

As office construction levels wane, some of the right buildings are in the wrong location

Demand for space in new office buildings slows as availability in desired places recedes

By Phil Mobley

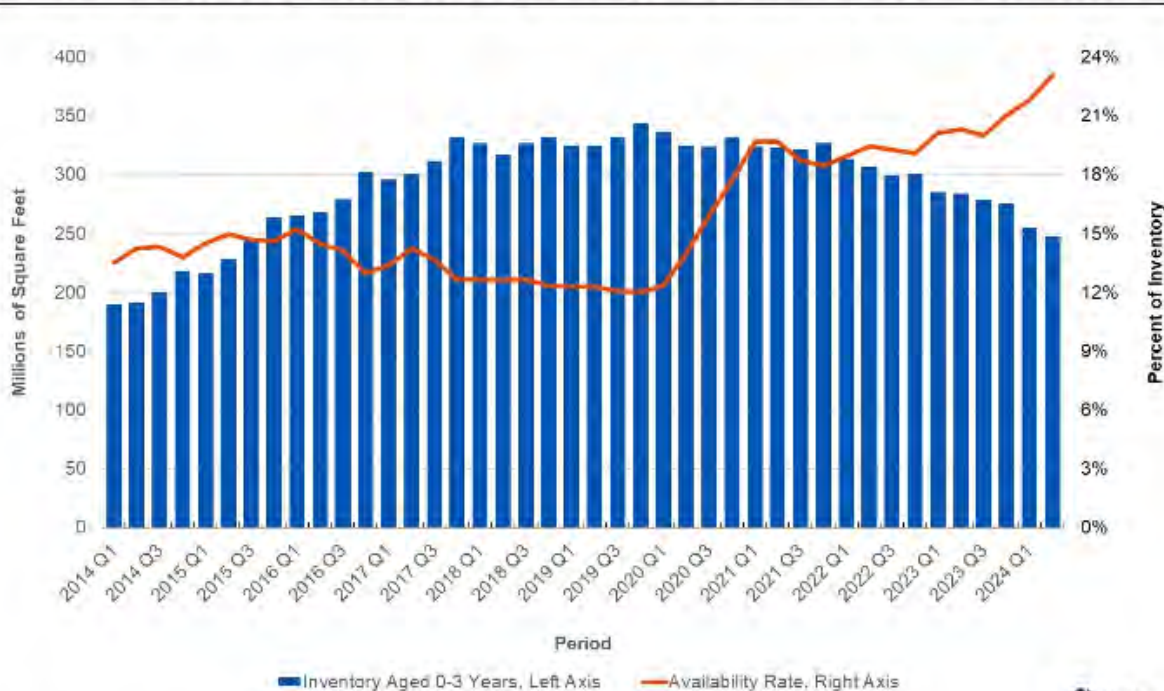
Throughout the post-pandemic era, the resilience of new office construction has been one of the very few bright spots in the commercial office market. Now, with development at a historical low and the amount of first-generation supply dwindling, many occupiers are taking a pass on even the newest buildings.

The interest rate-hiking that began in the spring of 2022 presented problems for developers looking to finance new office buildings. Since then, uncertain demand and still-elevated interest rates have remained a drag on new construction. During this time, as fewer new buildings get built, the amount of space in office buildings that are less than four years old has decreased by more than 50 million square feet.

Notably, however, the amount of available space in this same set of buildings has remained about the same, between 55 and 60 million square feet. The result is an availability rate that has skyrocketed above 23%, a level not seen for new construction since the Great Recession.

The implication of this unusual set of circumstances is clear: tenants are not finding all new office space equally attractive.

Take-Up in New Inventory Slows Even as Stock Shrinks

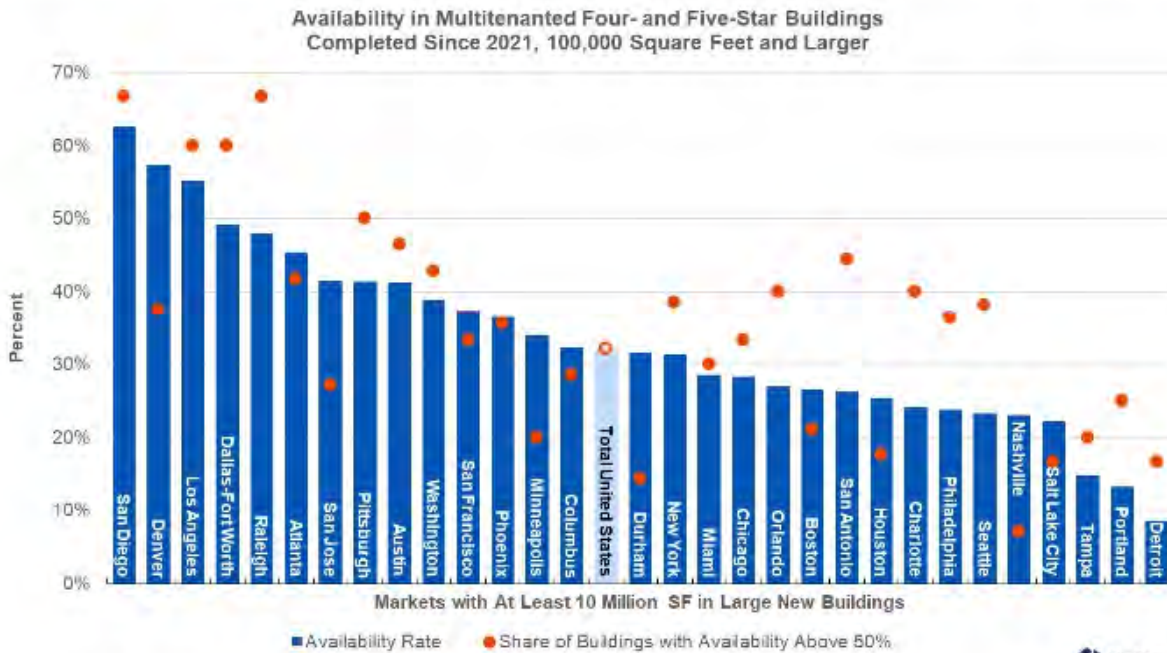


Source: CoStar, August 2024



On average in the U.S., about a third of all space in new, multi-tenant office buildings larger than 100,000 square feet is available. Similarly, about a third of these buildings are less than 50% leased. Some markets, including San Diego, Denver and Los Angeles, have much higher levels of available space in new office buildings. Even in some markets with relatively low new-building availability, such as Charlotte, Philadelphia and Seattle, more than a third of large new buildings are less than 50% leased.

First-Generation Availability Is Elevated in Some Markets



Source: CoStar, August 2024



This illustrates that demand is highly granular, even within segments that are generally performing well. One probable reason is the building's location within the market. Buildings in highly desirable areas like Denver's Cherry Creek and Bellevue outside of Seattle are still filling quickly, leaving limited availability in these prime locations. On the other hand, some new buildings in the central business districts of those same markets are struggling to attract tenants.

Any number of building features can influence perceptions about what constitutes an ideal location, including proximity to transit, access to parking and the number and type of amenities within a short distance of the property.

Elevated rents are likely a factor as well. The cost of construction has increased rapidly since inflation began rising in 2021. To cover these costs and earn a return on their investment, developers must keep rents high.

A year or two ago, large office occupiers did not appear to be terribly sensitive to high rents as they increasingly sought out superior workplaces in premium buildings, albeit often taking less total space.

Now, however, many of them have slowed or stopped hiring and appear to be balking at paying top-of-the-market rents, choosing instead to renew in place. In doing so, they not only avoid paying premium rental rates, but also skip the costs involved in moving furniture and equipment and, in many cases, coming out of pocket to configure new space to their liking.

With many businesses anxiously awaiting eased financial conditions to accelerate growth, a conservative approach to office occupancy makes sense. In addition to being expensive, renting premium workspace is a long-term commitment, often lasting a decade or more. In an uncertain economic environment, many are understandably reluctant to make this commitment without full confidence that they are in the right building and that that building is in the right spot.