Offices and Labs Take Different Paths to a Similar Place

Higher Vacancy for Life Science Properties Mirror That of Traditional Office, But Demand Dynamics Diverge

By Phil Mobley

The rapid growth of the life sciences sector is one of the most remarkable commercial real estate stories of the past decade, including the latter stages of the pandemic era.

Buoyed by massive investment from public and private sources, employment in life science research and development soared to nearly 50% above what it was a decade ago. After a brief dip with the onset of COVID-19, the growth rate for this sector accelerated even further, resulting in a 20% gain in life sciences jobs in just the past three years.

The implications for real estate have been limited in geographic scope, but are profound within the biotech clusters that dot the landscape near Boston, San Francisco, San Diego and several other U.S. cities. Expanding life-sciences startups have been hungry for the kind of specialized, expensive and rare lab space that enables their research.

Accordingly, life sciences labs have commanded a premium in commercial real estate capital markets. Of the top 27 office property sales in terms of price per square foot that closed in the four quarters ending in the first quarter of this year, 15 were life science facilities often referred to as labs, many of which garner rents near or above $100 per square foot.

But these eye-popping figures mask the reality that overall demand for lab real estate has been weakening. In some ways, the lab real estate sector now closely resembles that of the much-beleaguered office sector as a whole.

The travails of the office sector have been well documented. Nationally, vacancy is now about a third higher than it was five years ago, with practically all the increase occurring since April 2020. Perhaps surprisingly, lab vacancy has also increased substantially in the same period, rising nearly a quarter.

If the vacancy pattern is similar, however, the market forces that produced it is anything but. In the office sector as a whole, the increase in vacancy is the result of a negative demand shock produced by the pandemic and the subsequent response. For however long it lasts, the disconnection of demand from office-using employment represents a structural shift in how much space office tenants require.

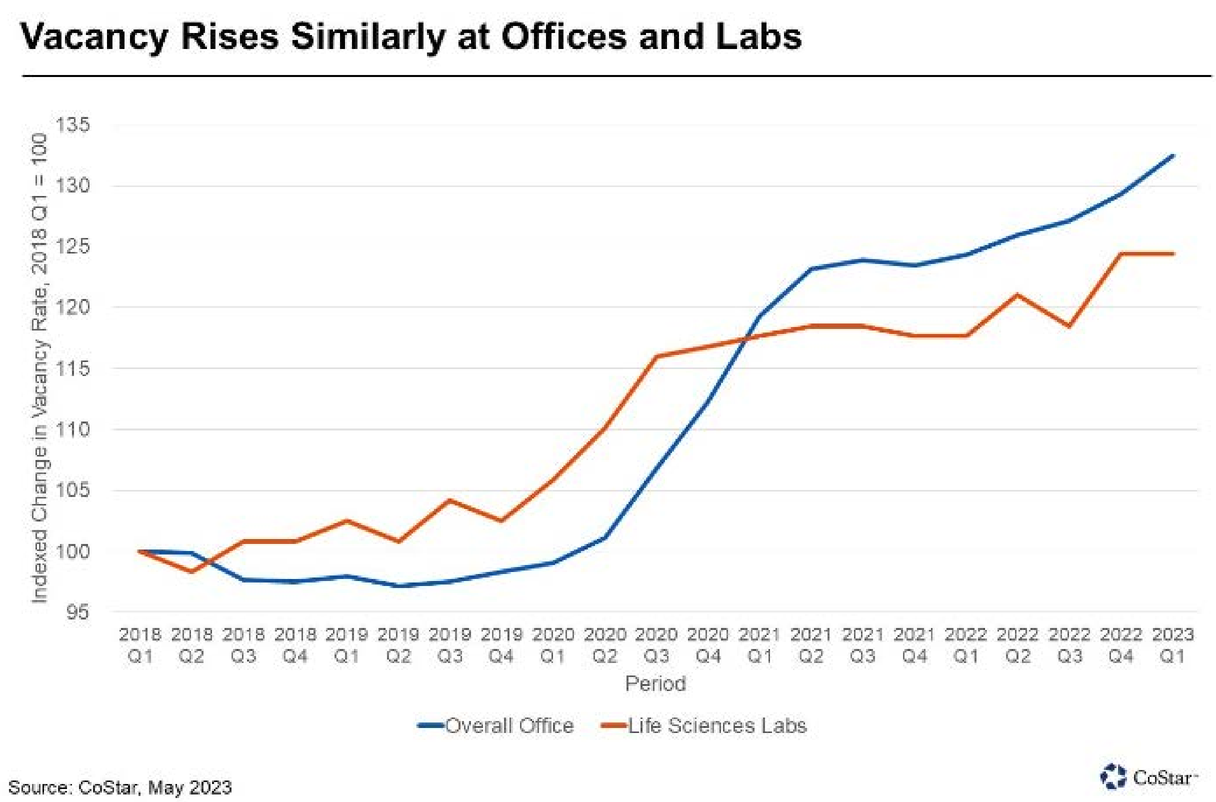
Labs have seen no such fundamental shift in demand because so much of the work itself requires physical proximity. Net absorption of lab space did turn negative in 2020, along with employment. But it has since recovered to resemble its pre-pandemic trend. Traditional office, on the other hand, has seen persistently negative net absorption in each of the past three years—and the forecast calls for more of the same in 2023.

The rising vacancy in labs can almost entirely be attributed to a massive increase in new supply. Overall office construction has held steady at under 2% of total office inventory for the past five years and has recently moderated further. Meanwhile, lab supply growth has exploded, with 8% of inventory under construction at the end of both 2021 and 2022.

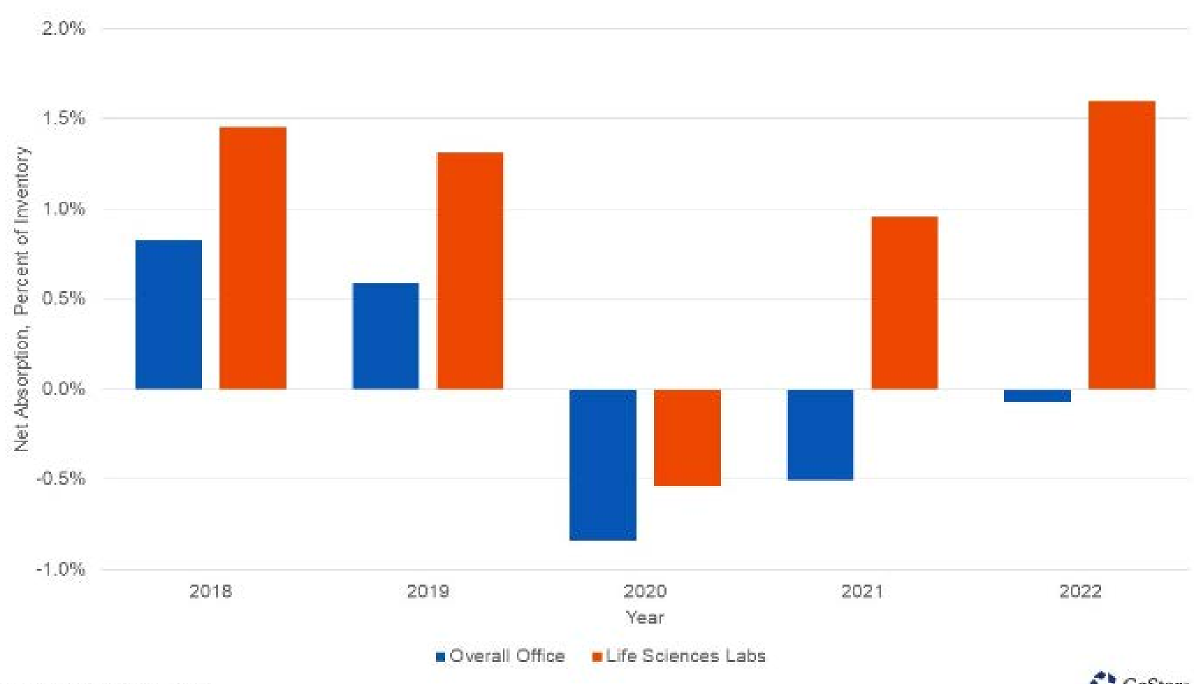
Ironically, much of this new lab supply is a result of office-to-lab conversions. Industry sources report 5 million to 6 million square feet of such conversions already completed in the Boston market alone in the past few years, with more expected in the next 18 to 24 months. This phenomenon has helped keep Boston's overall vacancy rate below the average for gateway markets but is now contributing to a softening in the lab subsector, especially outside the most established clusters.

The glut of new lab supply is now set to come online, just as lab demand slows due to a pullback in venture capital funding to the sector. This suggests that vacancy could continue to rise as the market absorbs the new inventory.

Even so, the basic relationship between the work done within labs and the space itself remains intact. Fluctuations in vacancy and rents are the normal outcomes of a functioning market on the way to equilibrium. When, as expected, the funding returns, so will both the jobs and the demand. This is in contrast with traditional offices, where vacancy is still rising while the market seeks its footing amid uncertain future demand.

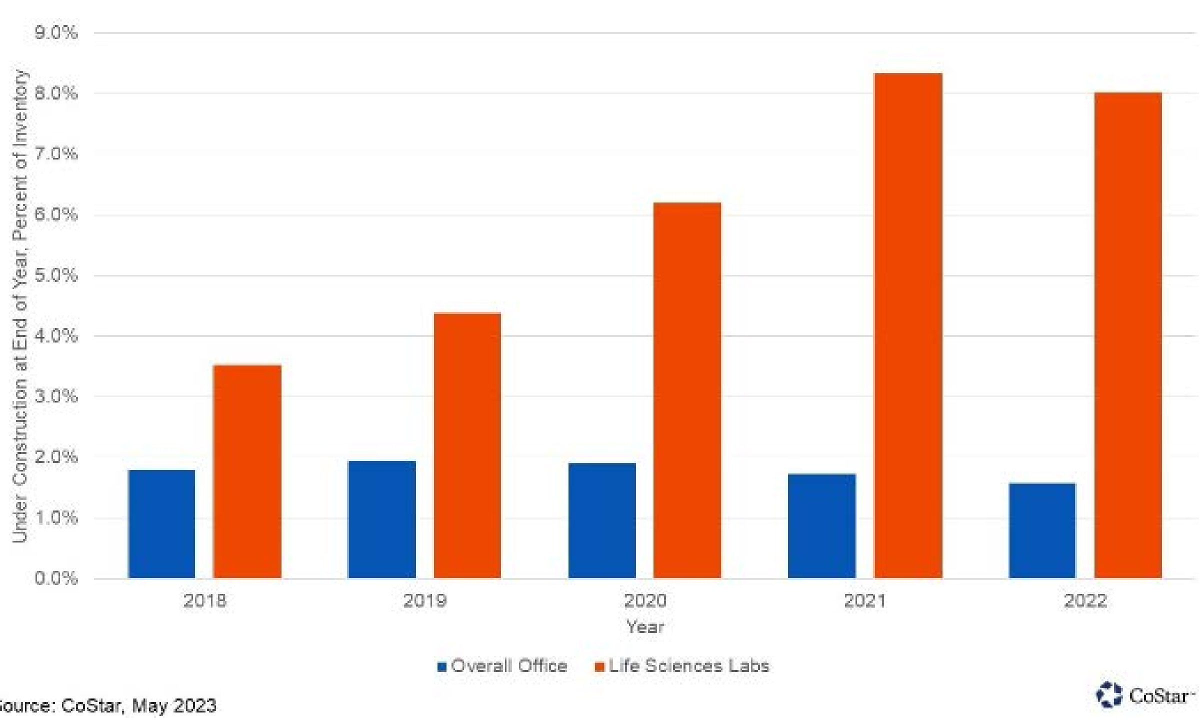


Demand Craters at Offices, Holds Steady at Labs



Source: CoStar, May 2023

Office Construction Moderates; Lab Construction Explodes



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