Office Market Swayed by the COVID-19 Crisis

Even as many firms successfully implement work-from-home policies, the benefits of the office far exceed the costs. We expect the office market to rebalance along changing preferences toward more individual space.

COVID-19 Crisis: A Substantial Headwind

The coronavirus crisis is thoroughly testing the office market. According to preliminary Q2 data from CoStar, demand for office space has severely contracted in Los Angeles, New York City, San Francisco and Houston. Demand has also substantially weakened in many other markets. The dropoff in net absorption largely reflects the April and May lockdowns, which prevented building tours and pulled the rug out from under lease negotiations. Heightened uncertainty surrounding the trajectory of the economy and questions about what the post-COVID economy will look like have caused many businesses to re-evaluate their longer-term space needs. An existential crisis has emerged, as the successful implementation of work-from-home policies has led some to question the necessity of traditional office space.

We still see the office environment providing the predominant workspace for office-using industries. While the switch to virtual working helps businesses comply with social distancing guidelines in the short-term and might significantly reduce operational costs in the longer-term, there are some less tangible benefits to office arrangements. With workers in separate locations, simple-yet-necessary tasks, such as assigning work and organizing group meetings, are less efficient and likely to grow more costly. Furthermore, while virtual work can keep projects rolling, it is far less conducive to innovation, which leads to new products and processes that drive a firm’s success. Thus, some of the cost savings associated with virtual work would also likely be offset by diminished productivity gains. Ultimately, the value proposition of the office is that it brings employees together and allows for frictionless collaboration between workers, boosting productivity and driving profits. Developing and maintaining a distinct corporate culture is also easier when people work together. Corporate culture is what differentiates one service from another, creating barriers to entry for new competitors. A dynamic, creative or eco-friendly workplace also helps attract the best-and-brighest talent.

As employment growth recovers, firms will need to bring back employees and find creative ways to maintain social distancing. Work spaces will need to be adapted to provide more individual space, and common spaces and meeting rooms will need to be reconfigured. The mix between urban and suburban space will likely shift back somewhat towards the suburbs.

Considering the recent resurgence of the pandemic, prospects for a swift rebound are diminishing, which suggests office demand will likely continue to weaken. We expect rising vacancy rates and a sharp deceleration in rents for the remainder of the year. Encouragingly, office development has been mostly restrained this cycle, which puts many office markets in a favorable position once a recovery gains steam. Still, it will likely take a couple of years for occupancy and rents to fully recover to prior-peak levels.

Source: U.S. Department of Commerce, REIS, CoStar and Wells Fargo Securities