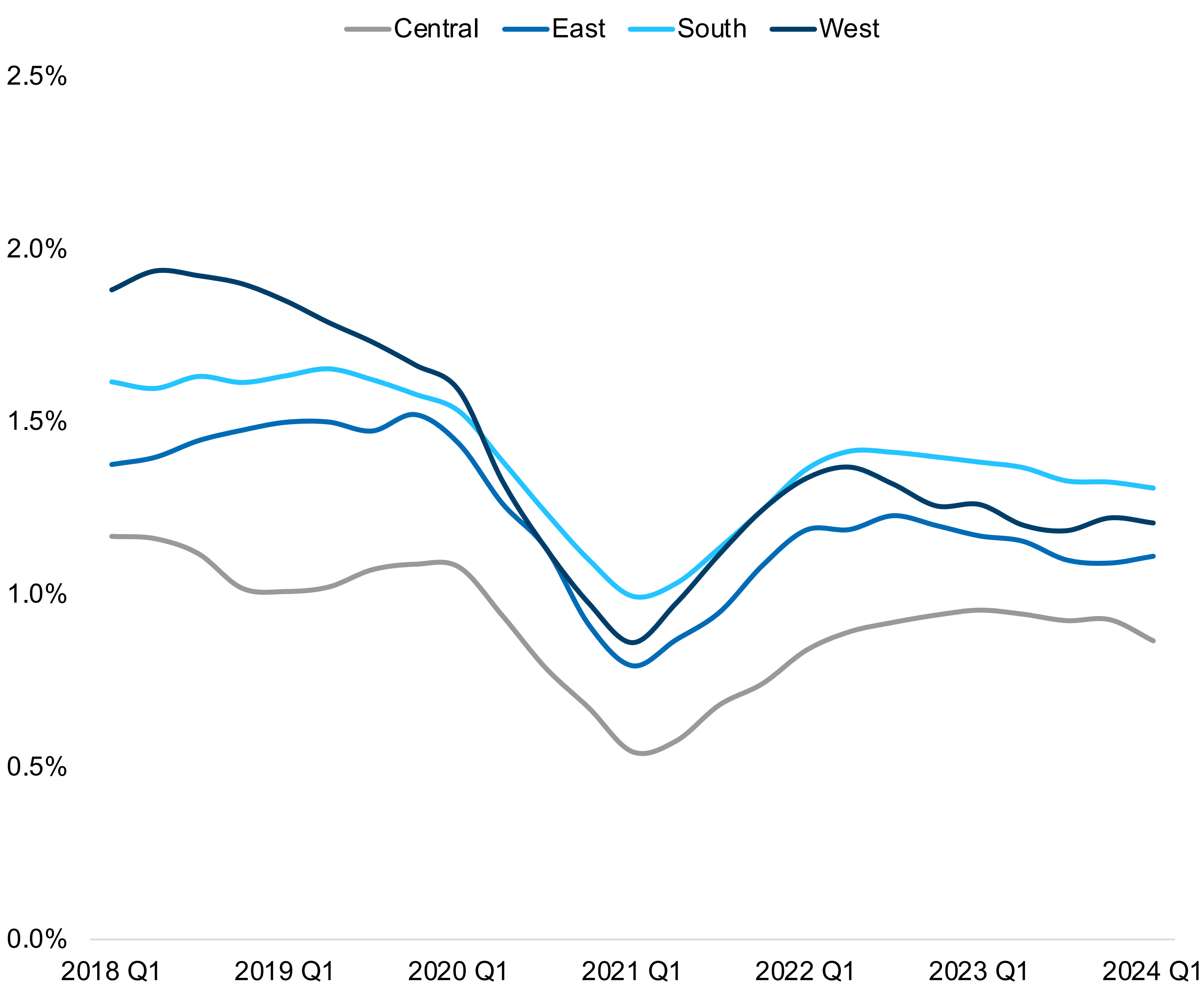


Source: CoStar, Newmark Research as of 4/18/2024
*CoStar pro-forma based on proprietary internal formula that estimates remaining leases not captured based on analysis of historical leasing trends.

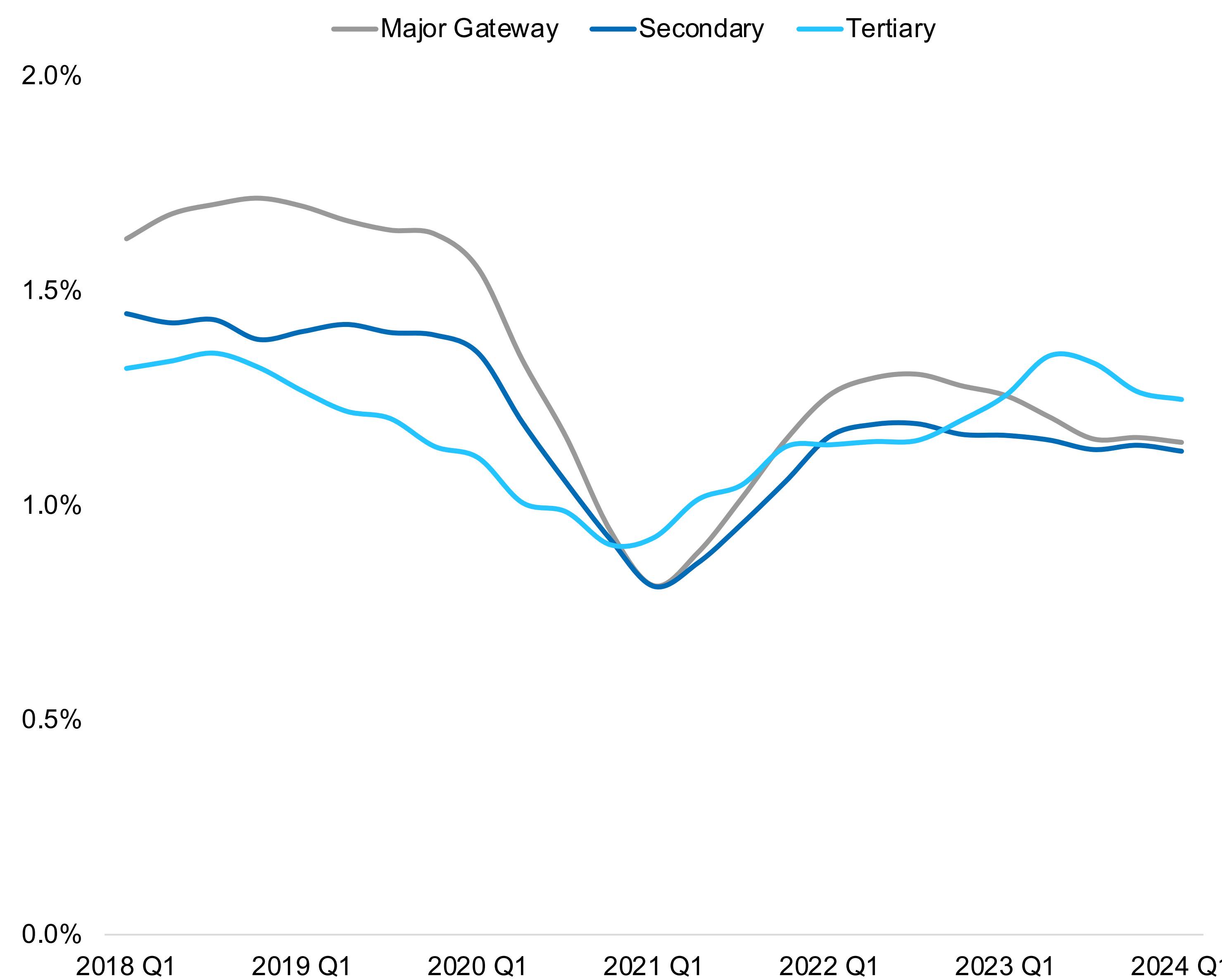
Leasing Activity: Historical Perspective

Most regions and market sizes have seen a slowdown in leasing activity compared to gains in 2022, with tertiary markets being a notable exception.

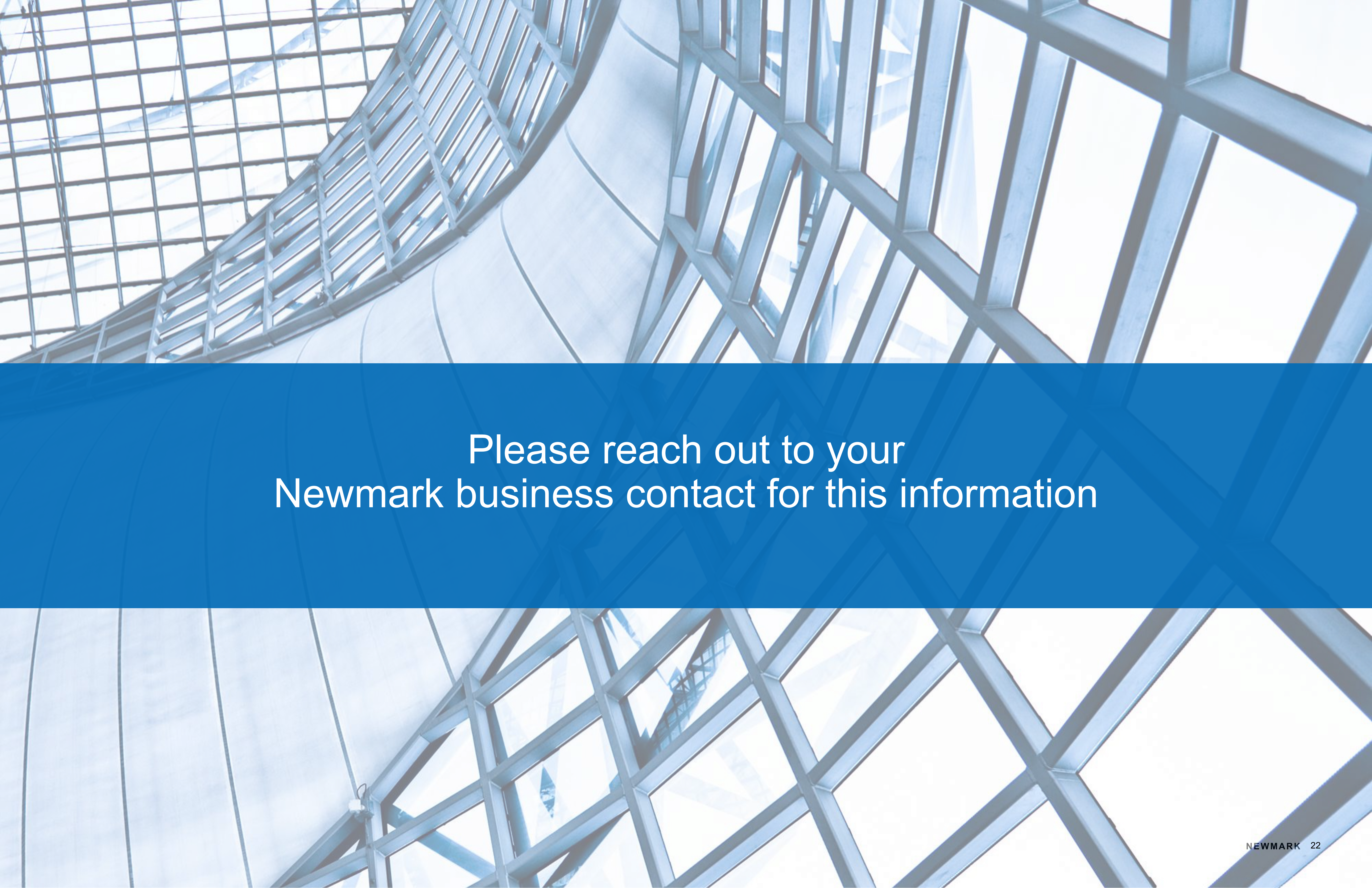
Regional Leasing Activity as a Percent of Inventory (4-Quarter Trailing)*



Market Size Leasing Activity as a Percent of Inventory (4-Quarter Trailing)*



Source: CoStar, Newmark Research
*The fourth quarter of 2021 through the first quarter of 2024 values used in four-quarter trailing calculation use CoStar pro-forma based on proprietary internal formula that estimates remaining leases not captured based on analysis of historical leasing trends.



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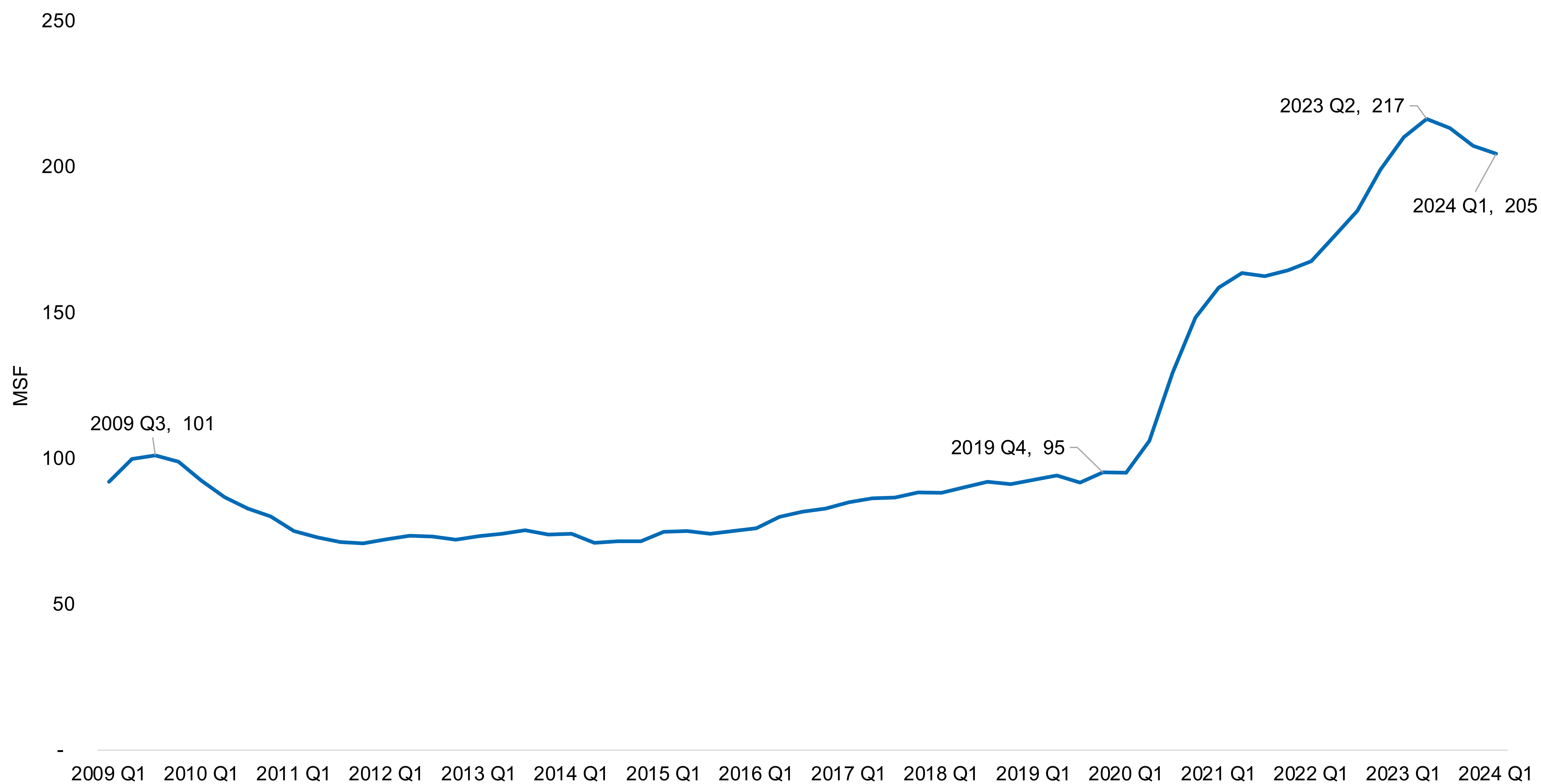
Sublease Availability Trending Down in 1Q24

Sublease availability continued to slide in the first quarter of 2024, having declined 2.8% from the first quarter of 2023. Despite the recent decline, the continuing rise in overall vacancy implies that a portion of the sublease spaces taken off the market are due to term expiration and are now being listed on a direct basis.

National Sublease Availability

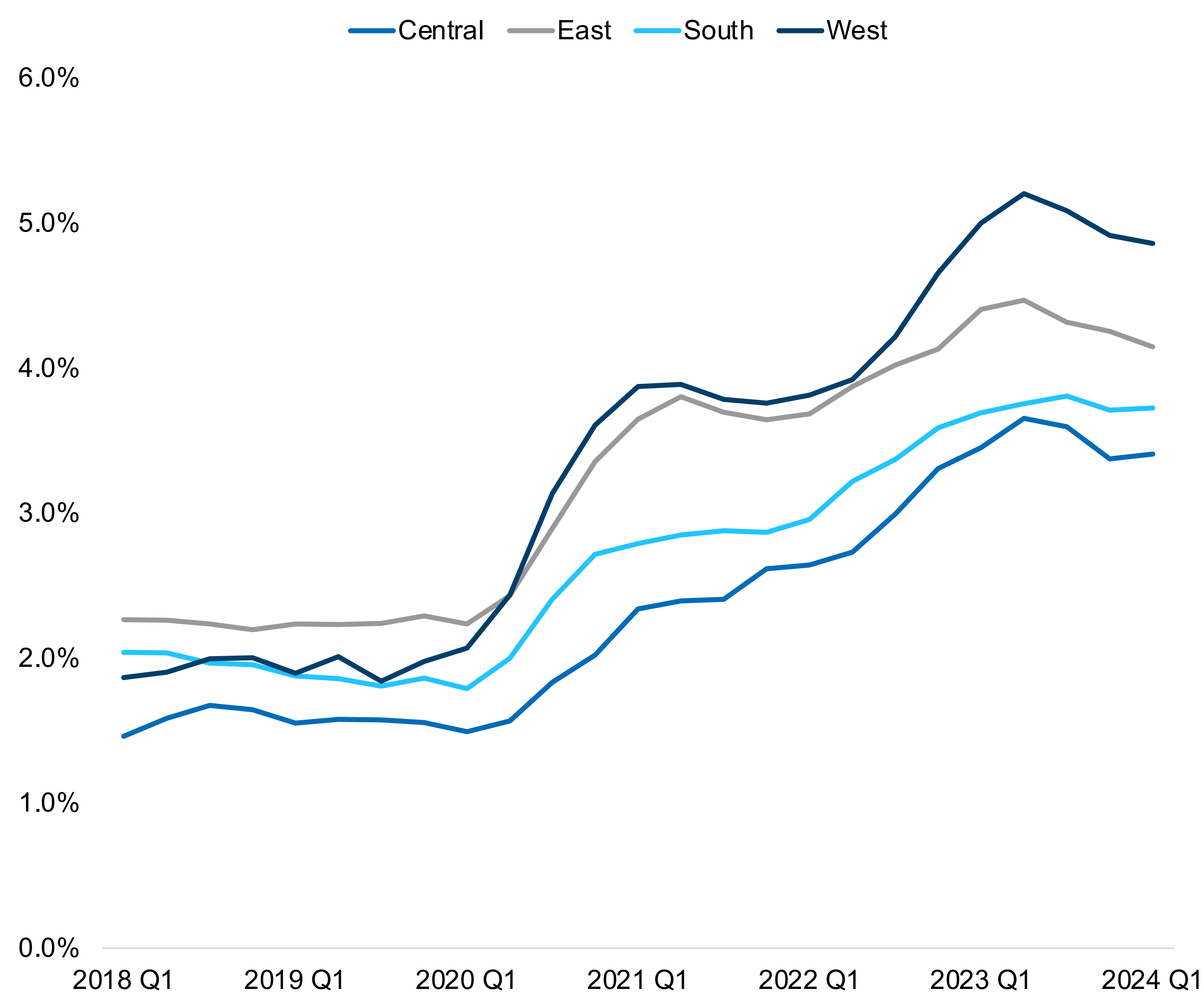


Source: CoStar, Newmark Research

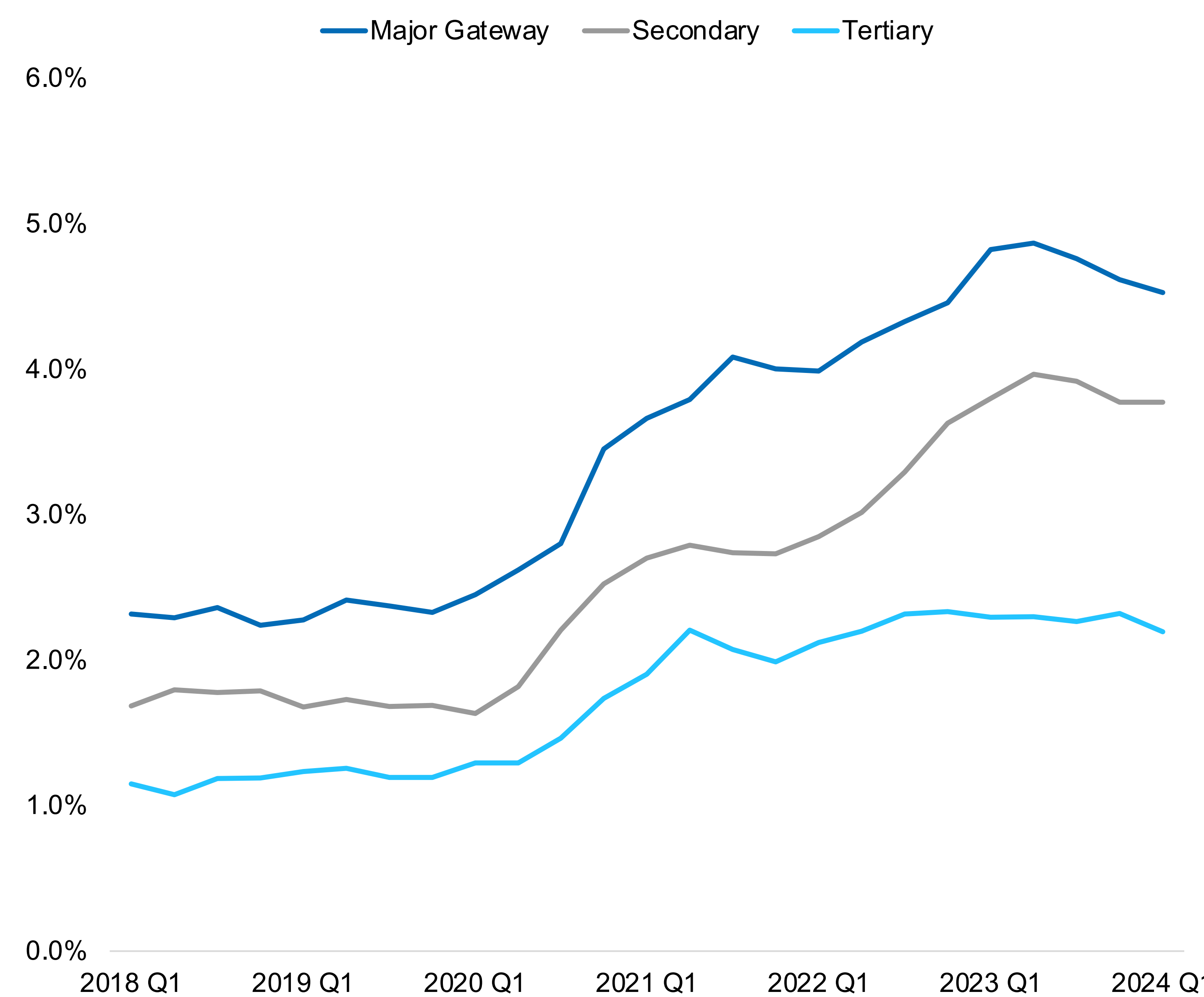
Sublease Availability Significantly Elevated above Pre-Pandemic Baseline

While sublease availability declined in the first quarter of 2024, it remains elevated from a historical perspective. Sublease availability is highest in Western Region markets, notably San Francisco, as well as major gateway markets more generally.

Regional Sublease Availability Rate



Market Size Sublease Availability Rate

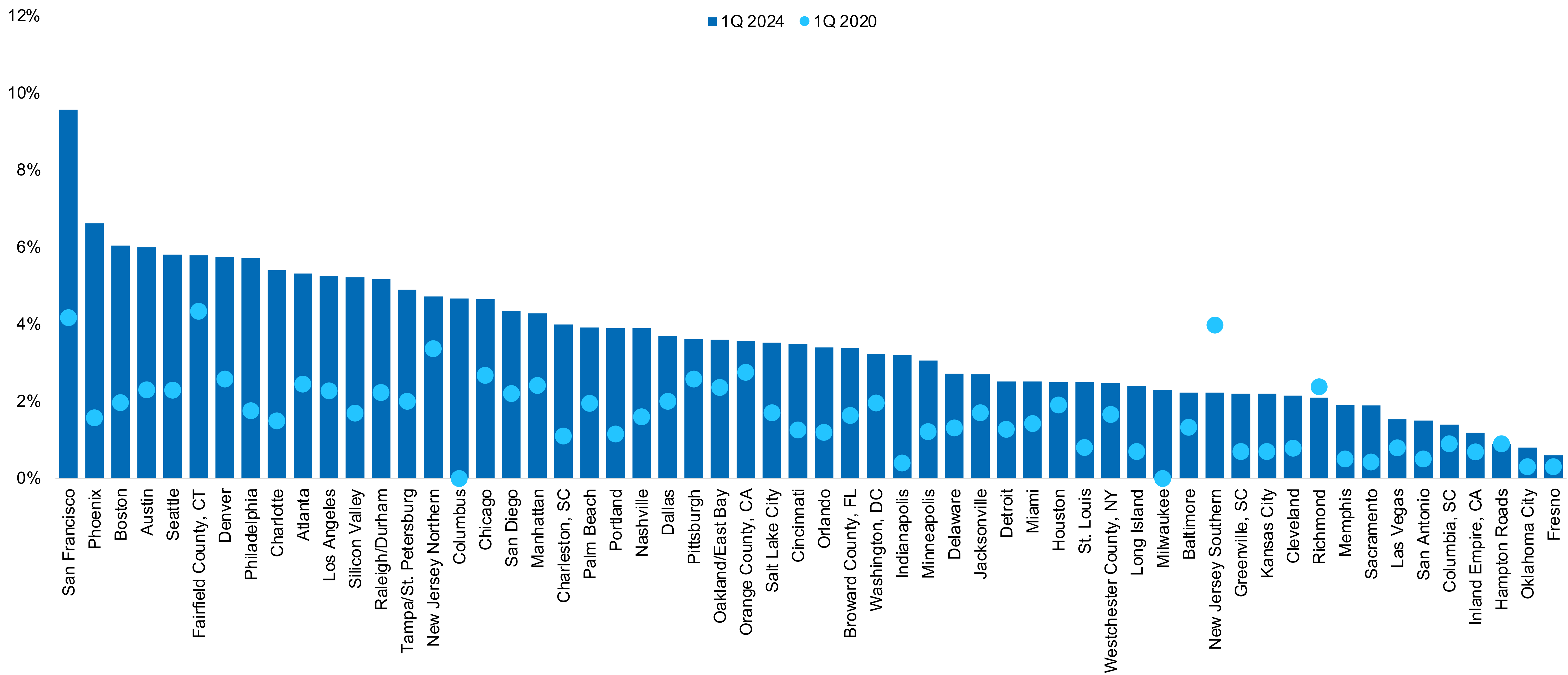


Source: CoStar, Newmark Research

Sublease Availability by Market

Sublease availability remains elevated above pre-pandemic baseline levels in most U.S. markets. Larger markets exhibiting particularly challenging sublease environments include San Francisco, Phoenix, Boston, Austin, and Seattle. Instability in the tech industry, evidenced by layoffs over the course of the last 12 months, indicates that these markets could experience greater increases in sublease availability, further softening fundamentals.

Current Sublease Availability Rate vs. 1Q 2020

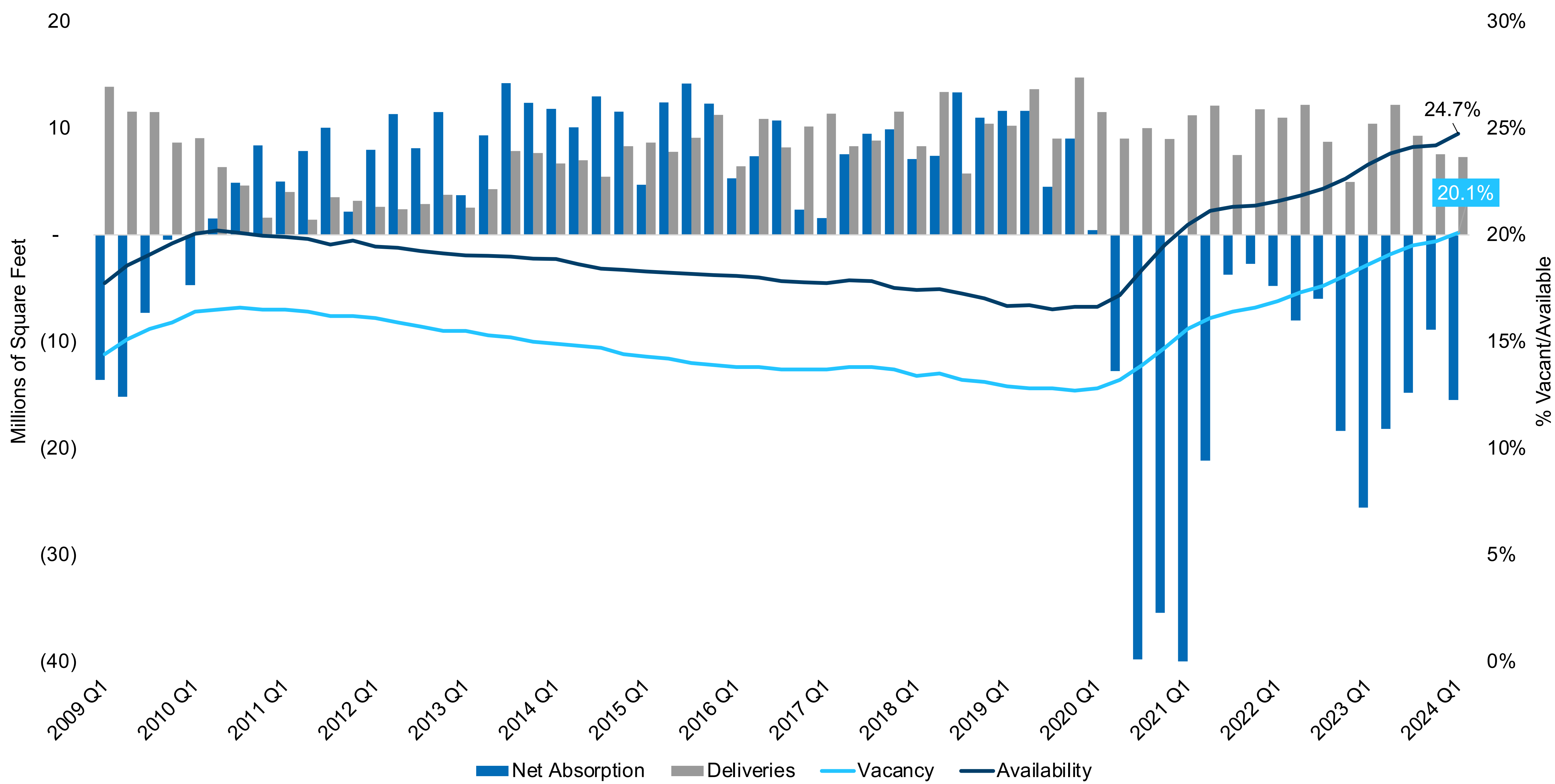


Source: CoStar, Newmark Research

Declining Losses Reverse Trajectory in 1Q24

After four quarters of improving (though negative) net absorption, losses accelerated in the first quarter of 2024, resulting in space givebacks totaling negative 15.5 million SF, a decline of 6.6 million SF from the prior quarter. Since the first quarter of 2020, net absorption has totaled over negative 275.2 million SF, significantly worse than either the Great Recession (negative 51.6 million SF) or dot-com (negative 75.7 million SF) market downturns. Despite consistent delivery of new product, the noteworthy reduction in demand has driven vacancy to its highest levels in the past two decades, reaching 20.1%.

Supply and Demand: Net Absorption, New Construction Deliveries, and Vacancy

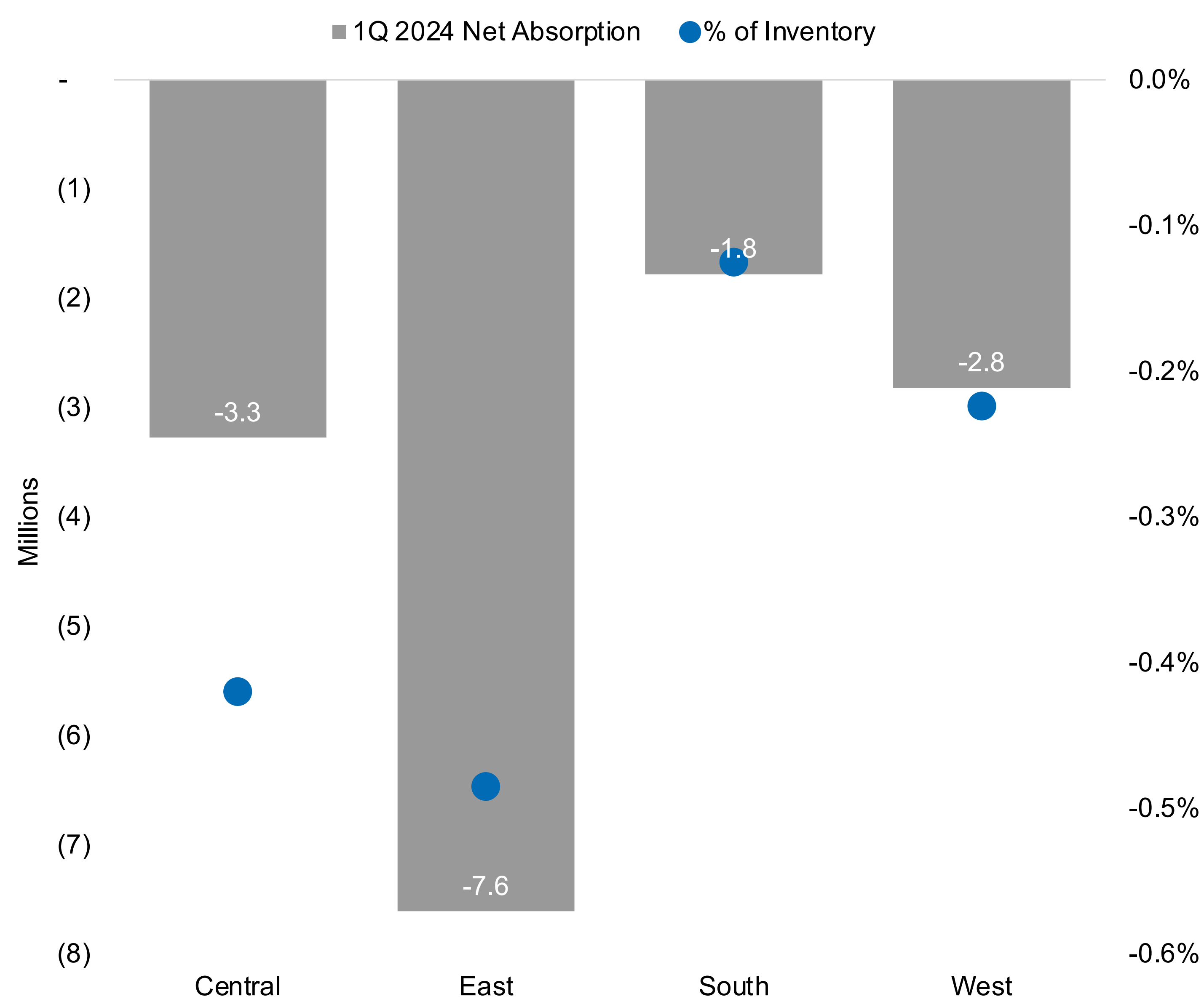


Source: CoStar, Newmark Research

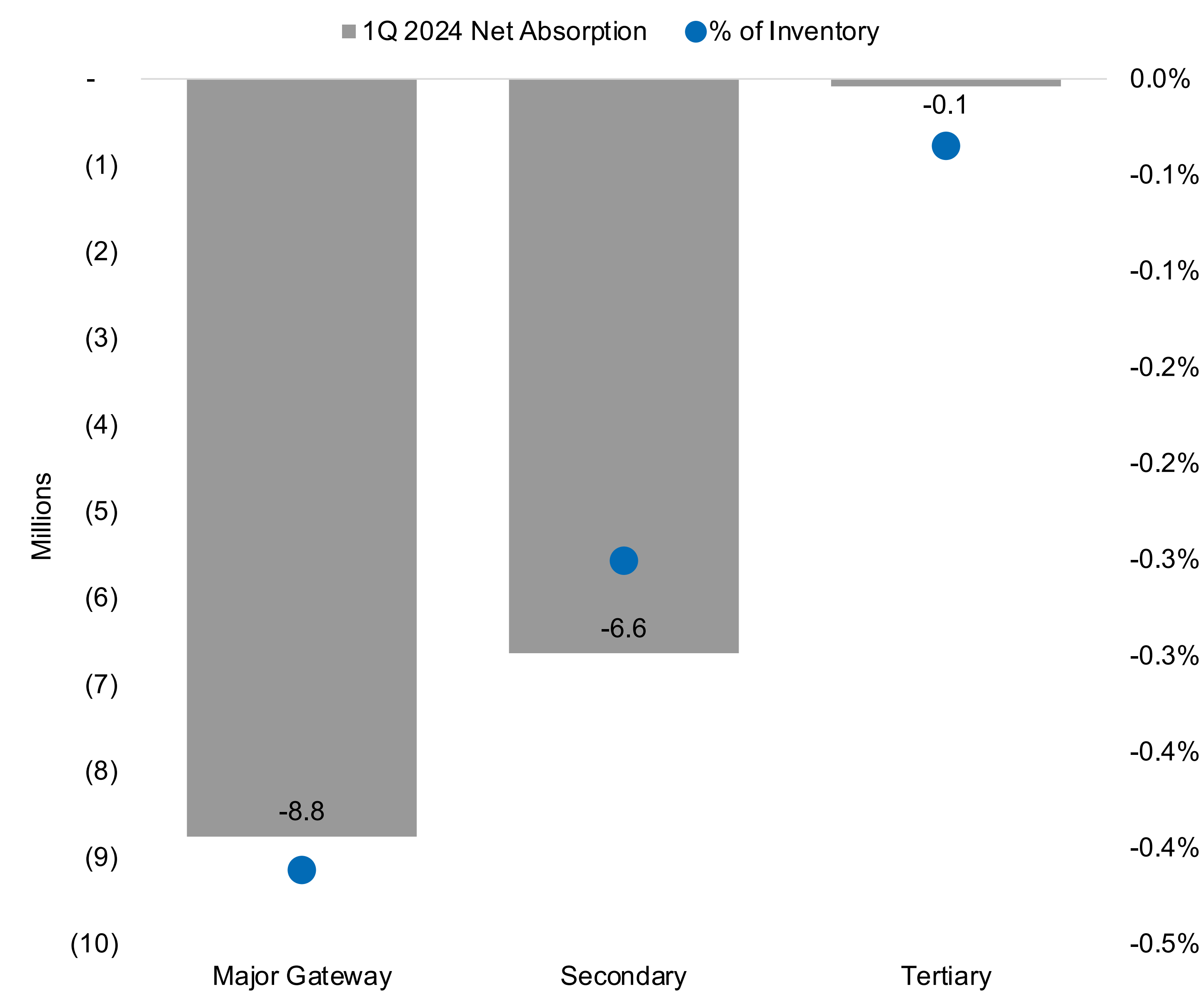
Net Absorption Contracted in 1Q24 across Regions and Market Tiers

Occupancy growth was in the red across the country in the first quarter of 2024, driven most strongly by the Eastern Region, where losses amounted to negative 7.6 million SF. Losses in major gateway markets amounted to negative 8.8 million SF.

Regional Net Absorption



Market Size Net Absorption



Source: CoStar, Newmark Research

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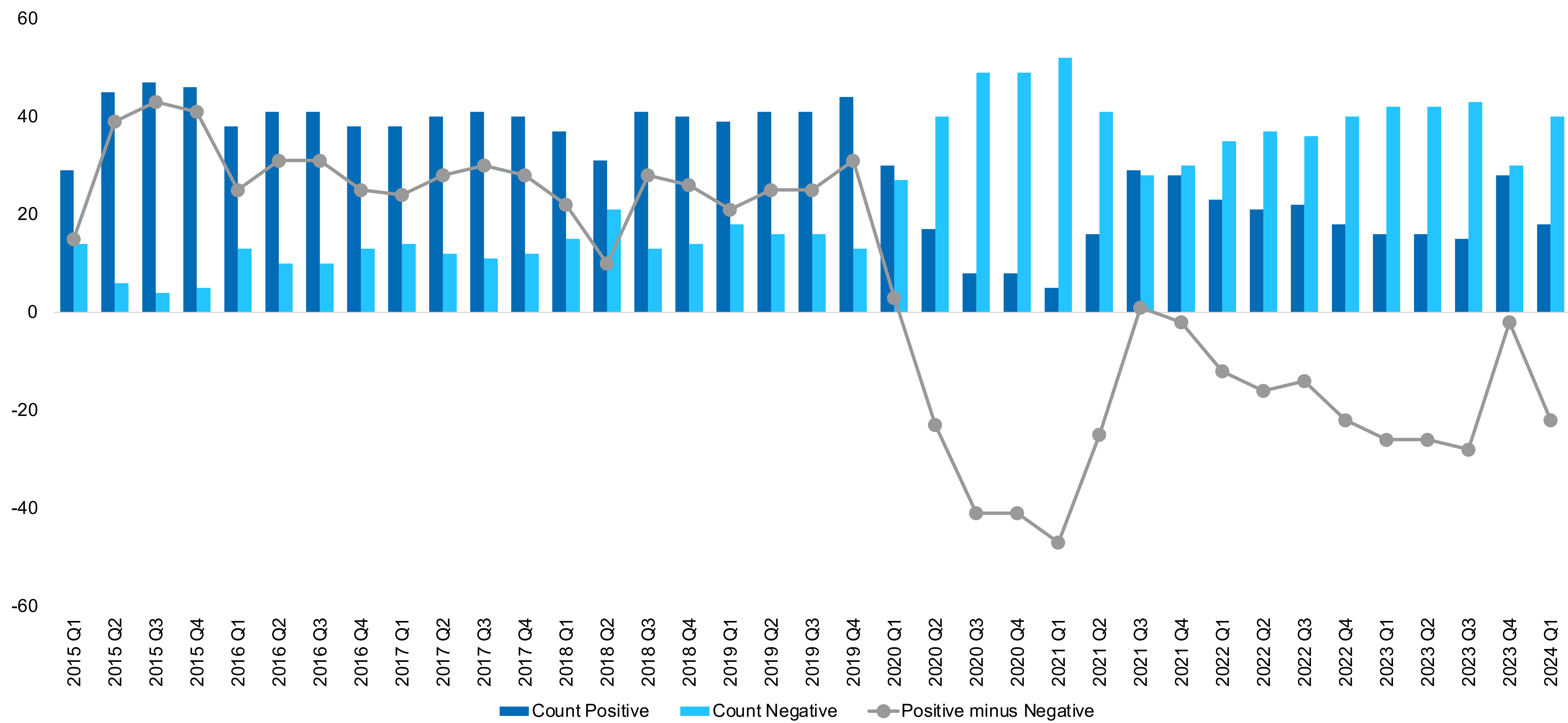
Net Absorption: 10 Consecutive Quarters of Negative Diffusion

18 markets recorded positive net absorption in the first quarter of 2024, while 40 recorded negative net absorption, yielding a diffusion index of negative 22.0 for the first quarter of 2024. Since the second quarter of 2020, an average of 40 markets have recorded quarterly negative net absorption, with an average diffusion index of negative 21.6.

Positive vs. Negative Net Absorption Markets



Sources: CoStar, Newmark Research

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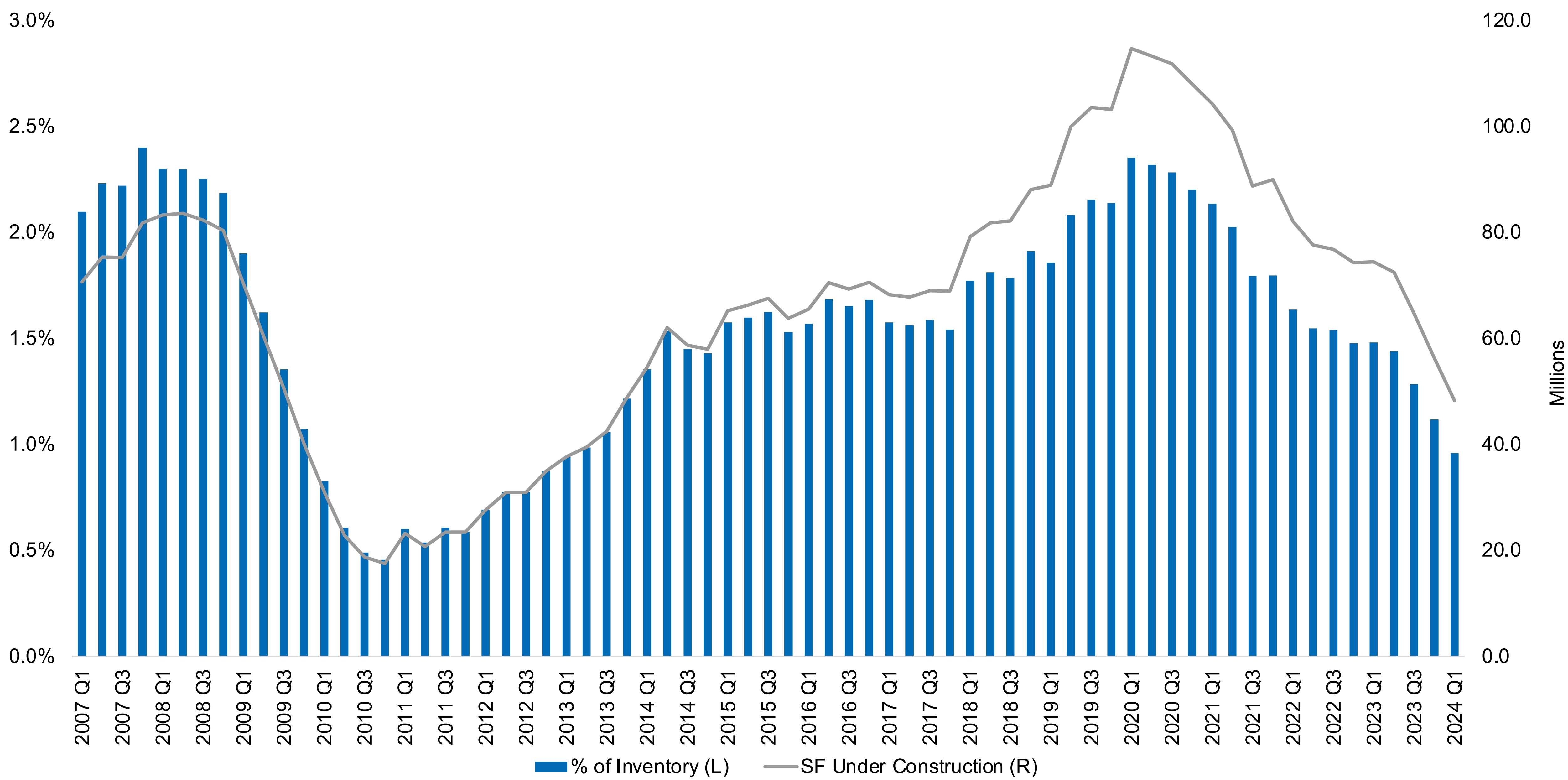
Office Construction Pipeline Contracts at Measured Pace

Office space under construction peaked in early 2020 at over 112 million SF but has slowed as the pandemic influenced office demand in the years since. Construction activity inched down in the first quarter of 2024 as pessimism among some discouraged new groundbreaking activity. The pipeline's continuing contraction will help curb the market's overall vacancy rise, as much of the product delivered since the onset of the pandemic has remained unleased.

Under Construction: Percent of Inventory and Total Square Footage

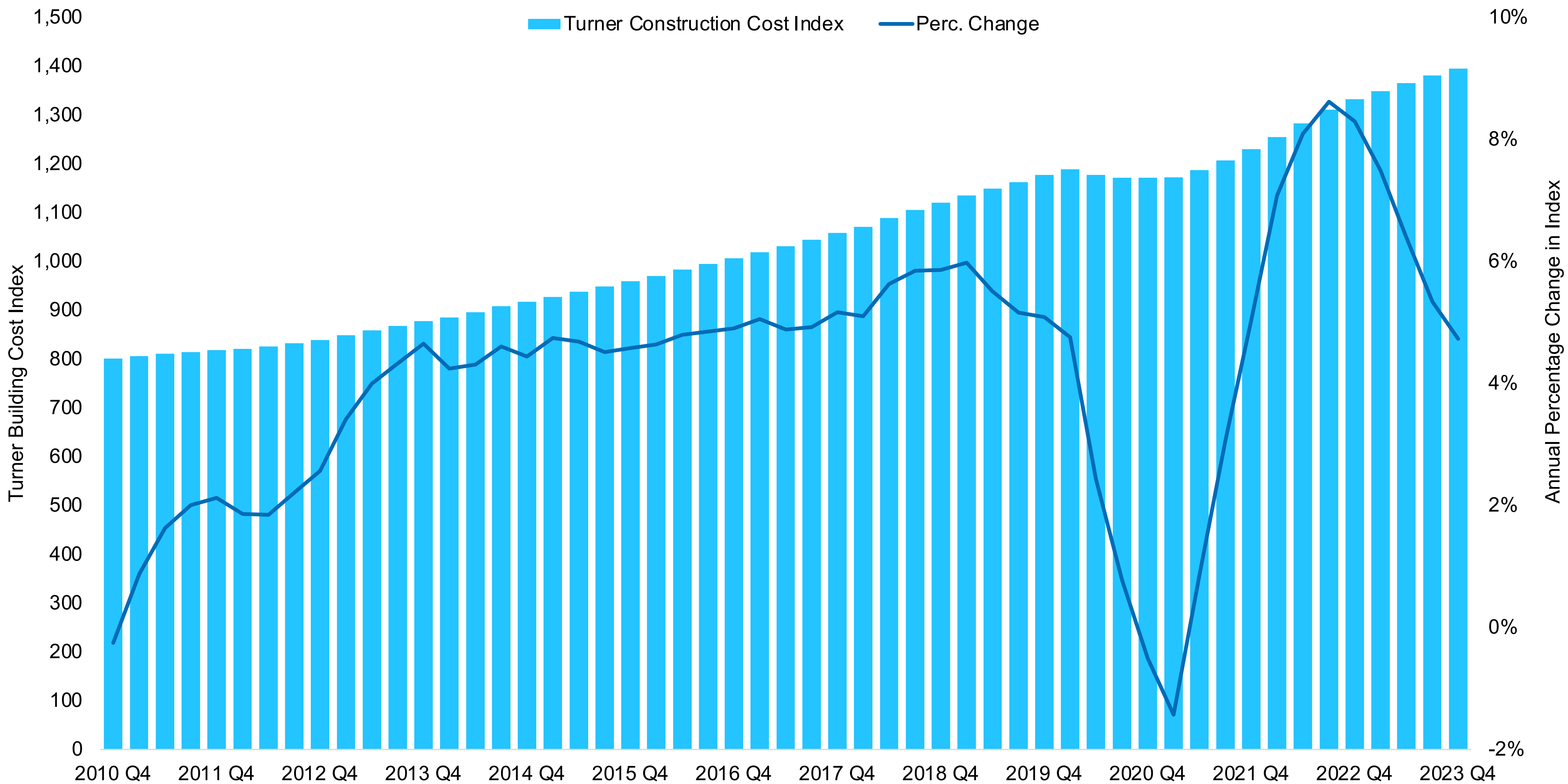


Sources: CoStar, Newmark Research

Office Construction Cost Growth Decelerated in 2023

Inflationary pressures continued softening in 2023, and construction pricing appeared to respond in the fourth quarter of 2023. Construction pricing generally increased from 4.0% to 5.0% through much of the mid-2010s. While the annual growth rate of the Turner Building Cost Index slid down in the fourth quarter of 2023, it remains high at nearly 4.7%.

Turner Building Cost Index



Source: Turner Construction, Newmark Research

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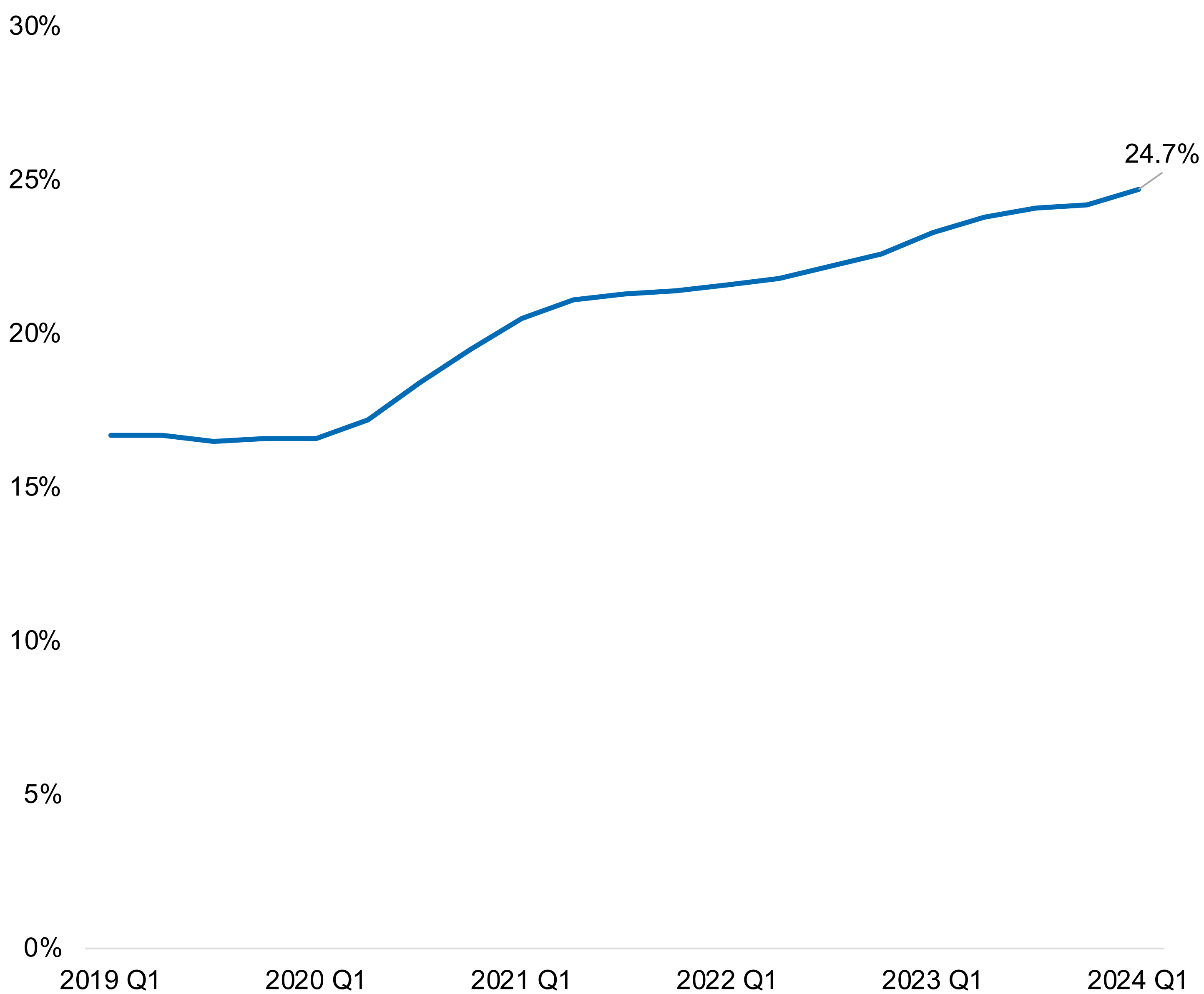
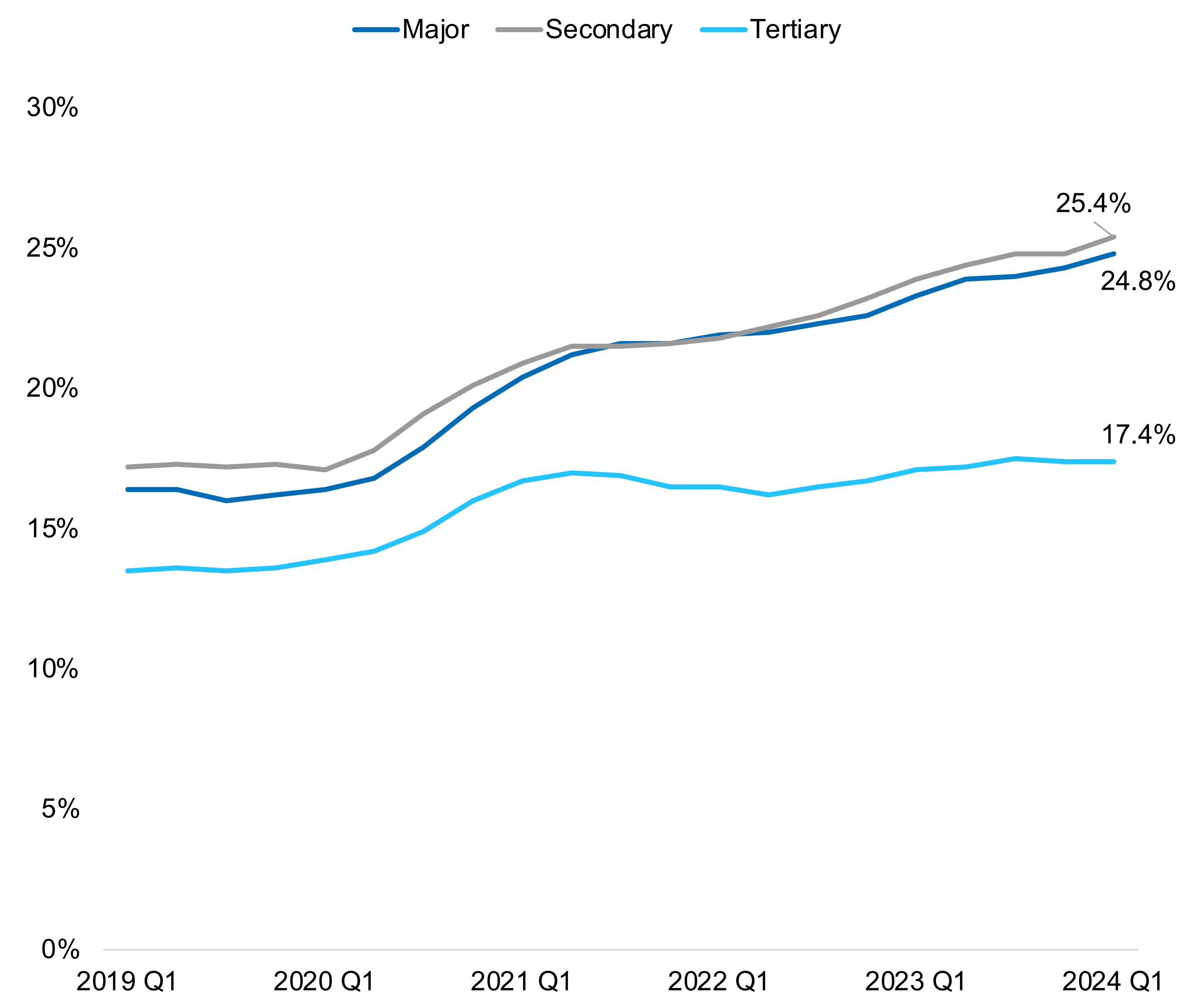
Availability Rates Have Not Yet Peaked

Overall availability rose in the first quarter of 2024 and is notably elevated in major and secondary markets. Prior to the second quarter of 2022, tertiary markets had recorded stabilizing availability levels, but renewed uncertainty has driven up availability rates alongside other fundamentals, including sublease space and vacancy.

National Office Market Availability Rate



Availability Rate Comparison By Market Size

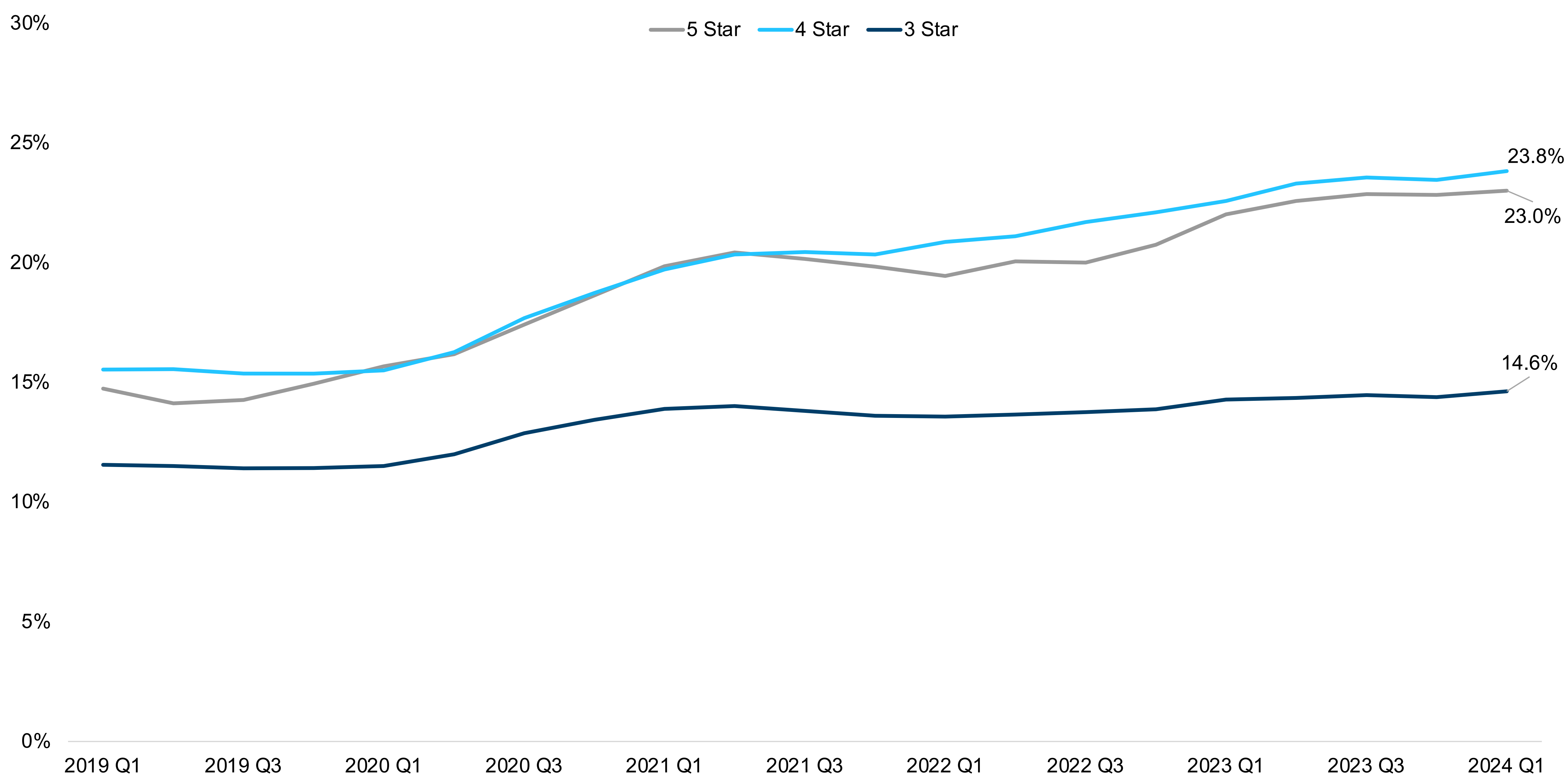


Sources: CoStar, Newmark Research

Availability Rates Continue to Rise across Building Grades

There is a disconnect between the well-attested preference for high-quality office space by investors and large tenants and data. CoStar is just one example that shows middle-tier outperforming upper-tier product on an availability basis. Partly, this seems to be due to a large performance gap between trophy office and commodity Class A, proxied here by four- and five-star properties. Class A owners arguably have yet to capitulate on rents to a sufficient degree to siphon demand from lower-quality buildings.

Costar Office Market Availability Rate By Class

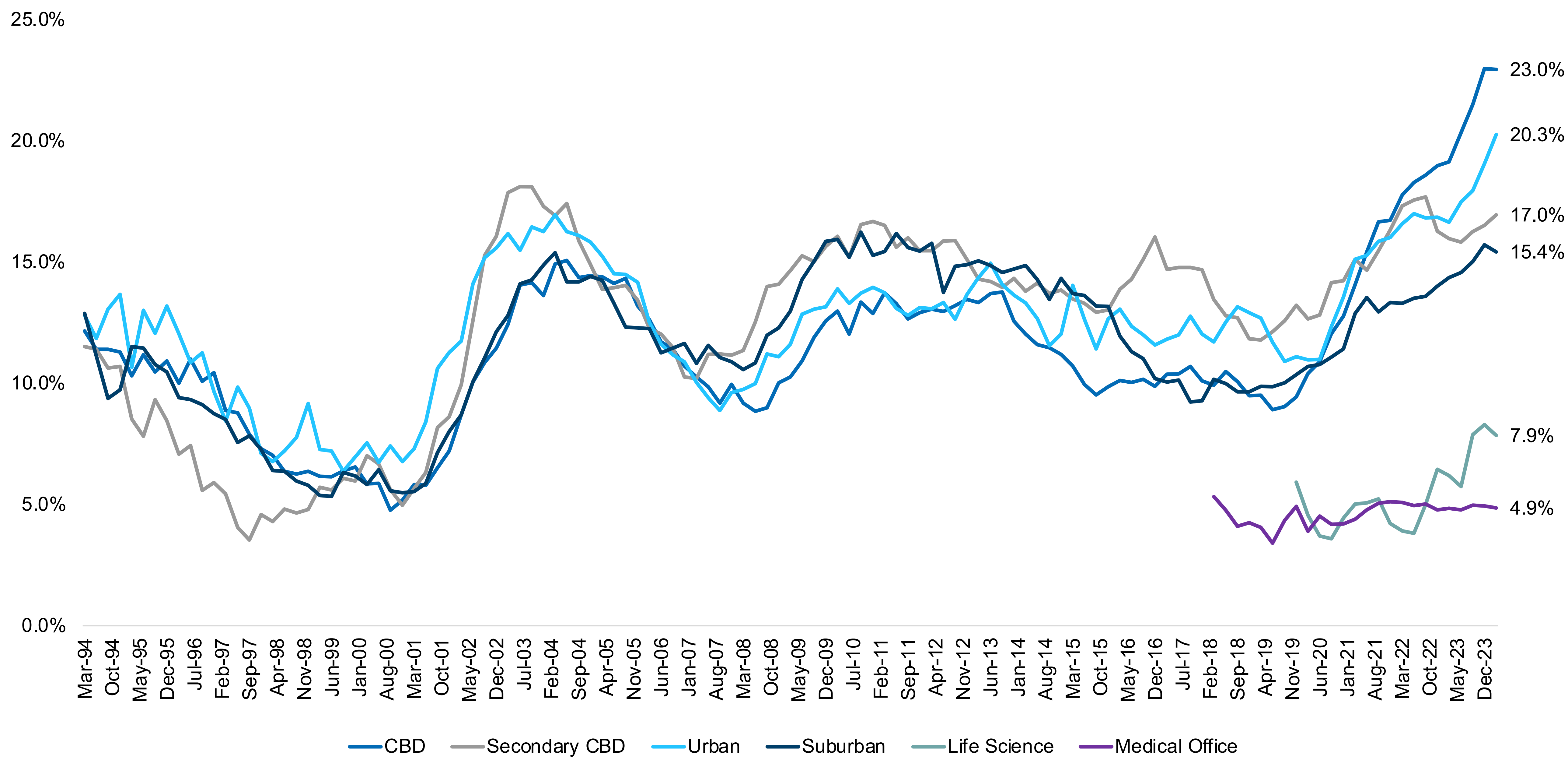


Source: CoStar, Newmark Research

CBD Office Most Impacted While Suburban Office and Niche Categories Outperform

CBD office buildings in NCREIF member portfolios have the highest availability rates. This contrasts with historical experience, where CBD offices experienced shallower downturns and quicker recoveries. Suburban office holdings have been impacted as well, but to a lesser extent. While availability continues to increase, Suburban office rates are still below the Great Recession highs. NCREIF member holdings of life science and medical office are comparatively small, but they are well-occupied.

NCREIF National Property Index Office Availability Rate



Sources: NCREIF, Newmark Research as of 4/29/2024
*We use the NCREIF National Property Index as a proxy for the national institutional grade office market.

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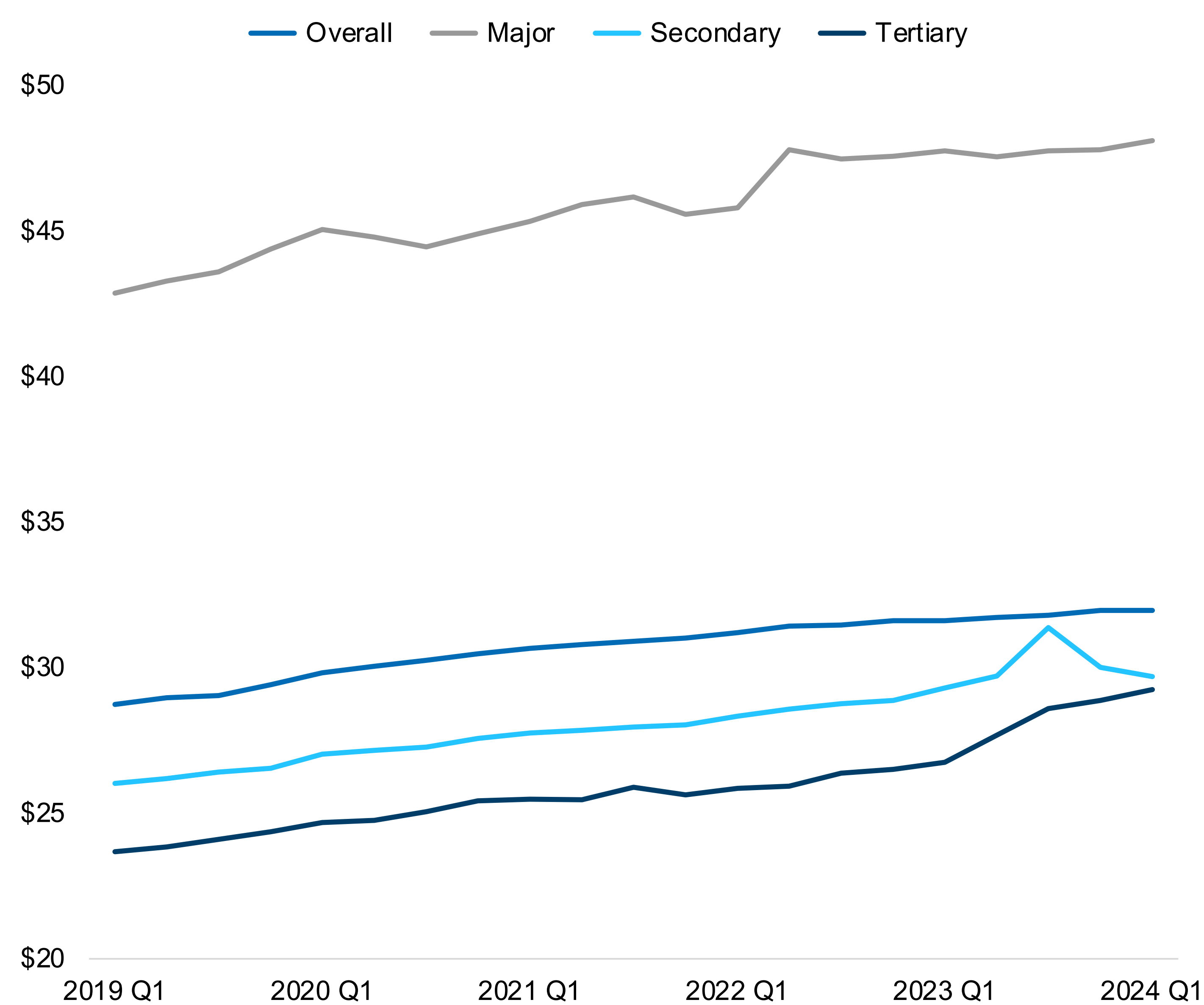
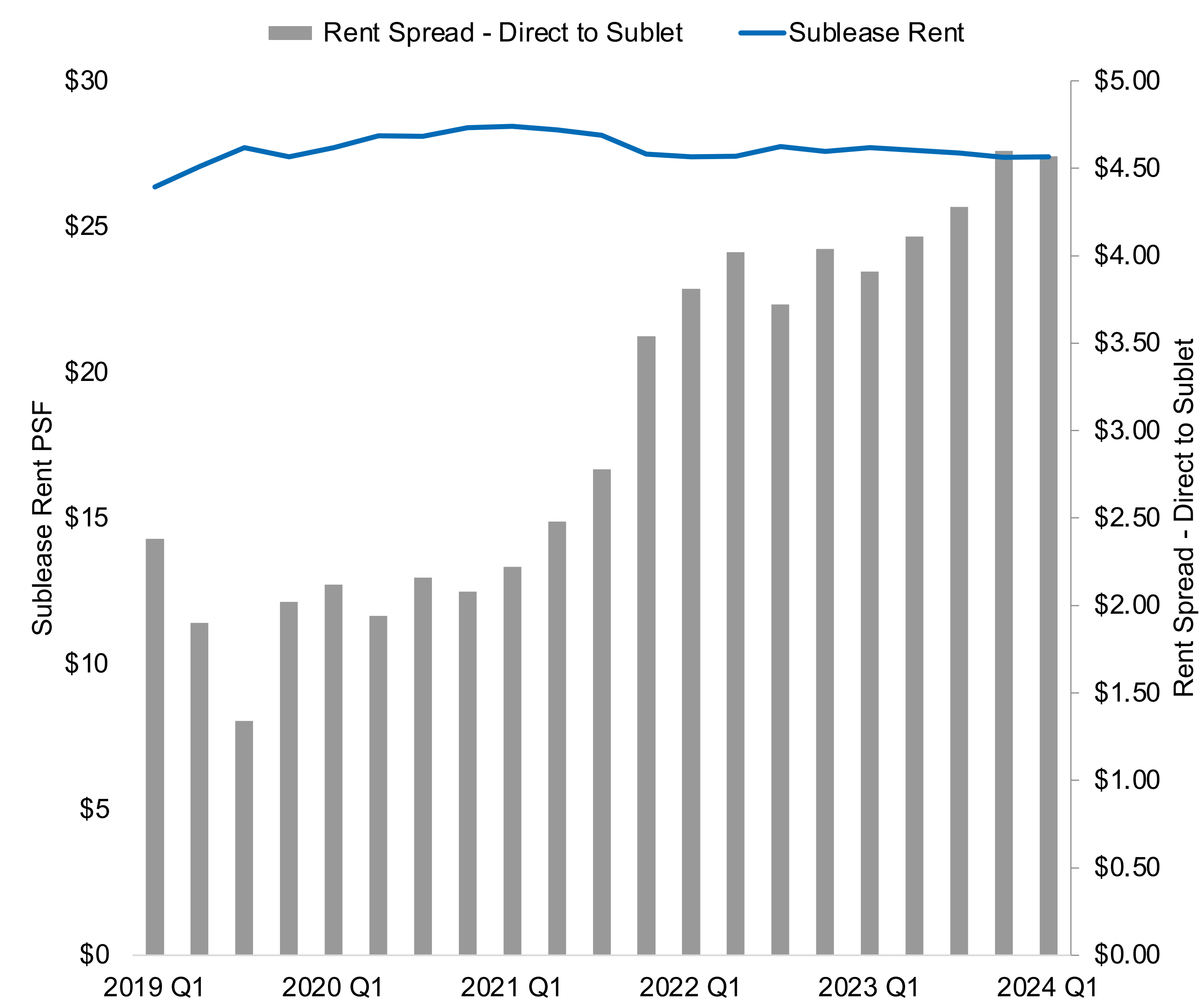
Asking Rents Defy Gravity

In past cycles, asking rents have adjusted downward to account for depressed demand; however, asking rents have largely held value since the onset of the pandemic. Some rent compression is being experienced among major and secondary markets, but tertiary markets continue to appreciate. Sublease rents have been holding relatively flat for much of the last three years, which more visibly exhibits the impact of low demand. As a result, the spread between sublease space and direct space has widened to near all-time highs.

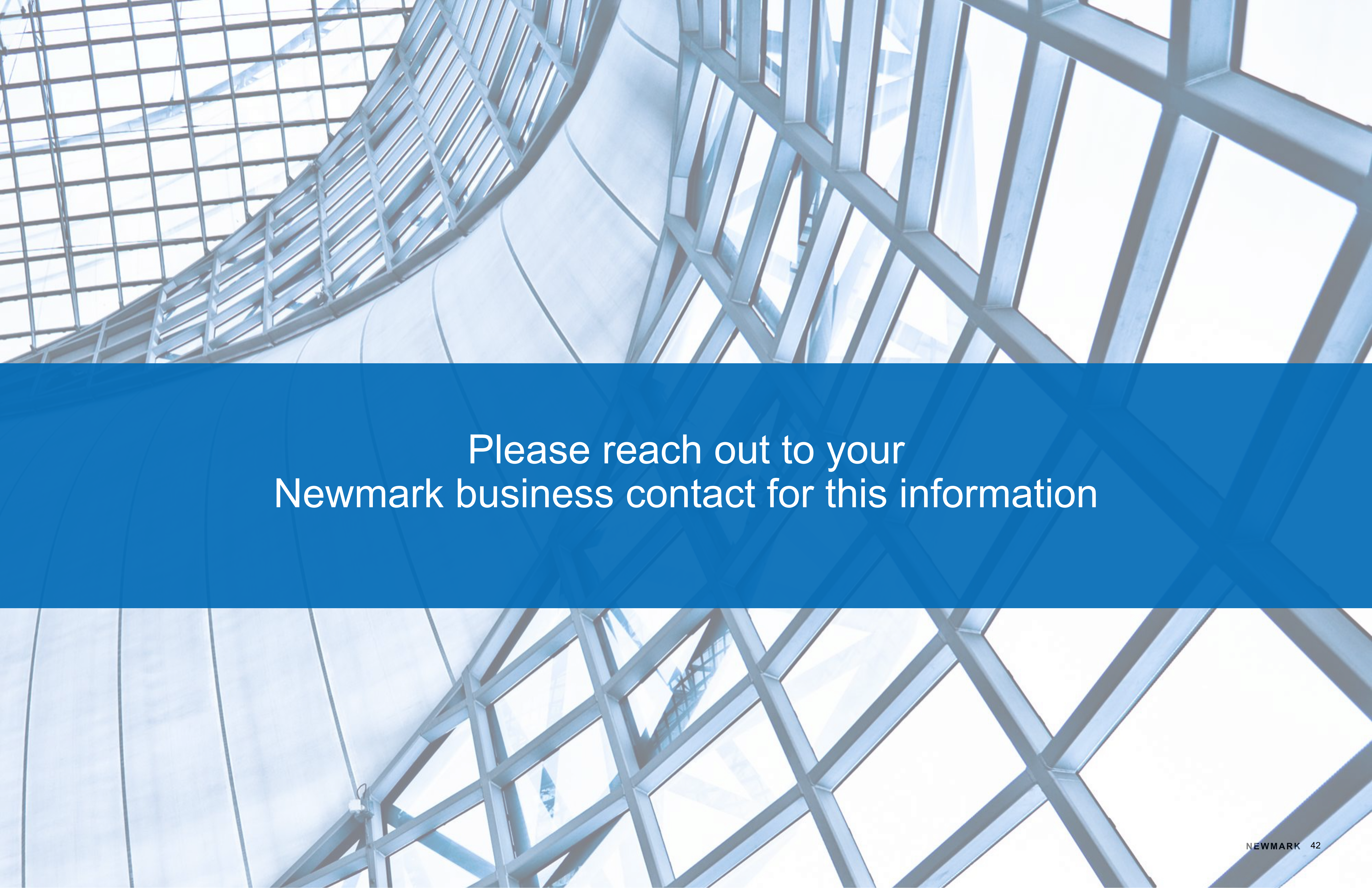
Overall Asking Rents Up 1.1% YoY in 1Q24



Sublet Rents Stabilized; Rent Spread Relative to Direct Rates Near All-Time High



Source: CoStar, Newmark Research



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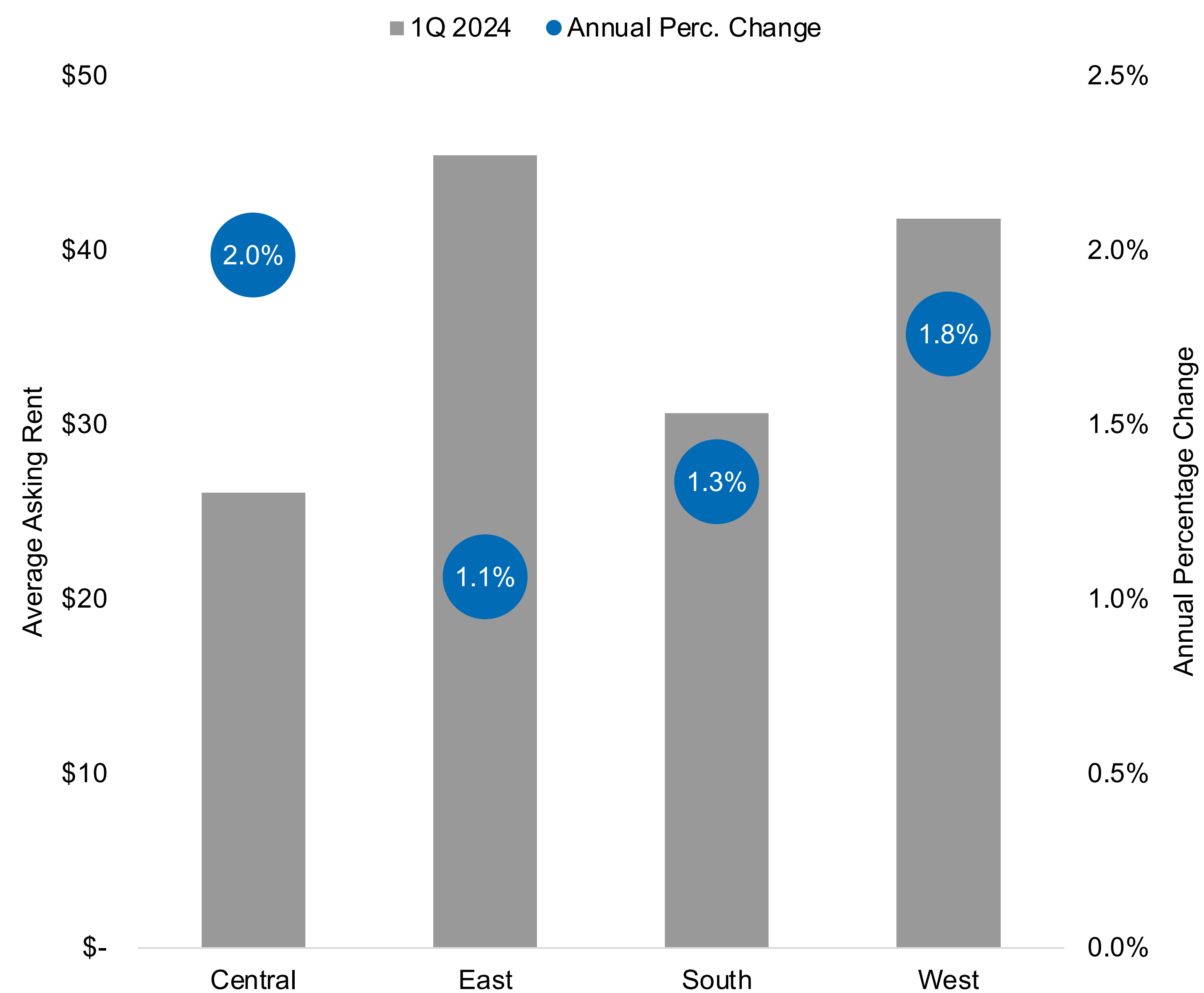
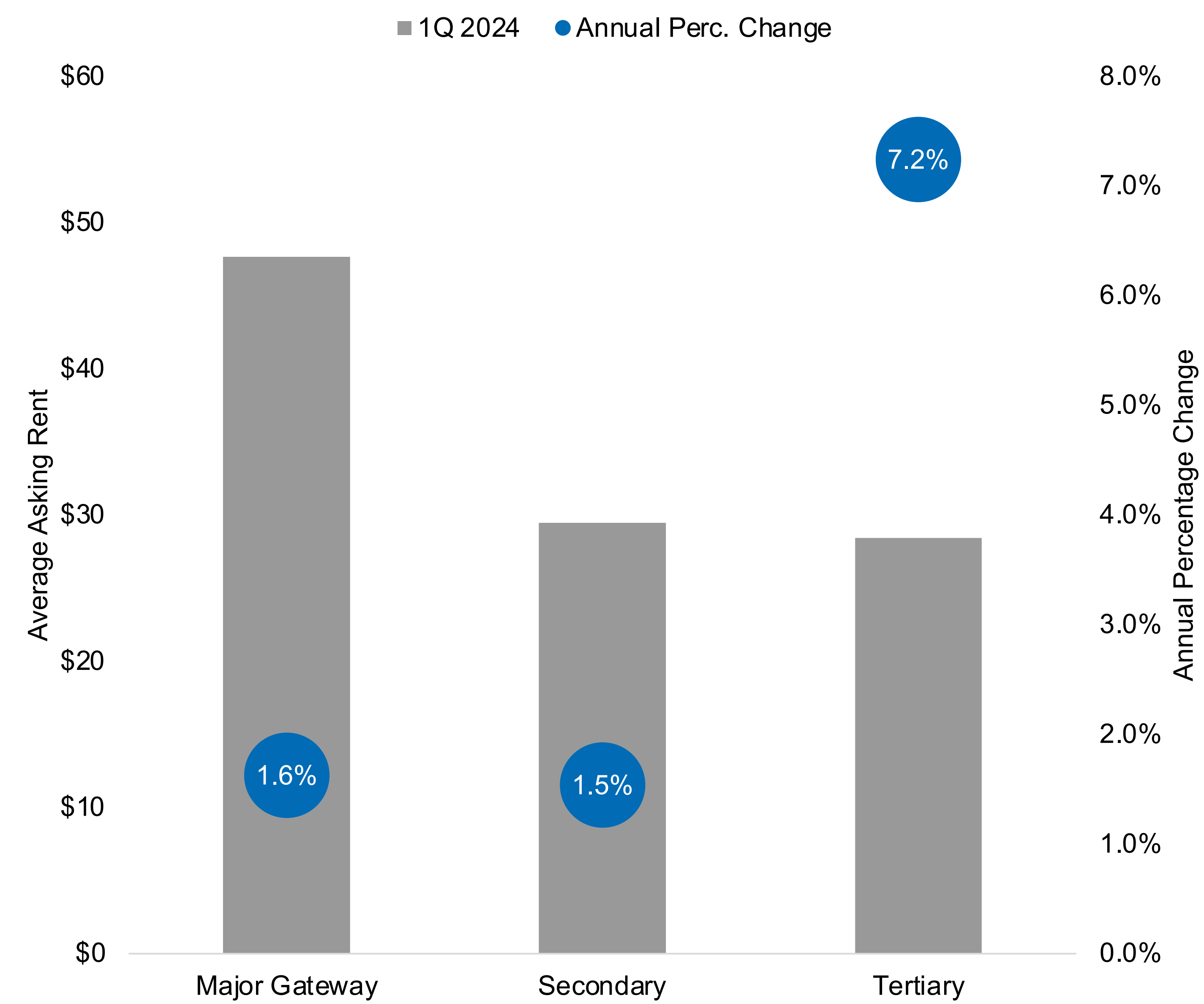
Central and Western Regions and Tertiary Markets Leading in Rent Growth

Overall asking rents are most elevated in major coastal Eastern and Western markets, including San Francisco, Manhattan and Silicon Valley. The Central and West regions continue to experience aggressive rent appreciation, driven partly by inventory expansion and the success of secondary markets in attracting office demand in an otherwise challenging time. Effective rents are under downward pressure and modest rent compression is being felt in some markets.

Asking Rents Growing Fastest in the Central and West Regions



Non-Major Markets Experiencing the Most Rent Growth



Source: CoStar, Newmark Research

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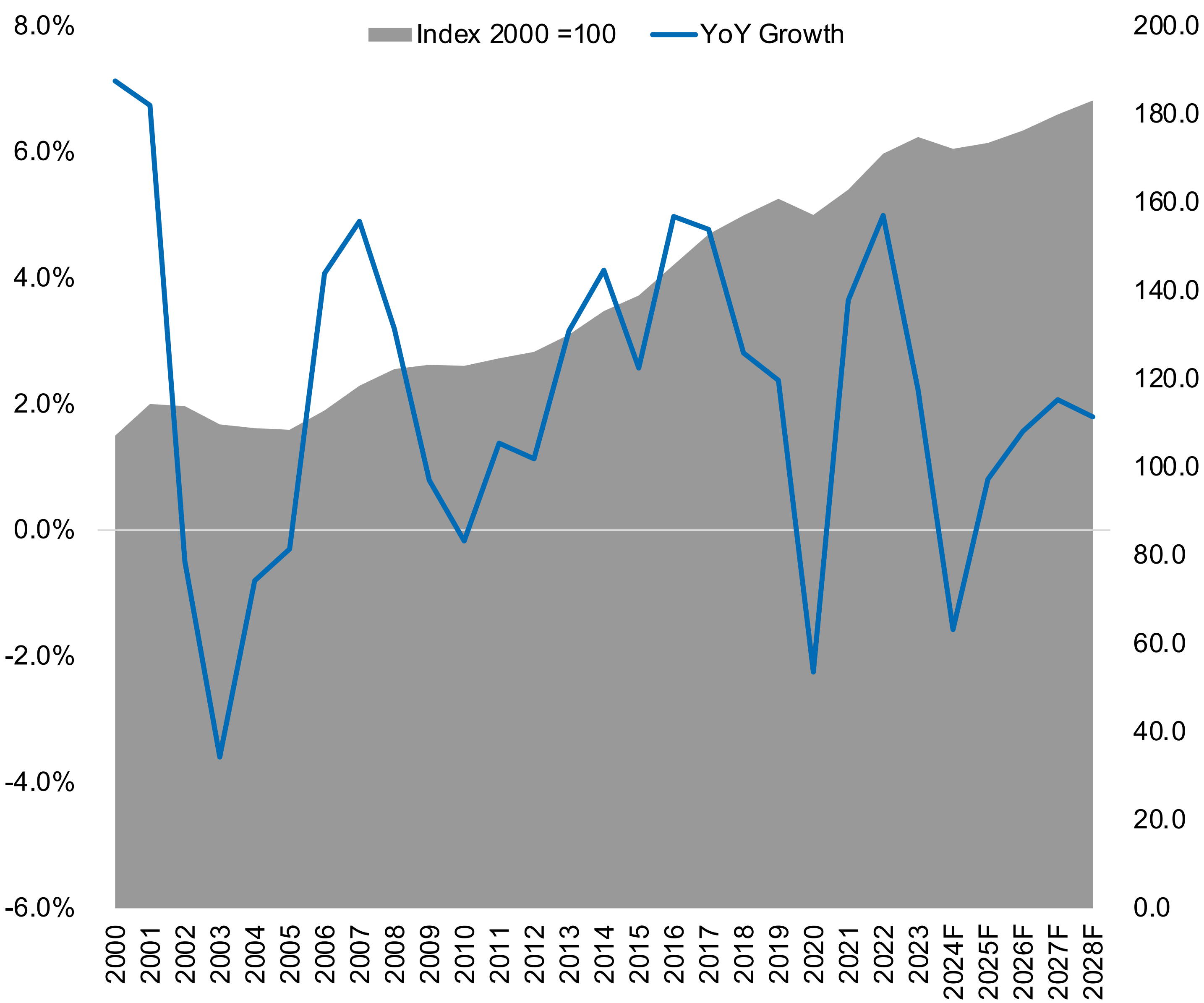
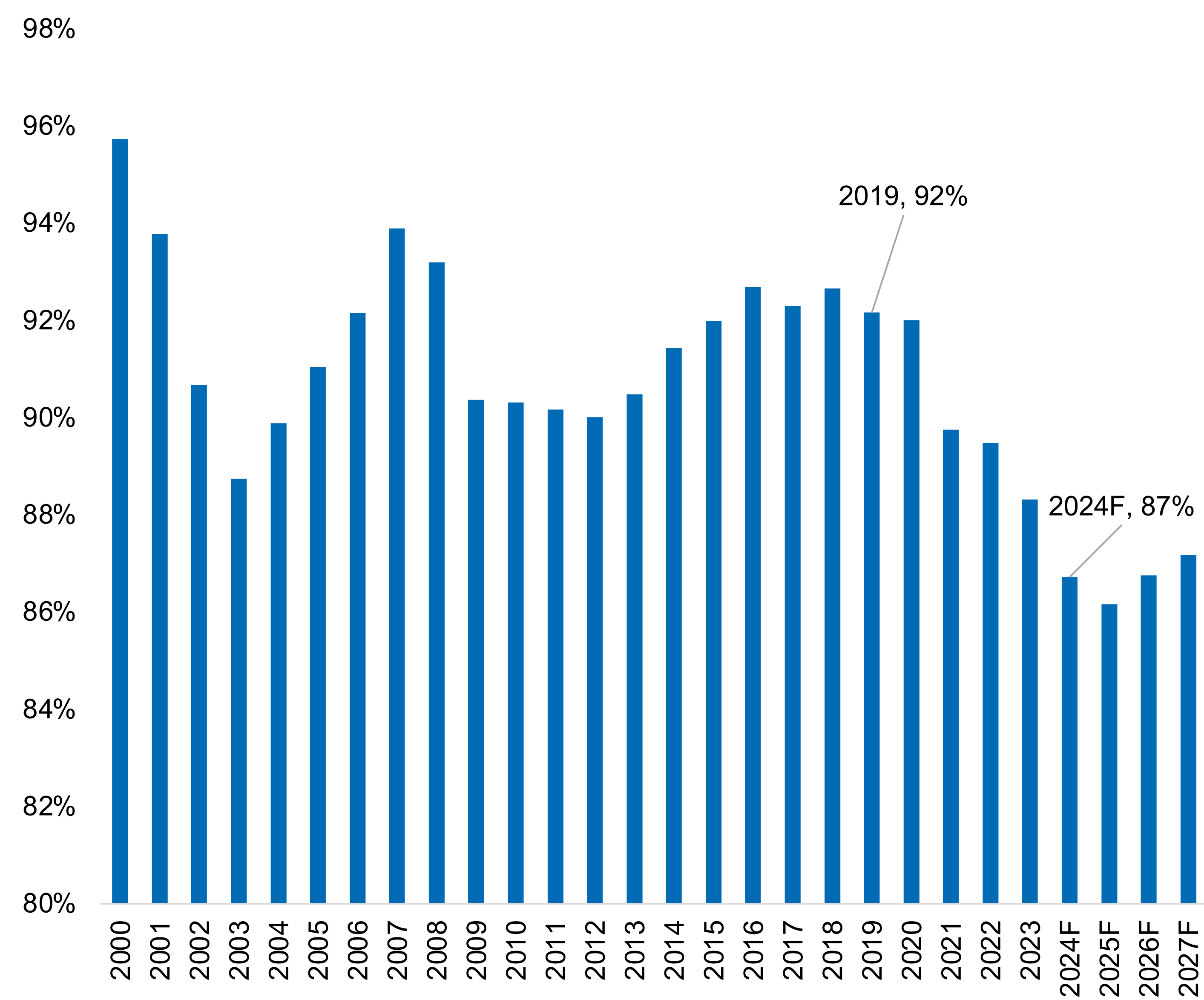
Office REITs Also Show Better than Expected Cashflow Trends

Despite the significant deterioration in overall leasing market conditions, office REITs have continued to grow their same-store NOIs. Partly, this reflects disposition of underperforming assets, but this still means that the pruned portfolios are performing. Occupancies are at their lowest levels since at least 2000, but projections suggest they could bottom soon.

REIT Same-Store NOI



REIT Same-Store Occupancy Stabilizing

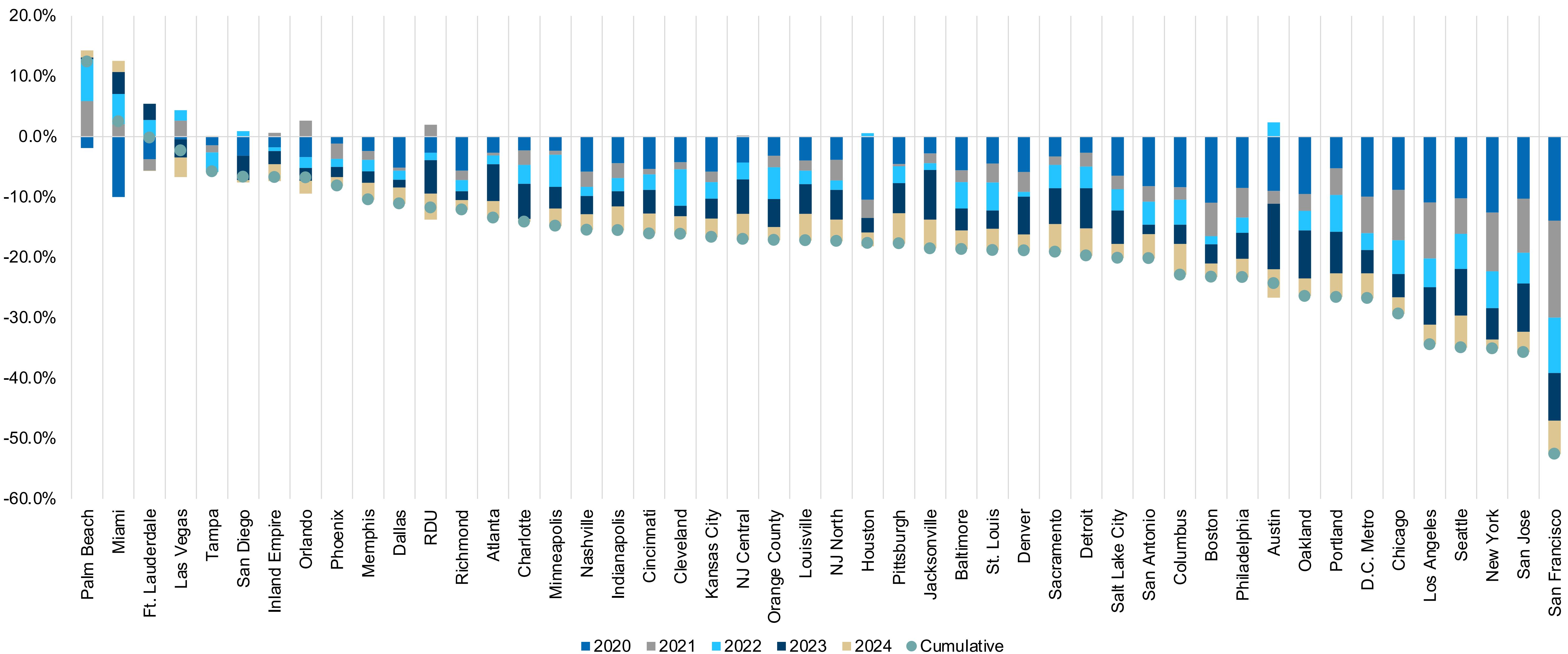


Source: Green Street data as of 4/24/2024, Newmark Research

RevPAF* Contracts across Markets in 2024

The larger picture shows that Sun Belt markets have outperformed since 2020, notably Florida markets, as well as San Diego and the Inland Empire. By far, the worst-performing market has been San Francisco, but other gateway markets have also been hard hit, including New York, San Jose, Seattle, Los Angeles, Chicago and DC.

M-RevPAF Growth by Market



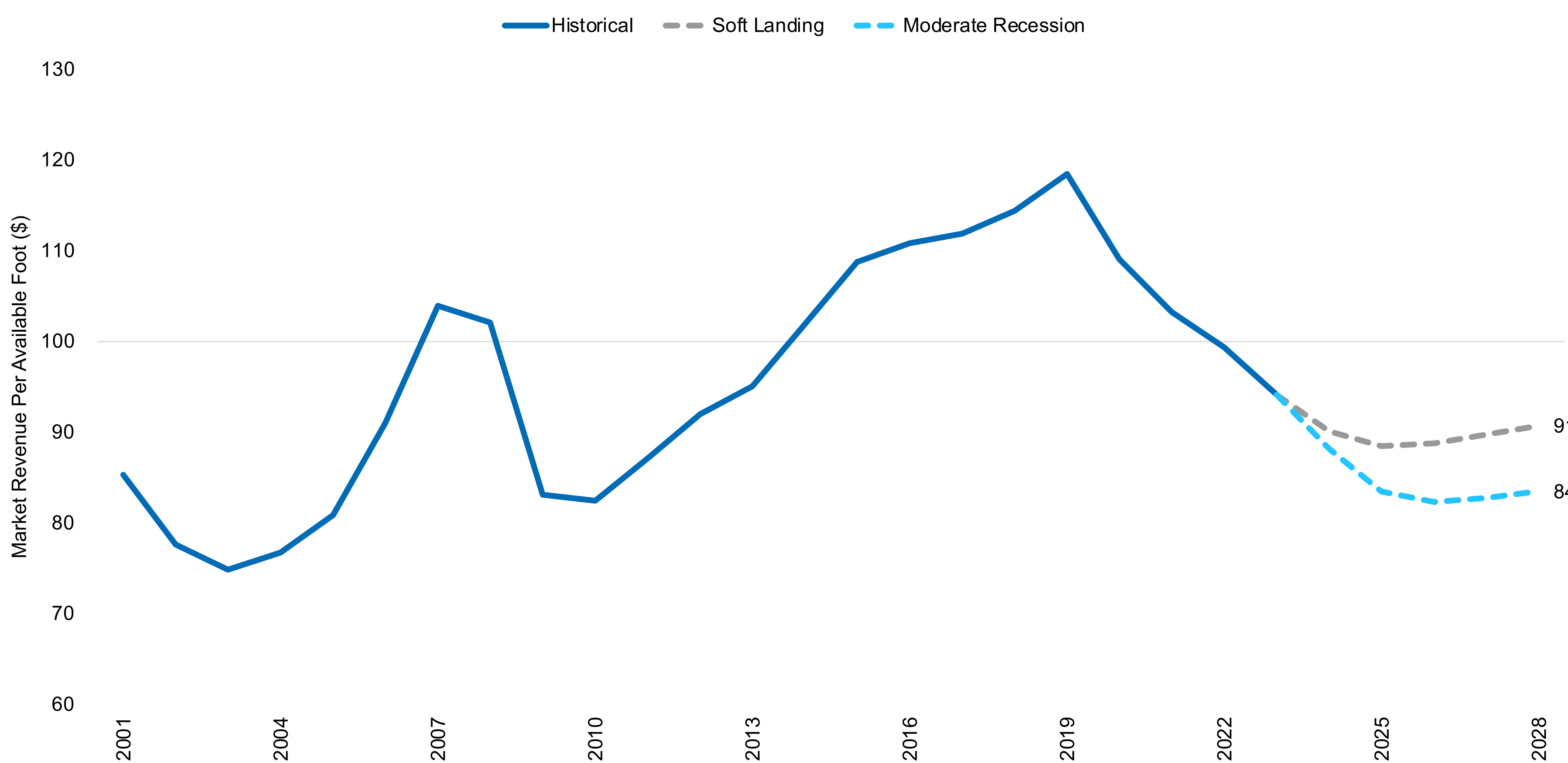
Source: Green Street data as of 4/24/2024, Newmark Research

*Market revenue per available foot combines the impact of changes in effective rents and occupancy to produce a measure of overall leasing market performance.

Broad Market Fundamentals Face a Slow Recovery

Market revenue per available foot has been trending downward since 2019, and it is not expected to hit bottom until the end of 2025 at the earliest. A recession would result in a deeper trough and a slower rebound. Even in the event of a soft landing, the office market fundamentals will improve slowly and only return to the previous peak through a process of eliminating large quantities of obsolescent stock. Newer, well-located properties have had a very different experience and will continue to do so.

Green Street M-RevPAF (December 2000 = 100)



Sources: Green Street, Newmark Research as of 2/12/2024

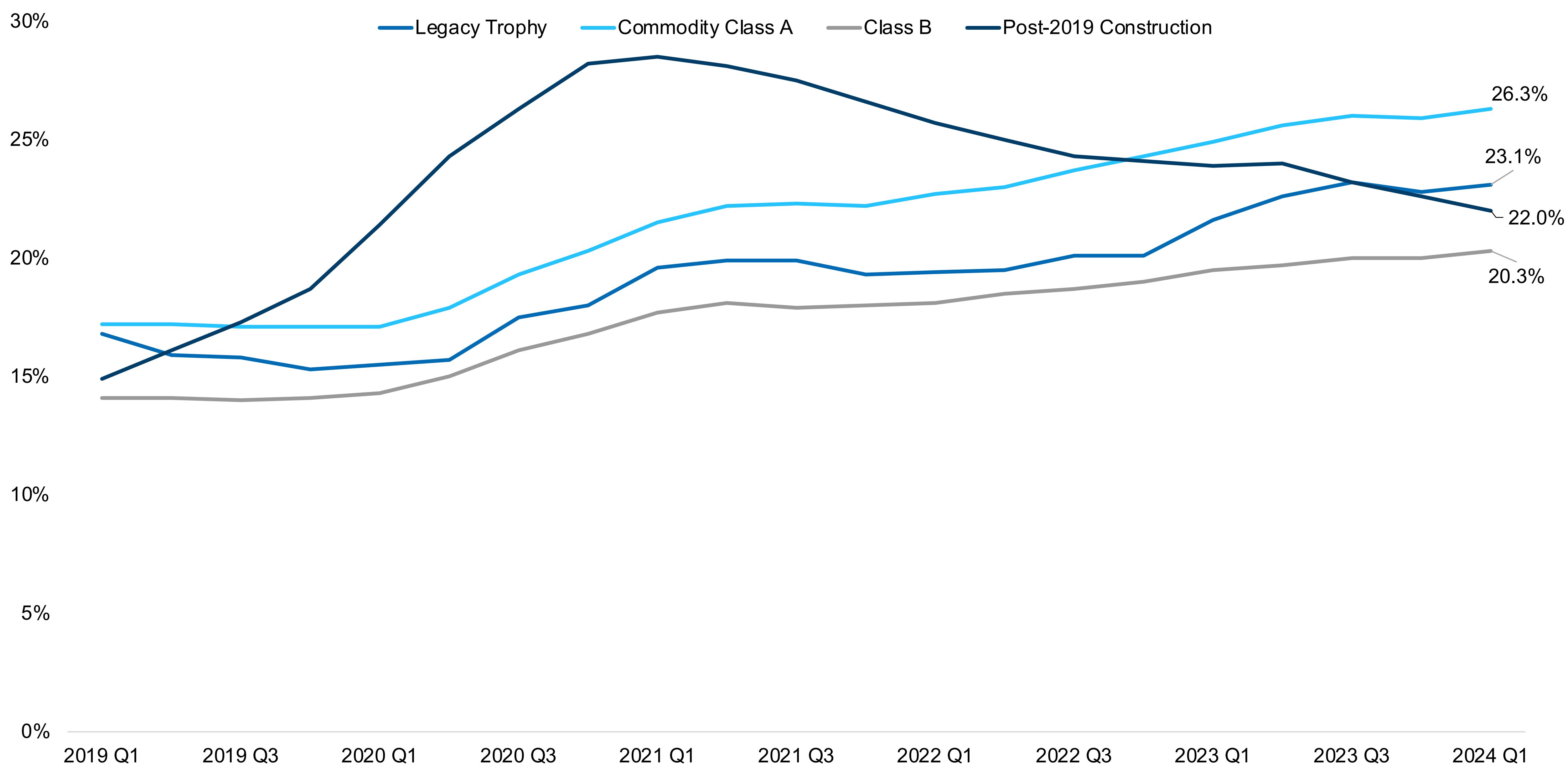
Class Conundrum

We often hear that the office market presents a dichotomy between “trophy” and “trauma”. We find that though true trophy outperformance exists, there remain other nuances and inefficiencies in the market today, namely the paradoxical solidity of Class B office relative to commodity Class A product.

Class B Office and New Construction Boast the Lowest Availability

Deeper perspective on the data emerges by including delivery date as a parameter in comparing availability by building class. Here, post-2019 deliveries have been isolated from CoStar's class data and isolated as their own series, while minimum building size has been raised to 50,000 SF. While middle-tier (three-star) product continues to outperform other quality grades, the performance gap shrinks considerably; furthermore, a greater divergence emerges between legacy trophy (five-star) and commodity Class A (four-star). Meanwhile, post-2019 construction outperforms both those categories, supporting a preference for high-quality new construction.

Costar Office Market Availability Rate By Class



Source: CoStar, Newmark Research
*Office buildings over 50,000 SF. Excludes owner-occupied. CoStar building classifications are defined as follows: Three-star: Class B, four-star: Commodity Class A, 5-star: Legacy Trophy. These categories exclude offices delivered after 2019.

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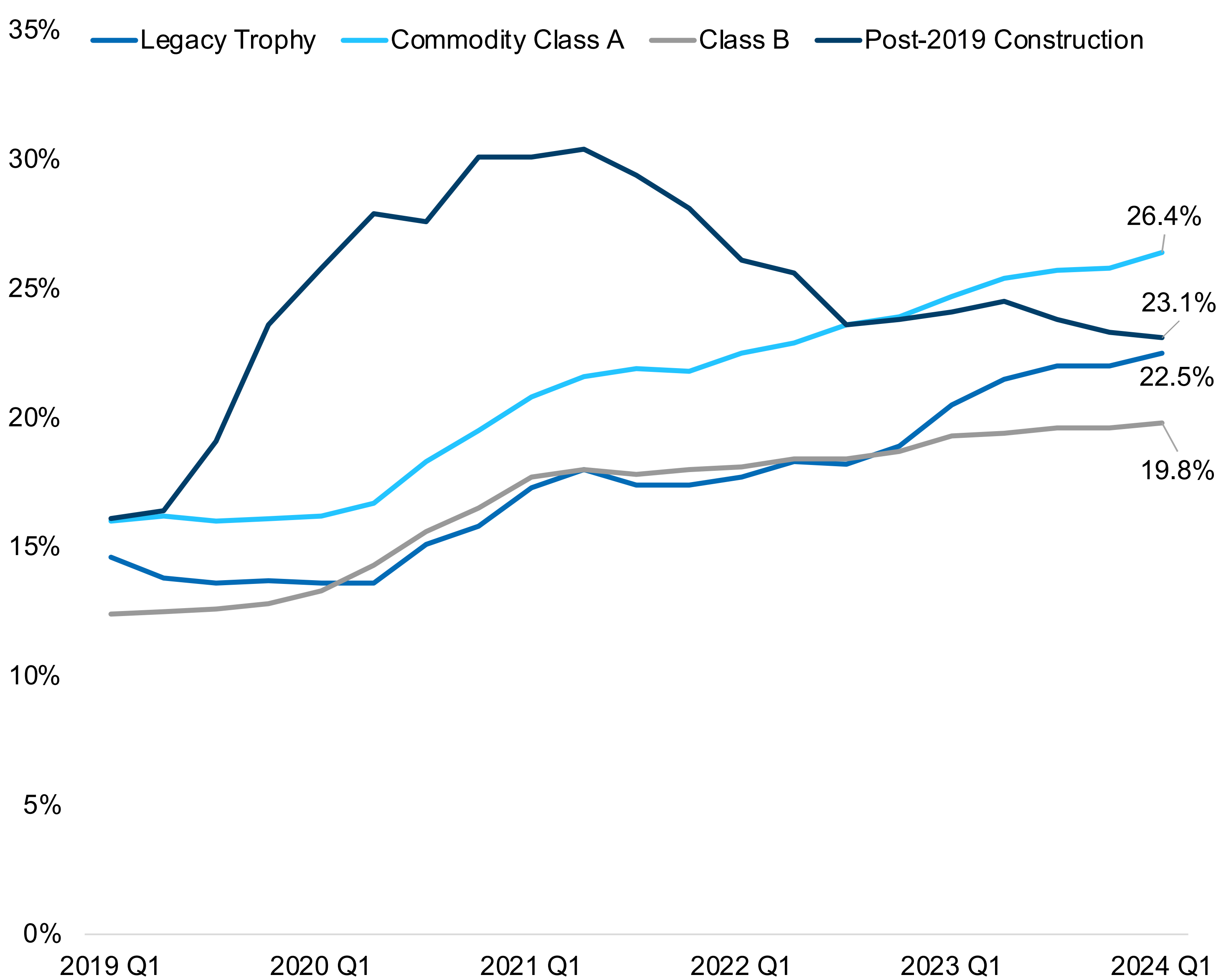
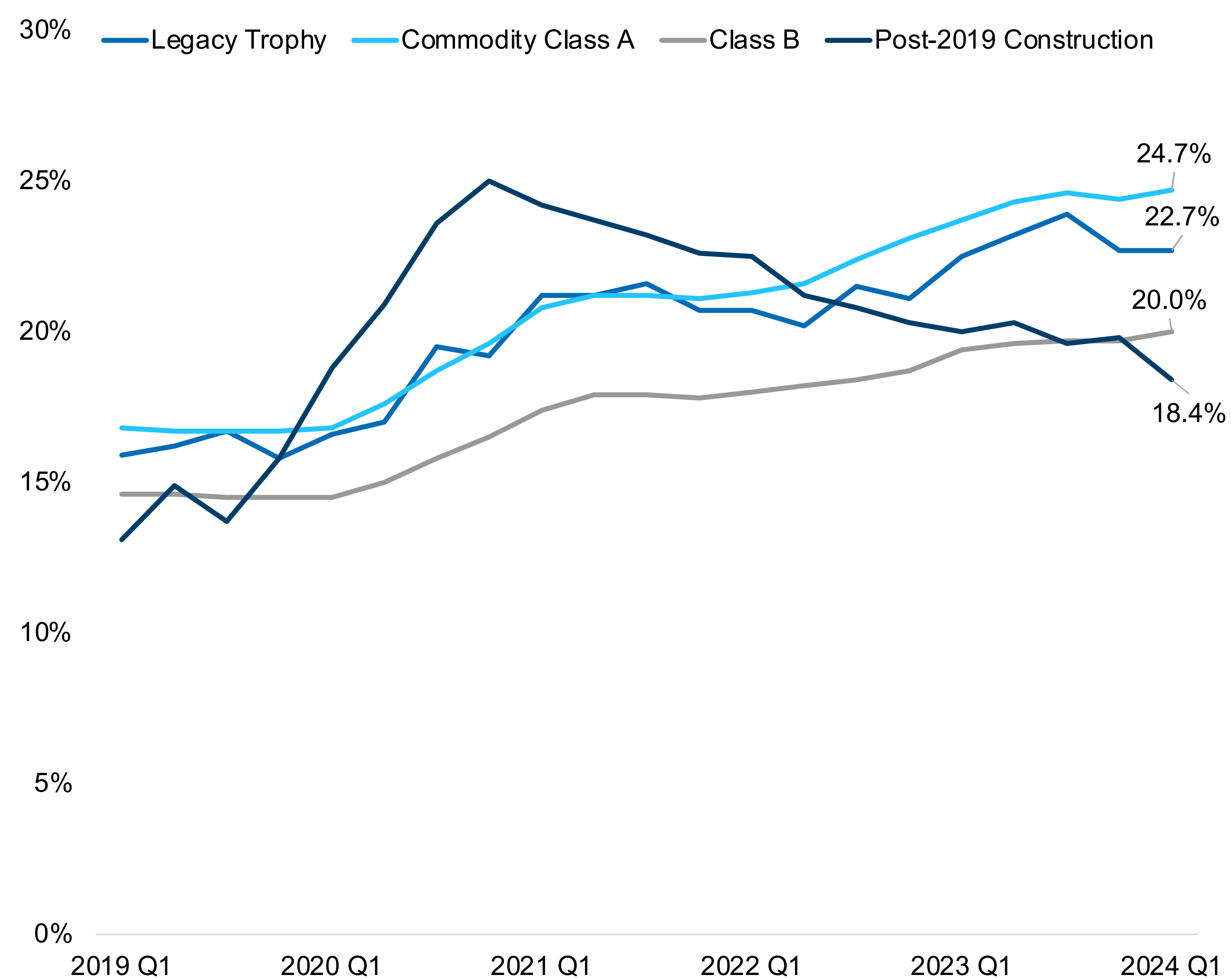
New Construction and Value Outperformance Are Occurring Both in CBD and Suburbs

Breaking out CBD and suburban availability by class and building age reveal a preference for both ends of the quality spectrum, especially in Suburban markets. Availability rates in post-2019 construction have been trending down over the past two years, partially due to a tightening pipeline but also due to a demand for this type of space.

CBD – Availability Rate by Class and Building Age



Suburban – Availability Rate by Class and Building Age



Source: CoStar, Newmark Research
*Office buildings over 50,000 SF. Excludes owner-occupied. CoStar building classifications are defined as follows: Three-star: Class B, four-star: Commodity Class A, 5-star: Legacy Trophy.
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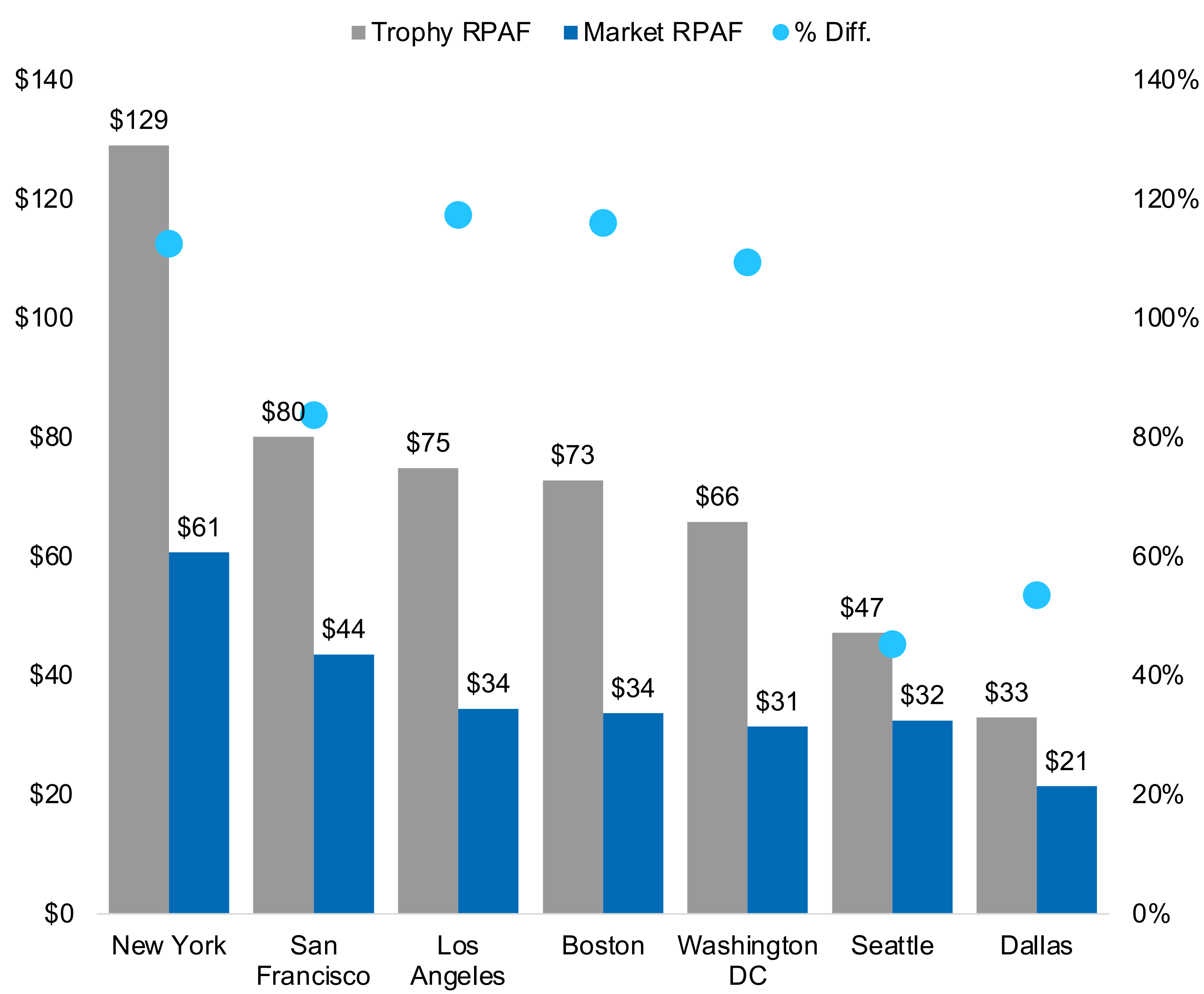
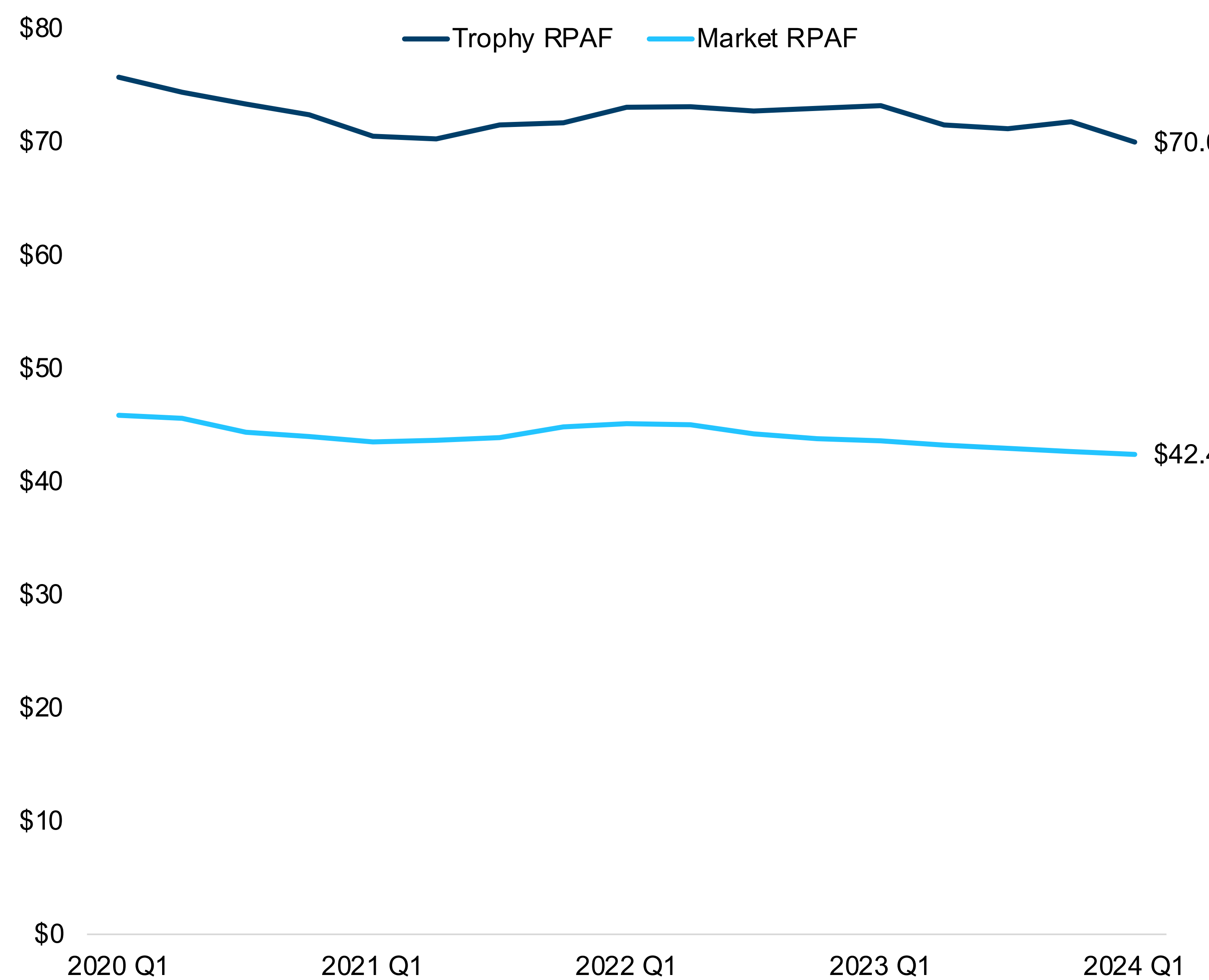
Trophy Cash Flow Premia Are Large, But Trophy Has Not Been Immune

In several key gateway markets, true trophy product* has significantly outperformed from a cashflow perspective. In New York, trophy product commands a 112.6% premium in market rent per available foot (RPAF) compared with the rest of the market. This premium totals 65.1% looking across the full set of gateway markets below. Trophy product has averaged a 64.8% premium since 1Q20. Nonetheless, trophy RPAF has declined by 10.8% since 4Q19 in select markets. This may improve as the newest product continues to lease up.

Gateway Market Comparison – Rent Per Available Foot**



Trophy versus Market – Rent Per Available Foot**



Source: CoStar, Newmark Research
*"Trophy product" in this analysis is defined as fully stabilized buildings, representing around 10% of each market's inventory square footage, capturing the highest gross overall asking rents.
**Gross Asking Rent x (1-Total Availability Rate)

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Newmark has implemented a proprietary database and our tracking methodology has been revised. With this expansion and refinement in our data, there may be adjustments in historical statistics including availability, asking rents, absorption and effective rents. Newmark Research Reports are available at nmrk.com/insights.

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