Contact IndyStar reporter Alexandria Burris at aburris@gannett.com or call 317-617-2690. Follow her on Twitter: @allyburris.

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Office space market 'on pause' as coronavirus keeps workers home

The past six months have brought dramatic change to the commercial real estate market as the novel coronavirus pandemic rages in Indiana.

Industrial real estate has been a bright spot as e-commerce surges. Multifamily remains on solid ground, despite some slippage in downtown Indianapolis. However, COVID-19 has upended the office and retail real estate sectors, casting both in uncertainty. The pandemic accelerated a wave of retail bankruptcies.

Office space now is largely a sea of empty chairs. One estimate indicates that nearly a quarter of the office space in Indianapolis would be vacant by the end of 2022. Yet experts in the field said the negative effects of the pandemic on that end of the market have yet to be seen in the Circle City.

"Folks are still paying their rent. The receivables are still coming in. I think that's pretty different than the retail sector at this point," said **Rich Forslund**, executive vice president of the Indianapolis office of Colliers International. He specializes in the office sector.

Demand was tepid in the third quarter. Meanwhile, office employers are on pins and needles as coronavirus cases rise.

"Most landlords — particularly Class A landlords — are holding firm on their rents," said Tim Michael, managing principal of Cushman & Wakefield's Indianapolis office. "Whether that continues or when that changes, we're closely watching."

'Someone hit the pause button'

"If there's a theme for the office sector right now, it's that it's on pause," **Forslund** said.

Out of an abundance of caution about the novel coronavirus and government mandates, employers closed their offices and sent employees home to work in mid- March. Remote working became widespread.

The pandemic has spurred questions about the future of office design and is expected to put downward pressure on rental rates. That hasn't occurred yet.

A recent report from CBRE, a commercial real estate services and investment firm with an Indianapolis office, indicates that average asking rates in the Indianapolis area for Class A and B office space increased 13 cents to $21.18 per square feet quarter over quarter. Vacancy rates rose to 19.5% in the third quarter, driven by emptied space in the suburbs, from 18.8% in the second quarter 2020.

The general consensus among those working in commercial real estate is that many office tenants are taking a wait-and-see approach on leases and about returning workers to the office during the pandemic.

"There really isn't a lot of activity there," **Forslund** said. "It's truly like someone hit the pause button, and everybody is just sitting on their hands trying to figure out what the next steps are."

For Colliers International, direct vacancy rates have not shifted dramatically in either direction — though they did inch up to 16.2% in the second quarter of this year from 15.8% in the same period in 2019, **Forslund** said.

A little bit of sublease space has hit the market. Class A space, on average, rents for $25.70 per square feet and office space outside the Central Business District rents for about $23.21.

Speed bumps and regression ahead

The long-term outlook for the office sector remains optimistic, said Tim Michel, managing principal for Cushman & Wakefield's Indianapolis office. Substantial job growth is projected to occur across the U.S. and lead to more office jobs.

In the meantime, COVID-19 could make the next two years difficult for the office sector. Cushman & Wakefield anticipates a downward trend in office occupancy and predicts a 5% decline in rents next year. That could be followed by another 3.5% to 4% in 2022.

"There's definitely some speed bumps, some, some regression," Michel said.

The national vacancy rate for office buildings was 13% in the fourth quarter of 2019 but is expected to increase to 17.6% in the latter half of 2022, according to data provided by Cushman & Wakefield.

If Indianapolis follows that trend, the local market, which has a vacancy rate of roughly 18.5%, could see that rate rise to 23% during that period next year, according to Cushman & Wakefield's projections.

"We hope it doesn't go that way," Michel said. "But if it follows a national trend, we could have an additional million-and-a-half square feet available that was previously occupied."

The potential ripple effect to other sectors is hard to quantify, he said. But when office buildings do well, and people travel Downtown or to an office park, the surrounding business community of restaurants and retail shops benefit.

It is hoped that Indianapolis is in a better position, so the trend doesn't pan out and that it's pro-business, family-friendly reputation will attract companies from other states or markets not faring well.

Testing the waters

Michel suspects the "pause" in return to work is largely due to employers trying to figure out how to move forward during the pandemic, which is seeing an upswing in positive coronavirus cases. He said about 10% of office workers have returned to the Central Business District downtown.

"Companies that use office space are really trying to figure out what they need," he said.

Colliers' tenants are paying rent despite having no or few bodies at the office. The commercial real estate company manages about 43 million square feet of commercial space in the Central Business District and in the suburbs. **Forslund** said, anecdotally, an estimated 25% to 50% of employees belonging to Colliers' tenant base is working from the office.

"The tenants aren't moving out," **Forslund** said. "They're still paying rent, and their cubes are still there. Their offices are still existing."

Tenants are starting to "test the waters" on return to work, offering the options to employees who feel comfortable. And while brokers are still working, activity in the sector has slowed.

He said employers are buying time to make short- and long-term decisions about whether to request shorter leases or extensions. Meanwhile, many deals aren't getting done. Those that are taking place involve employers and landlords buying time to push the conversation to a later date.

"They're sort of testing the waters as it relates to re-entry into the office space," he said. Colliers' larger employers are being a little more conservative about reentry to the office. They are likely to start transitioning back to the office in the second quarter of 2021.

"A lot of this is folks just trying to feel it out," he said.

A potential new normal

Cushman & Wakefield tracked the amount of people who worked from home prior to the pandemic. By its estimates 5% of U.S. office workers carried out their duties from home before the pandemic. The company estimates that figure could rise to about 10-15% once the economy stabilizes in the long-term.

Like other sectors upended by the coronavirus pandemic, office tenants are washed in uncertainty. "People just don't know when this will let up," **Forslund** said. "The other piece is, you know, when they reenter will they have to potentially reorganize their office space to accommodate the new norm."

Initially during the pandemic's economic shutdown, office tenants and their employees viewed remote work and the flexibility it offered as a positive. Companies were looking at cost savings on real estate and quickly transitioned workers out of the office.

That outlook has shifted. As the months wear on, employers indicated that some employees, having grown tired of being cooped up in their homes, missed the camaraderie and culture of the office and were eager to return.

"Couple that with the fact that winter is fast approaching, the thought of sitting in your home during a gray winter and not having the interaction or the social connection that you get in the office space is not exactly an exciting thing," **Forslund** said.

Some tenants are having conversations about leasing larger offices with more walls between workers so they can abide by social distancing guidelines when they do return to work.

Forslund said the pandemic could lead to the end of bench workstations, an office design in which desks are lined up next to one another like benches.

The concept — considered at one point to be futuristic — allows employees to sit together, see each other and easily work in collaborative workstations.

"That phenomenon is probably one of the past," he said.

Where retail stands amid bankruptcies

Essential retailers such as drugstores and supermarkets have fared well during the pandemic and so have restaurants with drive-thrus.

But on the opposite end of the sector, companies that had a lot of debt, department stores and retailers selling clothing and home goods, movie theaters, and restaurants with outdoor seating have been hard hit by the pandemic.

Malls, which struggled prior to the pandemic, are trying to figure out what to do with now empty, unfillable space vacated by department store anchors.

"The pandemic probably accelerated some of their problems," Michel said, adding that it could take a while to fill standalone retail and restaurant real estate emptied due to the pandemic.

Conversion lies ahead as landlords reevaluate what to do with vacant storefronts and restaurants. Michel said that means empty department stores could become apartments, hotel sites, or warehouses.