FINANCIAL ADVISORY

The Office Market: High Vacancies and Changes – A Place to Invest?

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While researching last month's article, "Growing Markets to Watch," I found surprisingly high office vacancy rates in otherwise thriving metro areas across the country.

That research inspired this month's article: we are going to look at the office market and evaluate the attractiveness of buying in this asset class.

WHAT THE DATA SHOWS

First, let's review the numbers for the entire United States. According to brokerage and research firm CB Richard Ellis, the nationwide office vacancy towards the end of our last recession (in the first quarter of 2012) was just over 16%. That number decreased steadily to just over 12% in the first quarter of 2020 just before the COVID lockdowns. The rate as of the 3rd quarter of 2022 was just over 17% - the highest rate seen since those lockdowns.

Real estate, of course, is a local business so national statistics don't really tell a complete story. What do the rates look like in strong downtown areas? CBRE reports they are still high: Tampa 15%, San Diego 21%, Austin 19%, Orlando 13% and Minneapolis/St Paul 22%. CBRE reports that these are among the "best recoveries from COVID vacancies."

Suburban markets show better numbers. Many areas have recovered well in a short time: San Francisco Peninsula (south of the city including Palo Alto) 11%, San Diego 11%, Las Vegas 12%, Orange County 11% and Orlando at 13%. This trend hasn't spread everywhere, however, as Suburban Houston was only able to improve to 23%.

Cambridge, MA (across the Charles River from downtown Boston) saw its' vacancy improve from a pandemic-high 8% to merely 5%. Boston is thriving as well, (at least when compared with other major downtown areas), with 11% vacancy.

WHAT THIS MEANS

How should we interpret all this data? I am used to seeing single-digit vacancy figures in multifamily markets, so I'll need to adjust my expectations a bit. Where 3% vacancy may represent a great residential market, a great office market may have 12%.

Although 12% vacancy may represent a "strong" office market this suggests that I'll need to deal with these issues as an office landlord: 1. Less pricing power: More vacancies generally mean more choices for potential tenants. This gives them more room to negotiate and could prevent me from driving rents as high as I would like to. 2. Longer vacancy periods: As tenants shop more potential alternative locations and

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work to sign leases at lower rates, I'll be dealing with more downtime where I'm earning zero rents from my space. 3. Potentially shorter lease terms: In a relatively "soft" market with many choices and much room for price negotiation, what incentive does a tenant have to "lock down" an office location and price with a long-term lease?

OUTLOOK FOR OFFICE INVESTING

Some may review the above figures and conclude that "we need to buy in markets with lower vacancy – so I'll look for Cambridge, Las Vegas or San Diego." I disagree with this because, as real estate investors, we are buying properties with a focus on long-term trends. If suburban rents are generally higher in San Diego, for example, than in suburban Houston TX given the formers' higher vacancy rate; companies will therefore start to move their operations to a less expensive location. So – lower prices elsewhere in the country will begin to draw our tenants away from us. How many people do you know that moved out of state because they could buy a much bigger, nicer and cheaper house somewhere else?

My article in 2021, "Winners and Losers of the COVID Crisis," explored the effect of these events on office rents. Most office workers were sent home during the lockdowns: how many of them will come back, and how many will continue to work from home for good. Even if only 10% of workers continue to work from home, this will be a permanent reduction in demand for office space. Buying offices space, therefore, could be like starting a cigarette manufacturing company or a nationwide chain of gas stations. While it is certainly possible to see success with each of these ventures, wouldn't it be easier to try and work with current trends rather than against them? My office number is (877) 313-1868.

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