The Looming Crisis in Commercial Office Space

The continuing popularity of remote work spells trouble for the commercial office sector, as companies consolidate space and property owners struggle to adapt to changing needs.

The U.S. office vacancy rate hit a record high of 18.6% in the first quarter of 2023.*

Anyone who has spent time in a downtown office building lately cannot help but notice the vacated office suites, the rows of empty cubicles, the shuttered cafeterias, and the lack of a lunchtime crush. In fact, the shift to remote work during the pandemic has left many office buildings half empty.

Cities like New York, Los Angeles, and San Francisco, which saw their downtown office districts empty out at the start of the pandemic, have experienced only a partial refilling as remote and hybrid work become the norm. As of March 2023, average downtown office occupancy was at about 50% of pre-pandemic levels.[1] Many businesses have adopted flexible work arrangements and now allow employees to work from home much of the time. Those that have tried to reinstitute full-time attendance have gotten pushback and lost staff as employees shift to more accommodating employers. Shared offices and cubes are common, and many businesses now use only a fraction of their leased space.

Smaller buildings in downtown office markets have been particularly hard hit, especially those near few amenities and in less desirable areas. And there has been a shift from crowded and expensive major urban markets to less dense and more affordable locations.

All this comes at a time when tech companies have announced large layoffs, putting millions of square feet of office space back on the market. What's more, fear of a recession has spooked even thriving businesses from committing to new office space.

Higher Rates Add to the Pain

As if all this weren't enough, building owners also face higher borrowing costs. Commercial office properties are typically financed through short-term bank loans that must be refinanced when they mature. Morgan Stanley estimates that there are approximately $1.5 trillion in commercial real estate loans that will come due by the end of 2025.[2] Given the dramatic increase in interest rates since early 2022, most of these loans will reprice at a higher rate -- at a time when occupancy and property

values are falling. If building owners are unable to secure refinancing or renegotiate terms, a surge in loan defaults could result, putting pressure on an already stressed banking sector.

Economic Repercussions

The question on everyone's mind is: How bad could it get? Will the fallout from the glut of office space drag down the general economy? Some industry analysts see a permanent structural shift in demand for office space, with occupancy rates continuing to drop as more and more companies downsize their office footprint. In cities such as San Francisco, some warn of a "doom loop," where workers don't return, offices remain empty, restaurants shutter, transit agencies go bankrupt, tax bases plummet, and public services disappear.

Yet there are others who see the whole crisis as just another chapter in real estate's ongoing boom/bust cycle. The office sector has tanked before and not brought the economy down with it. They point to the strength of other real estate sectors, such as apartments and light industrial space, which they claim compensates for today's weakness in downtown office space.

Whether the situation turns into a crisis or ends up being just a bump in the road depends mostly on location. Major cities like New York, Boston, Chicago, Los Angeles, and especially San Francisco clearly face real challenges ahead. Some office property owners are already looking to convert buildings to other uses, such as apartments, or adding features and amenities that make them more conducive to hybrid work situations. But these modifications cost money, and, for now at least, borrowing costs are high. Lenders are also reluctant to take big risks in the wake of recent bank failures.

Meanwhile, fast-growing downtowns in the Sun Belt have recovered more quickly than more expensive and tech-centric markets. And some cities, such as Nashville, Charlotte, Miami and Dallas/Ft. Worth, continue to see positive net absorption of space.

In the end, the pains that many commercial office properties are going through today will serve as catalyst for change. The more efficient use of real estate and the removal of poorly performing office buildings may leave the office market stronger than before the pandemic -- and more in tune with today's needs. But how long that will take and what fallout it will create along the way remain unknowns. So stay tuned.

*FDI Intelligence, *Out of Office: US Vacancy Rates Hit Record High*, based on projections from Cushman & Wakefield, April 5, 2023.

[1] CBRE, *Office Buildings Hardest Hit by Pandemic Share Common Characteristics*, April 4, 2023.

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[2] Bloomberg, *A $1.5 Trillion Wall of Debt Is Looming for US Commercial Properties*, April 8, 2023.

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