The Rising Tide That Floods All Office

In its Depth and Breadth, the Sublease Availability Wave Signifies the Pandemic's Lingering Impact

By Phil Mobley

The onset of the COVID-19 pandemic in early 2020 plunged the U.S. office market into an extended period of stagnant demand. Since the beginning of 2020, office tenants have given back a cumulative 115 million square, and true recovery has yet to begin, with net absorption, the difference between move-ins versus move-outs, remaining negative for an unprecedented third consecutive year in 2022, albeit only marginally so. Meanwhile, the national average vacancy rate at the end of 2022 was 12.5%, 300 basis points above where it sat at the end of 2019. Entering 2023, both office performance metrics were still trending negatively.

But these weak fundamentals are not the only sign of the pandemic's unique impact on the office sector. A sustained surge in sublease availability may be the surest signal of a persistent pivot in the way tenants use office space—one that could still be reverberating for years to come.

A Massive Wave

The most striking aspect of the recent rise in sublease inventory is its sheer size, the impact of which loses nothing in comparison with the much smaller increase that occurred during the Great Recession. Office sublease availability started rising at the beginning of 2007, even before the recession. By mid-2009, it would grow from around 95 million square feet to just over 147 million square feet, an increase of 55%.

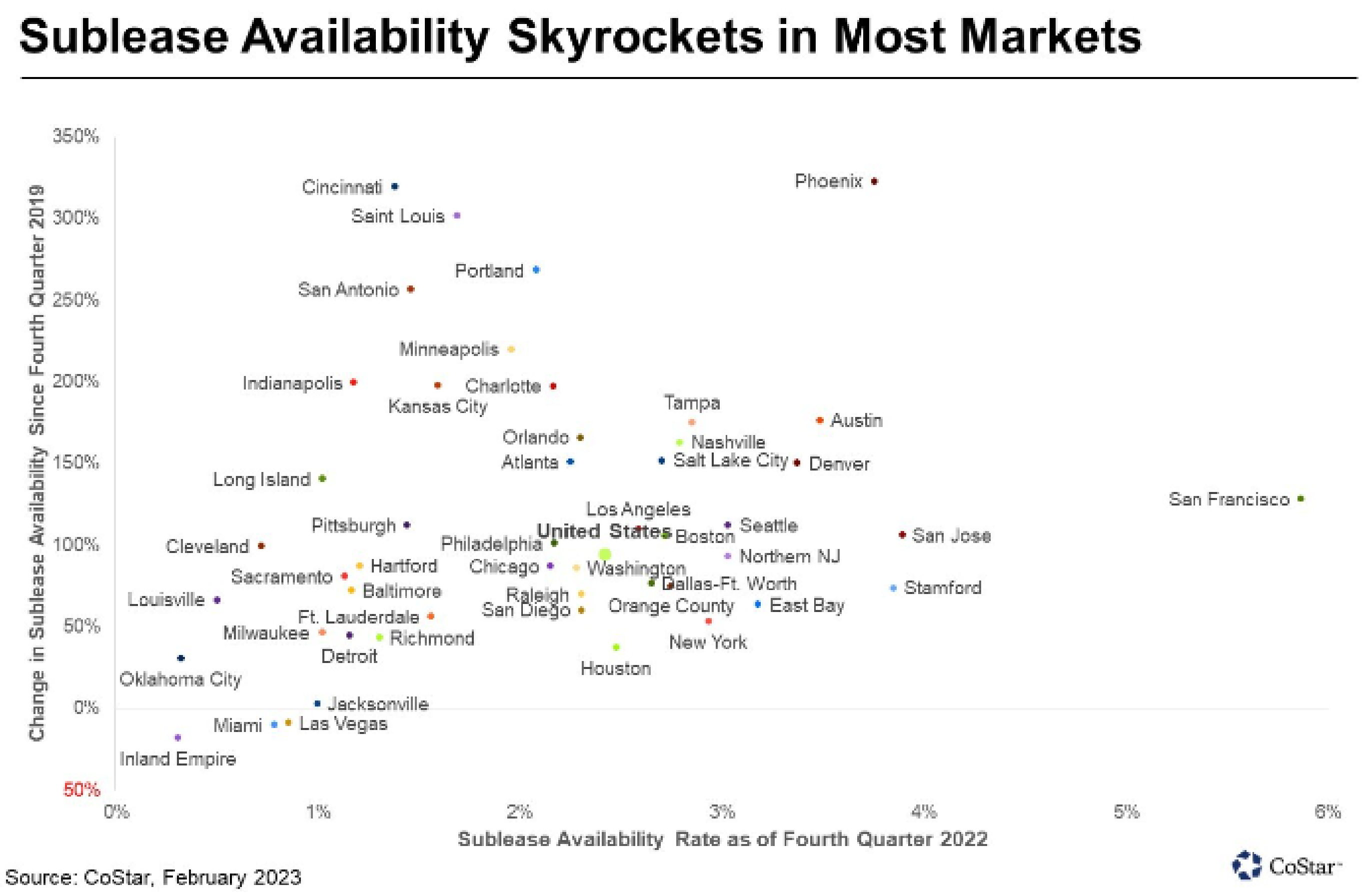
The sublease inventory increase in the current cycle has been far greater, exploding from 121 million square feet at the end of 2019 to 245 million at the end of 2022. This 103% increase is more than twice as large in square footage as the one during the Great Recession and has also already lasted six months longer before reaching a peak.

When tenants make space available for sublease, they are often attempting to cut their own short-term losses on space they no longer need. Thus, they are sometimes willing to offer the space at rents well below what it would cost a new tenant to acquire it directly from the landlord. In some markets, this discount can be 30% to 40% or more. Thus, while the landlord may not suffer lost revenue immediately, a large amount of sublease inventory can depress the market by holding down the price of competitive space.

Furthermore, the longer this excess inventory lingers on the market, the greater the risk that it will eventually become direct vacancy, taking income out of the landlord's pocket. The fact that the current sublease wave does not appear to have crested means that this downward pressure on rent and net operating income could last for some time.

A Broad Landfall

The impact of the surge in office sublease space is as broad as it is deep. Only a handful of primary and secondary markets have seen anything other than a substantial increase in sublease availability since 2019. For most, the increase in the amount of sublease space has been at least 50%; for many, it has been double, triple or more.



Nationally, the sublease availability rate, or the amount of sublease space available as a percent of total inventory, reached nearly 2.5% at the end of 2022, but for some markets, it is much higher. San Francisco, which has been particularly affected by changes in office usage patterns since the pandemic, now has a sublease availability rate approaching 6%.

The sublease wave has crashed across various markets with no clear pattern as to size. While secondary markets have generally weathered the past three years better than gateway cities in terms of office vacancy and net absorption, they have not escaped this particular indicator of softening tenant demand. With a few exceptions, such as Miami, Las Vegas and California's Inland Empire, sublease levels have been meaningful enough in most markets to weigh on rental growth, even as they portend a higher ceiling on vacancy.

Surging Across Both Downtowns and Suburbs

Just as markets of all sizes have generally seen similarly large increases in office sublease inventory, so too have downtown and suburban areas—at least in the aggregate. Central business districts and other urban areas have historically seen a higher sublease availability rate, which stands to reason as they also tend to have a greater share of large blocks of market-leading space. For this and similar reasons, urban core areas bore the brunt as tenants vacated space in 2020 and 2021, while the suburbs initially proved more resilient.

But the spring tide of sublease inventory has flooded into the suburbs as well, signifying a general decline in demand that appears to reflect more than a changing preference for location. Suburban offices, too, find themselves in a new competitive environment.

New Buildings Not Immune

One recessionary trend that has proven reliable in the post-pandemic era is the flight to quality. This is clearly visible in the stability of demand for space at newer-vintage buildings. While tenants have fled more than 300 million square feet in older-vintage buildings since 2019, net absorption has been positive in each of the past three years at buildings delivered in 2015 or later.

Yet the post-COVID sublease surge shows that even newer, high-quality office buildings are far from bulletproof. Among four- and five-star buildings—those at the top of the quality scale—sublease availability is now well over 4% at both newer- and older-vintage properties. Furthermore, it has increased at a similar rate for both.

This is a pointed reminder that the long-term implications of the pandemic are still playing out, even as the prospect of a new recession clouds the horizon. Such a recession could alter the balance of power in the labor market, and it is possible that this could lead to increased office utilization by motivating employees to come in more frequently.

But any impact on office demand would take time to occur, and the associated job losses from a recession would do little to stimulate office demand in the short term. With a tidal wave of sublease inventory already washing through the market, the bottom may be further out than it appeared a year ago. In any case, the office sector looks to be facing a slow road to recovery.