Our prior report observed that the negative impact of the COVID-19 pandemic on office sector fundamentals would be felt even harder in the second half of 2020. This proved true in Q3 2020.

Following a second quarter that provided clear evidence of the pandemic-driven downturn, the leading U.S. office markets saw even greater contraction in Q3 2020. Net absorption was negative across all but one of the top 10 markets, with vacancy rising in the remaining nine. The first signs of an erosion in asking rents are also being seen, as rising levels of sublease space continue to enter the market.

As the flow of sublease space accelerates, the greater the propensity for rents to drop as landlords seek to compete. Expect any decline in rates to be more prevalent in older, commodity space at first. Where asking rates do hold up, for now, this will likely be due to increased incentives on offer, thereby lowering effective rents.

Combined net absorption across the 10 markets in the third quarter was negative 15.7 million square feet, out of a U.S. total of negative 36.1 million square feet. Manhattan dominated these occupancy losses, with nine million square feet of negative net absorption. Three other markets – Boston, Los Angeles and the San Francisco Bay Area (Bay Area) – all contracted by more than one million square feet.

Vacancy rates continued to rise sharply in the tech-driven Bay Area and Boston markets, increasing by 160 and 200 basis points, respectively, in the third quarter. Two other markets posted three-digit increases. Manhattan’s vacancy rate rose by 170 basis points, while there was a 160-basis-point increase in Los Angeles.

Vacancy rates continued to rise sharply in the tech-driven Bay Area and Boston markets, increasing by 160 and 200 basis points, respectively, in the third quarter. Two other markets posted three-digit increases. Manhattan’s vacancy rate rose by 170 basis points, while there was a 160-basis-point increase in Los Angeles.

Chicago was the lone exception in the third quarter, with a series of large tenant move-ins resulting in modestly positive absorption and a 20 basis points drop in the vacancy rate. However, this is not seen as indicative of future performance.
Looking forward, the extent and duration of the current office downturn is largely dependent upon the continued severity of the pandemic and the development and widespread introduction of an effective vaccine and/or therapeutics. At that point, the economy and business confidence should improve, resulting, albeit with a lag effect, in an uptick in office market fundamentals.

With a growing number of firms delaying their return to the office until mid-2021, the sector and its leading markets appear likely to remain challenged through the next 12 months, but we could see signs of stabilization as we move into 2022.

Market fortunes will vary dependent upon tenant composition and local conditions. Houston is suffering from its exposure to the energy sector while Washington D.C. has seen an oversupply of new product. In Los Angeles, the pandemic’s impact on the entertainment industry is being felt while tech-led markets, most notably downtown San Francisco, are being hit hard. Markets with a diverse tenant base, such as Chicago and Manhattan, may be better placed to weather the storm.

Although not widespread, we are seeing temporary moves out of the larger cities by some residents. New York and the leading California cities are among the most impacted. With more firms further delaying their return to the office and a resurgence in the pandemic, it remains to be seen whether some of these moves will become more permanent.

Rising Sublease Space Puts Pressure on Rents

Over the last two quarters, the volume of sublease space on the market in the U.S. has increased by 35% and is approaching 170 million square feet. With the volume in this cycle already surpassing the previous peak by a fair margin, this has the potential to affect the trajectory of vacancy and rents significantly.

Top 10 Markets: Sublease Availability Rate Q3 2020 (%)

- San Francisco is bearing the brunt of the downturn as sublease space continues to ramp up and now stands at 7.4 million square feet – equivalent to 7.8% of market inventory.
- Manhattan led all markets in the third quarter, with 3.1 million square feet of sublease space added. Sublease space now accounts for 23.2% of Manhattan’s total availability, putting further pressure on asking rents.
- In an analysis of rental discounts for sublease over direct space for Class A CBD properties in the top 10 office markets, the average discount was 23.9%. Houston led all markets at 49.5%; at the other end, Dallas and San Francisco saw an 11.3% discount.
- While the volume of sublease space coming back to the market is expected to continue to rise over the short-term much depends on the future path of the pandemic. Potential relief may be in sight given the recent promising vaccination news.

Featured Highlights

- Manhattan retains the lowest vacancy rate of the major markets despite five consecutive quarters of increasing negative absorption.
- Vacancy in Washington D.C., continues to rise, but the flow of new space onto the market is slowing.
- Chicago posted positive absorption and a fall in vacancy in the third quarter. However, this is expected to be temporary.
- Houston remains significantly challenged with more energy firms placing sublease space on the market.
- Vacancy in Los Angeles rose sharply in Q3 2020. Both Downtown and West L.A. are facing supply challenges.
- The Bay Area was hit hard once more, particularly in downtown San Francisco where there is a glut of sublease space.
- Midtown remains the center of construction activity in Atlanta with 4.5 million square feet underway.
- The Dallas office market slowed in the third quarter and has the second-highest vacancy rate in our survey.
- Boston had the most significant increase in vacancy among the top 10 markets in the third quarter, rising 200 basis points.
- Rents in Seattle are coming under pressure from rising levels of sublease space and new supply.
LOCAL INSIGHTS

- The Manhattan office market saw further retrenchment in the third quarter with rising vacancy, a fall in asking rents and significant negative absorption. The vacancy rate rose by 170 basis points to 7.6%. Despite this increase, which is the highest since 2004, Manhattan is tied with Seattle for the lowest vacancy rate of the markets tracked in this report.

- Net absorption totaled just over negative nine million square feet in Q3 2020, which is the highest negative total recorded since Q1 2009, during the Global Financial Crisis. Leasing activity in the third quarter totaled 4.8 million square feet. While this represents a 50% increase from the second quarter, it is approximately one-half of the level seen one year earlier in Q3 2019. If leasing volume continues at its current pace for the remainder of 2020, it has the potential to post its lowest annual total this century.

- On a positive note, several large leases were signed in Q3 2020, including nine for more than 150,000 square feet. These were led by Facebook, which took 730,000 square feet at 390 Ninth Avenue in the Penn Plaza/Garment District submarket.

- As the market continues to shift in tenants’ favor, we are seeing the first signs of a fall in rents with average Manhattan asking rates down by 2.8% in the third quarter to $77.12 per square foot. Average sublet asking rents are $61.99 per square foot. Sublease space continues to enter the market at a significant pace with a net increase of 3.1 million square feet in Q3 2020. Sublease space now accounts for 23.2% of Manhattan’s total availability putting further pressure on overall asking rates.

- The Washington D.C. office market, which witnessed a slight contraction in the second quarter, was hit hard in Q3 2020. Net absorption fell to negative 924,751 square feet and the vacancy rate rose by 50 basis points to 15.9%.

- Absorption in the suburban markets of Northern Virginia and suburban Maryland, which was positive in the second quarter, turned negative, totaling a combined 565,487 square feet, with the greatest loss occurring in the Tysons Corner submarket at negative 280,314 square feet. Vacancy rates in close-in submarkets such as Ballston, Rosslyn and Virginia Square are now above 20%.

- A similar pattern occurred in The District, where Q3 net absorption was negative 359,264 square feet. The East End was the hardest hit submarket posting negative 202,150 square feet of absorption and a 17.9% vacancy rate, well above The District’s overall rate of 15.2%. Construction activity is slowing with 2.6 million square feet underway in The District. Several projects have pushed back delivery dates and groundbreakings are on hold.

- Chicago was the only market in the top 10 to witness both positive absorption and a drop in vacancy in the third quarter. Net absorption totaled 228,309 square feet while the vacancy rate fell by 20 basis points to 13.8%. Average asking rates held steady at $42.66 per square foot.

- The positive activity in Q3 was primarily attributable to several major tenants that signed pre-pandemic leases and are now occupying their spaces. These included CBOE and Cisco Systems moving into space that they had pre-leased at the Old Post Office redevelopment in the West Loop. In addition, in the East Loop, Northern Trust took occupancy of 404,719 square feet at 333 S. Wabash St.

- The third-quarter gains are likely to be only temporary. The downtown Chicago market saw 2.3 million square feet added to the market in the third quarter, taking availability to 19.3%. This rate is expected to increase with more tenants making physical moves out of space once pandemic conditions ease and they formalize their office space needs. Additionally, new construction has continued through the economic downturn. There is 6.5 million square feet currently underway with several projects due to deliver over the next six months.

- The Houston office market continued to contract in the third quarter. Net absorption came in at negative 911,853 square feet. The vacancy rate increased by 60 basis points to 22.6%, which is the highest among the markets tracked in this report. Average asking rates held steady at $34.90 per square foot, but concession packages are becoming more aggressive.

- The third quarter’s largest lease transaction by far took place in the CBD with JP Morgan Chase & Co. signing for 239,672 square feet at 600 Travis St. Unfortunately, this was something of an anomaly. There is a surfeit of large blocks on the market, with 93 buildings with 100,000 square feet or more available across the metro. This includes 28 options with 200,000 square feet available for lease or sublease. Vacancy rates are elevated across all the submarkets covered in this report, with only Katy Freeway and West Loop coming in below the market average at 20.2% and 22.4%, respectively.

- There is 3.9 million square feet of space under construction within the metro area, approximately two-thirds of which is pre-leased. The largest development underway is Hines Securities Inc.’s 1.1 million square foot Texas Tower in the CBD. The project is scheduled for completion in Q4 2021 and currently stands at 39% pre-leased.
In Los Angeles, office market fundamentals, which started to weaken in the second quarter, saw a severe downturn in Q3 2020. Net absorption totaled negative 1.5 million square feet while the vacancy rate rose by 160 basis points to 15%. Rents are now coming under pressure, even in the most prestigious submarkets on the westside.

The Downtown submarket remains challenged. Vacancy stands at 20.4%, following 373,100 square feet of negative absorption in the third quarter. In addition, there is 1.2 million square feet of space under construction Downtown with very little pre-leasing activity.

In West L.A., a decade long run-up in rents has come to a halt and vacancy has spiked to 12.9% following a 230 basis points increase in the third quarter. This comes at a time when there is 3.3 million square feet under construction in 19 projects across West L.A. Unless leasing activity gains traction, this new supply has the potential to drive up the vacancy rate significantly.

In this report, vacancy in Tri-Cities is the lowest of the three core L.A. submarkets tracked at 12.4%. The submarket received a boost in the third quarter with Netflix leasing 171,000 square feet in Burbank for its animation studio. Additionally, Netflix is still in talks to take the entirety of the 250,000-square-foot former IKEA building, also in Burbank.

The Bay Area office market came under further pressure in the third quarter. Net absorption totaled negative 1.1 million square feet, following negative 1.5 million square feet in the prior quarter. The vacancy rate increased by an additional 160 basis points to 8.1%, while average asking rates fell by 8.9% to $79.26 per square foot.

San Francisco is bearing the brunt of the downturn. The city has seen 4.6 million square feet of negative absorption through the first nine months of the year, including more than negative 1.5 million square feet in the third quarter, 79% of which was seen in the Financial District. This resulted in a 12.6% decline in Class A Financial District effective rents in Q3 2020. Sublease space continues to ramp up, and now stands at 7.4 million square feet – equivalent to 7.8% of market inventory. As more sublease space flows to the market, look for a further decline in San Francisco’s office rents.

While Silicon Valley is not immune from the downturn, it is being impacted less. Net absorption in the Valley was negative 197,670 square feet in the third quarter, bringing the year-to-date total to negative 1.3 million square feet. Seven projects totaling almost one million square feet delivered in the third quarter, with 81% of this space being pre-leased. Sublease space on the market has risen to 3.2 million square feet, equivalent to 3.0% of inventory.

Net absorption fell into the red in the Atlanta office market in the third quarter at negative 294,375 square feet. Although average asking rates held steady at $33.91 per square foot, the vacancy rate rose by 40 basis points in Q3 2020 to 14.3%.

All four of the Atlanta submarkets tracked in this report posted occupancy losses in Q3, most notably in Central Perimeter, where net absorption was negative 169,602 square feet with State Farm moving out of 200,000 square feet at Ashford Perimeter. Central Perimeter also has the highest vacancy rate at 16.7%, while Midtown has the lowest at 11.9%. Average asking rates in Midtown are the highest in the market and stand at $40.54 per square foot, followed by Buckhead at $36.96 per square foot.

Atlanta’s construction pipeline remains active with 6.3 million square feet underway, about a quarter of which is set to deliver by year end. Midtown remains the central focus of development activity with 4.5 million square feet of new construction. Encouragingly, the third quarter’s largest lease transaction was a pre-commitment in Midtown with Mailchimp signing for 300,000 square feet at 760 Ralph McGill Blvd.

The Dallas office market contracted in the third quarter. Net absorption, which had been slightly negative in the second quarter, fell further to negative 384,322 square feet while the vacancy rate increased by 80 basis points to 17%. Average asking rates held steady at $34.36 per square foot.

The third quarter occupancy losses were concentrated in Far North Dallas and Uptown/Turtle Creek with negative net absorption of 158,236 square feet and 221,168 square feet, respectively. Preston Center retains the highest average asking rents at $43.55 per square foot and lowest vacancy rate at 10.3%. Vacancy stands at 17.7% in Far North Dallas and 16.7% in Uptown/Turtle Creek.

 Asking rents in the close-in submarkets are expected to hold up the best, while Far North Dallas is facing rising volumes of sublease space, which will put pressure on rents. While landlords strive to hold face rates, tenant concessions are on the rise to attract tenants in a low-velocity market.

Seattle felt the effects of the downturn in the third quarter. Net absorption turned negative to the tune of 434,837 square feet while the vacancy rate rose by 50 basis points to 7.6%. Despite this increase, Seattle has the lowest vacancy rate among the top 10 markets (along with Manhattan).

More tellingly, rents are now being impacted. Class A asking rates in the Seattle CBD fell by 4.1% in Q3 2020, while there was a 5.5% decline in Class B asking rents. While prime Class A assets in the CBD and Lake Union may still be posting asking rents in the $55-$60 per square foot range, effective rents have the potential to be markedly lower when increasing concession packages are factored in. Average Class A asking rates downtown stand at $48.61 per square foot.
Rising sublease space and new construction are both pushing up vacancy and putting pressure on rents. An additional 520,000 square feet of sublease space was placed on the market in Downtown Seattle in the third quarter and more is set to follow. In addition, the 722,000-square-foot Rainier Square project delivered in Q3. The entire building was originally leased to Amazon but is available for sublease, with only 18% of the space taken to date. There is an additional three million square feet still under construction.

Boston’s office market has witnessed a sharp about-turn in the past six months. Net absorption was negative by more than one million square feet for the second successive quarter, posting an occupancy loss of almost 1.3 million square feet. At the same time, vacancy rose by an additional 200 basis points in the third quarter to 12.7% and is now back at 2013 levels.

The flow of sublease space onto the market continues with 630,000 square feet added in Q3. The greatest impact is being felt in the Financial District, where there is now 1.4 million square feet of sublease space available. Third quarter net absorption in this submarket was negative 627,742 square feet, pushing the vacancy rate to 13.4%. Vacancy in Seaport stands at 16.2%. Back Bay is below the market average at 9.7%.

Rents are showing little signs of decline so far, but with limited leasing activity, there are few deals to help set the market. Back Bay retains the highest average asking rates at $73.39 per square foot compared to a market average of $66.44 per square foot. Landlords are trying to hold on to face rents, but tenant concessions are increasing. With the rising wave of sublease space being added, look for Class B rents to soften first.