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Small-Cap Office Properties See Negative Absorption in 1Q, Still Outperform Large Properties

Small-capitalization office properties vastly outperformed their large-cap brethren during the first quarter in terms of negative net absorption, or the vacancy of previously occupied space.

Buildings with 50,000 square feet or less, which broadly defines a small-cap property, suffered nearly 5 million sf of negative absorption during the first quarter, according to analysis by Boxwood Means LLC. That was the first time since early 2021 that the sector had seen negative absorption. In contrast, large-cap properties suffered 32.2 million sf of negative absorption during the period, according to Cushman & Wakefield, which said that had helped push the national vacancy rate up 60 basis points, to 18.6 percent.

NAIOP, meanwhile, predicts that absorption in the national office sector would remain negative this year, reaching 24.4 million sf. That, however, is expected to turn around next year, when the trade group predicts that 30.6 million sf will be absorbed, meaning previously vacant space would be leased. It expects that negative absorption would be 10.4 million sf in the second quarter.

Boxwood Means, which relies on CoStar Group data, calculates the size of the small-cap office market at roughly half the country's 8.4 billion sf of office space. It said the availability rate in the small-cap sector, which takes into account the roughly 20.5 million sf of space available for sublease, had increased in the quarter by 20 bps to 8.5 percent. That's well below the 10.5 percent long-term average for the sector.

Part of the reason could be tied to a shrinking universe. Barclays Capital recently noted that overall inventory levels of class-C office buildings - a big chunk of the small-cap market - has been taken offline and converted to other uses. It had pegged the class-C availability rate at 6 percent, as of last year's first quarter. In contrast, the class-A availability rate was 23 percent.

The 20.5 million sf of space available for sublease is dwarfed by the 146 million sf of sublease availability that Cushman & Wakefield gauges. That volume is driven by three markets: Manhattan, with 22.4 million sf; San Francisco, with 8.9 million sf; and Chicago, with 8.08 million sf.

Boxwood Means noted that the difference between the overall availability rate in the small-cap office market and the vacancy rate is at 200 bps, "well below the long-term average" of just more than 250 bps.

In explaining the relative health of the small-cap market, the company noted that properties generally are leased to relatively small companies that don't lease beyond their needs. In addition, leases typically have shorter durations than do agreements for larger-cap properties, making them less risky for tenants. In addition, rents, it noted, are generally lower than they are at large-cap properties. Small-cap properties also tend to be concentrated in suburban markets, as opposed to central business districts, often making occupancy more "sticky."