

REASONS FOR OPTIMISM: Office Tour Activity Is Surging. Now What?

August 2021

The office sector's near-term performance remains clouded and is still clearly tied to a resolution of the pandemic. With the continued spread of the Delta variant, some occupiers are delaying plans for a full return to the office. Yet, despite the uncertainty, we are seeing encouraging signs forming in the office recovery.

In this brief, we examine both the latest tour activity and new leasing data to determine implications for future office space demand.

Green Shoots Everywhere

The U.S. office sector is a two-sided tale told by lagging indicators on one side and leading indicators on the other. Lagging indicators confirm that the pandemic created the worst recession the office sector has ever faced. The U.S. has shed 171 million square feet (msf) of space (3.1% of total inventory) since the pandemic started. For perspective, during the entirety of the Great Financial Crisis (GFC), December 2007-June 2009, the U.S. shed 104 msf of space (2.2% of inventory)—so by this metric, the impact from the COVID-19 recession has already been more severe. On the other hand, the leading indicators are consistently lining up to suggest the worst of the impact is either over, or almost over. Indeed, we are now observing multiple positive indicators in the leading data.

The first green shoot to note is the recovery of office jobs. The U.S. cut 2.9 million office-using jobs in March and April of 2020. Since then, the economy has recovered 76 percent of that loss (2.2 million jobs) through July 2021.¹ At the current pace, the U.S. will return to pre-pandemic peak levels of office employment sometime in the first quarter of 2022—which means it will have taken a little more than two years to reach full recovery. For context, it took six years for office employment to fully recovery from the GFC.

The second green shoot is the trend of businesses signing longer-term leases, which we interpret as a sign of confidence in the long-term future of office. Over 75% of new leases signed in the first half of 2021 have been for more than four years, and one-fourth have been for 10+ years—percentages consistent with pre-pandemic norms.

A third shoot is leasing activity, which notably improved in Q2 2021. New leasing totals were up 18% from the first quarter of the year, and up 28% from Q2 2020.

Perhaps the most notable green shoot is space search activity. As of December 2020, office tour activity was 65% below pre-pandemic levels (i.e., February 2020). But 2021 has been a different story. After improving every month in Q1 2021, tour activity in March, April, May and June ranged between 80% and 90% of pre-pandemic levels. Touring activity in four of the six gateway markets² more than doubled from December 2020 to May 2021.³ These tours are leading to lease negotiations. In Washington, DC, for example, the number of lease proposals to occupy space in March, April and May of 2021 have already surged back to pre-pandemic levels of activity.

When Will It Translate into Increased Demand for Space?

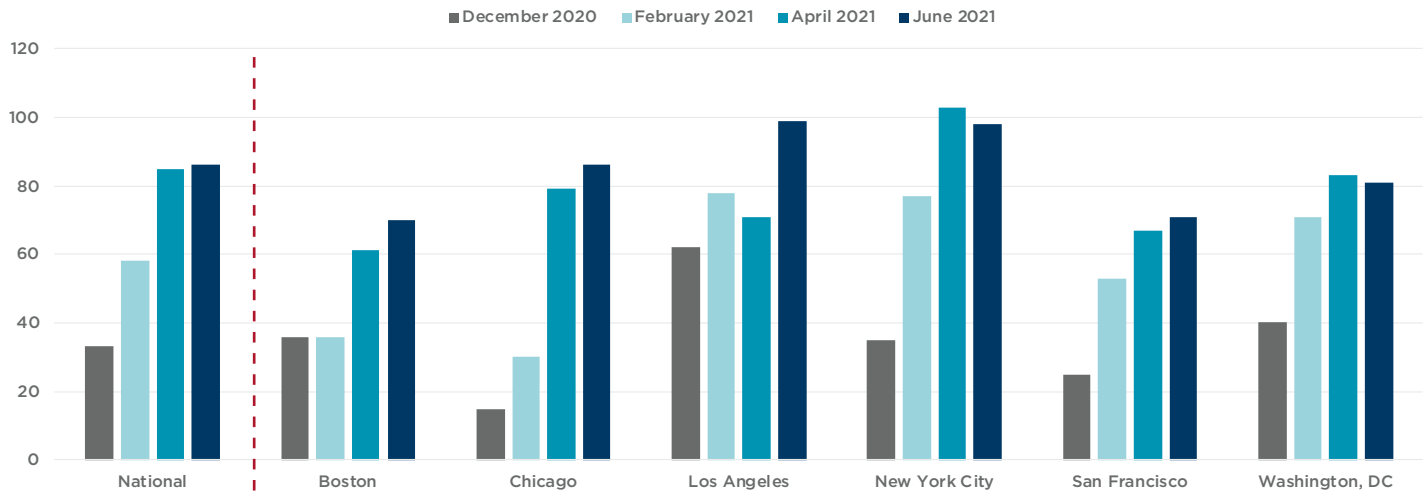
Given this increase in interest, the logical question is whether all this optimism is translating into increased demand in the U.S. office market. The short answer is no *and* yes.

Overall net absorption was negative again in Q2 2021. It is the fifth quarter in a row of negative net absorption and is similar in volume to the last three quarters (all between -36 and -41 msf). National vacancy increased for the seventh straight quarter to 17.2%.

The silver lining is that tour activity picked up in the first half of the year and is starting to impact leasing activity, even if it is not showing up in the net absorption statistics quite yet. New leasing and renewals jumped quarter-over-quarter (QoQ) by 18% and 7%, respectively, in Q2 2021. New leasing was stronger than in any of the previous four quarters. And the four-quarter rolling total of new leasing appears to have bottomed out in Q1, increasing by 11 msf in the most recent quarter—the single-largest increase since Q1 2017.

Tour Activity Is Picking Up

THREE OF PAST FOUR MONTHS HAVE BEEN OVER 90% OF PRE-PANDEMIC ACTIVITY (FEBRUARY 2020)



Source: VTS Office Demand Index (VODI), July 2021 Report

***Tour Activity is Surging
Businesses are in the market searching for
space again. After nearly a year of muted
activity, the first half of 2021 has seen
touring return to near pre-pandemic levels.***

Is This Out of the Ordinary?

The COVID-19 recession is different than previous ones due to its brevity and severity. In the previous two recessions, growth in office-using employment was negative year-over-year (YoY) for nine consecutive quarters: Q3 2001-Q3 2003 and Q2 2008-Q2 2010. However, this time around, the most recent quarter—ending in June 2021—is positive YoY (+5.1%) after just four quarters of negative YoY office-using job losses. This is due to the “shape” of the recession, which involved a record-breaking severity of job losses confined to two months (March and April 2020) followed by growth each quarter since.

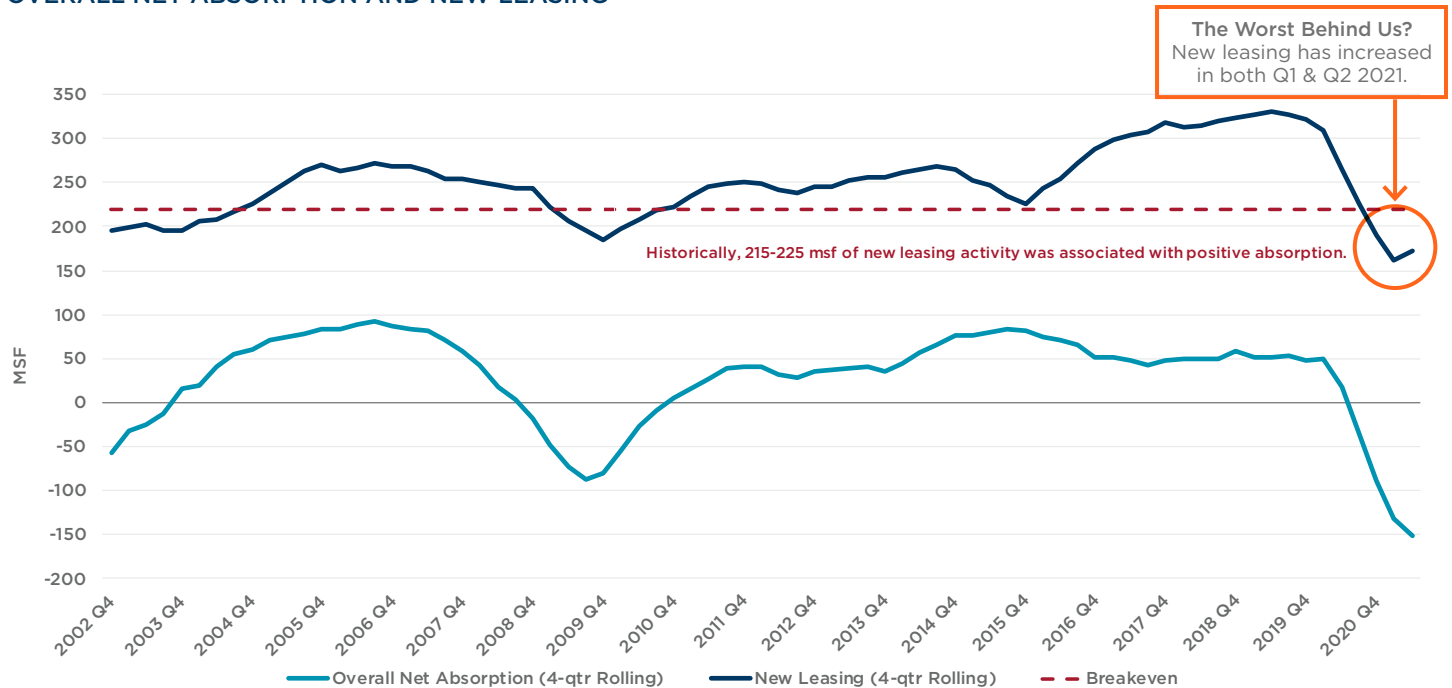
During previous recoveries, office space absorption followed a nearly identical path as office job growth. After the Dot-Com recession, four-quarter rolling net absorption hit its trough at -62.5 msf in the same quarter that office employment hit bottom (-3.4%). And again, after the Great Financial Crisis (GFC) net absorption hit its lowest point at -87.0 msf amidst office

employment’s second worst quarter (-6.6%). In fact, these measures of absorption and employment have typically been 82% correlated.

That is most certainly not the case right now. Over the last five quarters, there has been a negative relationship (-81%) between office job growth and net absorption. This recession has been typified by greater uncertainty along with an unprecedentedly sharp decline and recovery. Accordingly, net absorption is lagging behind employment. Additionally, the fact that “occupied” office space has not been utilized at normal levels over the past 15 months—and uncertainty remains about how the office will be utilized once employees do return—has meant that even occupiers that are growing are not rushing to add space to accommodate new hires. The ambiguity related to remote work versus physical occupancy may weaken the correlated relationship between office-using job growth and net absorption in the short-term.⁴

New Leasing Trending Up

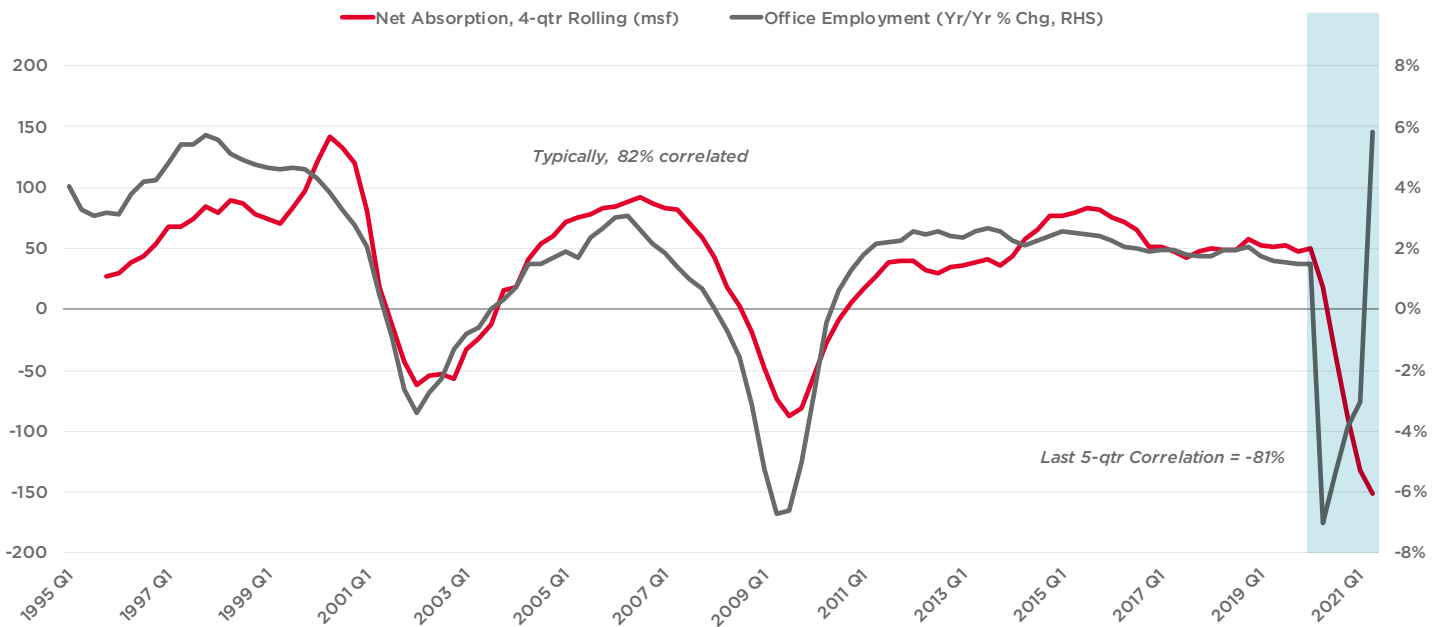
OVERALL NET ABSORPTION AND NEW LEASING



Source: Cushman & Wakefield Research

Office Demand in Uncharted Waters

U.S. OFFICE EMPLOYMENT VERSUS OFFICE NET ABSORPTION



Source: U.S. Bureau of Labor Statistics; Cushman & Wakefield Research

What to Expect Moving Forward

Looking at activity in the first half of 2021, we can surmise a few things about when absorption will start to impact the market.

There is, of course, a lag between when new leases are executed and when tenants physically occupy the space, which is when net absorption is realized. In the first half of this year, that lag has averaged 117 days (or just under four months), down from 2019 H1 when the average was 140 days, which may indicate some urgency among occupiers who sat on the sidelines for most of 2020 and have now resumed actively exploring their lease options. The five-year average leading up to the pandemic for leases of 5,000 sf or more was 134 days (or 4.4 months).

As one might expect, the larger the lease, the longer the gap between lease execution and move-in. A smaller lease may involve several months of searching and then approximately a quarter to go from lease signature to occupancy. The touring, negotiation, lease signature and move-in process for a larger lease, however, can take four to six quarters or more.

The average gap between lease execution and expected occupancy for 2021 H1 leases of over 50,000 sf is 282 days (nearly nine-and-a-half months). In other words, large leases signed in April, May or June 2021 will not, on average, show up in absorption statistics until Q1 2022. The impact on net absorption in a given market will be determined by the degree to which these new leases are net-expanding. Tenants that are new to the market altogether and those that are relocating and increasing their space requirements will produce positive absorption. Conversely, any intra-market moves where the new leases are for less space will still produce net-negative absorption for the market.

The length of time that occupiers plan to take between lease execution and space occupation varies across geography, submarket and class. Leases in the six U.S. gateway markets are expected to take 15% longer (126 days on average versus 110 days in non-gateway markets). This is a change from the first half of 2019 when the average time was nearly identical for both gateway and non-gateway markets.

New leases in the Central Business District (CBD) and those at higher quality buildings typically take longer to be occupied. This was true pre-pandemic and remains so with the leases signed during the first half of 2021. New leases in CBD submarkets average almost a month longer between lease execution and occupancy than do those signed in non-CBD (i.e., suburban) submarkets. The variance across quality is even higher, with 2021 H1 leases at Class A buildings averaging 34 more days than Class B assets and 46 more days than Class C. Higher quality assets will, on average, have higher-end and more prolonged build outs. And CBD submarkets may require more time due to increased logistics associated with construction and move-in.

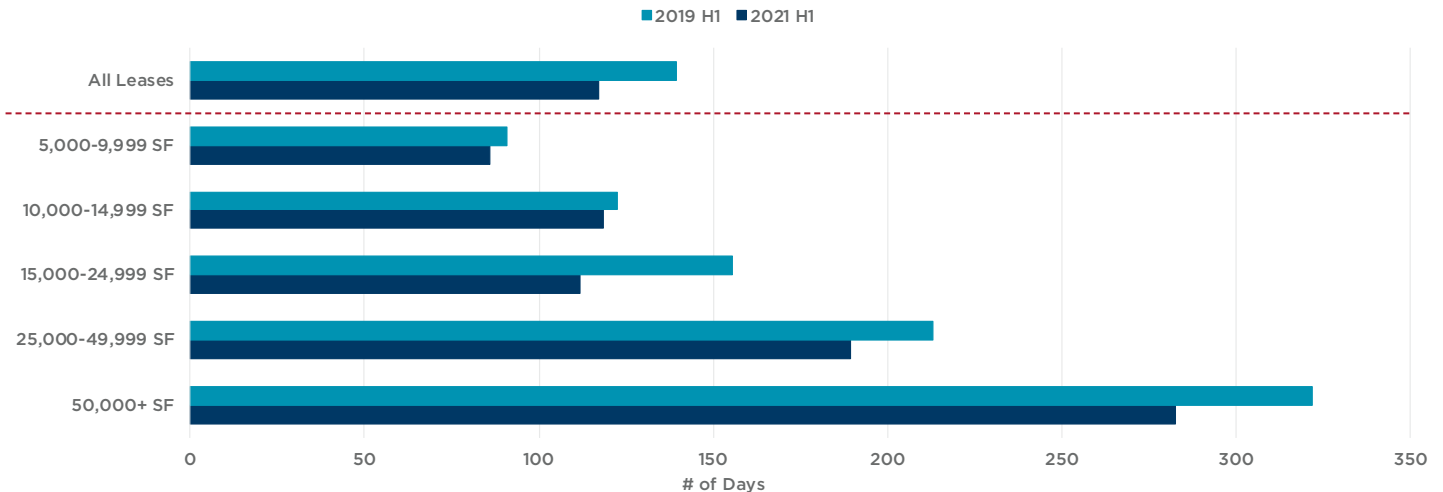
When can we expect this leasing activity to lead to positive absorption? Twenty-eight percent of new lease square footage signed in 2021 H1 was scheduled to be occupied before June 30, 2021. Nearly half is planned for move-in during the second half of this year—30% in



While the occupancy lag may be longer in Class A buildings, it should be noted that the volume of leasing post-recession will likely be weighted towards higher quality product. Immediately after the previous two recessions (2003 and 2010-2012), Class A product made up 80%+ of net absorption.

Occupancy Timelines More Compressed in 2021 H1 Regardless of Lease Size

AVERAGE TIME BETWEEN LEASE EXECUTION & OCCUPANCY DATE BY LEASE SIZE



Source: Cushman & Wakefield Research

**Higher quality assets will,
on average, have higher-end and
more prolonged build outs.**

Class A & CBD Submarkets Have Longer Lag Between Lease Execution & Occupancy (2021 H1)

AVERAGE TIME BETWEEN LEASE EXECUTION & OCCUPANCY DATE BY SUBMARKET AND BUILDING QUALITY



Source: Cushman & Wakefield Research

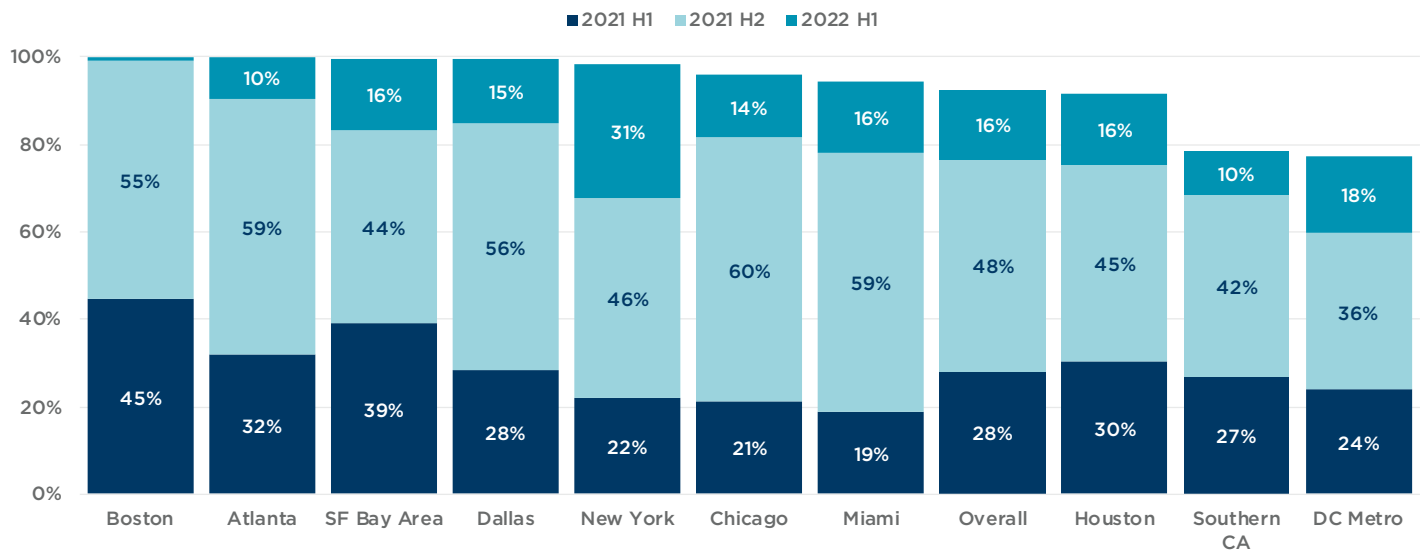
Q3 and 18% in Q4. Another 16% will be occupied in the first half of next year and the remaining 8% is over a year away. The average lease in New York is 31% larger than the overall average, which is likely a driving factor in why nearly a third of 2021 H1 new leasing square footage in New York is not expected to be occupied until the first half of 2022.

These findings are in line with Cushman & Wakefield's office forecast for negative absorption peaking in the middle of this year before turning positive in 2022 H2. It is going to take time for the nascent renewed interest and activity from occupiers to work its way through the lease process and for office vacancy to begin to drop. National vacancy is likely to peak in the middle of next year, due to the demand challenges noted throughout this report plus a new wave of construction that will impact the supply side. Of course, all real estate is local and individual market paths will vary.

The office recovery is clearly going to take time to complete. But unlike this time a year ago, we are now observing clear indications that demand for office space is forming beneath the surface and tour activity will remain a key indicator to watch on the road to recovery.

Occupancy Timing from 2021 H1 Leasing

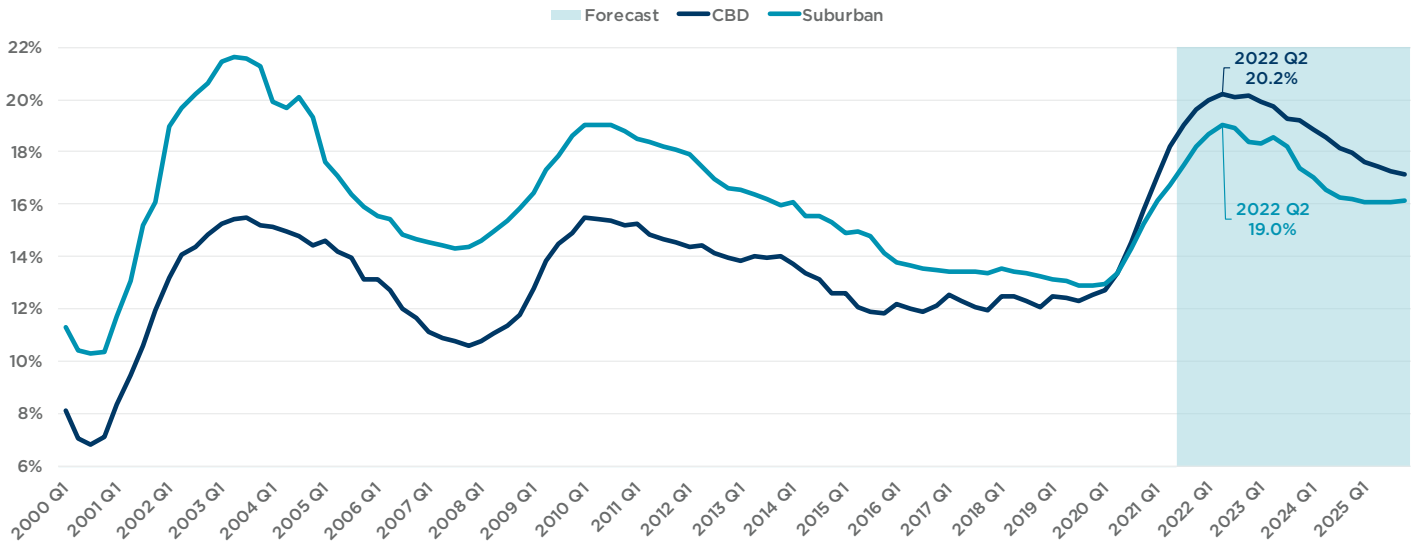
PERCENTAGE OF SQUARE FOOTAGE TO BE OCCUPIED FOR LEASES SIGNED IN 2021 H1 BY MARKET



Source: Cushman & Wakefield Research

Vacancy Expected to Peak in 2022

FORECASTED U.S. OFFICE VACANCY RATE BY SUBMARKET TYPE



Source: Cushman & Wakefield Research

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- 1 U.S. Bureau of Labor Statistics: Current Employment Statistics.
- 2 U.S. gateway markets include Boston, Chicago, Los Angeles, Manhattan, San Francisco and Washington, DC.
- 3 VTS Office Demand Index (VODI), July 2021 Report.
- 4 For insights from Cushman & Wakefield's Total Workplace consulting team on how clients are evolving new ways of working with an agile approach: [Leading an Active Recovery to Build the Best Workplace Experience](#).



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