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Economic headwinds impact office vacancy rates

Overview: The second quarter office vacancy rate report from real estate firm Jones Lang LaSalle (JLL) notes the Federal Reserve's raising of interest rates to fight inflation may be "in part responsible for a slowdown in capital-focused expansion, primarily but not exclusively in tech and related industries."

The report also hypothesizes that the sluggish nature of leasing activity can still be tied to the lingering presence of COVID as firms reassess their office space needs in the face of slow return-to-office plans of employees. Researchers did identify a trend of moving from older office space to newer, more amenity-filled spaces, better known as "flight to quality".

National data

The JLL research points out that net absorption of office space (space that became leased minus space that became unleased) for all markets across the nation, CBDs (central business district) and suburbs, was negative for 2022's second quarter (-7.8 million square feet) —a bigger drop than the -5.4 million in the first quarter of this year. The report notes that negative net absorption is more prominent with space that is designated lower class (class B and C), an indication of firms' desire to move to office space with better amenities. All data in this *Brief* comes from JLL.

Prior to the pandemic, in 2019, the net absorption rate was decidedly positive at 67.3 million square feet. Due to pandemic effects, the first quarter of 2021's absorption was a negative 53.3 million square feet. After 2021's second quarter, the national net absorption rate began to improve with smaller quarterly reductions and ended the year on a positive note. However, through two quarters of 2022, those gains have been reversed. Except for the rise in 2021's fourth quarter, each quarter since 2020's first quarter has seen negative absorption.

A sluggish economy accompanied by 40-year high inflation and rising interest rates, coupled with the lingering effects of the pandemic, have weakened the office-leasing market.

In 2019, the total vacancy rate nationwide for all classes of property stood at 14.3 percent. By 2021's second quarter, it had risen almost five points, to 19.1 percent, and, a year later, it has only marginally improved, to 18.9 percent. It is important to bear in mind that the vacancy rate is the amount of unleased space as a percentage of total available space. If a firm has unused space in its lease—for example, as a result of employees not returning to the office to work—it is not counted as vacant space. In the current environment, the vacancy rate may be understating the actual unoccupied space in office buildings.

Pittsburgh area compared to national data

In 2019, the net absorption rate for the Pittsburgh area—CBD and suburbs—was a positive 96,652 square feet, for a yearly absorption rate of 0.2 percent of the 53.5 million square feet of inventory. This was below the national average of 1.6 percent.

For the first half of 2021, the net absorption rate was a negative 740,811 square feet or -1.3 percent of inventory—slightly worse than the national rate of negative 1.2 percent. But in the first half of 2022, the Pittsburgh area's net absorption rate has returned to positive, although just slightly, at 0.4 percent, while the national rate has stayed slightly negative at -0.3 percent. Over the last three years, the overall Pittsburgh market has been steady regarding the turnover rate of leased office space.

As mentioned above, the national vacancy rate in 2019 was 14.3 percent. The Pittsburgh area was more than three percentage points higher, at 17.6 percent. This trend continues as the local vacancy rate remained above the national in the second quarter of 2021 (21.0 vs. 19.1 percent) and again, a year later, in the second quarter of 2022 (20.9 vs. 18.9 percent).

Another key measure of the health or vibrancy of the local office market is the square footage of new space under construction as a percentage of total inventory of office space.

In the fourth quarter of 2019, the Pittsburgh area had over 1.65 million of square feet of total office space under construction—3.1 percent of inventory. Nationally, that percentage was slightly less, at 2.8 percent. The Pittsburgh and national rates were nearly equal in the second quarter of 2021, at 2.3 and 2.4 percent, respectively, as the amount of square feet under construction in the Pittsburgh area fell to 1.27 million—a reduction of 23 percent from the pre-pandemic level.

During the same period, the amount of square footage under construction nationally fell 11 percent. However, in the second quarter of 2022, the Pittsburgh area had just 558,000 square feet under construction, a further drop of 56 percent from a year earlier. The national reduction was only 1.3 percent.

It is likely that the economic conditions and slower than anticipated return-to-office plans by workers, cited in the JLL report, are slowing the demand for new construction in the Pittsburgh area. The soft market for office space caused one major real estate firm, North Carolina-based Highwoods Properties, to put up for sale its Pittsburgh property holdings, PPG Place and EQT Plaza, to concentrate on the market in Dallas.

What's interesting about this move is that, on paper, the Dallas office market doesn't seem as well-off as the Pittsburgh office market. The vacancy rate for all office space in Pittsburgh's CBD was 18.2 percent in the second quarter of 2022. For Dallas' CBD, it was 31.4 percent. For the urban market, Pittsburgh's vacancy rate was 21.3 percent whereas Dallas' rate was 27.4 percent. Even suburban Pittsburgh fares better, coming in at 21.2 percent. Suburban Dallas's total vacancy rate was 22.7 percent.

The amount of square feet under development offers a reason why Highwoods has chosen Dallas over Pittsburgh. In Dallas' urban market, there are 944,494 square feet under construction, which represents 2.3 percent of the total inventory. In Pittsburgh's urban market there are 458,000 square feet under construction (presumably the taxpayer-subsidized FNB Tower), or 1.3 percent of total inventory.

Dallas' suburban office market has over 5 million square feet of office space under construction, spread out over a few areas (3.0 percent), whereas the Pittsburgh suburban market has just 100,000 square feet under construction (north suburbs), or 0.4 percent of total inventory. Clearly, the ongoing pace of office space development in the Dallas suburbs points to expectations of strengthening leasing activity in the near future as the Texas economy continues its far-better-than national performance.

While local leaders have shrugged off Highwoods' decision as just business—and nothing to worry about—it could be evidence of a softer office market outlook brought about by lack of population growth and very meager gains in employment in Pittsburgh and the region in recent years.

That, all brought about as the result of a very poor business and labor climate in Pittsburgh, the region and the state. High tax rates, onerous regulations and poor schools in several municipalities, which are documented in many *Policy Briefs*, have and will continue to dissuade businesses from moving into the city and region.

Until these issues are addressed and see radical improvement, the economic torpor of the city and region will continue.

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