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When will high office vacancy rates begin to subside?

Summary: An earlier *Policy Brief, Vol. 23, No. 19*, analyzing first quarter office vacancy statistics, noted that the Pittsburgh area's rate of 21.8 percent represented a new high watermark. Among the reasons given for such a high rate was the prevalence nationally of the work-from-home culture, firms buckling down for an impending recession and layoffs, particularly in the tech sector. It also noted the prevalence of crime and homelessness in the central business district (CBD) as a more local factor. The second quarter data shows the vacancy rates have only worsened.

The vacancy rate is based on unleased space, not empty space which could eventually become unleased space as leases expire.

The real estate firm Jones Lang LaSalle (JLL, *us.jll.com*), from which our vacancy rate data is derived, has released the results from the second quarter. It's not good.

Second quarter office vacancy rates

The second quarter data show the area-wide vacancy rate for all classes of office space reached a new high of 22.5 percent—a rise of 0.7 of a percentage point. It was the seventh-consecutive quarter of increase. Pre-pandemic, the 2019 second quarter vacancy rate was just 14.9 percent. 2023's second quarter class A rate of 22.3 percent is 0.9 of a percentage point higher than the first quarter, while the class B vacancy rate of 22.3 percent in the first quarter edged modestly higher to 22.8 percent in the second quarter.

The slower rise in the class B, or lower quality office space, rate may be attributed to the reduction in overall inventory of such space. In the first quarter of the year there was about 27.18 million square feet of this space. For the second quarter, that fell by 0.8 percent to 26.96 million square feet. The changes happened in the south and west suburbs, down a combined 131,076 square feet, as well as in the CBD, down about 110,000 square feet.

However, the fringe of the CBD added 20,546 square feet of class B office space while the Oakland/East End market added another 3,910 square feet.

The amount of class A space in the area was also down slightly in the second quarter, going from 36.09 million square feet to 35.95 million square feet (-139,768 square feet or -0.4 percent) in the previous quarter. The CBD lost 260,400 square feet (-1.7 percent) while the Oakland/East End area added 120,787 (4.9 percent) and the fringe area added the remainder.

As had been noted in the last few *Policy Briefs* on office vacancy rates, two trends really emerged post-pandemic: the first is the work-from-home culture as employees chose to work at home instead of at the office. The second is the move to offer better quality space to bring them back to the office as firms noticed a decline in productivity with the work-from-home situation. The consistently high office vacancy rates also spurred the movement to convert office space into other uses, such as residential.

The JLL research noted that it tends to be lower-class office space, typically with long-standing high vacancy rates, that is being converted to other uses as firms are looking to upgrade office space to lure workers back to the office. This may be the reason for the reduction in class B space in the area, both in the suburbs and in the central business district.

Central business district

The CBD, the Golden Triangle, contains one-third of the office inventory in the area with 21.6 million of 62.92 million square feet. It also contains 43 percent of the area's square feet of class A office space. No other segment of the area comes close. With a total office vacancy rate of 20.3 percent, only the south and north regions have a lower rate at 13.6 and 16.8 percent, respectively.

It is also important to note that in the Pittsburgh area, there are 650,000 square feet of office space under development, all of which are class A. This includes the taxpayer-subsidized FNB tower on the site of the former Civic Arena. At 469,452 square feet, it is 72 percent of the total square footage under development. The remaining 180,621 square feet are being built in the west suburbs.

Pittsburgh's CBD's total office vacancy rate of 20.3 percent was higher than Philadelphia (17.3 percent), Boston (17.7 percent), Raleigh-Durham (19.1 percent) and New York City (19.6 percent). But it fared better than Charlotte (21.1 percent), Indianapolis (21.2 percent), Columbus (21.8 percent), Nashville (23.4 percent) and Austin (24.8 percent).

Of all the CBDs listed above, only Raleigh-Durham had fewer square feet under development (150,000 square feet) than Pittsburgh. Boston had the most (2.91 million) followed by Austin (2.63 million). All development in these markets is defined as class A. Only Charlotte had non-class A space under construction (340,960 of 1.12 million square feet). This lends credence to the notion that firms believe they need quality space to entice employees from home back to the office.

Conclusion

The office market nationally, and in Pittsburgh, is going through a major change. With some experts forecasting a slowdown in the economy brought about by higher interest rates as the Federal Reserve continues to battle inflation, most companies have been preparing for a slowdown by reducing office footprints resulting in a higher sublease market. The JLL research notes that the tech sector and life sciences sector have been the most active in reducing both employees and space. They expect this trend to continue as leases expire over the next year or so.

However, the push to bring employees back into the office in downtown areas especially should have a moderately positive effect on vacancy rates. While firms are pushing to bring them back, it appears that the work-from-home culture will remain as employees are only doing so on a hybrid basis, coming into the office only a few days a week. How this evolves will be very important to the future of office space vacancy and development. A recession and the threat of job losses may force a return to the office on a more full-time basis.

A more important factor facing office buildings and firms is the prevalence of violent crimes and homeless squalor in many major cities, including Pittsburgh. If employees don't believe the CBD is safe, they won't return, and firms may be forced to relocate to safer areas. Local news articles suggest this is already happening in Pittsburgh. Even if crime data shows a decline, perception is a very hard notion to fight. It could take years to convince employees that Downtown is safe. By then, office vacancy rates will be locked in at high levels.

As vacancy rates rise and stay high, the value of buildings will decline, and owners will seek reductions in their assessed values. This will reduce property tax revenues for the local taxing bodies.

Business cycles and the work-from-home culture may be hard to fight. But local officials can do something about public safety. And they had better do it quickly to avoid a long term and possibly irreversible negative impact on Downtown employment and real estate values.

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