Capital Waiting to Deploy—Office's Savior?

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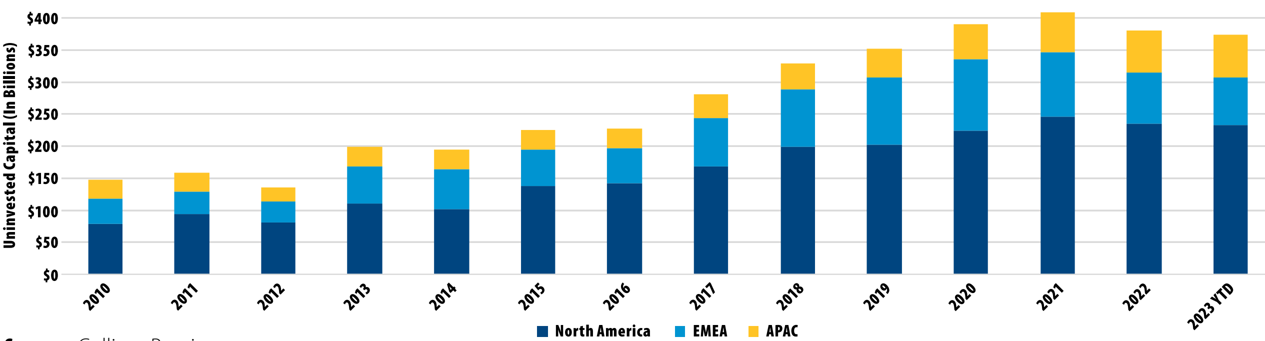
Real estate investors are sitting on an enormous quantity of uninvested capital, a total of $379.1 billion as of June, per data from Preqin, near the record high of $414.8 billion in 2021. Further analysis of this data unveils key indicators of where capital is likely to go, allowing investors to better plan strategies (Exhibit 1).

Regional Differences

Although overall uninvested capital is down 8.6% globally, differences between Asia-Pacific (APAC); Europe, the Middle East, and Africa (EMEA); and North America are stark. In fact, APAC, with $66.8 billion uninvested, has never seen so much capital. APAC-focused investment is up 6.9% from that in 2021. EMEA is the polar opposite—total EMEA funds to be deployed have fallen to $74.4 billion, a 26% decline. But unlike the case in other regions, its total capital peaked in 2020, which means a total decline of 33.4%. In North America, the $232.5 billion of dry powder is down 5.6% from 2021's highs (Exhibit 2).

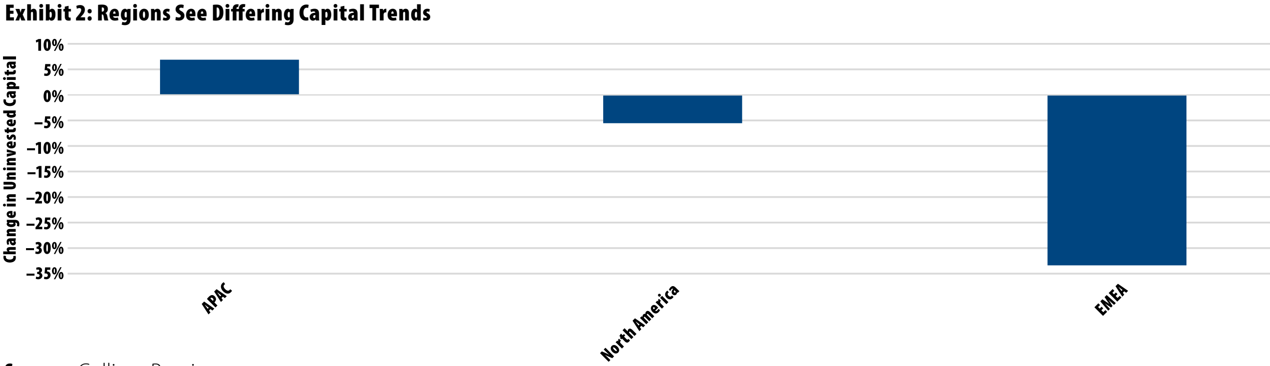
Where and how these funds will be spent are still unclear. There are differences in both regional capital stockpiles and asset-class focuses. Office has been the most popular asset class globally over the past 15 years, and its 37% share of total investment is twice that of any other property type. Office is a far more popular focus in APAC and EMEA, where volumes, though down, totaled 38% and 35% of recent sales, respectively. In North America, sales volume has fallen below 20% of real estate total sales because industrial has outpaced office volume of late, while multifamily sales have soared. US office vacancy rates are at all-time highs.

Exhibit 1: Investors Have Substantial Capital to Invest



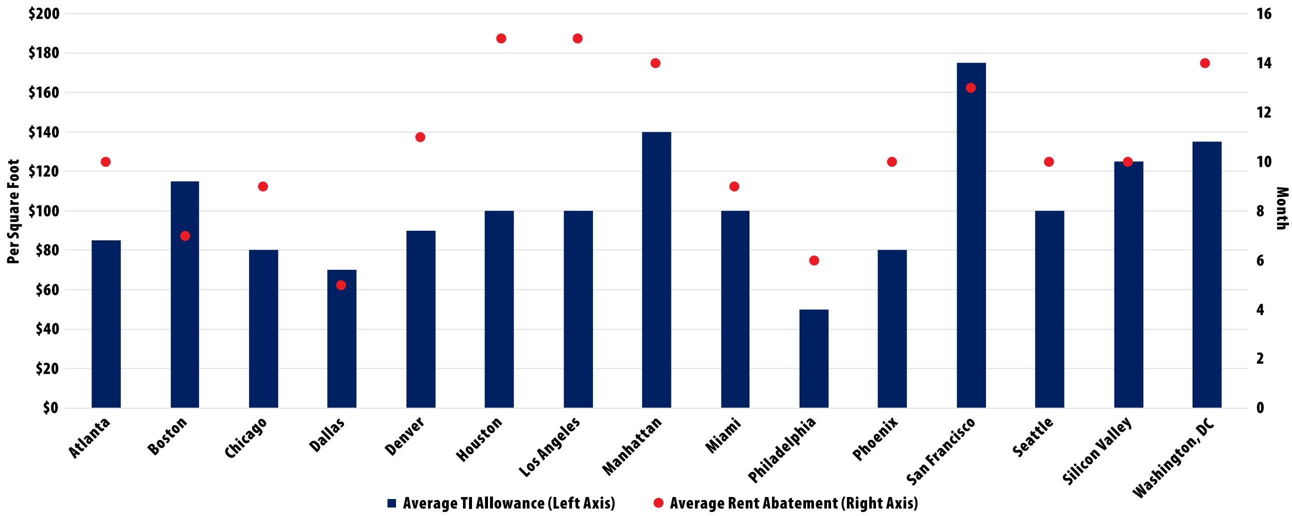
Sources: Colliers, Preqin

Exhibit 2: Regions See Differing Capital Trends



Sources: Colliers, Preqin

Exhibit 3: US Office Market Outlook: 1Q2023—Concessions Remain Generous*



Source: Colliers
*Assumes new ten-year lease on Class A space

North America

The softening of key US office market fundamentals accelerated in the first half of 2023. Net absorption remained negative, occupancy losses increased, vacancy rose at a faster pace, and available sublease space hit a new record high. The US office vacancy rate stood at 16.4% in the second quarter.

Vacancy now exceeds the prior peak of 16.3% at the height of the global financial crisis, with further increases expected. Net absorption, which measures the change in occupied office inventory, was positive in only 24% of the metro office markets in Colliers' national survey in the first quarter, down from 43% in the fourth quarter. National average office absorption totaled –25.4 million square feet. Seventeen metro markets posted negative absorption above 500,000 square feet in 1Q2023, up from 12 markets in 4Q2022, reflecting this shift.

Although asking rates are generally showing little change, the gap between asking and effective rents remains significant because of generous concessions. Tenant improvement allowances of $100 per square foot or more were available in 10 of the 15 leading US office markets for new ten-year leases on Class A space (Exhibit 3). Similarly, two-thirds of the leading markets offered ten months or more of rent abatement on such transactions.

Cap rates continue to rise, and investors are generally down on the office asset class, making it challenging to price the market accurately today.

As a result, risk capital is circling office, looking for bargains. It is not uncommon for offers to come in 20% to 40% short of pricing guidance. Meanwhile, debt maturities are beginning to create distress as investors default. Central bankers' statements are signaling flexibility in their phrasing, suggesting that the rate-hike cycle could be at its end or soon will be.

The return-to-office trend in Canada is on a par with that in the United States, especially in the downtown cores of major cities. However, Toronto's physical office occupancy rose to 60% by the end of Q1. Vacancy has surged into double digits across most of the country, and after subsiding in 2022, subletting has reemerged as an issue for the office leasing market in 2023. In several cities, more than 20% of vacant space is sublet, and that percentage is rising.

Transaction volume has been extremely low for office, preventing price discovery in an era of much higher borrowing costs. Many major institutional players, traditionally the largest owners of high-quality office assets, have opted to sit back, pursue development strategies, or diversify abroad.

EMEA

In Europe, office take-up and absorption rebounded very strongly in 2021 post-COVID-19 shutdowns but started

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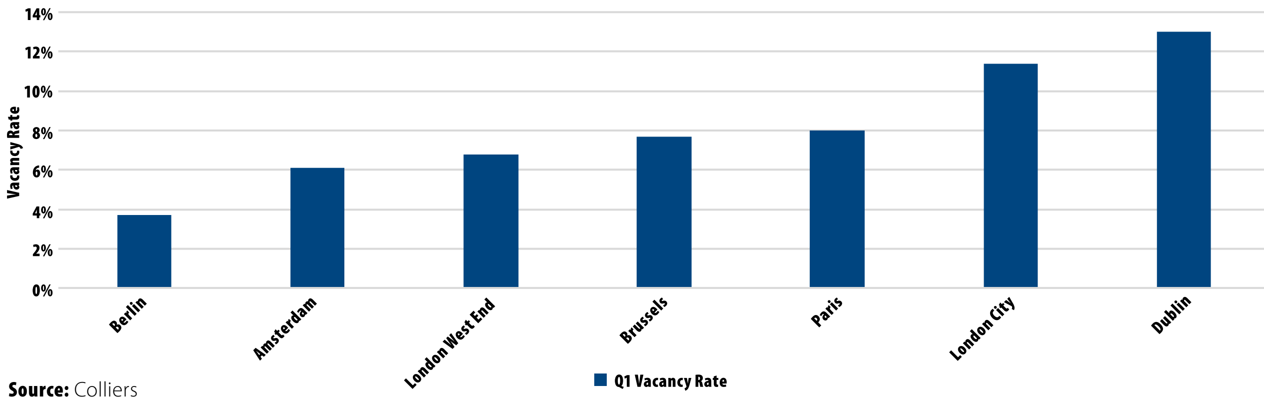
Exhibit 4: 1Q2023 Select EMEA Cities' Vacancy Rates



Source: Colliers

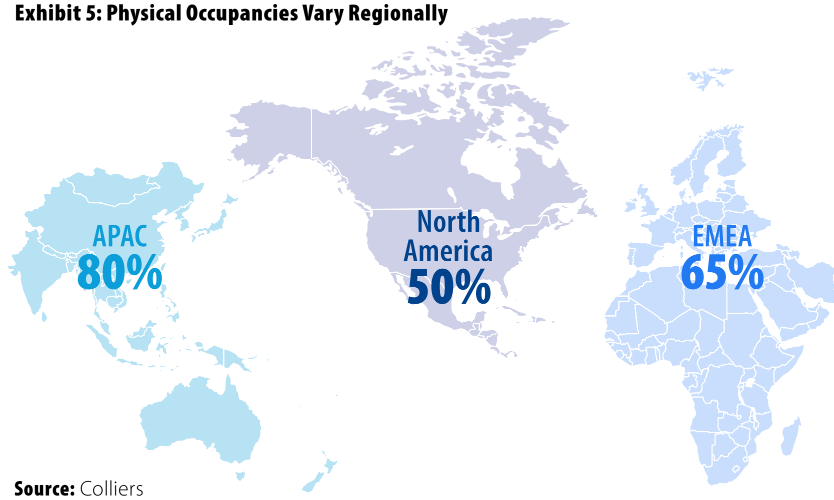
to flatten out during 2022, and this trend has continued. New development has been declining for a year in light of higher construction costs and a weakening economic outlook. As a result, vacancy overall crept up only marginally for the European aggregate, reaching 8.1% by the end of 1Q2023, but this masks differences in performance across markets.

London City's vacancy rose from 9.7% to 11.4%; in Dublin, a market oriented to the tech sector, vacancy jumped from 10.6% to 13%. Vacancy rates in Paris rose from 7.4% to 8%, and Berlin's rates crept up from 3.1% at the beginning of 2022 to 3.7%. Meanwhile, vacancy in Brussels dropped from 8.3% to 7.7%, Amsterdam rates fell from 6.5% to 6.1%, and London's West End held steady at 6.8% (Exhibit 4).

Older, obsolete stock is a significant part of vacant space, and a real scarcity of high-quality, energy-efficient space is pushing higher prime rental values up. Markets will feel pressure to repurpose secondary space that doesn't meet contemporary demands, but that is nothing new; markets constantly repurpose, triggered by down cycles.

A more important challenge for European pricing is the extent to which inflation is sticking because of consistent core inflation, wage increases, higher imported energy costs, and rising food prices. Interest rates will likely continue to rise in 2023, causing office yields to move out further. However, they are now at or very close to peak rates.

Exhibit 5: Physical Occupancies Vary Regionally



Source: Colliers

The end of 2023 should provide much more clarity around inflation and interest rates and a clearer path on pricing across multiple markets. Pricing needs to hit the right level to match future exit yields. Capex must also be factored in to allow for asset upgrades to meet higher energy/operational carbon and ESG requirements.

APAC

Throughout the past 12 months, the APAC region has been more resilient than North America and EMEA. Still, the change in sentiment caused by inflation-driven interest rate increases will continue to create some headwinds for the region for the rest of the year.

Physical occupancy levels across the region are above those of EMEA and North America, averaging around 80% (Exhibit 5). Average vacancy across major APAC markets

is around 10%, although the divergence is vast, with Seoul vacancy at 2.3% and Beijing at 16.9%.

Although APAC has had a more robust rebound in occupancy than that in other regions, global uncertainty is weighing on occupier demand, and supply- and demand-side fundamentals are shaping different recovery profiles in major APAC office markets. Seoul and Singapore recorded net absorption at 30% above historical averages, with both having falling vacancy rates in 2022, contrary to most major markets globally. However, as in most markets, demand is wavering in Singapore, as occupiers remain wary of economic conditions. Still, low supply over the past 12 months in Seoul has driven vacancy to just 2.3%, down from 6.4%, keeping market conditions firmly in favor of landlords, contrary to global trends.

For the rest of 2023, underlying demand will be in a net-neutral state as expansionary tenant activity within some APAC markets and submarkets will be offset by demand contractions, particularly within the tech sector and in locales that lack amenities and infrastructure. As a result, vacancy levels are expected to increase across major APAC markets over 2023, although not as much as in 2020–2021.

Stability, or the initial recovery of face rents, has been apparent over the past 12 months. Hong Kong, Mumbai, and Melbourne are expected to be at or close to bottoming rents, and some rental growth is likely by year-end. Although rent growth is slowing its decline in the Tokyo market, rents may fall further over 2023, as vacancy remains above historical averages. Higher vacancy levels and weak demand will decrease rents in Beijing and Shanghai, and solid rental growth over the past 12 months within Seoul and Sydney is expected to taper but remain positive.

Although limited sales transactions occurred in 1Q2023, market sentiment will likely recover as an expected peak of the interest rate cycle comes to fruition in 2H2023, equipping investors and vendors with clarity and confidence about the region's asset values and the cost of borrowing.

Conclusion

The vast differences in market supply-demand dynamics, economic profiles and outlook, and general sentiment underpin how complex office investment has become. Each market has its own story, and picking the right ones will depend on risk appetite, use, availability of leverage, and return targets. The amount of capital on the sidelines suggests that markets will find a bottom soon if they have not already. ■

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