Research

United States | 2024 Q1

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U.S. Office Market Dynamics

Demand recovery continues, but occupancy losses persist as office users evolve

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Key findings

1

Demand continues steady path of recovery

- National tenant requirements continue to trend upwards
- Leasing volume pulled back slightly but outperforming 2023

2

Sublease stabilizing gradually

- Sublease additions saw slight uptick, but decline significantly from Q1 2023
- The sublease vacancy rate continues to gradually fall

3

Flight to new supply slows as availability thins

- While tenants continue to prioritize new supply, demand slows as availability becomes limited
- New and differentiated properties continue to outperform in occupancy and rents

4

Redevelopment wave creating notional occupancy loss

- Negative net absorption accelerated, but remains concentrated in a small segment of the market, many of which are earmarked for conversion and will be removed from office inventory

5

Supply pipeline continues to decline

- Groundbreakings declined to below 300,000 s.f., the lowest volume on record
- Overall inventory begins to decline as inventory removals outpace completions

Demand recovery continues, but occupancy losses persist as occupiers evolve

The first quarter of 2024 brought mixed results for the U.S. office market—while the macroeconomic picture and occupier demand are improving, negative net absorption remains stubbornly high as major occupiers continue to trim meaningful amounts of space from their portfolios. But despite persistent downsizing, the market is being rebalanced through a robust conversion and redevelopment pipeline that has grown at a near exponential pace over the short term. The significant uptick in inventory removals in the face of a rapid slowdown in development activity caused national office inventory to peak in Q4 2023, and in the new year overall supply is declining. With under 300,000 s.f. of new supply breaking ground in the past three months, the likelihood of a prolonged period of net inventory removal is increasing, and will drive the market towards equilibrium, especially as occupiers begin to stabilize their footprints in alignment with post-pandemic workplace strategies.

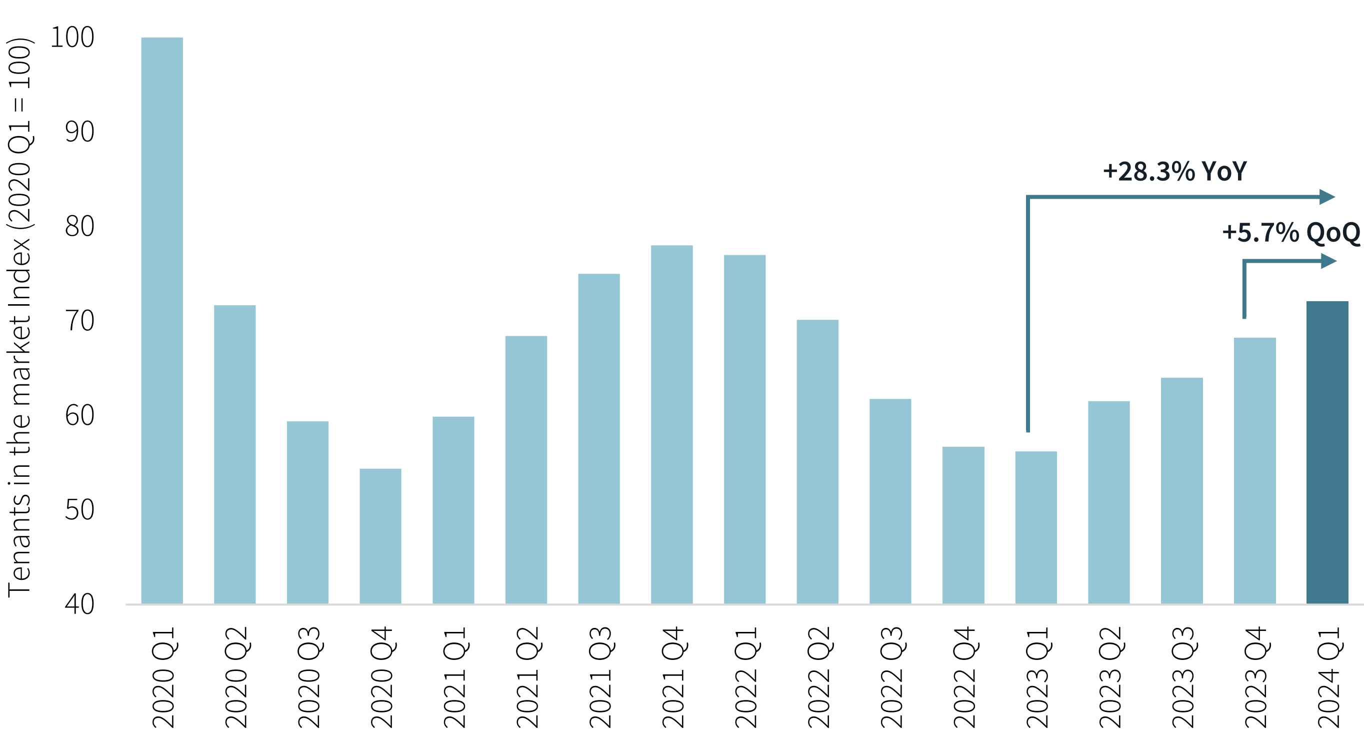
Considerable progress on taming inflation in 2023 began to stall in the beginning of the year, as year-over-year (YoY) consumer price index (CPI) growth remains at 3.2% as of February, elevated by key segments that continue to see price levels grow substantially, including housing (+5.7% YoY) and motor vehicle insurance (+20.6% YoY). However, the core Personal Consumption Expenditures (PCE), which is inclusive of those two elevated categories, has continued to steadily decline and fell to 2.8% in February. Investors now expect interest rate cuts to arrive between July and September and are expecting roughly 70 basis points (BPS) in cuts by year-end.

Labor market conditions continue to reflect a healthy job market where leverage is stabilizing after a shift in favor of employers. All office-using sectors added employment over the past three months, with Government adding 180,000 jobs, Professional Services adding 62,000, Information adding 21,000 and Finance adding 6,000.

Job openings are beginning to increase across office-using sectors as well after declining for nearly two years—office-using industries added 107,000 job openings in the past three months, and quit rates have generally increased quarter-over-quarter (QoQ), an indication that the shifts towards more employer-favorable conditions in the labor market are softening. Public equity prices, one of the strongest forward indicators of office demand, also continued to fare well during Q1. The S&P 500 Index saw prices increase 10.6% during the first three months of the year, and the NASDAQ index grew 11.0%.

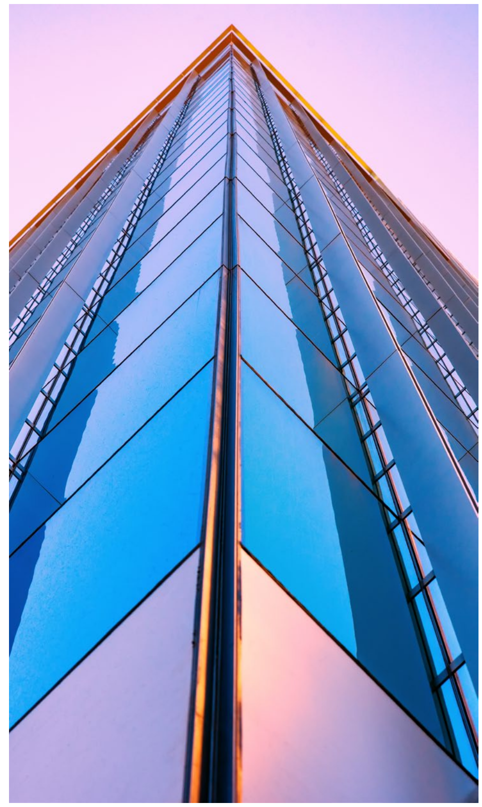
The alleviation of cyclical headwinds is driving occupiers back into the transaction market, with 70% of markets registering a QoQ increase in tenant requirements, and the national tenants in the market (TIMs) index increasing 5.7% to 72% of pre-pandemic levels. While some of these are expiration-driven tenants returning to the market after delaying decisions in previous years, some of the growth reflects new organic growth in office demand. ByteDance, although facing a tenuous path forward amid regulatory challenges, made headlines for actively seeking space and signing several large leases across at least three markets in Q1: Nashville, Seattle-Bellevue, and Silicon Valley. Outside of ByteDance and the growing artificial intelligence sub-industry, new demand has come from diversified sources from an industry perspective. Across industries, a larger driver of increases over the past year has been the gradual return of large-scale requirements. Requirements above 100,000 s.f., particularly those that were not near-term expiration-driven, were the first to be pulled from the market in mid-to-late 2022 as interest rates were increasing, but have

Active office requirements continue to climb upwards, returning to mid-2022 levels



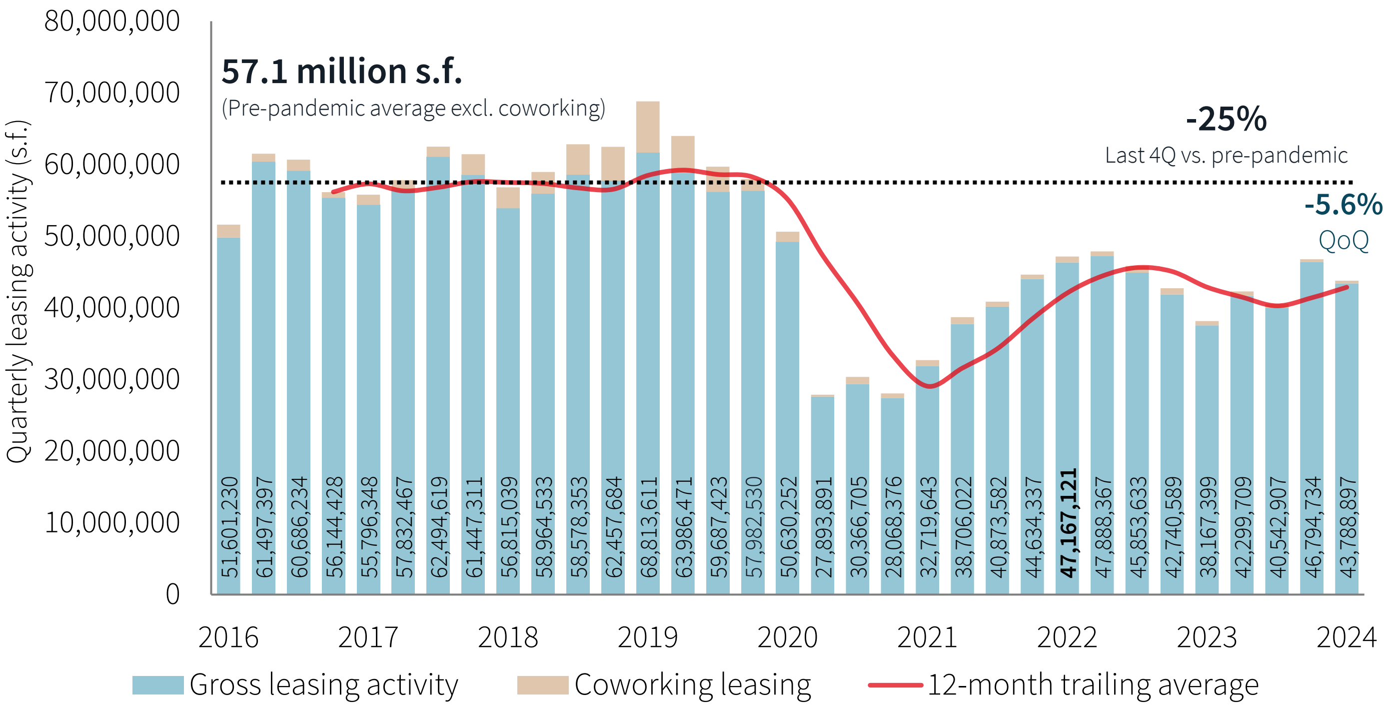
Source: JLL Research
Note: TIMs index covers roughly 70% of gateway markets and 75% of secondary markets in the U.S.

gradually returned over the past four quarters. In Boston, every single tenant requirement above 100,000 s.f. was removed from the market as of the end of 2022, but by the end of 2023 five large tenants had returned, and at the beginning of April that tally increased to nine office tenants actively seeking spaces of at least 100,000 s.f.



Steady improvement in TIMs volume is contributing to a gradual recovery in leasing volume, though progress on a leasing recovery has not been linear. Gross lease volume fell 5.6% QoQ to 43.8 million, but outperformed Q1 2023 by more than 14%, leading to a 3.5% YoY increase on a rolling 12-month basis. Similar to the narrative with tenant demand, the decline and return of large-scale leasing activity has been extremely influential in shaping overall leasing activity trends over the past eight quarters. The first quarter of 2023 saw just 40 lease transactions over 100,000 s.f. executed nationally, the lowest level throughout the entirety of the pandemic, but large leasing is gradually recovering, and Q1 saw only a marginal decline against Q4 activity, where 65 transactions above 100,000 s.f. were executed.

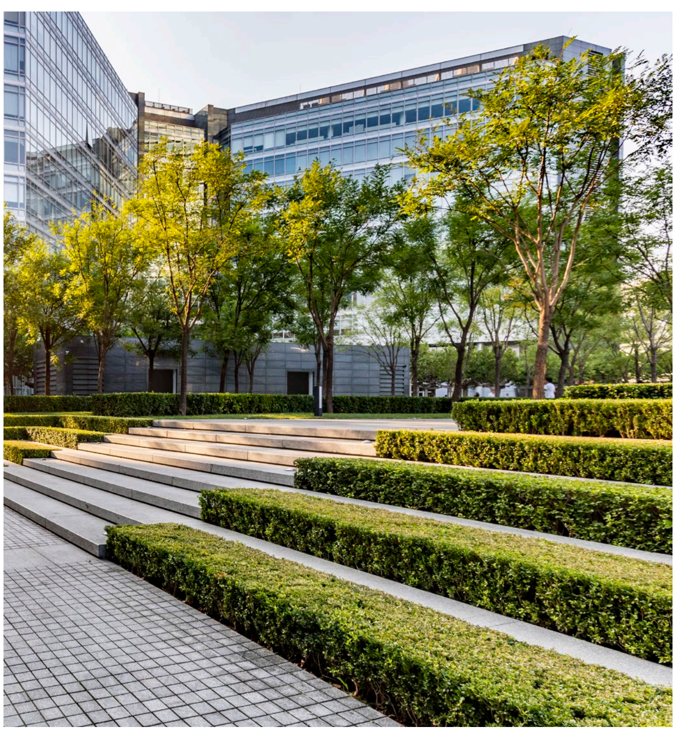
Leasing pulls back slightly but reaches second-highest quarterly total in past six quarters

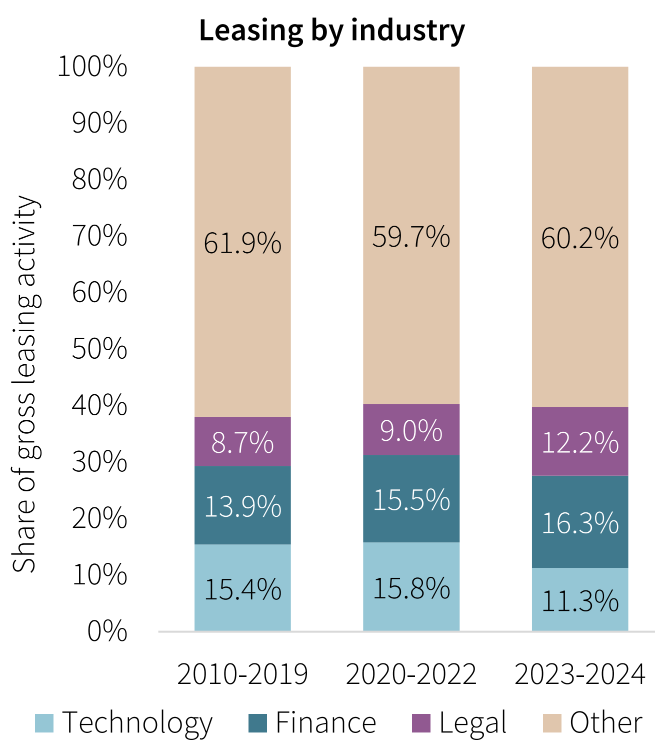


Source: JLL Research
Note: Leasing volume by coworking providers excluded from pre-pandemic average.

One factor in the sluggish recovery of large transactions has been financial turmoil for large landlords which is complicating concessions offerings—large leasing during the earlier stages of the pandemic recovery was fueled by growing tenant improvement allowances which have become considerably more costly amid higher interest rates. The City of Los Angeles signed a 310,000 s.f., 15-year lease in the 52-story Gas Company Tower downtown in the first quarter, a lease that had previously been placed on hold due to lenders' unwillingness to fund concessions packages. Despite the significant transaction, a notice of trustee's sale was filed for the asset on March 21, signalling an upcoming foreclosure sale that may once again place the lease in jeopardy.

While the lack of large transactions is largely responsible for the 25% deficit in leasing over the past 12 months compared to pre-pandemic levels, some industries have diverged from national averages in recent quarters. The technology sector, and particularly megacap technology companies, had grown to become the largest share of U.S. office leasing, but a significant pullback from Big Tech over the past 18 months has driven technology down to just the third-largest contributor, trailing banking & finance and legal services, who have generated 16% and 12% of gross leasing activity since 2023, respectively. Legal services firms have been the most active major industry in recent quarters: over the past 12 months, legal firms have leased 5% more space than 2019 levels. Sidley Austin signed one of the largest legal leases of the quarter in Dallas, leasing 118,000 s.f. in Granite Properties' 23Springs, which will deliver in 2025—an expansion of nearly 50% from their current office lease in Dallas, an 80,000-s.f. space at McKinney & Olive.





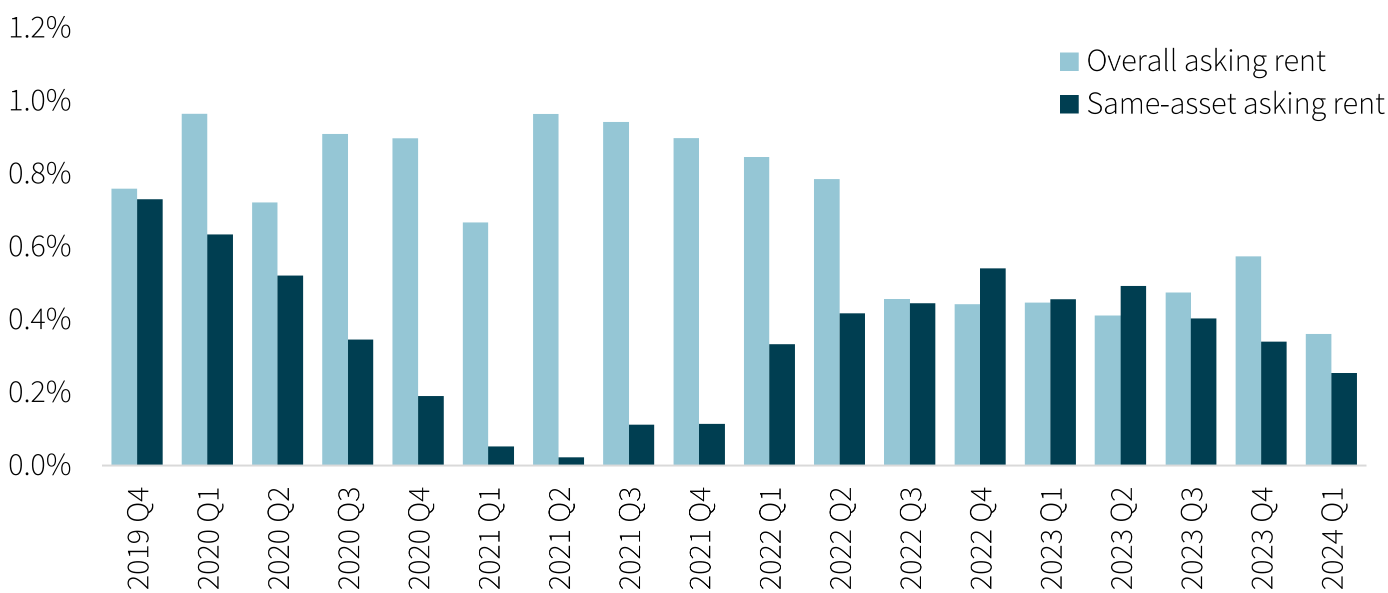
Source: JLL Research

In addition to being a bright spot from an activity level, legal firms have been less hesitant to make long-term commitments than other sectors: The average legal lease over 10,000 s.f. was executed with an 9.6-year term, and more than 50% of legal lease volume was in 10-year leases or longer. Nationally, roughly 45% of transaction volume over the past 12 months was in leases with ten-year term or longer, and the weighted average lease term has been 8.7 years for direct leases. Part of the driver of shorter-term leasing over the past year has been the type of transactions tenants are pursuing: 9% of transaction volume in Q1 took place in sublease transactions and 37% were renewals, typically the leases with the shortest term length and well higher than averages over the past cycle of 3% leasing volume from sublease and 29% from renewals. As a testament to tenants' persistent demand for high-quality and differentiated offices spaces, relocations also remain elevated, comprising 23% of lease activity in Q1 compared to a historical average of 21%.

Despite the increase in sublease availability, asking rents have held steady over the past year. Overall asking rents increased by 1.4% in the past year, and same-asset asking rent, which excludes the impact of new higher-rent supply delivering to the market, grew by 1%. Executed rental rates on signed leases are beginning to decline, as a function of a greater share of leases being renewals or subleases executed at lower rental rates, and the declining availability of high-end space, particularly large blocks in new construction and high-rise availabilities. However, the appetite for high-quality space remains strong, in fact Q4 2023 saw the largest number of leases executed at rental rates above $100 per square foot (p.s.f.) of any quarter on record, and more than 40 $100+ p.s.f. leases were executed in Q1, almost 20% more than Q1 2023.

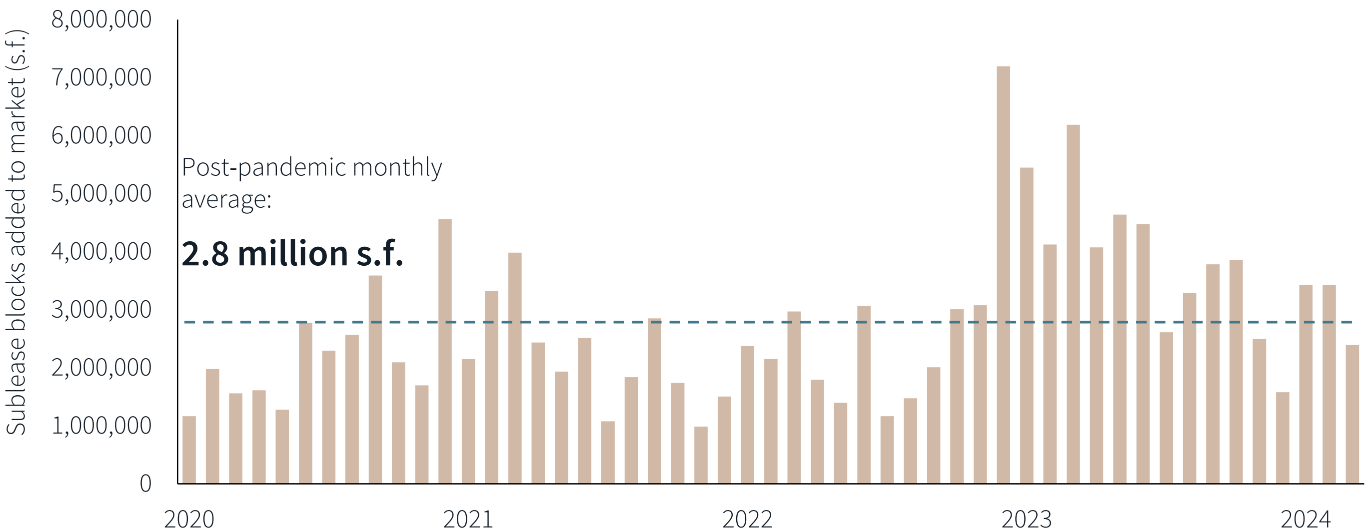
Direct asking rent growth

(Four quarter trailing average)



Source: JLL Research

Gross sublease additions over 20,000 s.f.

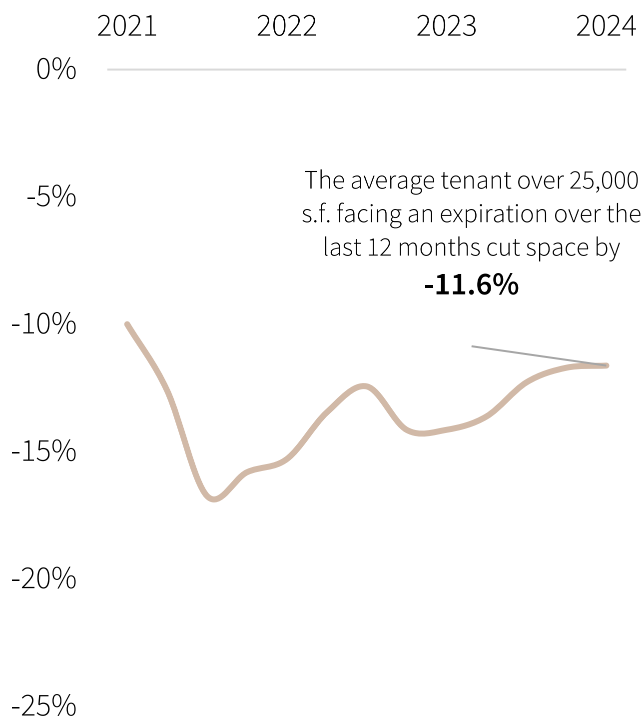


Source: JLL Research

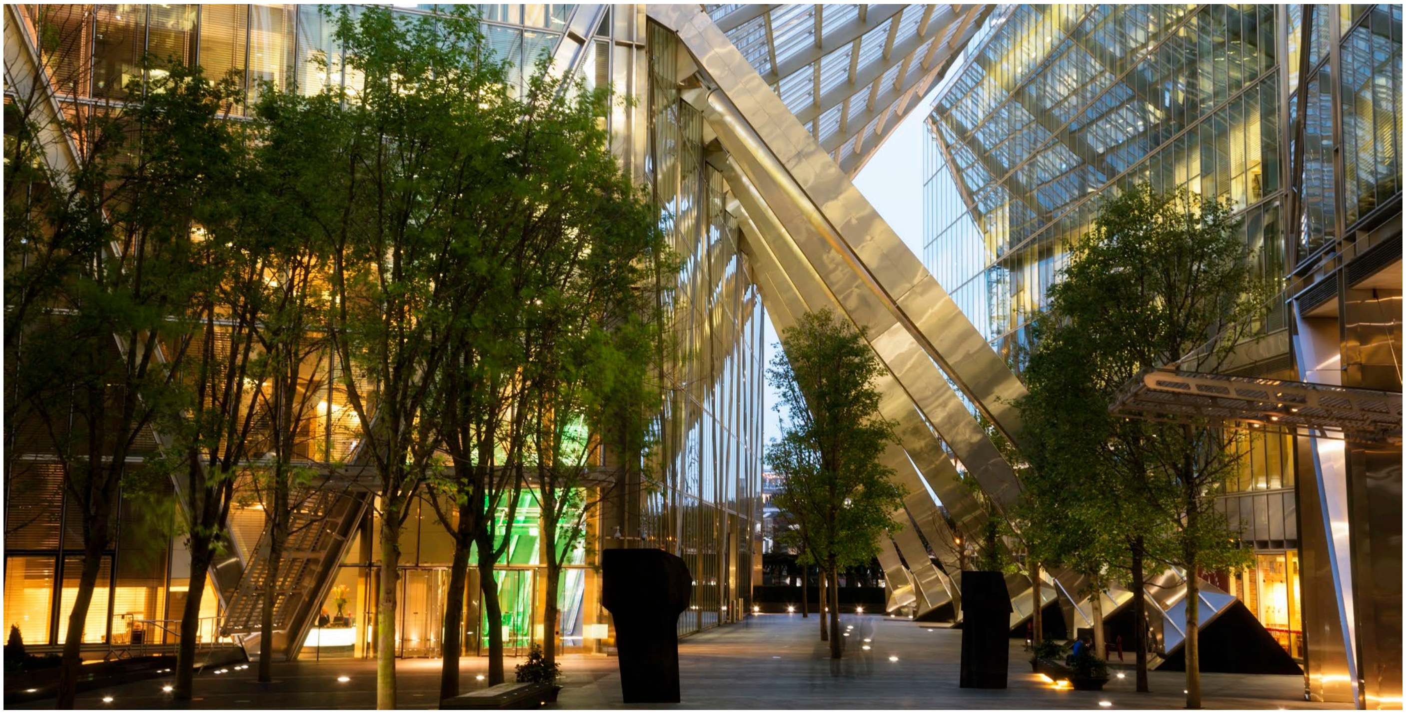
The wave of sublease additions spurred by rate hikes in late 2022 continues to normalize—although gross additions increased 17% QoQ, they fell by more than 40% compared to Q1 2023 and came just 7% above the quarterly average since the onset of the pandemic. Growth-minded tenants continue to actively take advantage of higher-quality spaces that have been added to the market, with five subleases over 100,000 s.f. executed in in the Bay Area and New York during the first quarter, led by ByteDance's 163,000 s.f. sublease of Roku's space in Silicon Valley. Steady backfill activity allowed sublease availability to continue to fall nationally, declining by 2.6 million s.f. and now 16 BPS below peak sublease availability rates registered in Q3 2023. Historically, sublease additions have borne a strong correlation to public equity prices in the private sector, so continued appreciation of major stock indices bodes well for further normalization of sublease additions through year-end.

Although sublease additions are slowing, tenants are continuing to trim their office footprints through downsizing expiring leases. Out of 20 tenants with single locations in a market over 100,000 s.f. that faced expirations this quarter, only six of them expanded their footprints, while 13 cut space. However, the rate of downsizing nationally is gradually stabilizing—where tenants were downsizing by 15-20% in earlier stages of the pandemic, that trimming has slowed to under 12% over the past 12 months. The continued downsizing of expiring leases poses a challenge for stabilizing vacancy rates, but organic demand growth is gradually returning to the market in select pockets and will eventually help to balance out legacy downsizing. The Pokemon Company signed a lease to expand their footprint in Seattle-Bellevue by over 100,000 s.f. in the first quarter, in addition to ByteDance and growing AI firms that have created a meaningful engine of new demand in recent months.

Downsizing rate for major tenants



Source: JLL Research
Note: Includes tenants above 25,000 s.f. with a single office location in the market. Excludes tenants who downsized by more than 50% or expanded by more than 50%. N = 1,362

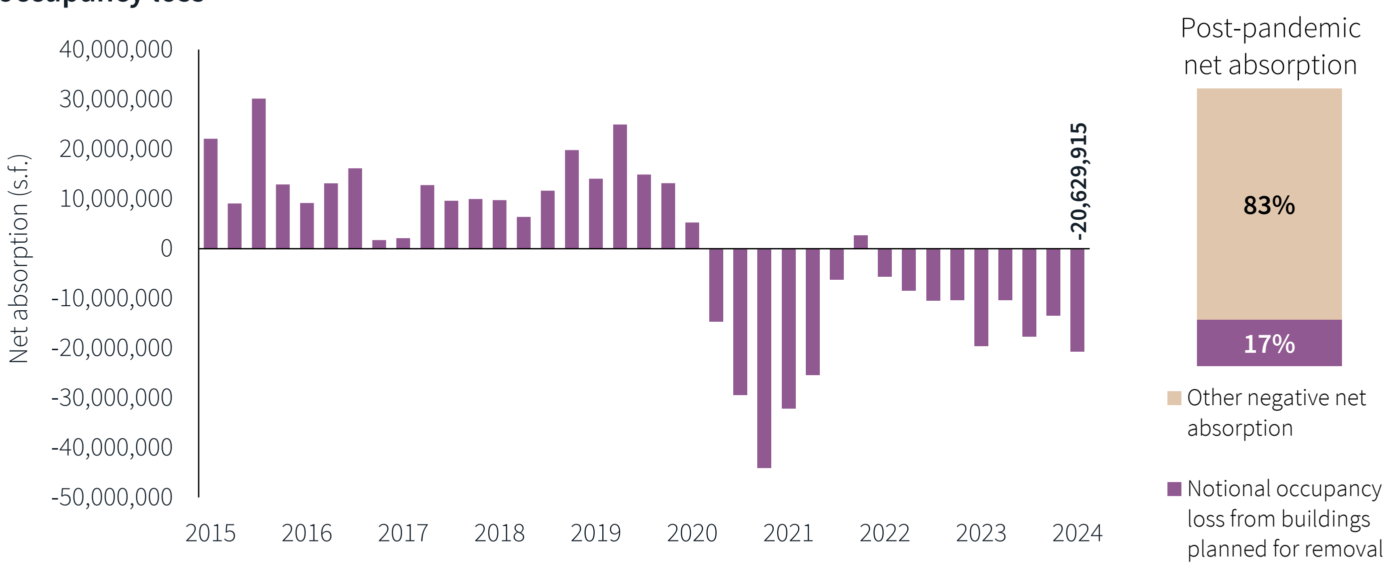


More aggressive downsizing in leases signed in early 2023 that are now taking occupancy contributed to a QoQ decrease in net absorption, with occupancy loss growing to 20.6 million s.f. in Q1, the highest level since the first half of 2021, driving overall vacancy to 21.9%. The increase was contributed to in part by a growing wave of *notional occupancy loss*, or negative net absorption in buildings that do not have a long-term role in the office market because they are planned for conversion or redevelopment. 1.3 million s.f. or more than 6% of Q1's negative absorption came from a single property, cloud computing firm Rackspace's former San Antonio headquarters, which has been vacated and sold for redevelopment. While driving a large part of this quarter's occupancy loss, that building will ultimately no longer compete against the remaining office market, and Rackspace relocated to anchor a new building completed in 2023.

Notional occupancy loss has been increasing and comprised more than 20% of the negative net absorption in Q1, and 17% of all occupancy loss since the pandemic onset. Because of the nature of the redevelopment pipeline, the share of occupancy loss which can be considered notional will increase over time as more buildings are proposed for removal.

The volume of occupancy loss that has been generated by similar instances of large-scale campuses or headquarters being vacated for newer buildings has concealed the fact that despite the recent downturn generating a record volume of negative net absorption, occupancy loss is not affecting the entire market. In Q4 2023, just 12.7% of office buildings nationally saw vacancy rates increase—the lowest level since Q3 2017—and in Q1 2024, the share of buildings with vacancy increases grew to just 13.5%, which is consistent with the

Negative net absorption remains stubbornly high, but becoming more dominated by notional occupancy loss



Source: JLL Research

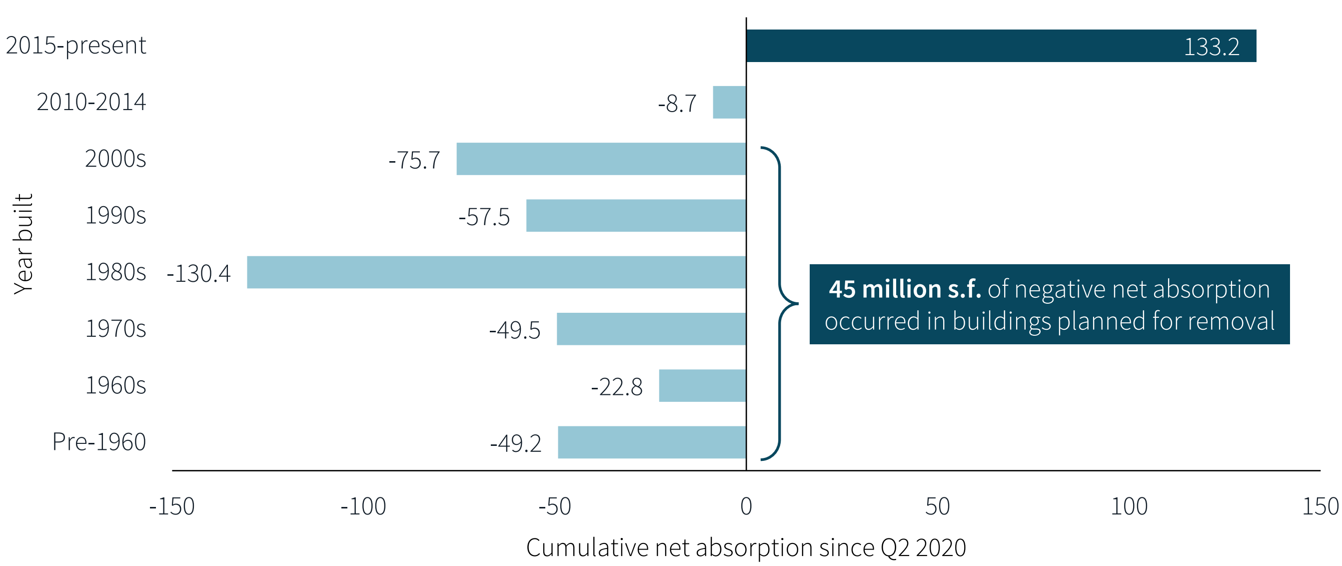
Notional occupancy loss: Negative net absorption occurring in buildings that are proposed for redevelopment or conversion and will be removed from office inventory over the short-term. While notional occupancy loss creates negative net absorption with the decline in total occupied space, redevelopments and conversions create a pipeline of new tenant requirements from remaining tenants forced to relocate into remaining inventory.

share of buildings that were losing occupancy in 2018-2019. In other words, the share of office landlords seeing their vacancy rise today is not much different than the years leading up to the pandemic, but the buildings that are experiencing it are seeing vacancy rise much more rapidly. Because of those factors, office vacancy is highly concentrated today in buildings that are strong candidates for conversion or redevelopment—in fact, 10% of office buildings in the U.S. comprise more than 60% of vacant office space, and 30% of buildings comprise more than 90%.

The concentration of underperformance has also created a corresponding segment of the office market that has outperformed considerably in recent years from a leasing standpoint. Highly-amenitized and well-located office assets have benefitted from the large share of office tenants whose existing spaces were 20+ years old that sought to upgrade during the pandemic. That has driven more than 130 million s.f. of net absorption in offices built since 2015 despite the occupancy loss in the broader market. While newer product has consistently illustrated the post-pandemic demand for differentiated product, new buildings are not the only segment of the market that has seen stable or increased occupancy since the pandemic began. Creative office product, offices within one block of major transit stations, offices within vibrant mixed-use submarkets, and high-rise spaces have gained occupancy in many markets irrespective of building age, and despite recent softening of executed rental rates, more than 80% of markets have established record office lease rates in the past three years, often in buildings that possess one or more of those key differentiating factors.

That demand for upgraded and amenitized office space has begun to exceed a very limited supply, compounded by the absence of a meaningful development pipeline in recent quarters. Direct available space in offices less than 10 years old has fallen more than 14% since the end of 2022, and now stands at just 86 million s.f. nationally, less

Net absorption by building vintage (million s.f.)

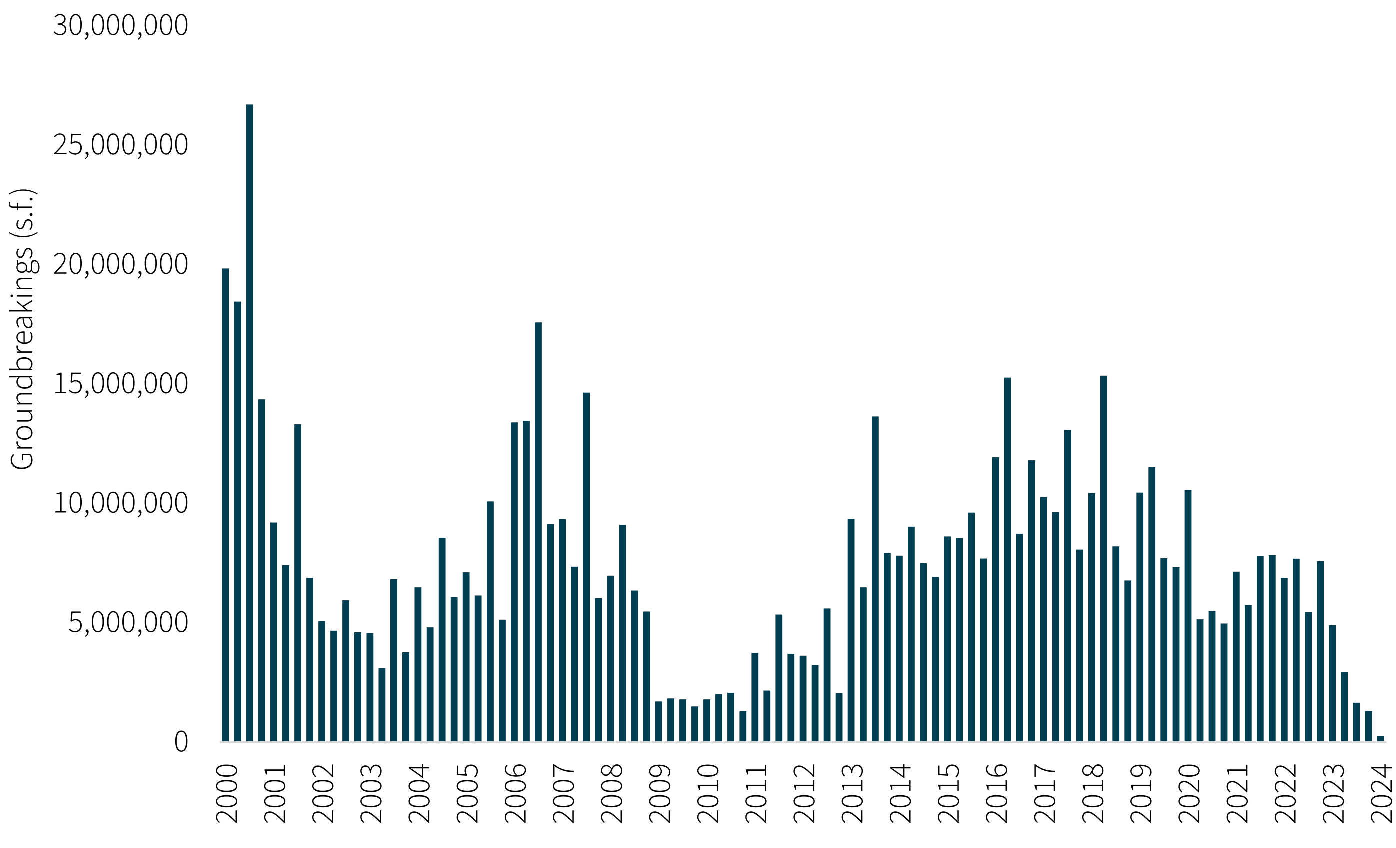


Source: JLL Research

than the amount of new space that was available on the market in 2019, despite national vacancy rates rising substantially from that point in time.

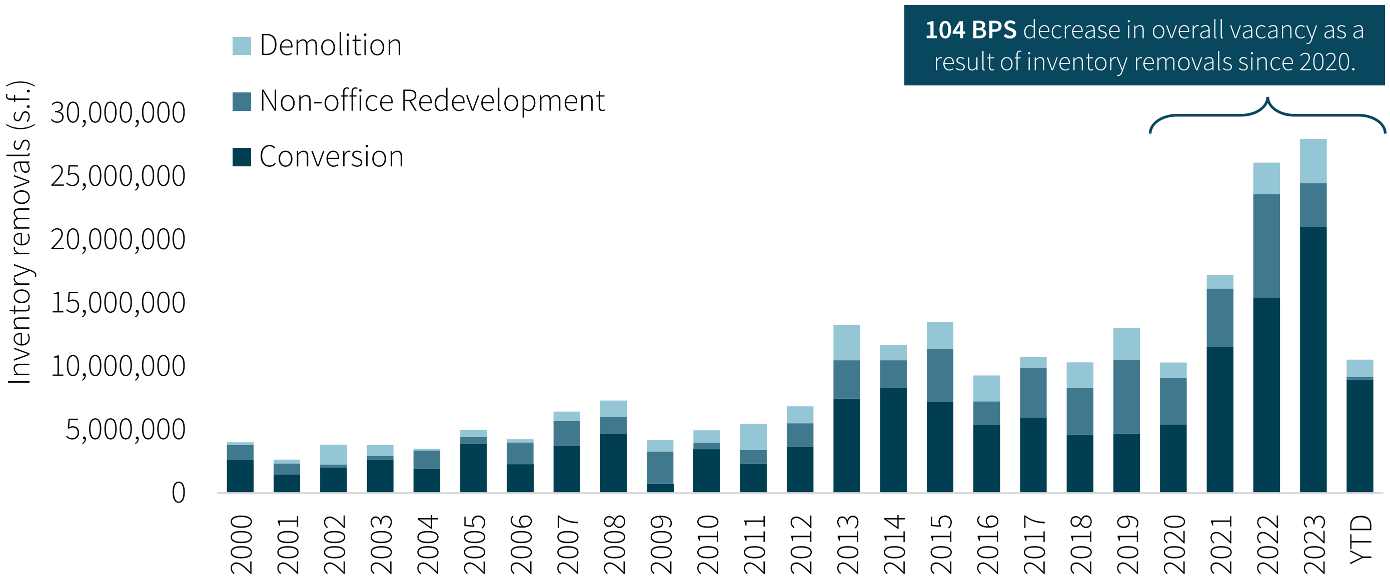
This limited availability of high-end space is not likely to abate for an extended period of time, due to the absence of new office development. 7.8 million s.f. of new office delivered in Q1 2024, the lowest volume of completions in the past several years but also the highest level of completions that will be seen for the next several years, as the office pipeline has responded aggressively to interest rate increases and shifting allocations from core capital. For the past five quarters, new construction groundbreakings have rapidly decelerated, to the point that Q1 saw less than 300,000 s.f. of office construction starts, by far the lowest total in nearly 40 years of recorded data. Out of the roughly 1.5 million s.f. that has broken ground over the past six months, more than 90% was fully pre-leased, meaning those developments will not add any new availability to the market upon delivery. The national construction pipeline still has 55 million s.f. of active projects, most of which will deliver in the next year, but this has fallen more than 60% from 2019 levels and will lead to subdued deliveries for at least the next three to four years, even in the unlikely event of an imminent acceleration in development activity. This comes while the U.S. is seeing record rates of inventory removals, which for the first time caused national office inventory to decline, falling by 1.3 million s.f. in Q1.

Groundbreakings fall to all-time low with under 300,000 s.f. of new construction starts



Source: JLL Research

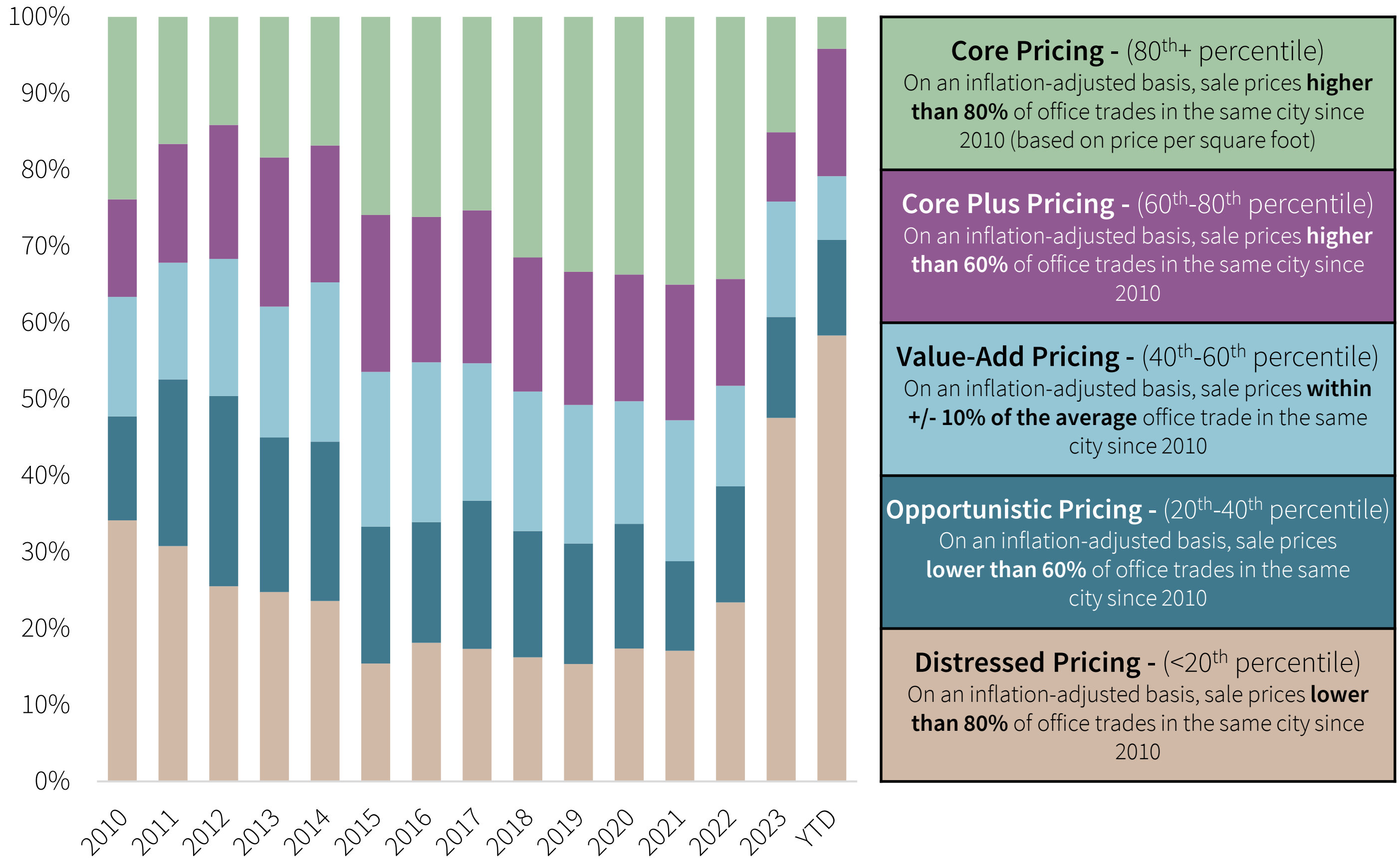
After three consecutive years of record conversion volume, pace of inventory removals jumps 50%



Source: JLL Research
Note: Includes buildings above 50,000 s.f. RBA. Demolition = tear-down of existing office building with no imminent plans for new development. Conversion = change in the use of all or a portion of the asset, while retaining all or a portion of existing structure. Redevelopment = capital improvement project which changes the use of a site by demolition and ground-up new development. Non-office redevelopment excludes office demolitions replaced with new traditional office ground-up development.

Inventory removals have accelerated in each year since the pandemic began, and over the past three years have set record volume nationally each year. A combination of factors, including relative outperformance of multi-housing in recent years, shifting allocations among core capital providers, a greater volume of office trades priced below replacement value, and most notably a slew of new local incentives targeted at spurring office-to-residential conversions has led to the acceleration. The federal government released new programs in 2023 which have had limited adoption to date, but new local programs introduced in more than ten major office markets since the outset of the pandemic are having a more intense impact. Chicago's Lasalle Street Reimagined initiative, which dedicates TIF funds to office-to-residential redevelopments in the Lasalle Street corridor of the Central Loop, recently received full approvals from the local government. To date, five conversion proposals have been selected in the program that would remove 3.5 million s.f. of vacant space from the Central Loop and create 1.7 million s.f. of new tenant requirements from the remaining office tenants who would need to relocate. Extensions of existing incentives and a variety of new resources enabling conversions in New York have also had a notable impact: 160 Water Street which is currently being converted was the largest office-to-residential conversion ever when the project began but has recently been eclipsed by a proposed conversion of the former Pfizer HQ by Metro Loft. The confluence of factors has driven a continued acceleration in conversions activity, driving the pace of inventory removals up by more than 50% in Q1 2024, with more than 9 million s.f. removed.

Share of office sales by pricing level

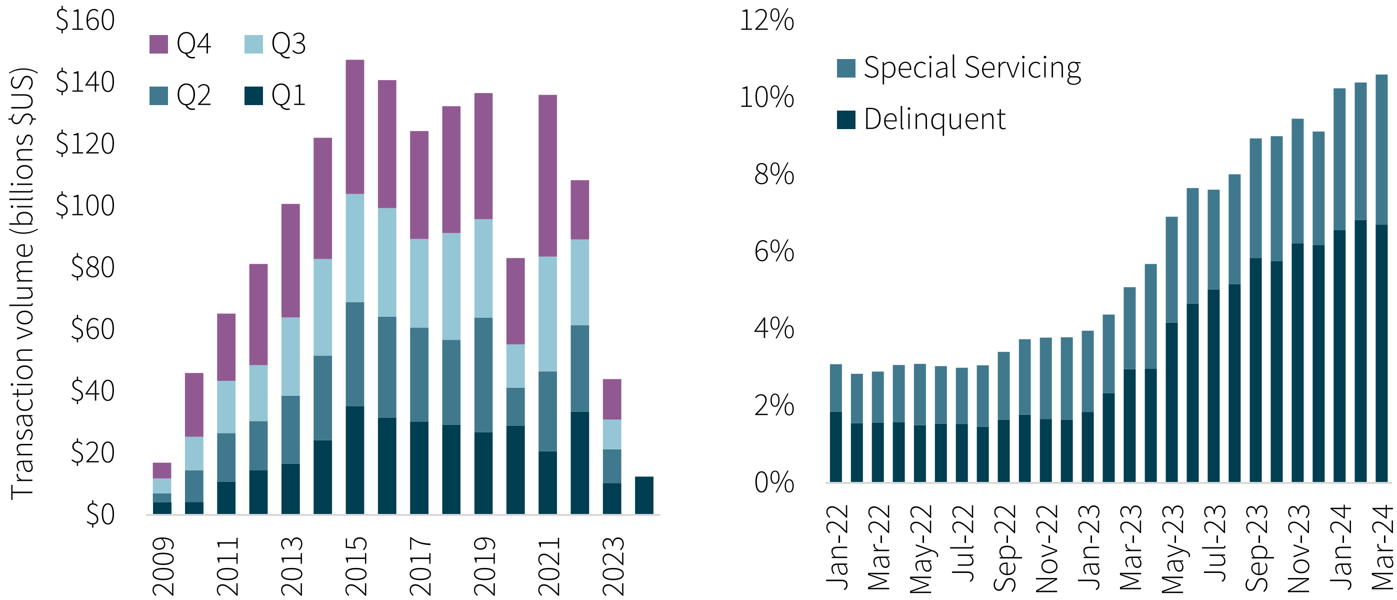


Source: JLL Research, Real Capital Analytics
Note: Single-asset transactions above $25 million; excludes data center, medical office, life science, and partial interest sales. Pricing levels reflect price per square foot of trades as compared to inflation-adjusted pricing levels for all office sales since 2010 in the same city. Classifications do not necessarily correlate with investment strategy.

Most of the factors driving conversions will continue to intensify. Cities who have already created incentives or new programs only reflect the first cohort of a wider set of cities that have proposed or began studying the feasibility of similar programs. Increased sales activity, particularly trades of offices at distressed pricing levels, will also enable more conversions and redevelopments, since costs are often high, and values need to fall significantly to enable the proper returns. Over the past year, more than 50% of office sales have taken place at distressed pricing levels, or lower than 80% of inflation-adjusted office sales prices since 2010 in a particular city.

Acquiring assets at such a low basis offers the new owner significant flexibility to either redevelop the property, upgrade it as an office asset, or position the building with discounted rents. However, leveraged acquisitions will also have to contend with higher financing costs, which will compress their operating income, impeding the ability to cut rents, and creating an even stronger incentive to deploy capital into a redevelopment or upgrade.

Sales market begins to slowly thaw with hopes of rate cuts; distress continues to rise



Left: Historical office sales volume; Right: Office CMBS delinquency and special servicing rates
Source: JLL Research, Real Capital Analytics, Trepp

The interest rate cuts expected in mid-to-late 2024 have begun to thaw what had become a highly illiquid office investment market in 2023. Transaction volume reached $12.4 billion in Q1 2024, a 20% improvement over Q1 2023 but more than 50% below Q1 2019 as material improvements to debt pricing have yet to occur. Buyer sentiment has improved notably over the past six months with the sense that pricing levels are near their trough and acquisitions will be ripe for outsized returns, but sellers have been more gradual in capitulating to current pricing levels. The pipeline of distressed assets continues to broaden, with 6.7% of office CMBS debt delinquent as of the end of March and an additional 3.9% in special servicing. While foreclosure sales have been rare to date, they are almost certain to be more common in 2024 amid the growing wave of delinquencies and elevated maturities.

The groups that have been most active in the investment sales market over the past 12 months have been groups with the strongest understanding of end user needs and local market dynamics: users themselves, and private developers and operators. Dislocated pricing enables corporate users to secure spaces at pricing competitive with long-term leasing, and the relative agility and local expertise of private developers and operators has given those groups more ability to take advantage of the discounted pricing environment.

Together, the two groups comprised their largest share of office acquisitions on record in 2023, comprising more than 75% of acquisition volume. Since the beginning of 2023, private operators and developers generated a net acquisition volume (purchases minus sales) of over $6.2 billion and users acquired a net $2.7 billion in office product, more than half of which came from universities.

Updates to company attendance policies in Q1 2024

Company	Industry	Announcement Date	Previous RTO Policy	Announced RTO Policy
Rockstar Games	Media	Feb 2024	No requirement	3 days / week
Independence Blue Cross	Health	Feb 2024	No requirement	3 days / week
PNC Bank	FIRE	Feb 2024	No requirement	3-4 days / week
Deere	Manufacturing	Feb 2024	2 days / week	4 days / week
Fidelity Investments	FIRE	Feb 2024	1 full week / 4 weeks	2 full weeks / 4 weeks
Deutsche Bank	FIRE	Feb 2024	3 days / week	4 days / week
Dell Technologies	Technology	Feb 2024	Team-dependent	3 days / week
United Postal Service	Logistics	Jan 2024	3 days / week	5 days / week
IBM	Technology	Jan 2024	Team-dependent	3 days / week
American Family Insurance	FIRE	Jan 2024	No requirement	3 days / week
Bank of America	FIRE	Jan 2024	Notifying managers for non-compliance	
EY	Prof. Services	Jan 2024	Tracking compliance	

Source: JLL Research
Note: Only includes private employers with over 1,000 employees in the U.S.

80%

of Fortune 100 employees work for hybrid employers

10%

of Fortune 100 employees work for fully in-office employers

1.4%

of Fortune 100 employees work at fully remote employers

3.08 days

Average weekly attendance requirement for Fortune 100 employees in April 2024.

Source: JLL Research

While the occupier market, and eventually the capital markets continue to gradually recover from cyclical headwinds, the structural shifts to the office market brought about by the pandemic are beginning to settle into a new equilibrium. Several larger employers continue to establish or modify office attendance policies, almost exclusively in favor of greater office attendance, but the pace of new mandates is slowing dramatically as remote-first companies have become a rarity. Increases in attendance in 2024 are likely to be driven by stronger efforts to drive adoption of policies, or incremental increases to company requirements, such as the shift UPS made in the beginning of the year from three days to five days of required attendance.

For more than three months, remote hiring has stabilized at roughly 9% of all postings according to LinkedIn Economic Graph, and 90% of the Fortune 100 currently work at hybrid or fully in-office companies, with an average requirement across the entire index of 3.1 days of required attendance per week.

While the public sector has lagged in establishing policies, the federal government and multiple state and local governments are beginning to conform to the private sector, suggesting that the vast majority of previously in-office employees will ultimately return to regular attendance over the short to medium term.

Outlook: The maligned conversion trend could be the office market's antidote

Office demand and the macroeconomic landscape have concurrently improved for several consecutive quarters, and active requirements and leasing activity are expected to continue to improve throughout the remainder of the year. Leasing volume is expected to continue to outpace 2023 figures by 10-20% at return to 80-90% of pre-pandemic leasing activity. Despite the improvement in demand, many of the leases being signed today still reflect downsizing footprints, with the rate of downsizing only gradually declining. That may lead to an extended period of occupancy loss which carries through 2025 while organic demand growth emerges more gradually. However, negative net absorption will be increasingly dominated by notional occupancy loss, which could lead to declining vacancy rates by early-to-mid-2025 and earlier in stronger markets.

Most core capital providers' office allocations remain considerably higher than long-term target allocations, which will drive a longer period of negligible new supply than other major property sectors will face. At the same time, conversions activity is expected to remain elevated and potentially continue to accelerate as the slow-moving process of establishing and executing new government incentive programs continues to roll out in major cities. This means that the decline in U.S. office inventory that began this quarter is likely to continue through the next two or more years, albeit at a gradual pace. Even as some employers have shifted to hybrid and remote policies, overall office-using employment has grown more than 6% since the pandemic began, and continues to trend upwards, and will eventually surpass impacts from remote work shifts. As demand continues to grow and inventory remains relatively static over the medium term, more stable office market conditions are on the horizon, but the recovery process is likely to be measured and gradual.

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