Office Sector in Early Phase of Multi-Decade Reshuffling

San Diego faces a glut of unoccupied lab facilities

By Kristen Smithberg

As remote and hybrid work solidifies into a permanent dynamic, the office sector is facing new realities marked by distress that is expected to continue at least through the end of next year.

The U.S. office market recorded $10.2 billion in transactions through the end of May, with properties trading at an average of $165 per square foot, according to CommercialEdge's National Office Report. Chicago was at the forefront in the Midwest, logging $223 million in office sales year-to-date through May, despite recording the lowest average sale price nationwide at just $81 per square foot. Meanwhile, Manhattan lost its status as the most active market for office investment after leading the nation in sales volume last year. With $570 million in sales through May, Manhattan now ranks fifth in sales, and average sale prices have fallen 66 percent since 2023 to $300 per square foot so far this year, the report found.

National vacancy stands at 17.8%, up 80 basis points from last year.

In addition to new work dynamics, the sector is further impacted by interest rates that are likely to remain elevated for longer than expected, unwelcome news for office owners hoping to extend or renegotiate loans. Despite challenging trends, the anticipated wave of distress is emerging slowly in part because some tenants are locked into long-term, pre-pandemic agreements, which is pushing downsizing decisions down the road. Prolonged negotiations and lack of sales comparables also impact the market, CommercialEdge said.

Through May, there have been 600 office sales, an increasing number of which are being sold at discounts. Last year there were 2,000 office transactions, which was half of the sales volume in 2021 and 2022 of about 4,000 transactions per year.

"Acceptance of the current office situation is becoming more widespread. We anticipate more finality at the individual property level, with an increase in distressed assets showing up," said CommercialEdgre director Peter Kolaczynski. "With this idea of 'acceptance,' we would also expect more creativity and ingenuity on how to handle this glut of space as the industry recognizes we are still in the early phases of what is likely to be a multidecade reshuffling."

The new office supply pipeline, which provides competition for tenants in a weak market, is beginning to slow, representing a silver lining for owners of existing office buildings.

In Western markets, San Diego benefited from a strong market for life science buildings coming out of the pandemic, but the market now faces the risk of a glut of unoccupied lab facilities. The market's vacancy has increased by 310 basis points during the past year, reaching 18.5% in May.

Meanwhile, San Francisco has positioned itself to capitalize on an expected boom driven by the development of artificial intelligence, but expectations have yet to live up to the optimism. Vacancies rose by 510 basis points year-over-year in May, reaching 25.2%, the highest among U.S. office vacancy rates, according to CommercialEdge. Tech markets outside of California saw comparable trends, with Seattle's office vacancy rate increasing by 350 basis points and Denver's by 280 basis points.