BEYOND THE GLOBAL HEALTH CRISIS

Marcus & Millichap

SPECIAL REPORT OFFICE

THIRD QUARTER 2020

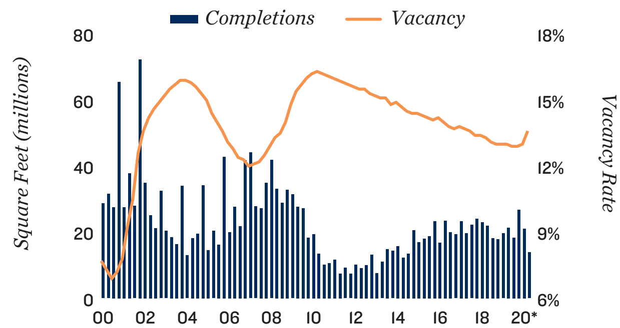
Health Crisis Redefining Organizations and the Workplace, Placing Focus on Low-Density, More-Suburban Markets

Office workers facing a new environment. The pandemic has rapidly reshaped Americans' daily routines with many office workers now working from home for six months with no clear end in sight. Some large tech firms have announced a full transition to remote work, raising questions over the future of the traditional office model. For the vast majority of companies, office space will remain essential to their operation, though many will adopt a more flexible model that allows for some days to be remote. In preparation for the return of the workforce, safety and employee well-being are top concerns that have led to temporary measures such as plexiglass barriers, thermal scanners and one-way hallways, though the pandemic will also create more lasting changes to offices.

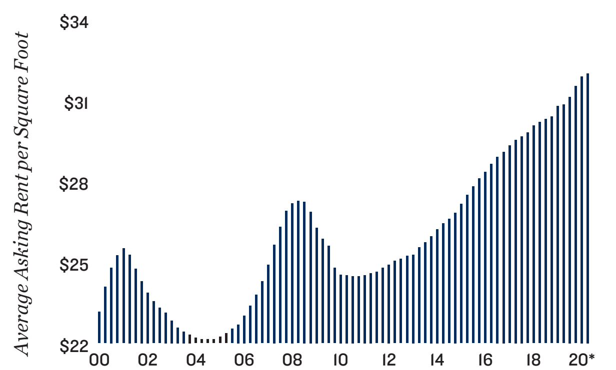
Uncertainties weigh on property performance. Companies put long-term commitments on hold as they await greater clarity, pushing the national office vacancy rate up 60 basis points in the second quarter to 13.6 percent. Supported by rising rates for suburban space, rent growth maintained an upward trajectory, inching up 0.3 percent to an average of $31.99 per square foot. Property performance is expected to soften in the months ahead as firms reconsider space requirements and the full impact of the economic shutdown is realized. More sublease space will come to market at discounted rates as firms seek to offload unused space, particularly in denser downtown corridors and larger markets. A bright spot for the sector, though, has been the high level of rent collections, which were above 96 percent in July.

New realities shifting buyers' focus. The need for office space is still apparent and highly desired among the majority of workers, which will continue to attract investor attention. While it is more difficult to locate available assets and acquire lending, buyers are shifting their focus to properties designed for a post-pandemic world. Interior design, access to open spaces and the ability to easily reconfigure workspaces will be top priorities going forward, while increased interest in suburban office buildings will form as well. Employers are placing more focus on lower-density buildings in the suburbs for their access to green spaces and simpler entrances that don't require an elevator. The movement of households outside of the urban core will support demand for suburban office space in the years ahead as more firms locate closer to workers.

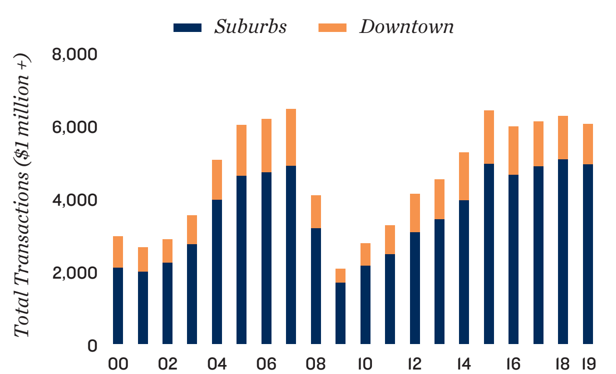
Supply Additions Moderate During Recent Economic Expansion



Asking Rent Well Above Prior Peak



Yield Profile Sustains Suburban Investment



* Through second quarter
Sources: CoStar Group, Inc.; Real Capital Analytics

Smaller Markets and Suburban Areas Poised to Benefit From Shift in Demand Characteristics

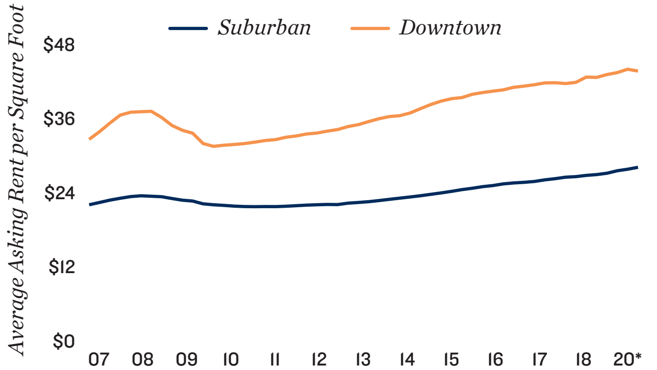
Workplace to be reimagined for greater flexibility. With reentry into the workplace still on the horizon, firms and employees are finding new ways to manage in a virtual world. It is estimated that about 37 percent of the U.S. workforce could plausibly do their jobs from home, which will lead to a greater adoption of a hybrid model that allows remote work some of the time. In a recent survey of office-occupying firms, 82 percent will allow remote work part of the time as employees are demanding greater flexibility in an uncertain environment. More focused work can be done at home, while the office will be a space for collaboration and meetings. This will alter design as efforts will be made to create more space for workers after years of condensing the office from roughly 250 square feet 10 years ago to just under 200 square feet.

Secondary and tertiary markets more resilient. In the years leading up to the pandemic, employers were adding more office space in secondary and tertiary markets to access a larger talent pool and lower expenses. While most markets in the second quarter registered softening demand, some smaller metros remained more stable. Tampa-St. Petersburg, St. Louis and Sacramento proved to be more resilient with minor increases in vacancy at midyear. The pandemic will accelerate the movement to smaller markets and suburban areas as businesses transition to a more decentralized hub-and-spoke model. This has been recently highlighted by Amazon after it announced a greater commitment to Detroit, Denver, Phoenix, and San Diego, which could signal other companies that are looking at expansions.

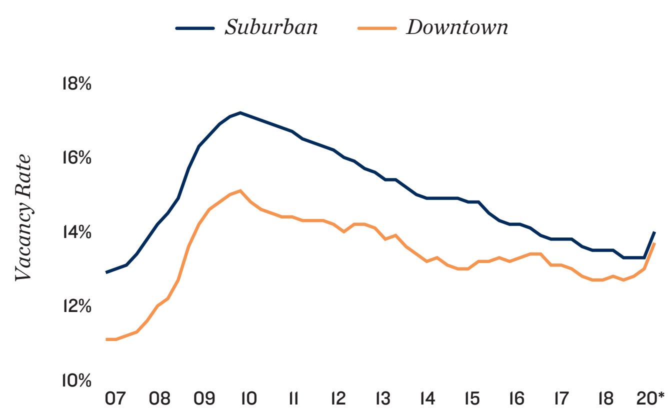
Suburban office finds greater balance with demand. A pullback in leasing pushed vacancy higher for suburban and central business district office space, both climbing 70 basis points in the second quarter to 13.9 percent and 13.6 percent, respectively. Rental rates climbed in the suburbs, rising 1.1 percent to $27.55 per square foot in June. A 0.7 percent decline was recorded for CBD office space, reaching an average asking rate of $43.12 per square foot. Even with interruptions on the job site during the second quarter, more than 8.9 million square feet was added to suburban areas, while 3.1 million square feet was delivered in downtown corridors. Suburban office construction has been more aligned with demand in recent years, maintaining stable performance and closing the vacancy gap with the urban core to 30 basis points.

Large cities face an employer exodus. Primary markets are likely to face greater hurdles in the quarters ahead as companies reassess space needs and move to shore up financial reserves. More expensive markets like New York City, San Francisco and Seattle-Tacoma could take longer to recover, particularly with large tech companies giving their workers more freedom to work elsewhere. San Francisco could face more hurdles as the market has a higher share of start-up firms that are unable to weather the crisis, bringing more sublet space available. An exodus from larger markets with a high cost of living by households and employers was already underway, and the pandemic will build more momentum around this movement with growing interest in low-density, less expensive secondary markets.

Downtown and Suburban Rent Spread Beginning to Narrow



Suburban Office Closes the Vacancy Gap



** Through second quarter*
Source: CoStar Group, Inc.

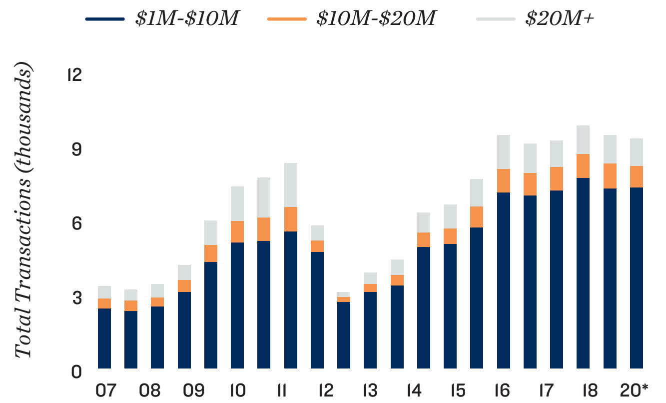
Sales Activity Slows in Second Quarter as Investors and Lenders Assess New Climate

Office investment pauses in wake of health crisis. Sales activity took a considerable hit in the second quarter as the pandemic altered traditional ways of doing business and created uncertainty surrounding future tenant demand. Deal flow for CBD assets fell 72 percent in the second quarter from the same period a year ago, while investment beyond the urban core was less impacted. Trade volume for suburban office properties fell 54 percent, accounting for the highest share of quarterly volume since 2009 at 66 percent. While activity was lower across most markets as sales inventory shrank, transaction velocity was more resilient in several secondary metros that continue to add more households and employers. Philadelphia, Denver and Phoenix were the most active in this segment, drawing buyers for their strong underlying demand factors and attractive yield profile.

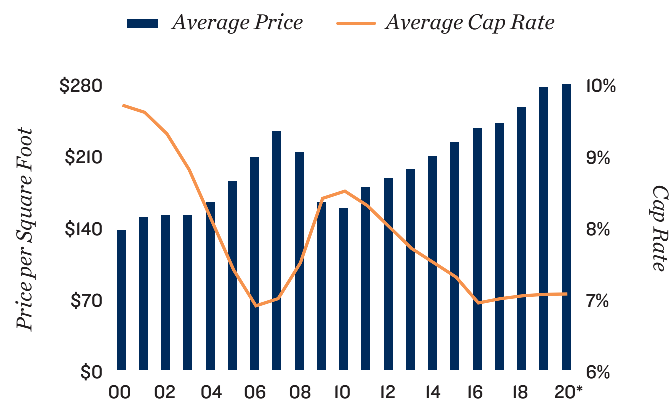
Healthy yield spread to encourage office investment. The rapid decline of the 10-year Treasury rate to below 1 percent has widened yield spreads for office investors. Cap rates have stabilized over recent quarters with the average holding in the low-7 percent territory. Overall, prices per square foot over the 12 months ended in June averaged about $280 nationally. Gateway and tech markets often recorded the nation's tightest yields with San Francisco, Miami-Dade, and Seattle-Tacoma falling in the upper-4 percent to upper-5 percent band. Secondary markets including Nashville, Sacramento and Phoenix typically traded at an average cap rate in the mid-6 percent to mid-7 percent range. Many of the Midwest markets drew buyers in search of even higher yields, which often fell in the mid-7 percent to upper-8 percent band.

Banks more conservative as they await greater clarity. The limited number of active lenders at the onset of the health crisis created a major challenge in sourcing new deals, while many that were already in process took longer to close. More lenders are active in the marketplace now than several months ago, and they have been conservative with their underwriting criteria in a new climate. With the office market recording some of the highest rent collections across asset classes, this could give banks more comfort with risk, though. A widening gap between buyer-seller expectations could be a hurdle in the months ahead with increased operating expenses and slower rent growth driving net operating incomes lower. These trends will influence investing decisions as buyers seek out properties that will be the least impacted from the pandemic as possible based on location, layout, and tenancy.

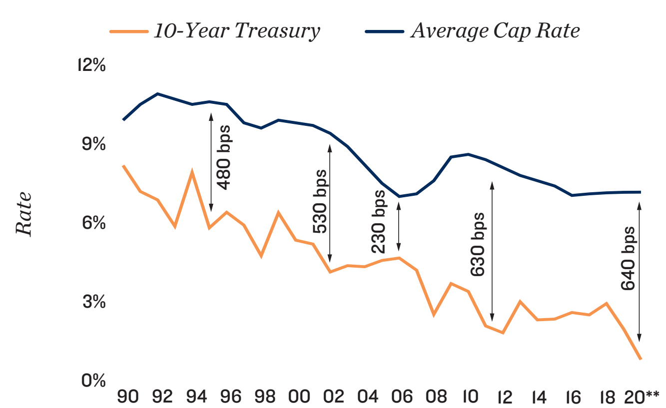
Transaction Activity by Price Tranche



Attractive Yields Encourage Investment



Yield Spread at Historic High



* Trailing 12-month period through second quarter
** Through second quarter
Sources: CoStar Group, Inc.; Real Capital Analytics

Property Metrics Softened Across Most Markets in the Second Quarter

Market	Vacancy	Quarterly Basis Point Change	Average Asking Rent	Quarterly Change
Atlanta	16.3%	60	$26.12	0.7%
Austin	13.5%	160	$36.42	-0.3%
Baltimore	12.2%	10	$23.61	1.2%
Boston	12.2%	60	$32.37	-4.7%
Charlotte	10.7%	70	$28.63	2.6%
Chicago	16.5%	50	$28.84	3.2%
Cincinnati	11.6%	30	$17.40	0.6%
Cleveland	11.0%	30	$18.08	-1.0%
Columbus	11.1%	60	$19.65	1.2%
Dallas/Fort Worth	19.2%	110	$26.71	0.3%
Denver	15.1%	100	$27.77	0.5%
Detroit	15.0%	50	$20.41	-0.6%
Fort Lauderdale	14.6%	90	$29.85	2.1%
Houston	21.2%	40	$29.50	0.2%
Indianapolis	10.7%	30	$19.85	0.7%
Kansas City	10.3%	90	$20.19	-1.3%
Las Vegas	14.0%	60	$23.28	2.9%
Los Angeles	14.1%	100	$40.14	0.4%
Miami-Dade	12.7%	90	$36.48	3.8%
Milwaukee	14.1%	90	$18.45	1.5%
Minneapolis-St. Paul	11.5%	30	$25.60	3.6%
Nashville	12.2%	110	$28.33	1.0%
New York City	11.5%	20	$62.59	-2.1%
Northern New Jersey	15.9%	90	$27.99	0.4%
Oakland/East Bay	12.7%	40	$40.59	-0.3%
Orange County	13.8%	60	$33.64	0.9%
Orlando	10.8%	10	$23.74	1.8%
Philadelphia	13.0%	30	$26.65	2.1%
Phoenix	16.3%	110	$27.09	1.2%
Pittsburgh	12.7%	80	$22.46	1.2%
Portland	10.7%	40	$27.55	0.8%
Raleigh	10.0%	60	$25.34	1.8%
Riverside-San Bernardino	9.5%	60	$23.75	2.7%
Sacramento	11.4%	30	$24.48	0.9%
Salt Lake City	10.8%	150	$22.51	1.1%
San Antonio	13.0%	100	$22.75	0.2%
San Diego	13.6%	110	$34.85	0.3%
San Francisco	12.0%	200	$69.60	-0.6%
San Jose	10.6%	40	$58.40	11.6%
Seattle-Tacoma	8.5%	80	$37.89	-1.1%
St. Louis	10.4%	0	$20.04	0.3%
Tampa-St. Petersburg	10.4%	10	$24.39	0.5%
Washington, D.C.	17.6%	40	$38.56	0.1%
West Palm Beach	12.9%	0	$31.77	2.3%
United States	**13.6%**	**60**	**$31.99**	**0.3%**

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Price: $1,000

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Gartner; National Bureau of Economic Research; Real Capital Analytics