CBRE ROUNDTABLE

Real Estate Market Outlook & the Implications for the Legal Sector

Key Takeaways:

1. The commercial real estate market is cyclical, and despite the current downturn being driven by an external shock, this time is no different.
2. The office market is under stress, with muted leasing and rising vacancy as tenants are exercising caution amidst an uncertain outlook around the future of office demand.
3. The legal sector has proven resilient throughout the pandemic-led recession and has more certainty around the role of the future office.
4. What is a challenge for the office market overall could turn into real opportunity for law firms.

Supply and Demand

Currently, real estate fundamentals are expected to continue to weaken throughout 2021. Tenants are largely pausing long-term real estate commitment, yet near peak levels of new construction are being delivered to the market along with record levels of sublease space which is driving market vacancies up. Although all markets will experience continued weakness, the pace of recovery will be shaped by local market dynamics. Understanding supply and demand particulars in local markets is critical for tenants who want to be opportunistic in a softening market.

- New York: Long-term demand is projected to return once people feel safe, particularly using mass transit and being in close proximity in the office. The duration and adaptation of remote working will impact demand in New York as well as the other major gateway markets. Flight-to-quality has also been an incredibly strong story over this cycle.
- Chicago: Law firms are currently one of the most active industries in the market with six requirements totaling 670,000 sq. ft. However, that 670,000 sq. ft. won't completely offset the amount of space those law firms are leaving behind.
- Los Angeles: With similar numbers to Chicago, large class A blocks of available sublease space are holding steady while we're seeing an erosion in lower-quality smaller suites, which is creating a dichotomy that's emerging in product types hitting the market to date.
- Washington, D.C.: Office vacancies hit a record high pre-COVID-19, and vacancy is likely to grow along with record concessions being offered. Thus far, D.C. has not been as negatively impacted as the other larger gateway markets in terms of jobs or office demand.

SUBLEASE SPACE

While all the major gateway markets have seen an increase in sublease space, it varies in the degree of severity. New York and Los Angeles are projecting an increase in sublease availability and anticipate large block availabilities in new installations and newer buildings coming to the market in the next several months. Chicago has 4.6 million sq. ft. of sublease availability downtown – a number that is expected to continue growing. This now represents 3.2% of the inventory – the highest percentage in 15 years of CBRE data. In Washington, D.C., sublease space has plateaued recently and there are few viable right-sized sublease options.

Rent & Concession Discovery

Despite the supply and demand changes, it is somewhat surprising that in Q3 average gross asking rents rose by about 0.9% quarter over quarter and 3.9% year over year. This is partially due to the reality that there are limited transactions to allow price discovery currently. The softness in the market is showing in net effective rents, e.g. asking rent less free rents and TI allowance. The rapid rise in concessions to date is creating a fall in net effective rents.

Asking rents are expected to fall as we close Q4 2020 and are likely going to continue falling through 2021. CBRE forecasting models anticipate that average rents will start to stabilize at the end of 2021, and in several markets, the window of opportunity may be much shorter than the Global Financial Crisis. The biggest unknowns are the structural shifts in workforce behavior which could change real estate demand in the future.

Accelerated Real Estate Trends

The future of the office depends on a string of decisions around labor, location, occupancy, design and experience. All of these things have been accelerated in terms of their application as a result of COVID-19.

- Regardless of industry or market, employees are signaling they want to operate in a more autonomous way in the future that favors freedom and flexibility in how they work.
- We expect to see a greater demographic shift to lower-cost and higher quality of life markets that had been growing pre-pandemic also.
- The long-term future of major gateway cities still looks optimistic, with highly skilled recent college graduates coming into the workforce who still want all the amenities, convenience and activity that's associated with more urban areas.
- Although there is still uncertainty around office demand, we will likely see a flight to quality space as organizations strive to make their workplace a destination of choice for employees.
- Workplace design and agile real estate strategies are pillars of the future. The soft, tenant-favorable market provides the opportunities to negotiate business terms that satisfy both right now.

"In the last six months, we've seen the rapid acceleration of both space trends and operational strategies law firms were considering prior to the pandemic. We're at a very soft point in the cycle and suggest there is currently a great opportunity to evaluate all market options. However, it's important to note that as large law firms continue to prioritize trophy space while speculative construction stops, these opportunities for large blocks in the best buildings will become more and more limited in the coming years," Lou Christopher, Vice Chairman, CBRE Law Firm Practice Group.

The opportunities are growing in the major gateway markets, and this cycle may not be long-lived. The competitive landscape for law firms has only increased, and a sophisticated solution means a consultative, multi-disciplined approach involving top professionals in brokerage, research, workplace strategy, labor analytics, financial consulting and project management. 2021 is going to be a tenant's market – a great year to test the market, and certainly an excellent time to evaluate your options and opportunities.