ALLEGHENY INSTITUTE
FOR PUBLIC POLICY

March 8, 2023 **Policy Brief: Volume 23, Number 10**

Downtown's vacancy rate remains high

Summary: As 2022 closed, high vacancy rates continued plaguing office markets across the United States. In the final quarter of 2022, vacancy, for all classes and markets, came in at 19.6 percent, just one-tenth of a percent better than in 2021. The Pittsburgh office market was no exception to this rule as the vacancy rate for all classes and markets in the final quarter of 2022 was 21.3 percent, which was four-tenths of a percent higher than it was at the same time last year (20.9 percent).

Overview

What is unclear is whether the stagnation in vacancy rates will change in 2023. Private companies are beginning to push return-to-office policies with some offering a hybrid schedule to get employees into the office at least a few days per week. Having employees in the office is a catalyst for productivity and collaboration. As noted in the Jones Lang LaSalle (JLL*) U.S. Office Outlook for Q4* report (all data is from JLL), this push should result in higher office attendance rates at least on peak days (Tuesday through Thursday).

2022 started out strong as first quarter leasing activity nationally was 15.1 percent higher than the same quarter a year earlier. However, by the fourth quarter it had fallen to 10.3 percent lower than 2021's fourth quarter. Leasing activity was still only 72.3 percent of pre-pandemic levels. When a company does enter into a lease, it has been looking to improve the amenities offered as a way to encourage workers back into the office, what is known as a "flight to quality." Nationwide, of the large leases signed, 73 percent were for class A, or premium, office space.

New tenants are looking for quality and new construction, causing the current office market to be more of a renter's market. As they look to move up, vacancy rates in lower-quality spaces will begin increasing. In the Pittsburgh market, in all areas, the fourth quarter 2022 vacancy rate for class A office space came in at 20.5 percent whereas for the remaining classes it was 22.4 percent. It was more pronounced in the fourth quarter of 2021 when class A vacancy was 21.0 percent; and the remainder was 23.6 percent.

In their *U.S. Real Estate Outlook for 2023*, JLL experts are not forecasting a recession but are predicting little, if any, growth in office space demand. The report notes that a still-healthy labor market should help the economy weather a slowdown even if wage and job growth slow in 2023. But the implication is that companies will be looking to trim costs, which also means that office space will continue to be under scrutiny. "The office sector remains under pressure with tenants looking to reduce footprints and improve efficiency."

Changes in the Pittsburgh office market

As the work from-home-culture appears to be here to stay, at least in some form, and a slow economy is being predicted for 2023, firms are placing sublease space on the market to reduce costs. Nationwide, 136.6 million square feet in 2022 was subleased to other firms. This was a record with most of that being done by the tech sector (54 percent). In Pittsburgh's East Liberty neighborhood, Philips, the electronics and medical equipment maker, recently announced that it is relinquishing 74,000 square feet in East Liberty's Bakery Square development. In 2022, it had subleased about 37,000 square feet. Philips blamed the hybrid model of working to "optimize our footprint while maintaining a world class working environment."

In August 2022, the local news reported that Citizens Bank moved across town from 525 William Penn Place to Four Gateway Center. In that move, the bank relinquished 100,000 square feet in their former home to assume just 60,000 square feet in its new home. The bank listed as a reason the flexible/hybrid work environment of its employees. This appears to be a more common post-pandemic strategy of companies to use space more efficiently, provide better amenities and make it more inviting for employees to return to work. The result is a shrinking of a firm's footprint and driving up vacancy rates.

It is worth noting here that both buildings—Four Gateway Center and 525 William Penn Place—spent money to upgrade their buildings to keep and/or lure new tenants. With the loss of its main tenant, Citizens, the vacancy rate at 525 William Penn Place was near 58 percent.

Northwest Bank announced in February 2023 that it will move into some of the space vacated by Citizens—but only 5,300 square feet. That bank noted the improvements made to the building as one reason for the move from the Oliver Building on Smithfield Street.

A January news article noted that Pittsburgh companies are relocating more frequently than they did before the pandemic as many take advantage of landlord concessions, such as construction or tenant improvement allowances and free months' rent. The estimate is that tenants are cutting footprints by about 14 percent or 3,000 square feet. This flight to quality is hitting lower-class buildings particularly hard.

Net absorption

Absorption is the process that measures whether unused office space becomes leased (positive absorption) or used office space becomes vacant (negative absorption). Also keep in mind that if a firm is still leasing unused space, it is not counted toward vacancy or absorption.

Nationwide, for all markets and all classes of office space, the fourth quarter year-to-date net absorption, including subleases, was -37.36 million square feet, which represented -0.8 percent of total inventory. This is an improvement over 2021's -59.01 million square feet of space that became available year-to-date or -1.4 percent of inventory. While the negative absorption rate slowed in 2022, it still indicates a continued downsizing activity among firms nationwide despite the sublease additions.

For the Pittsburgh area, the central business district (CBD) and suburbs, the absorption rate is -159,522 square feet or -0.3 percent of total inventory for 2022. This represents a marked improvement over 2021's -907,856 (-1.7 percent). The difference is in class A space which in 2022 had a positive 352,074 square feet of absorption or 1.0 percent of inventory. 2021 had -71,783 square feet of absorption or -0.2 percent of inventory. The remaining classes still struggled in 2022, illustrating the flight to quality theory, with -511,596 square feet of absorption whereas that total was -836,073 square feet in 2021.

Looking at just Pittsburgh's CBD, in 2022 the total net absorption of class A space was -163,148 square feet or -1.0 percent of total inventory. It was the only area in the Pittsburgh market with negative net absorption. The remaining urban areas of the fringe and Oakland/East End each had positive absorption results of 98,504 and 24,847 square feet, respectively. The suburban area also had total positive net absorption of 391,871 square feet with none having a negative rate. The implication is that the central business district is not doing as well as the remaining Pittsburgh market for class A office space.

For the remaining classes of space, the CBD had the largest amount of negative absorption (-241,299 square feet), while only the Oakland/East End market had positive absorption. For the suburban areas, only two areas had positive absorption, the East and Southpointe markets. The others had negative absorption for a net total of -221,145 square feet.

In 2021, class A office space in Pittsburgh's CBD had a positive absorption rate (39,538 square feet) as did the fringe and Oakland/East End markets. The suburban areas struggled as only the South market had positive absorption (3,121 square feet).

Conclusion

The effects of the pandemic are still weighing on the office market in the Pittsburgh area. The work-from-home culture has caused firms to rethink their personnel strategies. While they are encouraging workers to return to the office, the hybrid model of some days in and some days out appears to be here to stay. As a result, firms are looking to upgrade spaces to lure employees back to the office. One way to accomplish this is moving to higher quality spaces with more amenities. At the same time, they are also looking to reduce their office expenditures by lowering footprints. The result is putting more space on the market, especially at the expense of lower-class space.

The prevailing thought is to begin converting buildings with lower-class office space into residential spaces. This will certainly lower the inventory of office space and likely the vacancy rates. However, if this is to take place, it should do so without the interference of government agencies. Taxpayer funds should not go to subsidizing this conversion. If the market is there for residential dwellings, then let the owners of the buildings shoulder the cost and the risk.

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