Office Recovery Takes a Cautious Step Forward

Leasing Is Improving, but Sublease Space Will Weigh on the Sector for Years

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While uncertainty is still the prevailing theme in the office sector, after two consecutive quarters of improved leasing activity a case can be made that the national office market is stabilizing and entering the early stages of recovery.

Office leasing activity remains slightly below pre-COVID-19 norms, but leasing volume in the fourth quarter of 2021 roughly matched the third quarter's total. The steady leasing environment persisted despite the effects of the omicron variant, which upended return-to-office expectations for many office tenants.

Stronger leasing volume in the second half of 2021 helped contribute to positive net absorption, the net change in space occupied by office tenants less move-outs, and demand roughly matched new office supply added in the fourth quarter. As a result, the national office vacancy rate flattened out just above 12%.

The uptick in leasing is a positive leading indicator for the office market's recovery, but the sector still faces considerable challenges. In particular, the amount of sublet space available in the office market is a persistent drag on efforts to increase rents, but it has been a boon to tenants in the market for office space. While the amount of sublet availability has slowly drifted lower in recent quarters, it is still near a record high. And with more sublet options out there, office users are increasingly taking advantage of generally more affordable sublet leases for their space needs.

The prevalence of sublet space on the market is eroding the bargaining power of landlords in lease negotiations, which is translating to relatively flat rent growth on a national level. It will remain difficult for office owners to push asking rents higher until leasing activity improves further, the amount of sublet space on the market trends lower and the office vacancy rate starts to decline.

Office sales volume picked up in the second half of 2021 following a slow start to the year, an indication that investors are regaining confidence in the sector despite a still-uncertain near-term outlook.

Average same-store pricing has trended slightly higher, driven by sales involving well-leased trophy assets. Rent collections for leased space remain strong and institutional owners are still generally well capitalized, which has limited acquisition opportunities for distressed asset sales at discount pricing.