Office Tenants Mostly Holding on to Existing Space into 2021

Renewals Are a Way of ‘Kicking the Can Down the Road,’ Cushman & Wakefield Economist Says

Harborside in Jersey City, New Jersey. (Mack-Cali Realty Corp.)

Make no mistake, office leasing volume is down majorly across the U.S. in the wake of the coronavirus outbreak — or 34% from the previous five-year average, to be exact. That and other unsurprisingly grim findings dominated Cushman & Wakefield's third quarter report on the topic. But what many might not realize is that office renewal activity is actually higher this year than in prior years, and leases that renewed were generally for more space — not less. And notably, there's been no mass exodus out of cities just yet.

In its "Are Businesses Leaving Cities?" report released last month, the firm found that, in the 87 markets it tracks, total leasing volume was sliced nearly in half in Q3 2020 — to 46 million square feet, from an average of 96 million square feet in a typical comparable quarter.

Renewing Rather than Reacting

But of all the leases signed in the two most recent quarters, renewals represented 29%, a notable uptick from the historical average of 19%. This trend echoes that seen in previous downturns, so it doesn't come as a total surprise; it simply confirms the apprehension faced by tenants, landlords and market observers heading into the new year, according to Ken McCarthy, Principal Economist for the commercial real estate services firm's Global Research department and co-author of the report.

"Near-term, there's still a lot of uncertainty about how people are going to behave and how business is going to be done and whether there is going to be growth or contraction in various businesses," McCarthy explained to LoopNet. "When you're uncertain about the future, the best thing to do is just sort of kick the can down the road. If you don't need to sign a lease, just stay where you are, and if you have to sign a lease, just renew as is and do what you need to do to keep your business running."

Office leases for larger companies are typically signed for a term of 10 or even 15 years in length, McCarthy reminds observers, so the renewals during this period were mostly for firms that had leased their space around a decade ago. As a result, those that did renew generally did not opt for less square footage; of the report's sample set, 34% of renewals were for less space, but around 24% were for the same amount of space and 42% were for more.

That doesn't mean that renewals signed recently will stretch into the 2030s, though. The report explained that more than a third of renewals were for less than one year in length, representing a notion of bridging a gap to better times. "We're definitely seeing situations where tenants took very short-term, 1-year, 2-year, or 5-year renewals to get past this, and then they'll revisit their real estate situation," McCarthy said.

Still, a snapshot of companies renewing their leases rather than subleasing or vacating – with some even expanding their office square footage this year – might seem to fly in the face of anecdotal concerns that the general trend in office leasing in 2020 is one marked by downsized footprints as more employees work from home.

But McCarthy urged observers to look at the big picture: "A lot of the renewals that we're looking at in Q2 and Q3 are renewals of leases that were done back in 2010, and companies in a lot of cases are very different today than they were then. For a typical large company with, let's say, a 100,000-square foot office, many may have grown to now need more space just because their business has gotten better. We're talking about a period of sustained economic growth — from 2010 all the way up to 2020, a 10-year economic expansion."

The reality is, the report purports, that if it weren't for the coronavirus pin bursting the economic bubble, leases for less space would have been far fewer, as those companies would likely be moving and expanding into bigger locations.

Top Priority Remains Attracting Top Talent

Further, there would have been far fewer renewals overall, McCarthy continued. "A lot of what drives real estate today is war for talent, so if your lease is up and you're in a situation where you're looking for a talent base and your current location or your current building just wasn't attractive, of course you want to attract talent, and this is a thing we've seen with all the new construction, is that companies are [moving] to attract talent. This has been less important during the downturn, but I think it's going to come back again quickly."

As for how the talent chase is guiding companies' real estate strategies through the 2020 downturn, McCarthy's take is that despite the pandemic's disruption of the status quo, there's been an almost imperceptible but inevitable, long-term shift in the "war for talent" that's top of mind for office-using firms, and it will continue to take precedence.

Ten years ago, no millennials were even in their 30s, he pointed out. Companies renewing those long-term office leases this year are seeing that a weighty portion of individuals representing the millennial workforce are reaching their peak homebuying years and slowly splintering off into the suburbs to start families.

The numbers from the last couple of quarters demonstrate that flow of residents from the city: home prices, rental rates and apartment demand outside of cities are either on par or up, while downtown housing demand has decreased substantially. Much of this may be chalked up to temporary reactions to the pandemic, but McCarthy said it's worth keeping a close eye on. “I think that was happening anyway, and then the pandemic hit and accelerated that trend a bit, but I think that's going to continue to happen, largely because of the demographics.”

Cities Remain Core to Strategy

That's not to say that cities are dead and office demand is shifting to smaller cities and suburbs, though. In fact, McCarthy argued it's too soon to even begin to answer the question that the title of the report posits.

“There have been rumors in the marketplace about companies testing the waters on suburban locations, and maybe that will come with this trend toward more people moving to the suburbs, which we do expect to happen, but right now I can't say with any certainty that we're seeing that at all,” McCarthy said. “There were some inquires in some markets, we’re told, but there’s nothing to indicate — and no transactions that we’re aware of — that suggest that companies are changing their real estate strategies as a result of [the pandemic].”

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>
> Ken McCarthy, Principal Economist, Cushman & Wakefield

Of leases that were signed in this period, the mix between core business district (CBD) and suburban locations remained within normal ranges of 31% to 37% for the former and 63% to 69% for the latter. All markets were underwater in terms of growth, McCarthy continued, and while some cities may have shown a bit less of a decline than others — such as Bellevue, Washington; suburban Washington, D.C.; Nashville, Tennessee; and Austin, Texas; – the data indicates no substantial shifts to emerging second-tier cities or suburbs.

In fact, the data does not demonstrate that the so-called “gateway cities” recognized by the firm – Los Angeles, Chicago, Washington, D.C., New York, San Francisco and Boston – won’t remain on top in terms of office leasing activity through the pandemic.

After all, he said, “There’s another generation coming right behind [the millennials] and many companies — such as tech firms, for example — that want to hire this talent are continuing to prefer downtown locations because the talent pool that they're trying to tap into is that next generation, so I think it will be a little bit of [catering to millennials' location preferences], but we're still going to see cities as an important place in which businesses want to operate."

And even though economic indicators such as employment growth have turned a corner to look a bit brighter going into 2021, the commercial real estate market tends to lag behind such metrics , he said, meaning that the worst may be still to come. "What we expect to see is continued increase in vacancy rates, leading to lower rents and it's probably going to take another couple of years before all of that works its way out of the marketplace."

That's also because many large office-using companies don't simply react with permanent changes during times of crises, he concluded. "There's going to need to be a lot of work that needs to be done before companies and businesses make any big decisions about their real estate strategy," he said. "Right now, they are still in survival mode. As we get through it and come out the other end, it's going to be a couple of years before we see any major strategic shifts, if they do come at all."

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