Breaking Ground

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NOVEMBER/DECEMBER 2022

OFFICE MARKET UPDATE

MBA

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On the cover: Two Doughboy Square. Photo by Massery Photography

PUBLISHER'S NOTE

I don't think there is anyone doing more to bring the office market back than Jim Scalo. The CEO of Burns Scalo Real Estate has cajoled, promoted, scolded, and generally encouraged people to return to work for at least the past year. Jim owns a lot of office property so it would be easy to dismiss those efforts as purely self-serving. But he is also investing tens of millions in office space and in upgrading his existing properties to meet the expectations of his tenants. While he may be doing some wish casting about the office market returning to what it was in the past, he is also preparing for what the future will bring.

Burns Scalo is just one of hundreds of office property owners in our region. For each, the ground has shifted beneath them. Like at any other time when there has been a seismic market event, there is a temptation to view this as a time of unprecedented change. While it is certainly true that a global pandemic is unprecedented for almost everyone alive today, there are parallels to more recent events that may inform how to respond to the current conditions in the marketplace.

The situation in the office market reminds me of the housing market following the mortgage and financial crisis. A tidal wave of foreclosures and overbuilt spec homes flooded the market with supply. Demand was crushed by a deep recession and the need to deleverage from high levels of consumer debt. Borrowers who wanted a mortgage had trouble finding lenders. Home values fell, deeply in some places. Dire forecasts about the future of home ownership abounded. (Of course, many of those forecasts came from the same people who suggested that subprime mortgages were nothing to be concerned about a year earlier.)

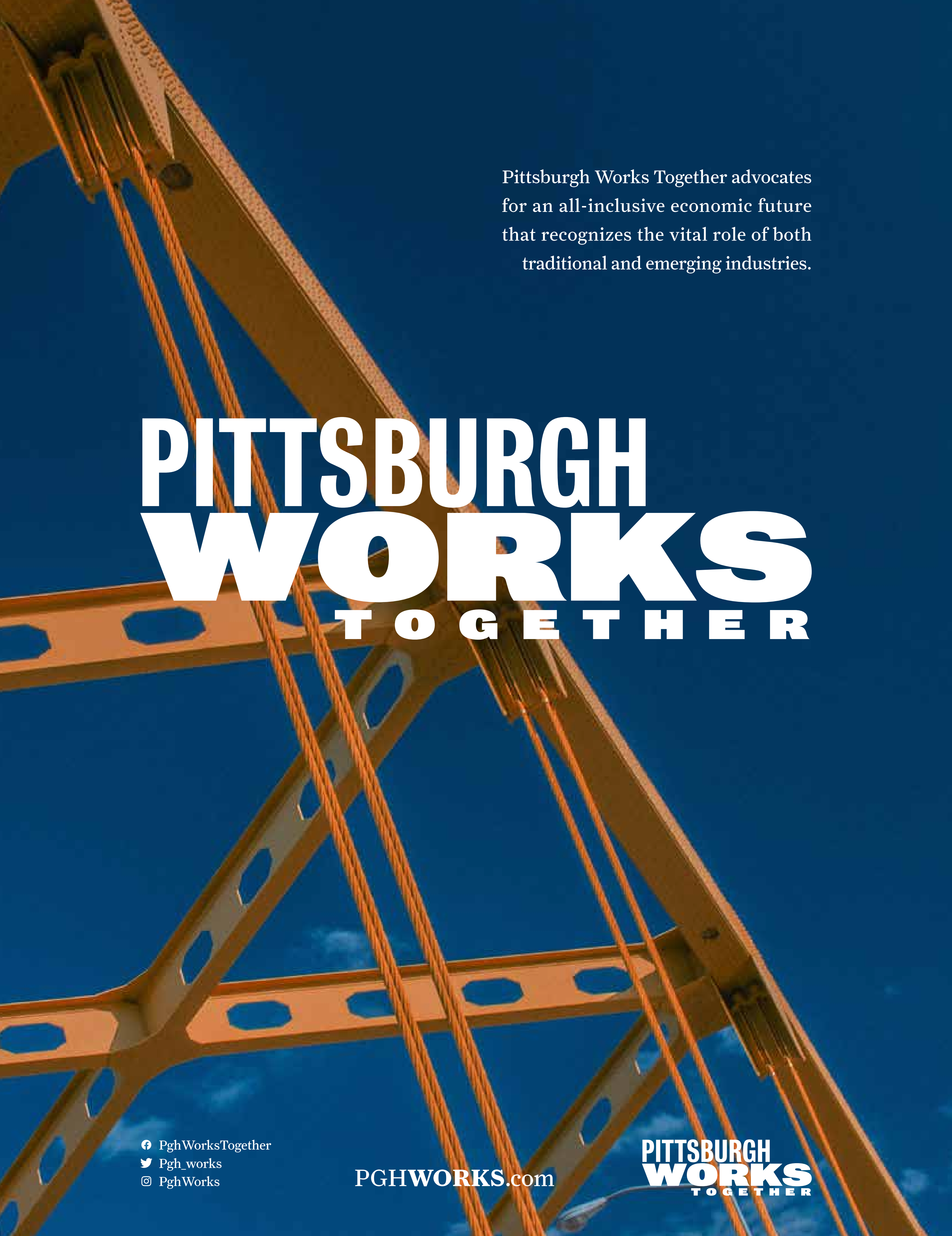
Does any of that sound familiar? Today's forecasts about the future of the office are pretty dire. Of course, dire predictions are not without basis now. People are not returning to the office as though the pandemic never happened. It is likely that some characteristics of office occupancy have been changed permanently. But it is far more likely that the office market will return to something with which we are familiar before too many years go by. After all, the housing market has recovered beyond expectations. There was no miracle cure for what ailed the housing market in 2009, just patience and perseverance. That is likely to be the prescription for recovery in the office market today.

I was fortunate to be present at a luncheon in 2009 that featured Jim Rohr as a speaker. Jim was CEO of PNC at the time and had been on the front lines of the financial crisis as several of the largest investment banks in the world collapsed. Rohr used his speech that day to urge everyone to take a deep breath, remain calm, and remember that the current crisis would pass. I suspect that advice would hold up well today.

It has been my experience in 43 years of working that when enough experts tell you to zig, you should zag. And a lot of experts are weighing in on the future of the office. There are some things we know about offices now. Workers expect them to be more than just the places we work. Vacancy is likely to stay high enough that some buildings will be under water. There will be a lot of competition for tenants. That said, however, there is much more unknown. That suggests to me that patience and perseverance will prevail over reaction.

Jim Scalo understands this. That is why he is building a new spec office building, even as he laments the slow return to the office. The same is true for the leaders at Oxford Development, Elmhurst Group, Rugby Realty, and most of the other property owners in Pittsburgh. That will be important to remember when you read about the inevitable distressed office sale or foreclosure. When you read the next catastrophic headline in the *Pittsburgh Business Times* or *Pittsburgh Post-Gazette*, take a deep breath, and remember this crisis will pass too.

Jeff Burd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REGIONAL MARKET UPDATE

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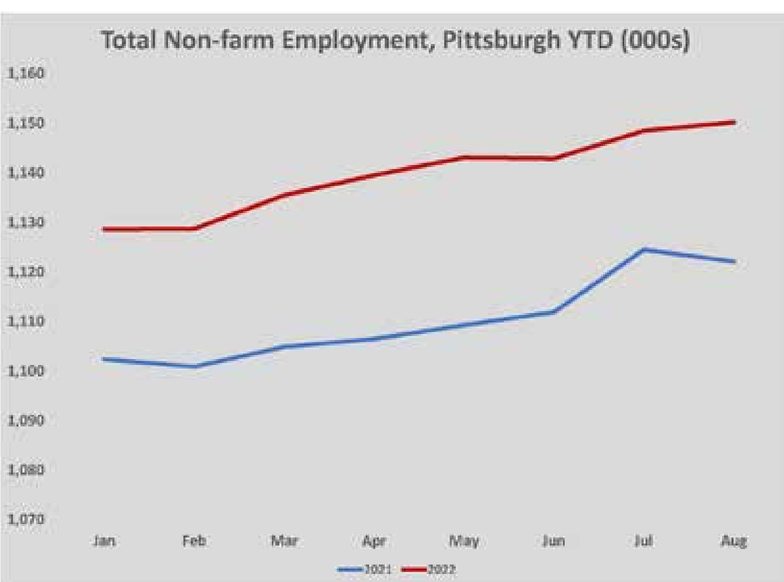
Weighed down by the same elevated inflation and higher borrowing costs as the rest of the U.S., Pittsburgh consumers and businesses are less optimistic about the arc of the regional economy as 2022 winds down. That is likely to have negative consequences for the construction market, but there are buffers that could insulate construction from a significant slowdown should the U.S. economy fall into a recession.

Hiring in the seven-county Pittsburgh metropolitan area has been stable throughout 2022, with an average of 29,310 more employed persons than in 2021. Six of the eight months have seen employment jump by 28,000 or more, but the highest year-over-year gain has been 33,800. The steady data also suggests that the labor force decline has stabilized for now. Unemployment has also stabilized at 4.4 percent, 90 basis points higher than the U.S. unemployment rate, but 1.8 percentage points lower than a year earlier.

Like in the rest of the U.S., employers are finding it difficult to attract talent in Pittsburgh, with the workforce at roughly 40,000 fewer persons in August 2022 than in August 2020, 45,000 fewer than before the pandemic. Unemployment remains higher in Pittsburgh than in the rest of the nation, largely because of higher unemployment rates in the outlying counties of the metropolitan area. Even with the higher unemployment rate, Pittsburgh has more available jobs than workers. As a result, wages in Pittsburgh are growing above the national average, outpacing all but 14 other metropolitan areas for year-over-year growth.



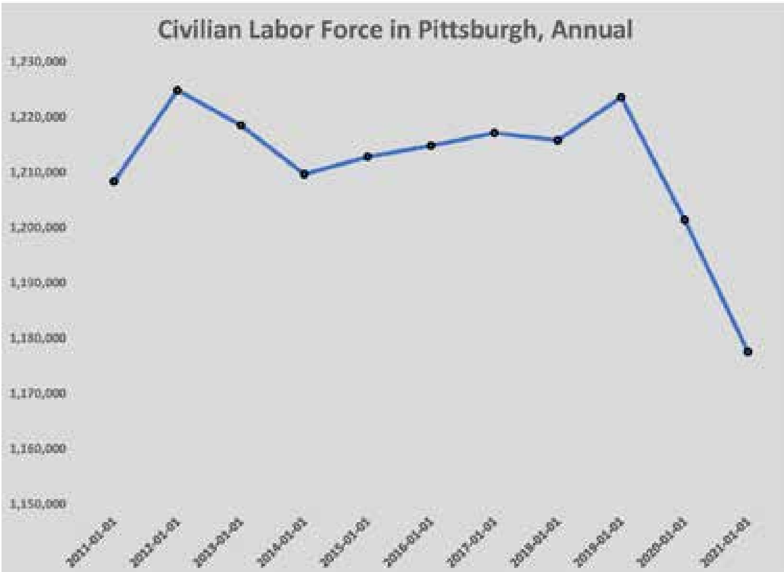
Source: U.S. Census Bureau.

The Bureau of Labor Statistics reported that wages grew 6.1 percent from August 2021 to August 2022 in Pittsburgh, to $1,018.71 per week. That far outpaced major cities like Boston, Dallas, Denver, and Houston, which had wage growth of roughly one percent, and peer cities like Baltimore and Indianapolis, which saw wages decline.

The strength or weakness of the local labor market is a key to the path of the economy, and the future demand for construction. Thus far, the continued expansion of the companies and institutions involved in emerging technologies has not triggered a spike in job creation (or related population growth) in the way that the Marcellus Shale play did in from 2009-2011. Moreover, even though the long-term job creation prospects for these industry sectors are strong, the uncertainty about how much space an expanded workforce will need to occupy may suppress future demand for office, research, and development construction.

Construction activity in the nonresidential and commercial sector remains ahead of last year's pace, although it is unlikely that the fourth quarter will match the strong end of 2021. Through the end of September, construction starts and contract awards totaled $3.31 billion (excluding the construction put in place at the Shell cracker) in the seven-county metro Pittsburgh area. That is $160 million, or 5.1 percent ahead of the pace through three quarters of 2021.

Nearly $1.1 billion in construction activity occurred during the fourth quarter of 2021. The higher-than-normal level of contracting was a result of the start of several larger projects and optimism about the return to normal from two pandemic years. Also at that time, the Fed was still signaling its own optimism about the need for monetary tightening to rein in inflation. Interest rates are now three percentage points higher than in October 2021 and are likely to go another full percentage point higher before the Fed stops hiking in 2023. That has chilled activity, especially in housing and commercial real estate. And, while the demand side of the economy has mostly normalized, concerns about a recession in 2023 have grown and will likely reduce construction spending into the first quarter. Tall Timber Group forecasts that the



Source: U.S. Census Bureau.

slowdown in the fourth quarter will result in contracting for the full year falling roughly $300 million short of the previous year. Including the impact of the construction put in place at the Shell project in Monaca, the year-over-year decline will be closer to $800 million.

In light of the regional and global economic uncertainty, you would expect the prospects for construction to be dimmer in 2023. It is more likely, however, that 2023 will be a markedly better year for construction than 2022, and that is primarily due to the lift that the Pittsburgh market continues to get from the mega projects in the pipeline.

In the public sector, the region's two largest projects – ALCOSAN's plant upgrade and the airport Terminal Modernization Program – have bid and awarded nearly $1.5 billion in construction contracts over the past two years. That accounts for nearly all of the major work at ALCOSAN'S Preble Avenue facilities and all but roughly $350 million of the airport's $1.4 billion budget. In the case of the latter project, the Allegheny County Airport Authority executed $1.1 billion in contracts during a 13-month period beginning in mid-2021. That represents about 20 percent of all the contract awards in the seven-county metropolitan region during the same period of time.

Another billion-dollar project, UPMC Presbyterian Heart and Transplant Hospital, was underway by the end of summer. The project is being managed by the PJ Dick/Whiting-Turner team. Although the project is scheduled to be under construction into 2026, the lion's share of the bidding should occur in 2023.

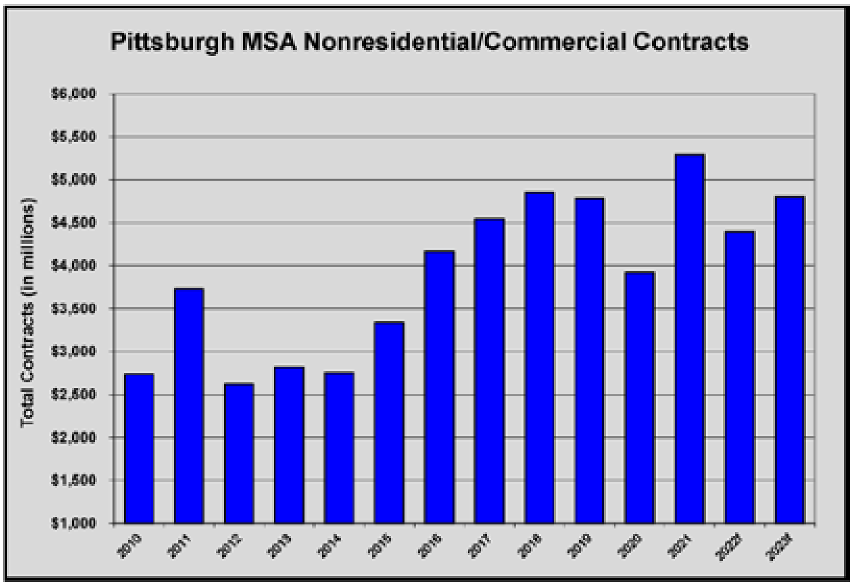
The education sector will provide a handful of opportunities to work on projects over $100 million. Construction has begun on University of Pittsburgh's $154 million Student Recreation Center, being built by Mascaro Construction. A few blocks to the north of that site on O'Hara Street, the Gilbane/Massaro team should start work on Pitt's $190 million Arena and Sports Performance Center in the first quarter of 2023. Pitt's $140 million Bouquet Street residence hall, which will be built by PJ Dick, is a third major capital project that may start on campus by the end of 2023. Carnegie Mellon's $200 million R. K. Mellon Hall of Science will be designed in 2023, with the PJ Dick/Mascaro team expected to bid the project at the end of the year. While the K-12 market will still offer limited opportunities, there are two projects that will be in the $100 million range. The new Quaker Valley High School and the Hempfield Area Middle School additions and renovations are scheduled to bid in 2023.

Beyond the coming year, in addition to the UPMC Presbyterian tower under construction in Oakland, there are several other major projects on the boards in the healthcare sector. Allegheny Health Network (AHN) has tentatively selected the Cool Valley development site for its new $140 million Canonsburg Hospital. AHN is also studying concepts for a new $300-$400 million cardiovascular tower at Allegheny General Hospital. Neither of these projects is expected to start before 2024. The merger of Excela Health and Butler Memorial Hospital is expected to produce a $100 million new facility in Westmoreland County that would be built in the middle of the decade.

Commercial real estate has been cooled off considerably by the rapid rise in interest rates, but the industrial and multi-family sectors will continue to put significant projects under construction in 2023. Site work has begun on the million-square-foot-plus distribution center for SunCap Property Group in New Stanton. Several new warehouses of 100,000 square feet or more are underway or in the pipeline for Westmoreland County and the Airport Corridor. While there are no $100 million apartment projects in the works, new developments over $50 million are in the pipeline. Dick Building Company has started demolition at 300 Sixth Avenue to convert the former GNC headquarters into 249 apartments. Major new construction projects of similar scale are proposed by Milhaus in Robinson Township, Alpha Capital at Newbury in South Fayette, Echo Realty at Shady Hill and Bloomfield Square, Albion Development in Lawrenceville, and New Burgh Properties in East Liberty. And after several revisions, Piatt Companies expects to get underway with the first phase of the $300 million Esplanade in early 2023.

This significant base of major projects will keep construction employment steady through 2024 and should push the total construction start activity to $4.8 billion in 2023. That will be roughly 10 percent higher than the current year's total, which will include the final construction put in place at the Shell Franklin project in Monaca.

The completion of the Shell project should have some beneficial impact on the regional construction workforce, although most of the local craft workers involved rolled off the project in 2022. Of growing concern for the Pittsburgh workforce is the potential impact of the $7 billion Intel manufacturing facility and the $3.5 billion Honda battery plant, both in the Columbus area. Those projects are projected to need 10,000 construction workers, which is beyond the labor capacity of Central Ohio. It is likely that the projects will be largely staffed by traveling workers – much as the Shell project was – but the demand could draw some workers from Western PA. With reports of the proposed PTT petrochemical facility coming back to life, labor availability may become a concern again, even in a slower economy. BG



Source: Tall Timber Group

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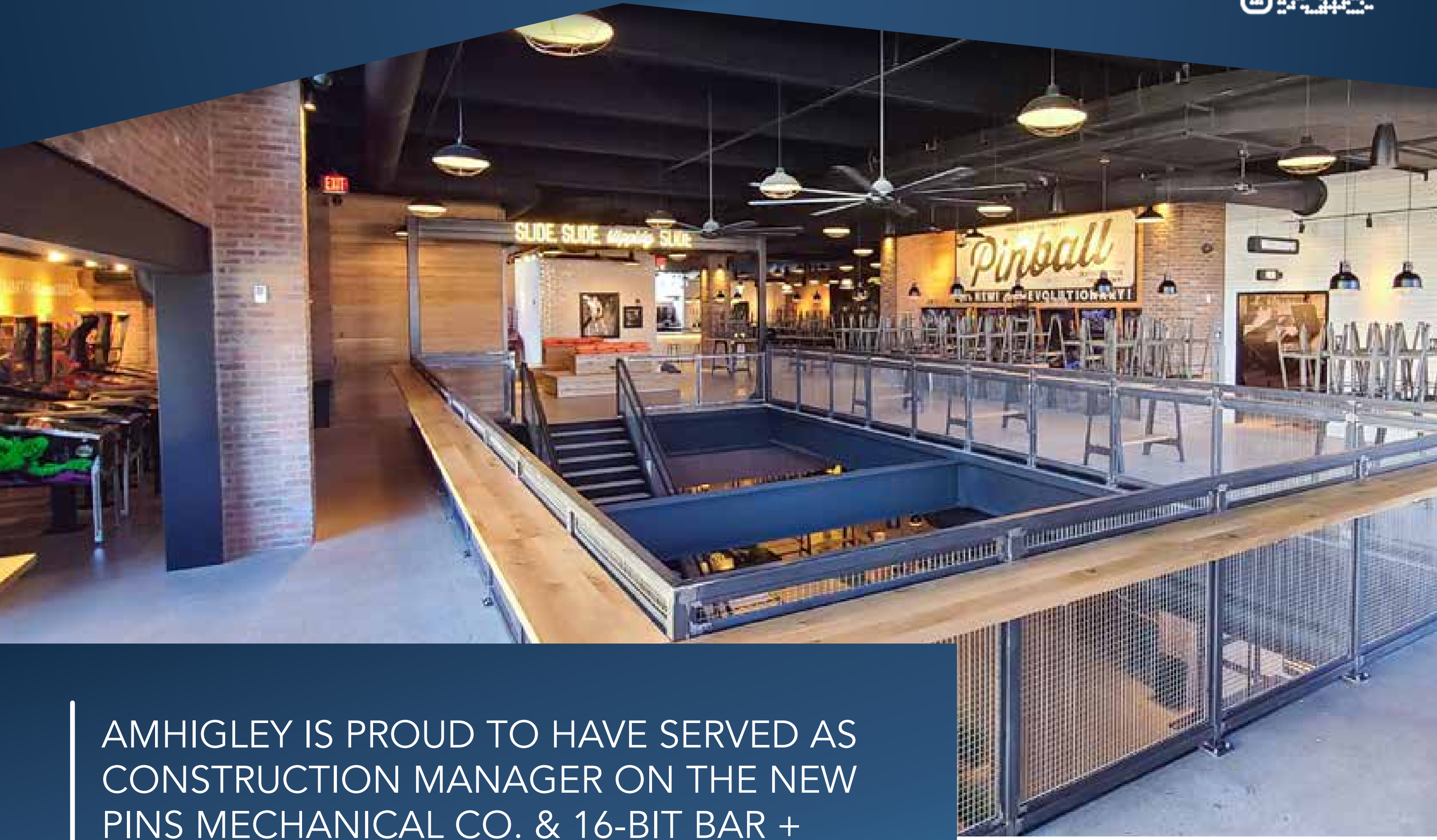

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NATIONAL MARKET UPDATE

For a few weeks in August, the hoped-for soft landing of the U.S. economy seemed more likely than not. In the decades since the Federal Reserve Bank embraced the dual mandate of low inflation and full employment, the central bank has tried, without success, to battle periods of inflation deftly enough to avoid tipping the economy into recession. After likely waiting too long to raise rates, the Fed was aggressive from March through July, and the data from mid-year showed a significant slowing in the rate of inflation from June to July. Perhaps, it was hoped, August would show further disinflation, allowing the Fed to keep rates from becoming restrictive.

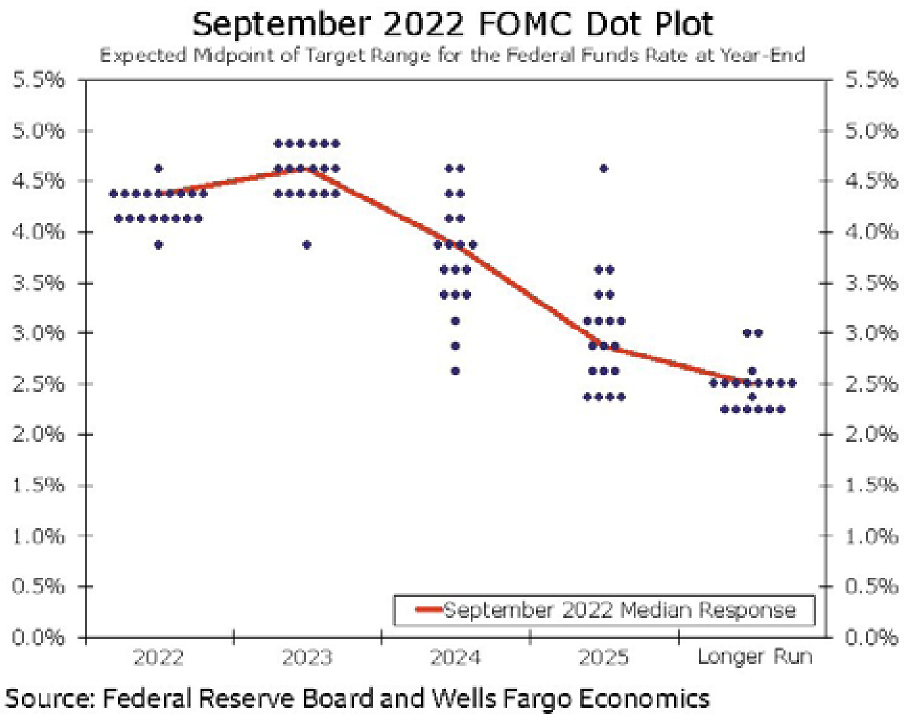
What transpired instead was an unexpected increase in both the consumer price index and core inflation in August. At the Federal Open Markets Committee (FOMC) meeting on September 20, a 75-basis point hike was announced, bringing the Fed Funds rate to 3.0 to 3.25 percent, a level above what was considered neutral to the economy.

Of greater significance than the rate hike itself were the comments and forecasts of Fed Chair Jerome Powell and the 19 members of the FOMC. Powell reiterated the central bank's resolve to bring inflation back to its two percent long-term level and betrayed his belief that that effort would cause a recession in 2023. While that position was consistent with what Powell had been saying openly all summer, the forecasts of the 19 committee members seemed to shake the markets.

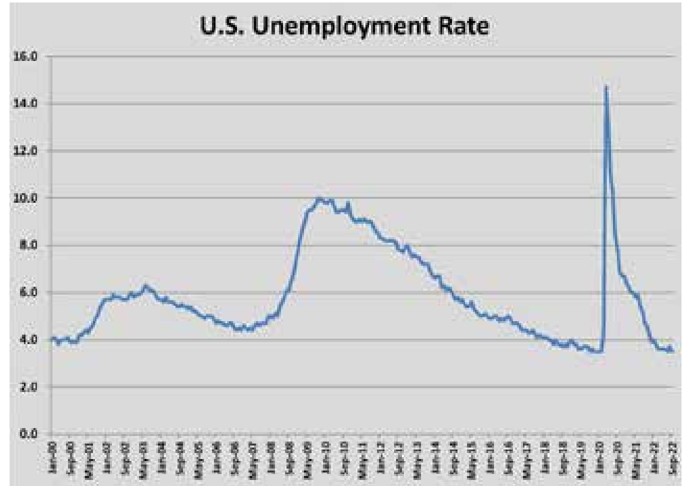
Members of the FOMC release their expectations for the Fed Funds rate at the end of each meeting. The dot plot of those expectations is usually a blueprint for rates in the coming quarters. Only one of the 19 members forecasted the Fed Funds rate to be below four percent when 2022 ends. All but one member forecasted the rate to be below 4.25 percent through 2023, with 12 of the 19 expecting the Fed Funds rate to exceed 4.5 percent. These same FOMC members expressed almost no expectation of rate increases in 2022, so the dot plot is not an accurate forecast beyond the next meeting or two; however, the strong consensus around the four-plus percent rate at the start of 2023 ensures that rates will go at least one percent higher after the November and December meetings have concluded.

The higher interest rate environment has had a chilling effect on commercial real estate (see page 51), but the Fed's actions have greater significance to the overall economy.

Leaving aside the debate about whether the central bank took inflation seriously enough, soon enough, the problem facing policy makers lies in the Jekyll-and-Hyde economy. Hiking rates by 400 basis points during the last three quarters of a year should bring the economy to a screeching halt, yet six months and 300 basis points into a tightening cycle, that is not the case. While the Commerce Department confirmed the 0.6 percent decline in gross domestic product (GDP) in the second quarter – marking two consecutive quarters of decline – many of the metrics of the economy are healthy. Unemployment remains unusually low, falling back to the pre-pandemic rate of 3.5 percent in September. Initial unemployment claims have fallen below 200,000 per week again. Continuing claims fell below 1.4 million, nearly 20 percent below the low for the pre-pandemic business cycle. Job creation was slower in September, but the 265,000 new jobs exceeded the consensus forecast for the month. Job openings fell by 1.1 million in August, but there are 5.1 million more unfilled openings than there are unemployed persons.



Expectations by FOMC members of higher rates for a longer period elevated recession concerns for 2023



Source: U.S. Census Bureau

Consumers are expressing their fears about the economy while spending at record levels, all while prices have been depressing their buying power. Consumer sentiment rose in August to a reading of 108. Factory orders for non-defense capital goods surged by 1.6 percent from July to August to $75.6 billion, surprising economists. The increase is evidence that businesses are continuing to invest in equipment, despite higher borrowing costs.

The housing market is an excellent example of the difficulty in measuring the effect of tighter policy. Housing is one of the first sectors to be hurt when monetary or fiscal policy becomes restrictive. And, so far this year, that has been the case. The average 30-year fixed mortgage rate was 6.7 percent at the end of September, more than 120 percent higher than one year before. Housing starts were off by nine percent year-over-year in August but have declined more steeply for the full year. New home sales rebounded by almost 29 percent in August – driven by a short-lived drop in mortgage rates – but are on pace for a 15 percent decline for the year. Existing home sales are off 19.9 percent year-over-year; however, the median home price was 7.7 percent higher than August 2021. While that level of home price appreciation was shrinking compared to earlier in 2022, the fundamental imbalance of supply to demand is unlikely to cause prices to plummet. In August, there were still 2.5 offers for each home sold.

This strange divergence in cause and effect from raising interest rates is evidence that the inflationary cycle is as much a product of supply not recovering from the pandemic as quickly as demand as it is a result of loose fiscal and monetary policy. Pandemic relief put trillions of dollars into the pockets of consumers and businesses, but prices remain stubbornly high well after those relief funds have been spent, even in the face of steep increases in the cost of borrowing. It is more likely that prices will begin to fall before the Fed can avoid a recession, but the upward pressure on rates will continue until unemployment rises above four percent.

Aside from the impact on the housing market, recession will slow commercial real estate more than other sectors. A

Source: U.S. Census Bureau, Federal Reserve Bank of St. Louis.

downturn will be felt differently from one property type to another.

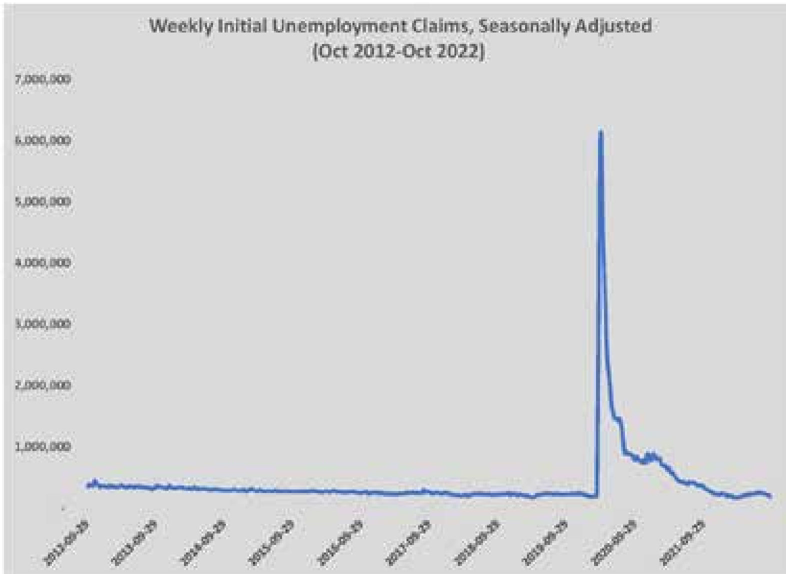
The office market is the largest commercial real estate subcategory. As a property type, office buildings have been under severe pressure since the pandemic disrupted the workplace. While a recession will likely decrease office employment, it is also likely to increase pressure on workers to return to the office. That may push occupancy levels high enough to halt the rising vacancy rates. Office vacancy rose to 12.5 percent in the third quarter.

Hospitality has rebounded smartly from its pandemic lows, with occupancy levels roughly equal to the same as October 2019. Average daily rate and revenue per average room are up by more than 15 percent year-over-year. Inflated travel costs and corporate cost-cutting will cool demand in 2023, likely offsetting the favorable conditions for foreign visitors to the U.S. Lending for new hotels and travel destinations is still tentative.

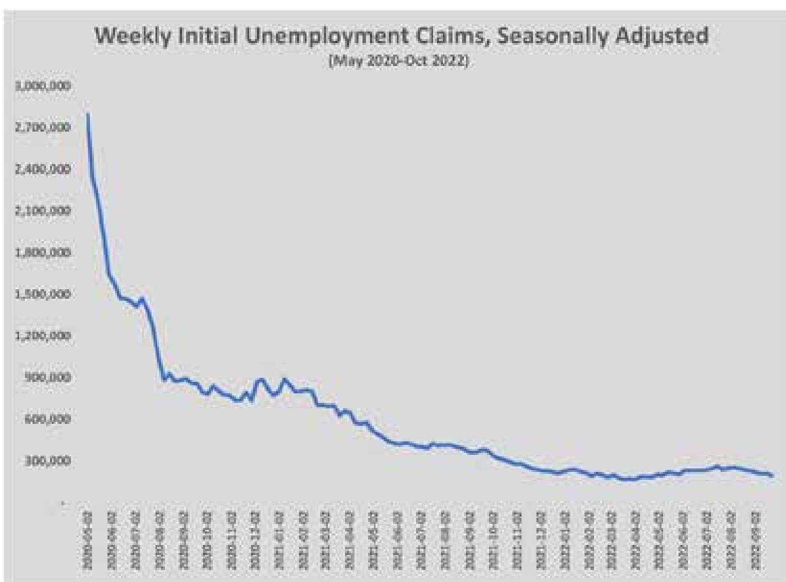
Retail properties were also devastated early in the pandemic, a tough blow to a property type already reeling from the impact of online shopping. Once vaccines were widely available, however, retail traffic surged, and retail properties have prospered since. Vacancy in retail is just above four percent and rents for retail have increased 4.4 percent year-over-year. Construction has not kept pace with demand, helping to absorb inventory. The outlook for retail is slightly negative, assuming that persistent inflation begins to be a drag on consumer spending in 2023.

Industrial properties remain the strongest commercial real estate category. Vacancy remains below four percent, an all-time low. Amazon's announced pullback on new construction will help keep net absorption positive and rents increasing. Construction demand will be supported by increased re-shoring of the supply chain and long-term growth of e-commerce.

The other winner of the pandemic economy was the apartment sector, particularly in desirable markets outside the major (expensive) gateway cities. Higher mortgage rates have been



Bureau of Labor Statistics, Federal Reserve Bank of St. Louis.



Bureau of Labor Statistics, Federal Reserve Bank of St. Louis.

a disincentive for homeowners to sell their homes, even as household formation grew. Financing and investor demand for apartments has facilitated a surge in construction, which has finally cooled rent growth. Vacancy rates are still at historically low levels but have gone higher for four consecutive quarters.

The most telling trend in the apartment market is the slowdown in net absorption. The quarterly average for 2022 has been 72 million square feet of net positive absorption, a rate that has been slowing as the year progresses. That compares to an average of 175 million square feet per quarter in 2021. Permits for multi-family units fell in August, to 571,000 units, but will need to fall well below 500,000 units to stop the downward trend in absorption.

The slowdown in commercial development has shown up in the construction data since June. Spending on commercial construction has been flat, at an annualized $112 billion, even though inflation has pushed higher by roughly two percent each month. The same has been true of construction spending overall. For August, the most recent month reported, overall spending fell only $8 billion compared to July. Construction spending is up 8.5 percent year-over-year, but that lags the 23 percent rate of inflation considerably. Only nine of the 39 sub-categories of public and private construction are negative year-over-year; however, only construction of manufacturing and water supply facilities have seen increases that outstrip inflation.

The outlook for U.S. construction in 2023 depends to some degree upon how much the economy slows, whether a recession is formally realized or not. There are bulwarks against much of a decline in construction spending. The steep decline in residential construction in 2022 will be a low basis from which 2023 will be measured and demand for new construction will be boosted by the tight inventory of existing homes for sale. Funding from the bipartisan infrastructure bill passed in 2022 will begin flowing through the state and local government to a higher degree in 2023. Interest rates should peak in the first quarter of 2023, so capital costs should be somewhat lower as the year goes on.

It will be the persistence of construction inflation and continued disruption of the supply chain that determines how much construction proceeds in 2023. While it seems inevitable that the Federal Reserve Bank aims to slow the economy to the point of recession, demand for construction has been pent up by higher costs and undependable availability for two years. Improvements in supply and/or relief from double-digit inflation could unleash pent up activity regardless of the strength of demand from the overall economy. BG


1926 - Eugenio Dozzi on the boat to America
1940 - Home building in East Liberty
1960 - JENDOCO Truck
1965 - Pete and Eugenio Dozzi
1952 - Pete Dozzi graduated from University of Pittsburgh
1968 - JENDOCO Office
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WHAT'S IT **COST?**

The October 12 report on inflation from the Bureau of Labor Statistics (BLS) showed a flattening of producer prices over the past 30-90 days that may indicate that price increases have peaked. But the rate of inflation compared to September 2021 remains elevated and, for construction, is nearly four times the rate of producer prices overall.

Producer price indexes (PPI) fell for construction metals and some of the products associated most closely with residential construction. That pushed the PPI for inputs used in nonresidential construction down 0.2 percent compared to August 2021; however, the change in PPI for nonresidential construction inputs from one year earlier was 12.8 percent, or more than four percentage points higher than the PPI for final demand overall. Moreover, inflation for nonresidential building construction, which includes the costs of labor and other contractor costs, rose to 24.1 percent year-over-year.

The decline in energy prices and global demand pushed steel, aluminum, and copper prices significantly lower compared to 90 days earlier. There was a 22.2 percent decline in the price of iron and steel scrap. The price of #2 diesel was also down significantly compared to June 2022, but a double digit increase in diesel since August represents a threat to the costs of construction, because projects require hundreds (or thousands) of truck deliveries of materials and equipment.

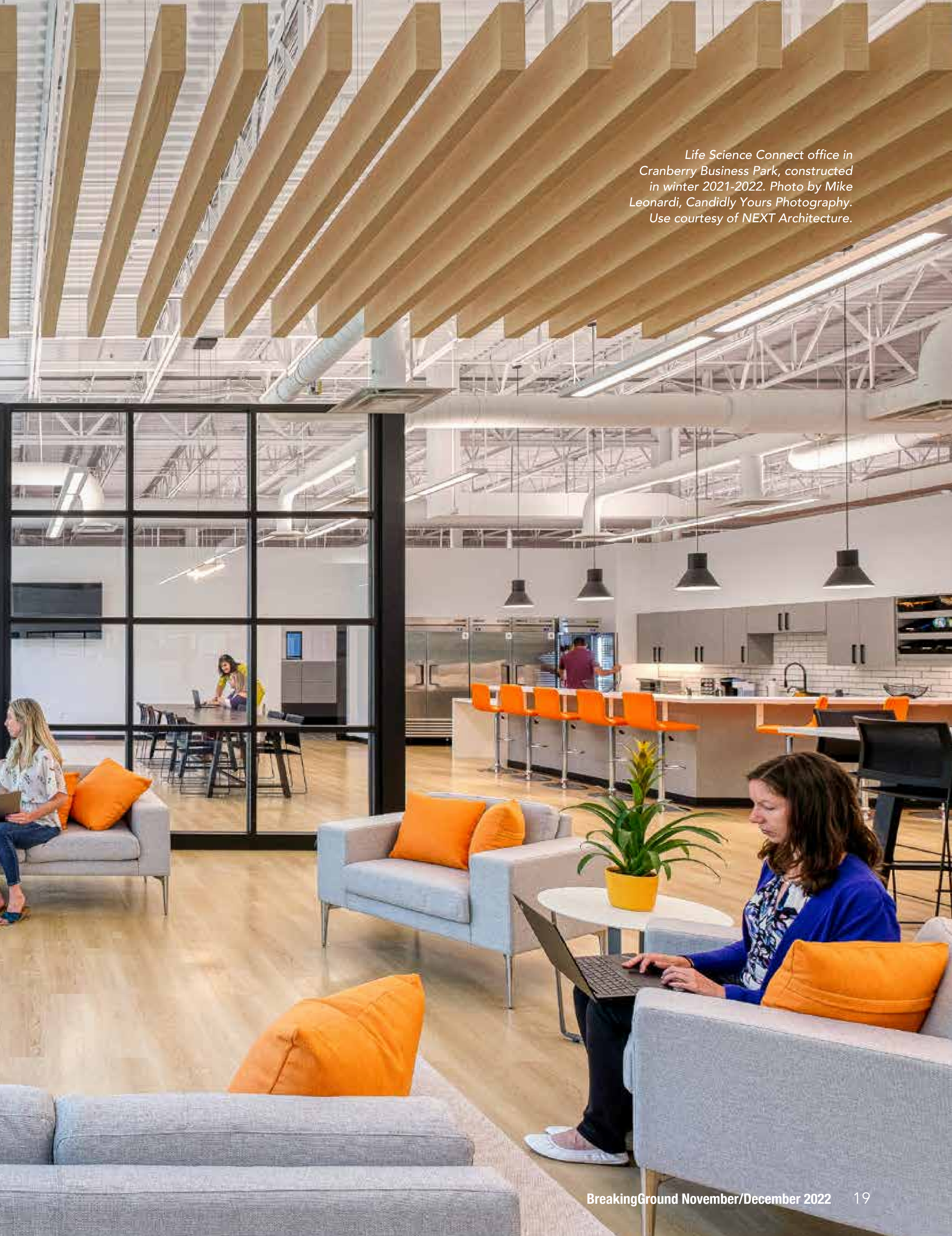
Even with the recent dip in some materials, prices of several widely used commodities posted double-digit increases over the past 12 months. The index for liquid asphalt was 43.3 percent higher, despite an 11.8 percent decline from August to September. The PPI for architectural coatings rose 27.2 percent over the previous 12 months. There were also double-digit year-over-year increases in the price indexes for materials used heavily in residential construction, such as drywall, which rose 18.4 percent, plastic construction products (17.9 percent), asphalt roofing materials (15.3 percent), concrete products, (14.3 percent), insulation (13.4 percent), and flat glass (10.3 percent).

September's stubbornly high consumer inflation will add to the pressure on the Federal Reserve Bank to maintain restrictive interest rates through 2023. The markets are betting that inflation will respond to that pressure by mid-2023. However, the lagged relationship between producer prices and construction put in place means that ongoing projects will continue to see costs that are 20 percent higher than in 2021 until spring 2023 or later. The BLS report found that the PPI for five major nonresidential building types – warehouses, schools, offices, industrial, and healthcare facilities – averaged more than 25 percent higher year-over-year. The PPI for warehouses was 33.4 percent higher year-over-year. Likewise, the increase in PPI for four types of specialty contractors – concrete, roofing, electrical, and plumbing – increased by an average of almost 9 percent. The latter reflect the bid prices from contractors, which historically lag increases in inflation by 12 to 18 months. Bid prices will remain elevated until disinflation trends for an extended period and margins begin to recover. BG

PERCENTAGE CHANGES IN COSTS	Sept 2022 compared to		
Consumer, Producer & Construction Prices	**1 mo.**	**3 mo.**	**1 yr.**
Consumer price index (CPI-U)	0.0	1.3	8.3
Producer price index (PPI) for final demand	0.2	(0.6)	8.5
PPI for final demand construction	0.4	5.6	23.1
PPI for new nonresidential buildings	0.4	6.0	24.1
Costs by Construction Types/Subcontractors			
New warehouse construction	0.2	5.9	33.4
New school construction	0.3	5.7	19.9
New office construction	0.2	5.3	24.4
New industrial building construction	0.4	6.7	28.0
New health care building construction	0.6	6.7	21.4
Concrete contractors, nonresidential	0.4	2.5	21.5
Roofing contractors, nonresidential	0.3	5.0	21.3
Electrical contractors, nonresidential	0.7	7.1	20.6
Plumbing contractors, nonresidential	0.1	2.5	11.7
Construction wages and benefits	N/A	2.0	4.0
Architectural services	0.0	0.3	2.3
Costs for Specific Construction Inputs			
#2 diesel fuel	11.7	(16.7)	65.9
Asphalt paving mixtures and blocks	(0.1)	3.8	22.4
Cement	1.0	4.5	10.9
Concrete products	0.9	4.0	14.3
Brick and structural clay tile	0.0	1.6	10.2
Plastic construction products	(0.6)	1.1	17.9
Flat glass	0.2	2.9	10.3
Gypsum products	(0.1)	3.2	18.4
Lumber and plywood	(4.3)	(8.5)	9.1
Architectural coatings	0.9	1.7	27.2
Steel mill products	(6.7)	(14.7)	(14.3)
Copper and brass mill shapes	1.1	(9.6)	(6.9)
Aluminum mill shapes	(1.6)	(10.4)	(3.4)
Fabricated structural metal	(1.0)	(2.5)	(16.6)
Iron and steel scrap	(3.6)	(22.2)	(23.8)
Source Bureau of Labor Statistics, Updated October 12, 2022			
Compiled by Ken Simonson, AGC Chief Economist			

OFFICE MARKET UPDATE

The problems facing the Pittsburgh office market in 2022 were mostly predicted as early as 2015. There were large chunks of space that were going to be available for sublease when big corporate tenants – Citizens and Heinz for example – relocated major workforces to other cities.



Life Science Connect office in Cranberry Business Park, constructed in winter 2021-2022. Photo by Mike Leonardi, Candidly Yours Photography. Use courtesy of NEXT Architecture.

To be competitive, landlords are investing in shared amenity spaces like this one at Cherrington Corporate Center. Photo by Candidly Yours Photography, courtesy A. Martini & Co.

The office employment growth engine of the previous decade, the energy industry, was in decline and the suburban campuses in Cranberry Township and Southpointe had growing vacancy. Then came the pandemic.

Since March 2020, attitudes about the workplace have changed in ways that were unforeseen and radically different from the previous norms. Forced to work from home, employees discovered the joys of not commuting and attending meetings in shorts.

Since the rollout of effective vaccines in spring 2021, a return to work has been mostly as safe as the conditions prior to the pandemic; however, the return to work has mostly not occurred. While only about one person in four still works remotely full time, office occupancy nationwide remains below 50 percent. In downtown Pittsburgh, occupancy has been stuck at 22 percent for months. Employers struggle to figure out what conditions will attract workers back to the office in sufficient numbers to allow for mentoring and maintaining culture. Workers are enjoying their current leverage in the marketplace and find they can resist returning to the office. Market experts predicted a resurgence in office occupancy after Labor Day 2022 that has not materialized, although occupancy has jumped higher. The future of the office is still very much a mystery.

That mystery is wreaking havoc on office property owners. The uncertainty about what tenants will want and demand makes it difficult to plan and operate. And yet, there are some trends that have emerged that offer some glimmers of what the office market will look like. Office tenants will almost certainly require less space for the same number of people than before the pandemic. The office has an increased

bearing on talent attraction and retention. Newer, higher-quality buildings with more amenities are proving more attractive than cheaper buildings.

The dislocation caused by the pandemic spawned numerous predictions about the future of office. Few of them have proven to be true or durable. Those that have come to pass may yet fade or mutate. But leases continue to be signed. The business of office endures. It will be different, but that is nothing new.

Fundamentals

The headline for the Pittsburgh office market report for the third quarter of 2022 is decreasing vacancy (slightly), declining rents (even more slightly), and improving absorption. Against the backdrop of uncertain future office requirements, the market fundamentals in Pittsburgh can be accurately described as holding their own.

That compares favorably to the overall U.S. office market, which experienced negative absorption of 18.5 million square feet from July to October and saw vacancy rise to 17.8 percent, according to Cushman and Wakefield. The mid-year cumulative net absorption was 12.6 million square feet, according to Newmark, so the trend of roughly six million square feet of negative absorption is continuing.

Negative absorption is normal in a recession, as companies shed workers and require less space. The U.S. economy has not been declared in a recession so far in 2022, but the downsizing trend does exist because of the prevalence of work-from-home. Brokers generally count the average lease term as seven years (commercial office leases typically run five-to-ten years), so about 15 percent of the office leases expire annually. With about half the office workers away from the office daily, the opportunity to reduce the footprint at renewal is being taken by tenants. And, with new construction continuing, more space is available than is being leased.

The same opportunity for downsizing due to work-from-home is present in the Pittsburgh market, but tenants seem to be reacting to the temptation less than in other markets. Pittsburgh's absorption rate also benefits from the relatively small volume of new construction.

Office construction in Pittsburgh has followed the changes in supply and demand since the recovery from the Great Recession. Given today's market conditions it is easy to forget that the lack of contiguous space was the big problem in the market in the mid-2010s. Looking back to 2014 through 2016, the total construction dollars spent on office space in the seven-county region averaged less than $290 million per year. That is roughly what should be the total spent in 2022. In 2022, however, only 460,000 square feet of new office space – either for rent or owner-occupied – will be started. That is half the total new construction in 2014, and almost 300,000 square feet less than the average built in 2014-2016. A smaller share of the construction dollar was spent on tenant improvements in 2014 than in today's marketplace.

In 2021, developers and owners responded to the uncertainty that the pandemic brought to the office by starting only 448,943 square feet in new office buildings. But the higher office vacancy rate – especially Downtown – created more opportunities for tenants to move and that showed in the total office construction spending, which was the highest in a decade at $566 million. New construction of office space should be slightly higher in 2022, but only because two new buildings got underway – Diamond Ridge One and 3440 Forbes Avenue – that total 370,000 square feet.

Construction cost inflation is a factor that further complicates the outlook. Typical office design involves materials that have not seen significant moderation as the housing market has softened. The declining cost of energy throughout the summer helped ease inflation on steel and other industrial metals, along with bringing some relief on shipping, transportation, and costs related to the price of oil. But even drywall and construction plastics, which tend to rise and fall with residential demand, remain elevated. According to the Bureau of Labor Statistics, the producer price index for new office construction rose 0.5 percent from August to September and is 24.2 percent higher year-over-year.

Oxford Development's vice president of development, Mike Barnard, says that his firm has looked at other construction methods that might be less expensive, but the code and occupancy requirements of office buildings make it difficult to pivot to wood framing or modular construction in the way that homebuilding can.

In general, it is not viewed as a favorable thing for construction to have costs rising rapidly and demand for space so uncertain as it is now; however, for the long-term health of the office market in Pittsburgh, there is some serendipity to the fact that new office construction was in a lull as the trying market conditions settled in.

During the third quarter, transaction and leasing volume remained slow, but there were a few significant deals done and more than 330,000 square feet of new leases were signed. The largest lease signed was at Gateway Center, where Citizens Bank agreed to take 60,000 square feet in 2024. Sublease activity increased, although more than 1.9 million square feet of space is available for sublease, according to Newmark. JLL pegged the year-to-date absorption of sublease space at more than 240,000 square feet, indicating that tenants are taking advantage of the sublease opportunities to get bargain rents. The amount of space declared available for sublease will keep pressure on rents for the foreseeable future.

The four major commercial real estate companies that published Pittsburgh office market reports put the average asking rent in the range of $25 to $27 per square foot, with the Class A rent in the range of $28 to $30 per square foot. CBRE reported an average asking rent of $24.74, with Class A at $29; Cushman and Wakefield reported $25.46 and $28 respectively; JLL reported $26.86 and $30; and Newmark reported $25.78 and 29 respectively.

Asking rents have been steady at near record high levels throughout the pandemic; however, the downward market pressures are bringing effective rents lower.

"What has gone up is the concessions that landlords are willing to make. Landlords are giving free rent and larger tenant improvement concessions. Those effectively reduce the rental rate," explains Gerard McLaughlin, executive managing director at Newmark.

In the acquisition market, there were too few transactions so far in 2022 to get a reading on the trends in office property values. It is unlikely that the appetite for office properties will improve until there is a better sense of occupancy levels that are durable. While that remains true, the rapidly rising interest rate environment has dampened enthusiasm for all commercial real estate property types.

"I have not seen the sentiment towards the office asset class be more negative than multi-family or retail. I think the interest rate environment has jolted all investors on all fronts," says Jason Campagna, managing director at SVN I Three Rivers Advisors. "Cap rates are rising and are expected to continue to rise. You simply can't sell a six-cap rate property with six percent interest rates. Most private equity funds have to show a return to their investors. There is an impact on demand and the number of buyers, but not specifically to office."

The Problem with the Office

Prior to March 2020, the office market was anything but stagnant. There were several long-range trends that were driving space demand, as well as some uncomfortable landlord adjustments. Most of the trends impacting the market prior to the pandemic were the result of demographics or the shift in economic winners. Specifically, offices were changing to accommodate the younger cohort of workers, and to provide more space for technology companies that were dominating the economic landscape.

The former trend was a product of the size of the Millennial generation entering the workplace and the particular perceived demands of that generation. Post-pandemic, it is difficult to recall how developers were responding to those perceived demands for more live/work/play environments. Office building owners were beginning to feel the need to create common area amenity spaces, both inside and outside the buildings. Tenants wanted to be located in buildings that offered places to eat and relax, or be within walking distance of those places, to keep their employees from getting in their cars and leaving campus.

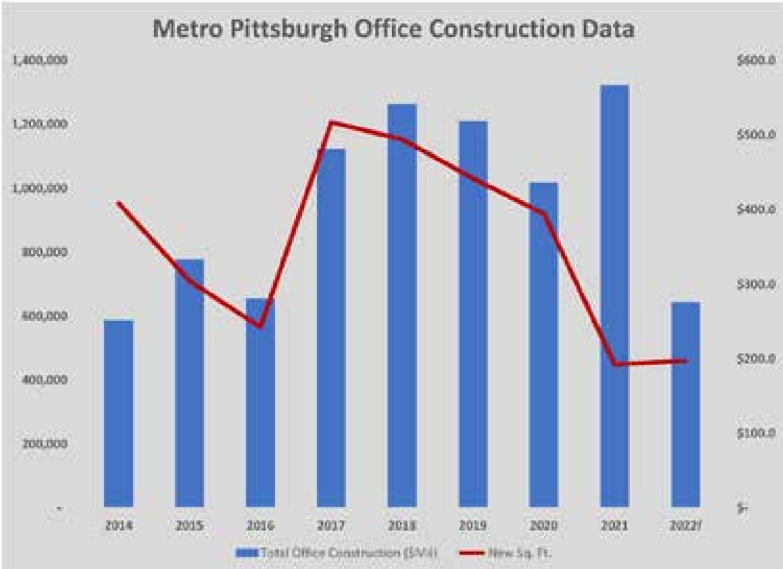
Technology companies in many industries were the growth engines of the 2010s. The growth of Google, Amazon, Facebook, Apple, and their peers resulted in millions of square feet of new space, most of which was clustered in a few cities. Cities that had become centers for emerging technology also boomed as these industries grew rapidly. Seattle and Silicon Valley may have been the epicenters, but places like Austin, Boston, Nashville, Atlanta, and even Pittsburgh saw the demand from tech companies drive absorption.

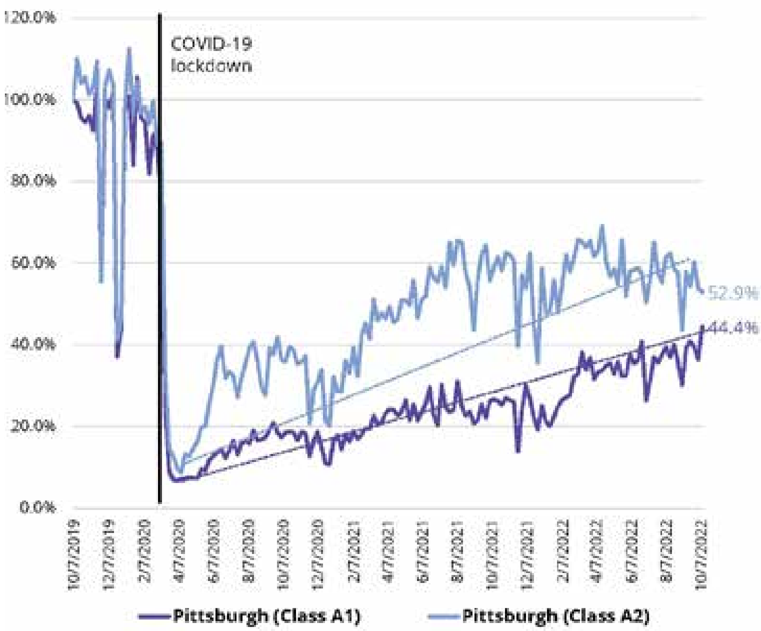
In Pittsburgh, the office market was facing challenges that were different from the gateway markets and peer cities. By the mid-2010s, the oil and gas industry had begun to decline when prices tumbled from oversupply (primarily from the shale gas boom that benefitted Western PA). As the energy companies began to downsize and consolidate, head counts plunged. Office space in suburban Pittsburgh became more vacant. Places like Southpointe and Cranberry had not seen overbuilding in the previous decade, but the market of energy companies leasing there hurt those sub-markets when the industry declined. Vacancy jumped to 20 percent or higher.

Meanwhile, the Central Business District (CBD) was experiencing its own heyday in the 2010s, as a combination of employment growth and strategic repurposing of office properties pushed the vacancy rate from 20 percent to single digits by the middle of the decade. The occupancy rate of the office properties available for lease (i.e. excluding owner occupiers like PNC Financial Services Group) swelled to more than 86 percent. By 2017, however, there were some drags on the CBD market emerging. Several corporate headquarters moved from Downtown and some key tenants – notably Citizens Bank – announced downsizings that were going to create vacancy by the end of the decade that would push the rate higher by several percentage points.

So it was that in March of 2020, Pittsburgh's office market was softer than its overall economy may have suggested. It was into that environment that the pandemic occurred. In the 30 months since public policy mandated that workers stay away from their offices, the fundamental problems facing the office market have not improved, and the problems caused by the pandemic have added pressures that landlords could not have imagined in 2019.

The greatest added pressure facing the office market is, of course, the steep decline in daily occupancy. After the lockdown phase of the pandemic passed, employers and employees made accommodations to working from home that were necessary because demand began to return to





Avison Young's Vitality Index, which uses smartphone activity to measure occupancy, tracks the number of people returning to the office in 20 Class A buildings in downtown Pittsburgh. Compared to the first week in October 2019, occupancy is 46.5 percent in October 2022. Older Class A properties (Class A2) have recovered to 52.9 percent of the 2019 levels. Source: AVANT by Avison Young, Orbital Insights.

the economy. Being "just as productive" – as many claimed during 2020 – was not difficult when demand fell 30 percent overnight. To keep up as consumers and businesses began to return to normal activity on at least a limited basis required adaptations, mainly to technology, that made work-from-home more productive. The emergence of the Delta variant in mid-2021complicated plans to return to the office after vaccines were made widely available. Work-from-home habits became entrenched.

By the time the Omicron surge of winter 2022 faded, those habits had calcified. Occupancy levels vary from city to city but remained almost constant during the past spring and summer. Throughout the U.S. that level was between 40 and 44 percent, according to Kastle Systems, a workplace consultant that has been tracking occupancy levels in 10 major cities during the pandemic. That was about the level of occupancy in Pittsburgh overall. In Downtown, occupancy was much lower but was also constant, leveling off at 20-to-22 percent.

The new expectation of some continued work-from-home and office mix is a headache for office property owners, tenants, real estate brokers, and businesses in general. While the biggest problem of the hybrid workplace remains the uncertainty associated with its future, there are other headaches that hybrid work creates.

"The biggest loser in this is the young workforce," says Jim Scalo, CEO of Burns Scalo Real Estate. "I think there is a lot of social anxiety and businesses are allowing the employees to be in charge. I think people want to be led. Employers are doing a disservice to their employees. I'm shocked with stocks down 20 percent that boards of directors are not demanding more from the CEO."

"Employees are in a position where they are dictating whether they will go back to the office or not. You can understand why people would want to work from home," says McLaughlin. "Historically though, you worked at an office with fellow workers together to an end, hopefully a profitable one. I'm anxious to see how companies will train people and create their culture with people working remotely."

"Collaboration still matters. Whether people are working 40 hours a week or 60 hours, if they are not together the work is not as good," continues Scalo. "The other quality that is lost is loyalty. That is a magic word for someone who has built an organization and who cares about their people. Loyalty and trust are hard to build when you are not together."

Virtually all business owners echo Scalo's concerns about the benefits of working together that have been lost over the past three years. In an environment where there are twice as many open positions as there are people seeking jobs, businesses have less leverage to demand workers return to the office. At the same time, much has been learned since March 2020 about working remotely. While learning and adapting to be productive from home, workers have also discovered that there are some work/life balance benefits to the office, including satisfying the need to socialize. Hybrid working has become entrenched, but work-from-home has lost some of its sheen.

According to Bianco Research, the percentage of employees who worked exclusively from home as a result of pandemic-induced policies fell below 25 percent in August. Most business and professional workers, including architects and engineers, had fewer than 15 percent still working from home full time.

Discerning workforce attitudes is anything but straightforward. Even the most thorough surveys are showing that large segments of the workforce do not share the opinion of the majority of respondents. Surveys measure the responses of workers at a fixed point in time, but the attitudes about pandemic life have mutated frequently. And attitudes may mutate further in a recession.

A survey by JLL, published at the end of August 2022, found that 44 percent of workers wanted to return to the office at least two days weekly. Nearly all workers said that a hybrid workplace was the expectation, regardless of industry. Workers at professional service and life science companies were far more likely to want to return to the office. Those involved in healthcare and technology were least likely. The survey found that 52 percent of respondents saw socialization as the most important reason for returning to the office.

Two important conclusions that JLL drew from the responses were that employers and employees had taken measures to make home more functional, increasing the productivity of work from home. In fact, only 21 percent of workers reported needing the office for resources. The starker conclusion came from a high (15 percent) share of workers who reported that there was no benefit from going to the office. JLL's advice to employers wishing to spark a return to office was to sell the benefits of the office better.

The Outlook: Recovery or Reconfiguration

Employees have consistently cited flexibility and the lack of commute as the biggest advantages of work-from-home. Employers can be more flexible about work/life policies. They cannot do much about the commute, except to make the office experience worth the time sacrificed commuting. There is

Vision on 15th is the first of only three major speculative office buildings under construction to be completed.

ample evidence that employers are doing just that, seeking buildings that are newer and offer desirable amenities. Kim Ford, CEO of Rise Pittsburgh, notes that tenants are looking for what she refers to as "five in five"–five amenities within five minutes' walk.

"Clearly the biggest trend in the office market is right sizing and upgrading to better space. There is a bifurcation occurring in the market where the Class B buildings, the pre-war buildings, are suffering. They are losing their better tenants to better quality buildings, which in Pittsburgh still means buildings that are 40 years old," says Dan Adamski, senior manager in JLL's Tenant Representative Group. "There is no bigger trend than that because it is also what is behind the talk of conversion of those older buildings to residential. I don't think the landlords want to convert them to residential, but I think they have no choice."

Landlords of buildings that are competing for tenants have taken notice of the trend. Owners have spent millions converting rentable space in their buildings to spaces that are lounges, eating areas, gyms, meeting rooms, and other uses that employees of tenants would find attractive. Beyond the capital outlay, the investment in amenity space results in lost rent that may be compounded two or three times.

"For a 100,000 square foot office building, for example, you could easily put in $300,000 or $400,000 in simple amenities. That's not space that is rentable," says Bill Hunt, CEO of The Elmhurst Group. "The other problem with the amenity space is that you are building out spaces that the tenants may have previously used in their own space and can reduce what they are renting from you. That's a double whammy but that's the competitive nature of the market right now."

"The demand for amenities is real. We used to build lobbies that were as small as possible. Now we use those to make the property more attractive to our tenants," says Scalo. "I don't know if I can put a percentage of the total cost on it, but the amenities can run in the millions of dollars."

Scalo believes amenity spaces are going to be permanent common areas for the benefit of the tenants, much like elevators and common toilet rooms. If that is the case, amenities will become part of the common area charges.

Michael Connor, senior director, office services for Hanna Langholz Wilson Ellis, thinks amenity offerings are a key to attracting younger workers back to the office. He suggests that experiences that make the commute worthwhile will be a draw.

"If you want to see employees in their 30s showered and at their desks at 8:00 in the morning, put a gym in the office," Connor says.

To a larger degree, it is the competition for workers that is characterizing the office market as much as the competition for tenants. Real estate has been a tool for attracting and retaining talent for the past five years or so. Today, it is a tool for getting talent to utilize the office. Up to now, most attempts to mandate a return to office have failed to gain traction. With a few high-profile exceptions – notably the

JLL Research Report

Office Statistics

Source: JLL Pittsburgh Office Insight Q3.

	Class	Inventory (s.f.)	Total net absorption (s.f.)	YTD total net absorption (s.f.)	YTD total net absorption (% of stock)	Direct vacancy (%)	Total vacancy (%)	Average direct asking rent ($ p.s.f.)	YTD Completions (s.f.)	Under Development (s.f.)
Northern I-79 / Cranberry	Totals	4,632,441	27,089	44,740	1.0%	16.9%	21.8%	$24.86	0	0
East	Totals	3,495,270	26,594	27,627	0.8%	26.5%	26.7%	$20.33	0	0
North	Totals	3,347,964	-2,269	8,947	0.3%	13.6%	13.7%	$21.79	0	100,000
South	Totals	2,687,470	13,596	8,223	0.3%	12.8%	12.8%	$20.56	0	0
Southpointe	Totals	3,750,244	16,710	220,475	5.9%	14.6%	20.4%	$22.11	0	0
West	Totals	8,810,947	-25,349	103,990	1.2%	20.9%	21.5%	$22.00	0	172,000
Suburban	**Totals**	**26,724,336**	**56,371**	**414,002**	**1.5%**	**18.3%**	**20.2%**	**$22.05**	**0**	**272,000**
CBD	Totals	22,126,351	-128,549	-186,296	-0.8%	16.9%	19.1%	$28.32	0	458,000
Fringe	Totals	9,908,459	7,168	-29,065	-0.3%	18.4%	22.0%	$29.64	239,990	0
Oakland / East End	Totals	4,249,603	-2,065	114,299	2.7%	29.7%	30.8%	$36.61	451,375	105,000
Urban	**Totals**	**36,284,413**	**-123,446**	**-101,062**	**-0.3%**	**18.8%**	**21.3%**	**$30.26**	**691,365**	**563,000**
Pittsburgh	**Totals**	**63,008,749**	**-67,075**	**312,940**	**0.5%**	**18.6%**	**20.8%**	**$26.86**	**691,365**	**835,000**

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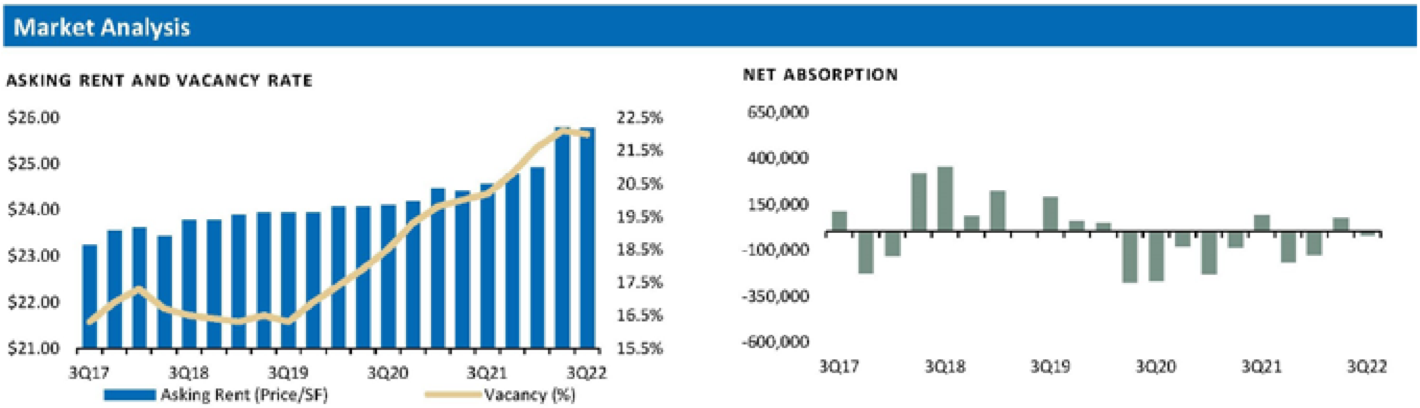


NEWMARK

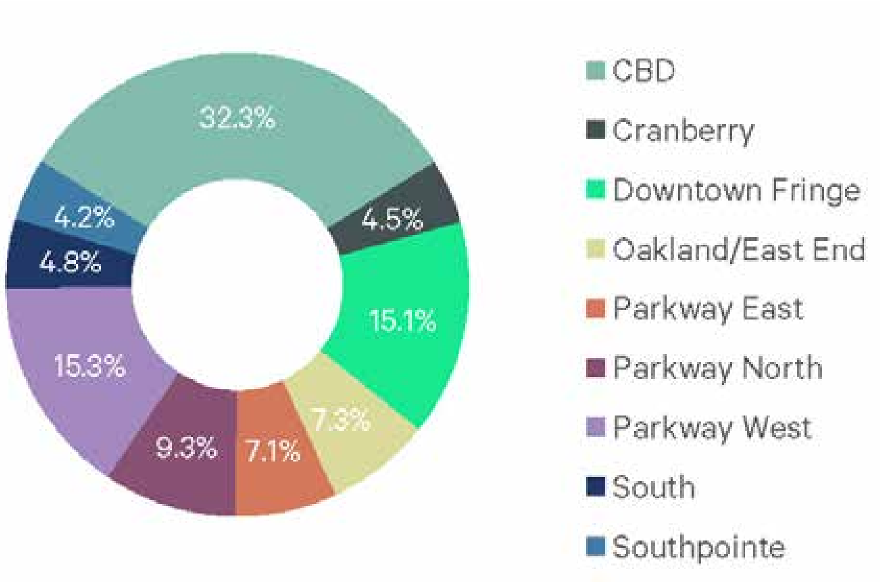
Source: Newmark Pittsburgh Office Market Report Q3 2022.

recent mandate by Goldman Sachs – the return to normal has meant adopting a hybrid of home and office.

"There are structured hybrid programs and there are many of them. The most common is a Tuesday-Wednesday-Thursday mandatory office appearance, with Monday and Friday work from home. That's seven out of 10 that I am aware of," reports Brad Totten, principal and managing director of Avison Young's Pittsburgh office. "While the plans are structured, the enforcement, almost without exception, has been lax. Our corporate clients tell me privately that the response has been somewhat flexible. They say they are trying it and are getting a better response since Labor Day, but certainly not at a pace that would get us back to normal anytime soon."

"Highmark is a good example. They have a work from anywhere policy that has been enacted," says Adamski. "Part of the issue with hybrid is defining what it is. Almost every company I'm working with has a hybrid policy to some extent. Other than one bank I know that is mandating five days a week in the office, every company has some amount of work from home."

Hybrid home/office policies have also mostly been flexible. That will work in the employer's favor if, over time, employees begin to feel that they are missing something from not being in the office environment, or if an economic downturn elevates fears about losing jobs. There is an element of fatigue being expressed by people who are working primarily from home. That was one of the reasons that there was a sense that office occupancy would spike after Labor Day.



The CBD and CBD Fringe comprise nearly half the total office inventory in metro Pittsburgh. Source: CBRE Pittsburgh Office Q3 Report.

There is data that suggest that Labor Day marked a change in sentiment, but it was hardly a spike. In the week following September 7, 2022, Kastle Systems tracked a three-point rise in occupancy to 47 percent. That trend has continued, with occupancy measured just under 50 percent at the end of October. Pittsburgh is not one of the cities that Kastle tracks, but brokers agree that occupancy has increased since Labor Day.

"If there wasn't an immediate effect, the point was to start pushing people back to the office. None of my clients have said they pushed people back to the office after Labor Day, but I think that's a regional Pittsburgh thing," says Connor. "Goldman Sachs is an example of a company that wanted employees back for a long time and used Labor Day as a date to say put

up or get out. Globally there hasn't been a mass jump but I do think we will look back at this Labor Day weekend as a point in time when things changed."

Assuming things continue to change, a shifting hybrid model will make the real estate calculation that much more difficult. A hybrid policy raises a number of management concerns, but is a particular challenge for calculating space needs.

"Five days a week is easy to solve for. If workers are coming in just one or two days a week you have opportunities to downsize, but if people are coming in three or four days a

week it's a struggle," says Adamski. "Workers all tend to come in the same days in the middle of the week.

The way companies are dealing with it is to add more unassigned seating. That is how companies are accommodating the variability of hybrid work."

"If you are doing a hybrid model, how does that equate to a real estate allocation and the spend on real estate? What I am seeing our clients do is make compromises internally because the workspace is different," says Connor. "Employees are going to have to make trade-offs. If they want a great kitchen and ample meeting spaces, employees who are only

"Down the road, I think if you can provide the right location, the right service, and the right rent structure, you can still win at the office game with the tenants."

in the office three days a week may not have a dedicated private office. It's an important time for employers to engage their employees and figure out how they work. It's difficult to manage that without giving preferential treatment, but I think you'll see that people who use the office more have preference over what is going to be there."

No matter how flexible an employer or landlord is about hybrid work, one in seven tenants will need to make a decision about its space in the coming year when its lease expires. That dynamic alone means that the office market will continue to change. The painful reality for landlords is that in times like 2022, when vacant space is plentiful, there will be more opportunities for tenants to change buildings or significantly upgrade existing spaces. That means the market for tenant improvements will be stronger for the next couple of years. What is the outlook for new construction and development?

For the time being, new development is mostly frozen. The Vision on 15th is delivering 230,000 square feet into the market now, with Allegheny Technologies already on board for its headquarters space and The Puttery taking 19,000 square feet of ground floor retail/commercial space. Beyond that, the 170,000 square foot Diamond Ridge One office in Moon Township and the roughly 300,000 square feet of rentable space at FNB Financial Center in the Lower Hill are the only major spec offices under construction. The 3440 Forbes Avenue project is aimed at the life sciences slice of the market and, therefore, unlikely to be a commercial office consideration.

In the Strip, two other major developments are in a holding pattern. AM/Wooly Group is currently demolishing the massive Wholey's cold storage building at 1520 Smallman Street, but the proposed 500,000 square foot office, to be built by the PJ Dick/Dick Building Company team, is searching for a lead tenant. Although 1520 Smallman is being marketed actively, construction is unlikely to start until after 2023. The remaining parcels of 3 Crossings include 350,000 square feet of office space to be built, but Oxford Development is also looking for tenants and does not expect new construction next year.

Commercial real estate is nothing if not cyclical, even in markets with a reputation like Pittsburgh's for being slow and steady. While most of us are ready to see the pandemic in the rear-view mirror, we are likely to be dealing with it, or its effects, for a few more years. That will probably mean a few years more of uncertainty about the workplace. As difficult a time as this is for office owners and developers, there have been more difficult markets in recent memory. Certainly, the loss of heavy industries and the corporations that served them in the 1980s created a greater challenge to the office market. Now, as then, people will still need places to work. And there are reasons to believe that the office of the future may not be so different from the office of the past.

"Clearly, I am glad that we also have industrial and hotel properties," laughs Bill Hunt. "Office will be challenged for some time. It's our belief that tenants will come back over time. Office is certainly not going away. It may be reengineered in a different manner or to different uses, but there will still be office. We do not feel now is the time to get out of the segment. Down the road, I think if you can provide the right location, the right service, and the right rent structure, you can still win at the office game with the tenants." BG

Photo by Massery Photography.

PROJECT PROFILE

TWO DOUGHBOY SQUARE

Luke and Chip Desmone moved their office into what was a dilapidated, but iconic, former bank at the intersection of Butler Street and Penn Avenue in 1992. Over the next 30 years, the firm grew, taking over more of the building until the staff was larger than the building could serve. When the firm approached 37 people in the mid-2010s, the Desmones began looking at the parking lot and related land they owned to the east of Doughboy Square for expansion, ultimately choosing to build a two-story addition of more than 17,000 square feet. They selected Jendoco Construction Corporation as general contractor to help them navigate preconstruction and build the new space.

The project was a validation of the Desmone's early investment in Lawrenceville, well before it was a chic zip code. Chip Desmone ruefully recalls demolishing a small retail building that was on the property adjacent to Doughboy Square because its value was less than the cost of replacing its roof. Thirty years later, circumstances in Lawrenceville improved.

"What gave us the ability to put the addition on our building was the fact that the value of the dirt increased to the point that it was equivalent to the equity needed to borrow the money," says Desmone. "The fact that we could have a ready tenant for the space made it a viable thing to do. Since we have been here and been an active participant in the Renaissance of Lawrenceville, we never considered another option anywhere else. It was never on our radar to leave a place that was transformational to our business and our lives."

During 2017, Terry Oden, the project architect, and Eric Booth, the principal in charge of the project, worked with the staff at Desmone and Chip Desmone, as owner's representative, to develop a design that met the needs of the firm and demonstrated what its designers were capable of doing. There were several interesting challenges to meet.

"When you're designing for a group of architects and designers, everyone is a critic. It was a challenge to come up with something that represented us well, that we could afford, and could respond to the challenges of the market," says Booth. "Ultimately, we are tenants in this building. We couldn't go crazy because this building, at some point the future, could be used for something else."

One of the challenges involved the adaptation of the program to an unusual topography, even for Pittsburgh. For those not familiar with Doughboy Square, the property is a triangle at

Photo by Massery Photography.

the intersection of Penn Avenue and Butler Streets. Although the site of the addition was narrow – Penn Avenue and Butler Street are separated by roughly 60 feet – there was a difference in elevation of more than one story height from one street to another. The two streets have differing property uses and massing for neighboring buildings.

"There were three conditions we tried to address. The addition is a building of two facades. One is on a commercial street, Butler Street, and the other, Penn Avenue, is on a residential street. So, it does have two different feels to it," says Oden. "The other thing that makes the project interesting is that we're on a triangle or trapezoidal site. How we massed that into place was interesting. The final condition is that it is a split level. You can enter on Butler Street where our parking garage is, or you may enter the main level on Penn Avenue in a couple of locations as a pedestrian. Getting those three things into place set the trajectory for the project."

The connection between the existing building and the addition was another challenge, as was the direction that the design of the new construction would take.

"It's difficult to add on to a beautiful existing building that we couldn't build today. How do you design a building that is respectful of that?" asks Booth. "There are two faces to the addition, the Penn side, and the Butler side. Because Butler Street is inherently more commercial, we went with something that was deliberately more commercial looking. It is north facing so we get a lot of diffuse light. And by creating something that's more modern it's something that is deliberately different from the original.

"We knew we could not duplicate the detailing of the original building, so by doing something that is complimentary the idea is that there is a dialogue between them. The stairwell acts as an intermediary between the two. The pattern of the mullions on the new storefront follows the three-bay configuration that is present on the existing building. We took the same arched three window concept from the existing building and applied it to the addition. That speaks to the original rhythm and structure of the existing building without imitating it. On the Penn Avenue side, we went with brick because the nature of most of the buildings on that side is residential and there are more brick buildings there. We felt it was more appropriate to do a punched opening in brick walls, but we did that same three-bay scheme for the windows."

The transition between the old and new construction is a staircase, located in the center of the buildings. While that made sense from a planning perspective, locating the staircase in the center meant connecting the structures through the former bank's massive concrete and steel vault.

"We had to cut through several feet of concrete wall. Structurally they are two separate buildings. We didn't want to integrate it to the point where the two buildings didn't move separately. We made the transition between the two buildings with expansion joints that were hidden by metal panels," explains Rob Borland, senior project manager for Jendoco Construction. "The real transition is at those openings between the two buildings.

Building the set of stairs in that Butler Street corner was very complicated. We had to make sure we were hitting the different elevation to connect the two buildings. It took some extra effort in layout and communication between us and the miscellaneous metals contractor."

Jendoco and Desmone Architects worked for several years to refine the plans to make construction feasible. Once construction began in February 2018, however, the real collaboration began.

"Terry Oden was able to manage the expectations on the design side. Chip and Luke were both involved, which was great for dealing with unforeseen items. They also helped us through some of the details that were not worked through entirely on the drawings," says Borland. "Terry was with our site superintendent, the late Dale Greenawald, daily, checking in and working through the details. That was a real positive. The difficulty was that they continued to evolve the design because they could. They continued to refine elements, which ultimately helped the building, but presented a challenge nonetheless."

"We felt very close with Jendoco and its team. The superintendent on the project was a critical piece of the project. We had daily conversations of 15 to 30 minutes in the morning," recalls Oden. "It was also critical that we had Luke Desmone working on this. He, Chip, Rob, Dale, and I would have lunch once a week to talk about the project. There was really great coordination with all of the subcontractors as well. For example, there were masonry items handed directly to Marsa that may have been purchased during the lunch hour. We were constantly aware of the construction aspects of the project."

Borland noted that tight urban setting, while not unusual in Pittsburgh, needed constant management.

"There was very little space for lay down. We had to work on both Penn Avenue and Butler Street and had to ensure that pedestrians had access to sidewalks. We had to lease parking spaces so that pedestrians could have walkways," he says. "We leased staging in other locations to store materials. When we did the steel erection, we were able to work with Chip to use the parking lot next door to bring in and set up a crane. Another challenge was that, even though we were not working in the existing building, we were working directly beside it. It was occupied space, so we had to be careful about noise, odors, dust, and debris."

Perhaps the biggest challenge of the project was meeting the goal of WELL certification. The WELL Building Standard, like LEED, establishes measurable steps in the design and operation of a building that will optimize the health and well being of its occupants. Chip Desmone says he pushed for WELL certification, despite the difficulty.

"It was a cultural decision around our desire to have the best possible space we could create for our employees to work in a healthy way. It just so happened that we moved in the year before the pandemic hit and we were in the safest office building to occupy in the city," he says. "We wanted to build it


Photo by Massery Photography.

WELL-certified to demonstrate to our staff and to our clients that we could do something at the cutting edge of design and well health. We are a smarter architectural firm for having done it."

There are areas where WELL and LEED overlap but the former includes facets of operating that are not directly related to construction. WELL certification has standards for water, light, nourishment, comfort, air, fitness, and mind. WELL buildings have lots of natural light and vision to the outdoors, enhanced ventilation and air filtration, water filtration, and spaces devoted to physical well-being. The latter includes spaces to exercise and eat that are accessible and hygienic. WELL certification also requires accommodations and encouragement of healthy behaviors.

"We learned a lot working on the first WELL-certified Gold project. It wasn't very different from what you expect in a sustainable building. We learned a number of things through design about the WELL program," Borland says.

"What came with the WELL certification was not just how we were going to design the physical space, but how it was going to be used, maintained, and serviced. Generally, as architects we consider whether something we choose is going to be hard to maintain but, in this case, we had to be very specific about where things went, what the actual schedule for maintenance was" explains Booth. "That's something that we don't normally get into. Obviously, like with any project, it was a challenge to balance the budget between the shell, the fit out, and the furniture."

Balancing the budget was more challenging with the firm's founder, Luke Desmone, intimately involved. The project was a labor of love for Luke, who passed away in February 2022, which added a layer of difficulty for his representative.

"My main challenge was trying to control my dad's spending. I am not joking about that," Chip Desmone says. When asked how he fared at that task, Chip laughs, "Not too well! We had Roman brick custom made to match the original building from 1902. We had a quote from Winston Churchill carved in stone on the cornice of the building!"

There are many examples of individual contributions to the building by Desmone Architect team members. Booth and Oden recalled extensive surveying of staff about needs and wants before design began. Borland calls out two examples of hands-on contributions from the architects.

"They did some neat stuff. On the back side of the building, you can see the doughboy silhouette through the perforated panels we installed if you're coming into the city on Butler Street. Terry was part of laying that out and painting it on the panels," he says. "Another collaborative piece for the project were the concrete countertops in the restrooms. Those were poured in place on the project by the Desmone folks."

Borland cites the collaboration between the design and construction teams, including the specialty contractors, as the thing he remembers best about the project.

"What Desmone wanted to accomplish was complicated. Our two firms have a great relationship that goes back many years. What we were able to move forward, the difficult and unforeseen items, were handled with great collaboration," Borland says. "We developed better friendships throughout the entire project. We stay in touch even today and reminisce about the project."

"Our building is essentially a representation of us, so we use it as a way of giving tours and demonstrating WELL. We did WELL because it was in line with our culture and the idea of putting people first, but also, we knew it would be a test case to introduce clients to the idea of wellness or WELL certification," says Booth. "The office becomes something of a living laboratory. Even if our clients are not going to be doing an office building or WELL certification, we can point to it to show features that are primarily done to promote healthy interactions of working and living and how they could be incorporated into the client's project, regardless of the type of building." BG

PROJECT TEAM

Pyramid Engineering	Mechanical/Electrical Engineer
Superior Concrete & Supply, Inc.	Caissons/Shoring
Costa Contracting, Inc.	Excavation
J. Rich Concrete, Inc.	Concrete
Marsa, Inc.	Masonry/Cast Stone
G & R Welding	Structural Steel/Misc. Metals
JLJI Enterprises, Inc.	Drywall/Steel Framing
Tom Brown Contracting, Inc.	Waterproofing
Modern Wall Systems	Metal Panel/Glass
Likar Roofing Company, Inc.	Roofing
HF3 Construction	Spray Fireproofing
Norco Painting, Inc.	Painting
Massaro Industries	Ceramic Tile
Redstone Flooring LLC	Flooring
Schindler Elevator Corp.	Hydro Elevator
Lawrence Plumbing, LLC	Plumbing
Independent Mechanical, Inc.	Electrical
Better Protect, LLC	Fire Suppression
Climatech, Inc.	HVAC
Inches Nursery	Landscaping

SIGNIFICANT CHANGES ARE COMING TO THE DAVIS-BACON ACT

BY KURT F. FERNSLER, ESQ., RICHARD W. SAXE, JR., ESQ., AND JANE SCHLEICHER

Significant changes to the David-Bacon Act that will impact many in the construction industry are expected to be put into place in December 2022.

The Davis-Bacon Act ("DBA") was enacted in 1931, amended in 1935, amended again in 1964, and is now in the process of being updated and modernized with the goal of providing greater clarity and usefulness in current times. The DBA applies to contracts in excess of $2,000 to which the Federal Government or the District of Columbia is a party for the construction, alteration, or repair, including painting and decorating, of public buildings or public works, and requires the payment of locally prevailing wages and fringe benefits to laborers and mechanics as determined by the Department of Labor. Congress has built DBA prevailing wage requirements into many statutes that provide for Federal financing assistance for construction projects in the form of grants, loans and guarantees.

For purposes of the DBA, a contract is for construction if "more than an incidental amount of construction-type of activity is involved in the performance of the government contract." "Construction" includes all types of work done on a particular building or work at the site, as set forth in the regulations at section 5.2(j)(1). Currently, a "public building" or "public work" includes a building or work which the construction, prosecution, completion, or repair of is done directly under the authority of or with the funds of a Federal agency to serve the interest of the general public. Without the proposed 2022 update, the DBA applies only to laborers and mechanics employed "directly on the site of the work." Currently, the DBA "site of the work" definition does not include a contractor's or subcontractor's permanent home office, branch locations, fabrication plants, tool yards, etc. whose location and continuance of operation are determined without regard to a particular covered project. As a result, it is common and accepted to perform a significant part of a project otherwise covered by the DBA at off-site locations without applying DBA wage rates.

Simply put, the DBA requires contractors and subcontractors working on federally funded public works projects over $2,000 to pay employees no less than local prevailing wages and fringe benefits for corresponding work on similar projects in the area. The idea behind the DBA is to level the playing field and protect workers by ensuring that all contractors working on the projects that receive federal funding pay the same wage rates, which are determined by state and federal agencies. The Supreme Court has described the DBA as "a minimum wage law designed for the benefit of construction workers." United States v. Binghamton Constr. Co., 347 U.S. 171, 178 (1954). The purpose of the DBA has been stated as a way "to protect local wage standards by preventing contractors from basing their bids on wages lower than those prevailing in the area." Universities Research Ass'n, Inc. v. Coutu, 450 U.S. 754, 773 (1981). Congress sought to "ensure that Government construction and federally assisted construction would not be conducted at the expense of depressing local wage standards" by requiring the payment of minimum prevailing wages. Determination of Wage Rates Under the Davis-Bacon & Serv. Cont. Acts, 5 Op. O.L.C. 174, 176 (1981).

In March of 2022, the Department of Labor published a Notice of Proposed Rulemaking ("NPR") that will dramatically expand the scope of the DBA. If passed, the DBA will apply to most projects arising from the $1.2 trillion Infrastructure and Jobs Act. The NPR comment period ended on May 17, 2022, and the Department of Labor received over 40,000 comments – with very mixed reviews.

The Final Rule implementing these changes is expected to be adopted in December of 2022.

Proposed Changes

With this vast expansion of the scope of the DBA, there are obviously noteworthy changes. One major change is the expanding of the definition of "building or work" from "construction, prosecution, completion, or repair" to include renovation work. Further, the Department of Labor proposes to modernize the definition of "building or work." Solar panels, wind turbines, broadband installation, and installation of electric car chargers will now be included among the construction activities covered by the definition. The change to the definition is intended to relay the significance of energy infrastructure and related projects to modern construction activities that are subject to the DBA. The Department of Labor also proposes adding language to the definition of "building or work" in order to clarify that these definitions encompass construction activity that involves only a portion of an overall building, structure, or improvement.

Of particular significance, the definition of "site of the work" will be expanded to include "significant portions" of the work that are constructed off-site, instead of only applying to laborers and mechanics employed directly on the site of the work. This change would appear to have a direct and material impact to labor costs on those portions of work traditionally performed off-site without DBA wages.

Further, a large part of the change would be to adjust the way in which the prevailing wages are calculated and determined in a specific area. The Department of Labor proposes returning to a three-step process to define prevailing wages. Currently, a single wage rate may only be identified as prevailing in the area if it is paid to a majority of the workers in a classification on the wage survey, otherwise a weighted average is used. Under the proposed three-step process that the Department of Labor proposes returning to, the first step would have any wage rate paid to a majority of workers be used as the prevailing wage. The second step would have the wage rate paid to the greatest number of workers be used if there is no wage rate paid to a majority of workers, provided the wage rate is paid to at least 30 percent of workers. The second step would be known as the "30 percent rule." The third step would have a weighted average wage rate be used if the 30 percent rule is not met.

Those that take issue with the calculating of prevailing wages aspect of the proposal, including Congressional Republicans, predict that unions will have an inflated role in determining a particular area's or county's wage rates, and have voiced their frustration revolving around the Department of Labor's failure to consider methods that would improve the accuracy of calculating wage rates. A method that they contend would result in more accurate calculations than wage surveys is using Bureau of Labor Statistics data. Congressional Republicans contend that the proposed rule reverts back to a decades-old definition of prevailing wage, via the 30 percent rule, in order to reward labor support for the current administration. They further contend that "lowering the threshold for what is considered prevailing to less than a majority of responses is nonsensical and is clearly aimed at making it easier for union wage rates to prevail because collective bargaining agreements often set a uniform wage for an entire group of workers." Associated Builders and Contractors ("ABC") surveyed its members in order to gather their opinions on the proposal and to assist in drafting informed comments. The survey revealed that members of ABC oppose current DBA regulations and strongly support repeal or reform. ABC members disagree with the opinions set forth by the unions and other DBA advocates that DBA regulations result in better quality projects, cost savings for taxpayers, and increased safety and other benefits. ABC members also indicated through the survey that the DBA increases administrative burdens and costs, artificially inflates wages, and discourages competition. Further, the survey revealed that the majority of ABC members do not participate in wage surveys and feel this exhibits the failure of the Wage and Hour Division to engage the full contractor community and collect accurate wage data.

On the flip side, and unsurprisingly, the construction labor unions are very much in favor of the proposal. Specifically, the United Brotherhood of Carpenters and Joiners of America believe the proposal holds general contractors liable and establishes an important principle on federal and federally assisted construction projects revolving around the "rampant and growing abuse of construction workers." The Center for American Progress Action Fund also supports the proposal and opines that the new regulations are necessary to restore a balance for workers through the 30 percent rule as it will help to ensure that the DBA rates reflect the actual wage rates paid in a specific area.

Should these changes be implemented in December 2022, as anticipated, those in the industry will need to carefully review the significant changes to ensure compliance. BG

https://www.federalregister.gov/documents/2022/03/18/2022-05346/updating-the-davis-bacon-and-related-acts-regulations

https://www.jdsupra.com/legalnews/comments-on-proposed-davis-bacon-act-9454992/

https://www.abc.org/News-Media/Newsline/entryid/19424/abc-survey-indicates-members-oppose-davis-bacon-regulations-and-proposed-changes-submit-your-comments-by-may-17

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BURIED TREASURE? YOU MAY BE SITTING ON A R&D TAX CREDIT AND NOT KNOW IT.

BY ROSS ALESSANDRO, ERIN HAASE, AND CHARLOTTE GARRAWAY

The construction industry is facing a unique set of challenges that are impacting profit margins. Supply chain issues related to the disruptions caused by COVID-19 continue to abound, driving up prices and extending project timelines. The current job market has resulted in fierce competition to attract the best talent, forcing companies to offer more generous compensation and benefits packages to attract and retain the best employees. Further, the current geo-political climate is resulting in unrest, uncertainty and inflation that will most certainly exacerbate both supply chain issues and the labor market, as well as cut into business profits.

In the current environment, businesses should be using all available tools to maintain cash flow and increase profits. One such tool that many in the construction industry may not be aware of is the Research and Development (R&D) Tax Credit. Based on the name of the credit alone, the majority of folks in the construction industry would quickly assume that this isn't a viable option for their business. However, this powerful incentive has been successfully deployed by some of the largest construction companies in the US and across Pennsylvania. Mark Di Pietrantonio, CPA, MST, CCIFP, a shareholder at Schneider Downs specializing in the construction industry, says that for his clients, "the research and development tax credit has proven to be a valuable tax savings strategy that can provide a meaningful reduction to a taxpayer's annual tax liability. The resulting tax savings provides contractors with a source of cash that can be reinvested into their business to improve operating cash flow, finance additional capital expenditures or reward key employees."

What is the R&D Tax Credit?

The R&D Tax Credit, formally known as the Credit for Increasing Research Activities, was first enacted in 1981 as part of the Economic Recovery and Tax Act, with the goal of incentivizing innovation and the retention of top talent in the US. It was originally intended as a temporary measure, but it was re-enacted for decades until it was finally made permanent in 2015, with the passage of the Protecting Americans from Tax Hikes Act.

Although the name "Research and Development," sounds like it should be reserved for scientists wearing white lab coats and goggles, taxpayers from all industries may be eligible for the credit if they meet the following requirements:

1. Permitted Purpose: The activity must be related to the development or improvement of the function, performance, reliability, or quality of a qualified business component, which can be a product, process, technique, formula, invention or computer software.
2. Technical in Nature: The activity must fundamentally rely upon principles of "hard sciences" to qualify. Examples include engineering, physics, materials science or geology.
3. Elimination of Uncertainty: The activity must be intended to eliminate technical uncertainty related to the capability or method to develop or improve a business component or to determine its final design.
4. Process of Experimentation: Substantial activity must contain elements of a process of experimentation in which one or more alternatives are evaluated to eliminate the technical uncertainty.

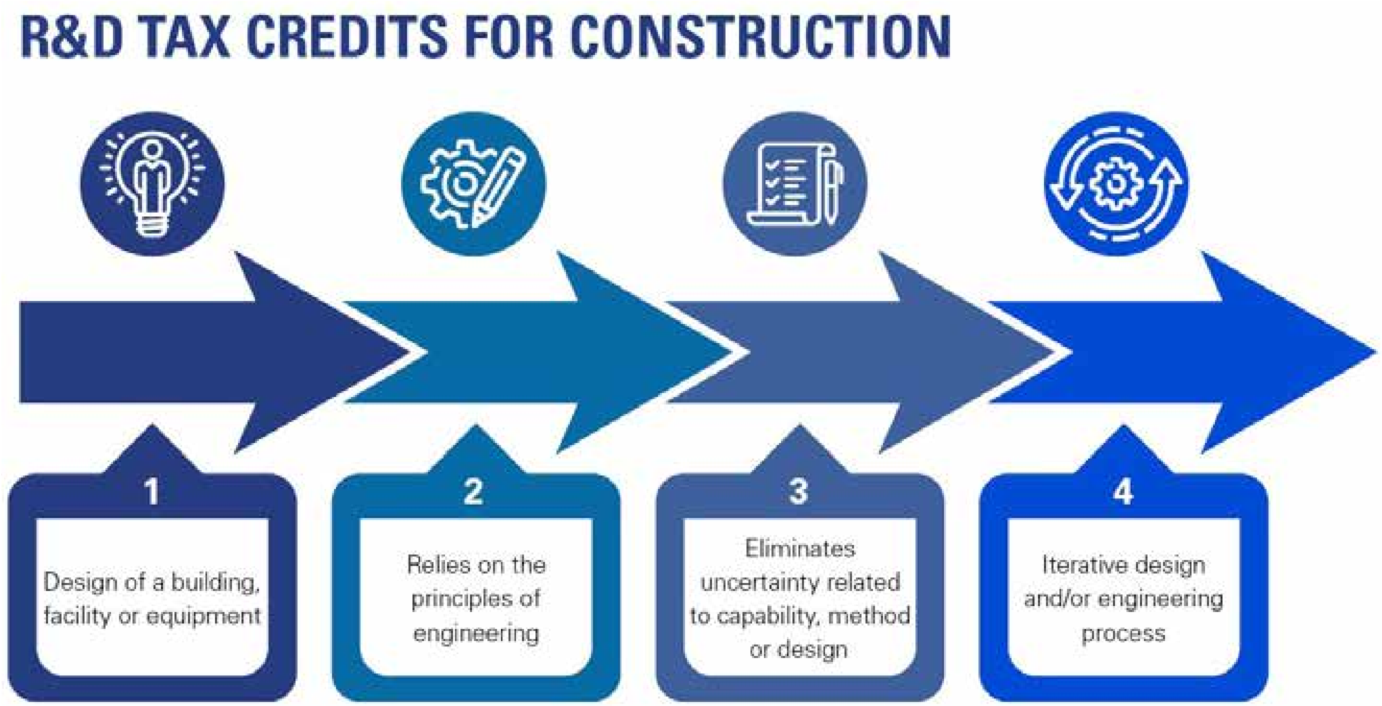
If a taxpayer is conducting activities that meet the criteria, then certain expenses for those activities can be used to calculate an R&D tax credit. The primary expenses that can be qualified for the R&D credit are wages, supplies, and contract research expenses.

How does the R&D Tax Credit apply to the construction industry?

The R&D tax credit can be applied to a myriad of industries, including the construction industry, that might not seem obvious at first. The criteria are not meant to describe specific qualifying activities and must be applied to each unique scenario to determine if those activities are eligible for the R&D tax credit.

Potentially qualifying activities related to the construction industry include, but are not limited to, the following:

- Developing prototypes or models
- Experimenting with new building materials
- Developing custom or first-in-kind construction equipment
- Designing a new building or facility or designing improvements to an existing building or facility
- Designing new or improved HVAC, plumbing or electrical systems to achieve energy efficiency requirements
- Developing new or improved construction methods or processes to incorporate new technologies
- Designing building foundations for unique or challenging topographies
- Designing and developing new or improved storm water management systems or water treatment plants
- Designing and developing "green" and/or LEED buildings



How do R&D activities translate into tax credits?

If you recognize some of the activities outlined above when you think about your business, you're probably wondering how to get from a qualifying activity to money in your pocket. Typically, the biggest R&D expense for construction companies is employee wages. More specifically, it's the investment of your employees' time in developing a new or improved design, process, or technique. Qualified wages are quantified by determining who is conducting qualified activities, how much time those individuals are spending on those activities and how much that time is valued according to their wages.

Another common expense is third party contractor or sub-contractor costs. These can be related to a variety of services, including geotechnical testing to gain critical information that informs the design of a building or foundation or outsourcing of design or engineering services.

Supply costs are less common in the construction industry because land or improvements to land are specifically excluded. However, supplies used in the development or testing of prototypes or models or to experiment with new building materials are eligible costs.

Once you have qualified costs for qualified activities, you can use those expenses to calculate the R&D Tax Credit. In addition to the Federal credit, many states, including Pennsylvania, Maryland and Ohio, offer state R&D tax credits. Generally, the Federal R&D Tax Credit represents a more robust tax savings compared to state credits, and functions as a dollar-for-dollar reduction of a taxpayer's payroll and/or income tax liability. It's important to note that, because the R&D Tax Credit was created to incentivize continued investment into research and development, the mechanics of the credit calculation benefit companies that are increasing their research activities and expenses year over year. For those businesses that are increasing their investment in R&D each year, they can expect approximately five percent to 11 percent of their qualified expenses to be returned in the form of a credit. Therefore, a taxpayer spending $1 million on qualified research expenditures could receive a credit equaling $50,000 to $110,000. The bigger the increase in spend over prior years, the closer you get to the upper end of the potential credit range.

How can I take advantage of the R&D Tax Credit?

Tax credits and incentives can be a dynamic and ever-evolving topic. An effective way to remain current on active opportunities is to consult with a research and development tax credit tax specialist. BG

Ross Alessandro is a tax shareholder at Schneider Downs. Erin Haase is senior manager at Schneider Downs. Charlotte Garraway is a manager at Schneider Downs. For more information on tax credits and incentives, send an email to contactsd@schneiderdowns.com.

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TREND TO WATCH

RISING RATES ARE CHILLING COMMERCIAL REAL ESTATE FINANCE

When the data on July's consumer and producer price inflation was announced, the decline in the rate of inflation was evidence that the Federal Reserve Bank's monetary tightening was working. The cooling of price increases came on the heels of an aggressive 75-basis point hike in the Fed Funds rate in July, meaning that the impact of the hawkish move had not been measured yet. For commercial real estate, which had seen deals dwindle during the second quarter, the good reports offered the possibility that activity would rebound before the end of 2022.

By mid-September, however, those hopes faded when inflation heated up again slightly and Fed Chair Jerome Powell signaled that beating inflation was the central bank's top priority, regardless of whether that battle produced a recession. At the Federal Open Markets Committee (FOMC) meetings that followed on September 20-21, the Fed put another 75-basis point hike in place and Fed officials made it clear in their comments that rates would remain at restrictive levels through 2023.

Most of the headlines about rates have focused on the chilling effect on residential mortgages and home buying. While the near doubling of mortgage rates has dampened the housing market, commercial real estate has been buffeted by the increased cost of capital, the inflation of construction costs, and – more importantly – the growing uncertainty about when conditions will stabilize.

It is the latter concern that has chilled commercial real estate activity. The economy has not necessarily dampened demand for commercial real estate. Other than the market for office properties, commercial real estate is still enjoying the growth in demand that followed the rollout of COVID-19 vaccines in mid-2021. Developers will complain about higher interest rates and cap rates, or higher construction costs, but history has shown that they can adapt to most conditions. To do so, however, developers must know what the rules of the game are. Until the Fed pauses or responds to an economic signal, the rules of commercial real estate finance remain fuzzy. Uncertainty is not a friend to either borrower or lender.

"I agree we can underwrite to any environment, but we do have to have less volatility," says Robert Powderly, executive vice president at FNB Corporation. "The demand will be constrained until we have some certainty about rates and inflation. The banks are challenged to underwrite to the unknown. They will look at the worst-case scenario as the stress of the project underwriting. Banks are underwriting to a 6.0 or 6.5 percent rate – and it may not end there – based upon the projection of the Fed rate hikes."

"Most lenders that I talk to are having trouble making deals pencil because they are required to "stress" the underwriting of the property with higher interest rates in the future," agrees Tyler Noland, chief operating officer for PenTrust Real Estate Advisory Service. "Stressing a property's performance with higher rates is standard, but the true difficulty is when the future of interest rates is so potentially volatile that you have to apply overly high rate projections into the financial model to be conservative."

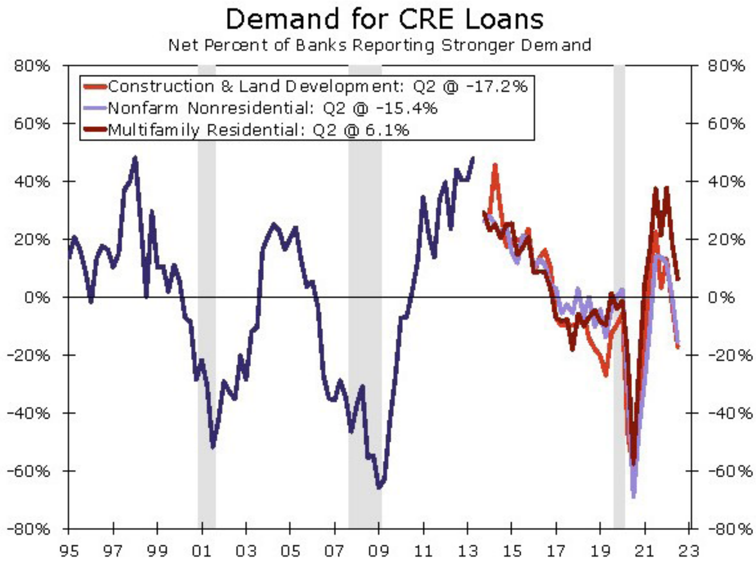
Noland suggests that focusing on the path of interest rates and Federal Reserve policy is "looking at the tail rather than the dog." He cautions that the determining factor in the current development cycle will be inflation and its effect on the overall economy, noting that Fed policy will react to inflation until it is under control.

Noland also points to the difficulty of forecasting capitalization rates for exiting a construction loan or selling a property when rates and costs are rising unpredictably. The cap rate is a calculation that divides a property's net operating income by its purchase price. Cap rates offer a standardized metric for buyers and sellers to evaluate properties to judge the yield or return on investment. Cap rates have been several points lower than historical norms since the end of the Great Recession, which ushered in a decade of near-zero rates. Lower cap rates mean higher prices for sellers. Now that rates are rising, so are cap rates, making it harder for lenders and borrowers to reconcile the future value of a property for which future income will be squeezed by higher interest rates.

"At this point, projecting one year out is almost impossible. Projecting five years or 10 years out is completely impossible," Noland says. "You just have to rely on historical norms and justify that, in the long-term, the world will return to normal. That depends on how you want to define normal."

Nick Matt, senior managing director and co-head Pittsburgh office of JLL Capital Markets, observes that sellers would prefer to live in the 2010s environment, but lenders have already moved on. Noting that cash-on-cash returns are still paramount to investors, Matt sees a disconnect between buyers and sellers that have not adjusted to the current environment. He says the gap has pushed buyers to the sidelines waiting for clarity.

"Our investment sale brokers were telling us there was supposed to be a large number of deals hit the market



Source: Federal Reserve Board and Wells Fargo Economics

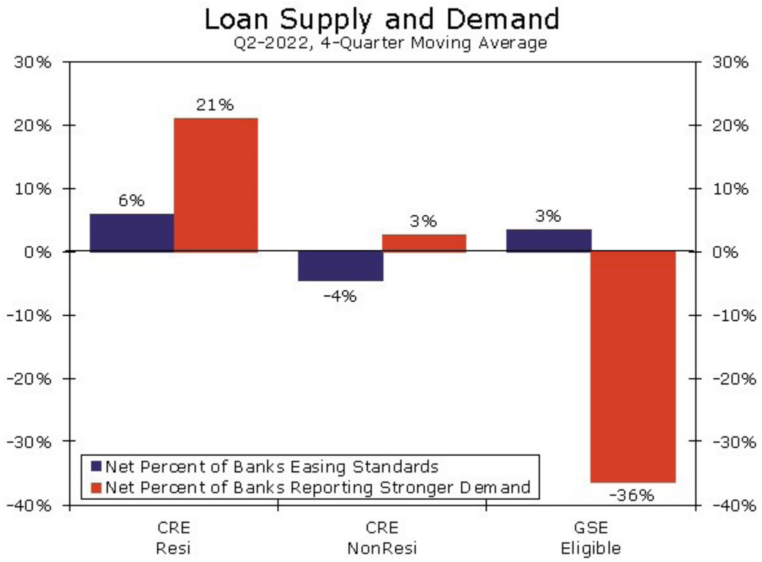
right after Labor Day. That hasn't happened," reports Matt. "There is too much uncertainty and buyer pools have shrunk considerably. How can a buyer calculate a cash-on-cash return and deliver it?"

There seems to be widespread recognition that the volatility will dampen the appetite for commercial real estate. Regulators appear to be quietly responding to the market, applying the lessons learned in 2008 about the systemic damage that can occur. Dan Puntil, senior vice president and office manager for Grandbridge Real Estate Capital's Pittsburgh office, says that there were reports from the National Multi-Housing Council annual conference that top tier banks – Wells Fargo, JP Morgan Chase, Bank of America, and their peers – had been told to slow lending, although not because of fears of overexposure to commercial real estate. The same expectation has since been communicated to the next tier of banks.

There does appear to be a difference in how the national lenders are experiencing the turbulent conditions compared to regional banks.

"Obviously our stress rates have increased quite a bit when we're looking at a property. The level of activity has slowed down slightly but has not come to a grinding halt by any stretch," says Lori Soles, vice president, investment real estate for Somerset Trust. "Developers are more cautious, of course, but we are still busy. We are fixing the rate up front when we can. I am looking at refinancing deals coming out of construction trying to lock in before rates increase again. I haven't received any new construction deals."

Greg Sipos, executive vice president of corporate banking for First Commonwealth Bank, agrees that market conditions are less than ideal but says that the deal flow is still robust. Sipos expressed concerns about the market that go beyond those of inflation and higher rates.



Source: Federal Reserve Board and Wells Fargo Economics

"The undesirable nature of both hospitality and office are concerns. Banks remain unwilling to lend into these two segments, although hospitality is showing strong signs of recovery," Sipos says. As a result, banks are full of multi-family. Big banks are having to hit the brakes due to regulatory issues and the smaller banks do not have the balance sheet. There is a lack of cheap capital for banks due to the decline in deposits of the past two years. This will push spreads as well as rising rates."

Sipos reports that First Commonwealth still has more construction loan requests, but demand for permanent financing exists as well. He says the difference between the expectation of rates during the near term compared to long-term expectations has had an impact on what clients are seeking.

"Clients would rather do some short-term bridge financing floating for three to five years, rather that fix into a longer-term rate with the fed projecting that the increase could be short term," Sipos says.

The disconnection between short-term and long-term rates makes development financing more expensive, another factor that is an incentive to wait. Loans for development and construction activities are based upon short-term, floating rates, which are in the process of converting to a Secured Overnight Financing Rate (SOFR) as a basis. After the September rate hike, markets have been pricing SOFR at four percent and higher through 2023. That compares to just over one-half percent in January 2022. Moreover, uncertainty has made lenders and investors more cautious and, therefore, spreads have crept higher. Borrowers are likely looking at SOFR plus two percent (or 6.5 percent) for floating rates until markets settle.

The change in market sentiment in September is important because the next FOMC meetings will not occur until November, which will give more time for reaction and for inflation to cool. It was the commentary of the FOMC members that sealed the market reaction, especially the dot plot of expectations that showed that 18 of 19 members expected the Fed Funds rate to settle in above four percent through 2023. It is worth noting, however, that in January 2022 few of these same members expected a rate hike in 2022.

There is an element of good news that uncertainty has cooled off the appetite of buyers, sellers, and lenders. There have been times in the past few decades when enthusiasm got the better of common sense and caution. Commercial real estate thrives on doing deals, but sometimes the best deal is the one not made. Current conditions are unfavorable but will pass. Those who are exercising caution today will be the ones positioned to take advantage when conditions improve again.

"The world has changed drastically in a very short period of time," says Matt. "That said, the market will adjust - and maybe it already has - and all the players will need to adjust accordingly."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BEST PRACTICE

ARCHITECTS AND DESIGNERS CONTEMPLATE THE POST-COVID OFFICE

In the fall of 2020, Tall Timber Group publisher, Jeff Burd, asked a group of architects about how COVID-19 was influencing client requirements (see DevelopingPittsburgh Fall 2020). Six of those architects with significant office portfolios affirmed that their clients had changed their expectations as a result of the pandemic. The replies focused on measures that responded directly to the health concerns of the virus: more space, fewer places to congregate, cleaning, adding barriers between workplaces, better ventilation, and air filtration, and eliminating as much touching of surfaces as possible.

While there was some recognition that working from home was gaining traction and would require more flexibility, the architects understandably emphasized health and wellness. Two years later, we have learned that the physical environment had a negligible effect on the spread of the virus. Instead, the workplace has been transformed by the share of the workforce that does not regularly inhabit it. BreakingGround asked those same six architects what has changed in workplace design since 2020 and what have been the major surprises in post-COVID thinking.

What is not a surprise is that work-from-home or hybrid work is driving client conversations. Architects are looking for direction from clients about how they are approaching the return to the office. They are pointing to technology and flexibility. And their responses tell you that employers are not all on the same page when it comes to thinking about solutions.

"I am surprised that companies are not giving adequate thought to their actual work locale policies and going straight to leasing less space. We'd like to see more companies meaningfully try to link a hybrid work policy with rethinking and/or redesigning their office space," says Jeff Young, principal for Perkins Eastman. "What we're finding is that companies are committed to leasing new office space because of expiring leases and the need to address business consolidation, growth/expansion, and so forth, and yet their first objective is to reduce the total

Perkins Eastman's Pittsburgh studio was completed in summer 2021. Photo by Andrew Rugge, courtesy Perkins Eastman.

floor area they are seeking to take. This is not news – uniformly companies are seeking to save on space. However, these desired space reductions are often not connected to how the company plans to address the issue of where their employees are expected to work in a given week."

"Making decisions about a 'work from anywhere' policy, as we refer to it, will directly influence the decisions companies should be making about their new space," Young continues. "Parameters such as employee frequency in the office, assigned versus unassigned seating, space governance, available work tools, and on and on, all impact just how much space a company should be looking to lease. I'd encourage companies to prioritize their 'work from anywhere' policies with the same vigor and scrutiny they apply to their real estate searches. There are incredible opportunities for these guidelines to directly inform exactly how much space should be leased."

Perkins Eastman applied a vigorous scrutiny of its own policies when designing its new space in 525 William Penn Place during the lockdown phase of the pandemic. Doing so changed the floor plan of the new space dramatically, resulting in multiple styles of workspace, from traditional workstations to couches. The process also resulted in a slight reduction of the space that Perkins Eastman rented.

Gretchen Zeitler, principal at DRS Architects, sees clients responding to employees in ways that are very different from the pre-pandemic employer/employee relationship. The changes in that relationship affect real estate solutions.

"One thing we have found, which is surprising, is the speed with which leaders are shifting their views on workplace culture. Leadership is reevaluating their relationship with their employees and vice versa. Equity, diversity, and inclusion (EDI) initiatives have pushed forward at an accelerated pace and are being supported at all levels of corporate structure," Zeitler says.

"All of this in turn has had a dramatic effect on the office environment. With EDI, hybrid work models, flexibility in workspace, and employee autonomy at the forefront of leaders' initiatives, companies are finding they need less space, less hierarchy of space, and a greater variety of spaces which can be molded to their employees' needs. We believe part of this can be attributed to the pandemic and a global shift in people's views on how work is, or should be, done. We weren't expecting leaders across so many market sectors to embrace these changes as readily as they have been, and that is a pleasant surprise."

"We have seen numerous design pivots as clients determine what is best for their business operations, evaluating their company culture, and sometimes redefining their company vision, says" Paulette T. Burns, president and partner at LGA Partners. "The client's company vision influences the art of our design. The last few years challenged business models in ways we didn't anticipate. Some clients were in full support of return to work, and others were in full support of a hybrid model."

Burns' observation reflects the difficulty businesses have had responding to public health concerns until vaccines were available and, after that, to the shifting dynamics of attracting and retaining employees. Most employers accepted that keeping workers away from the office was a necessity in 2020, even if they disagreed. After vaccines were rolled out, however, the desire to return staff to the office has been blunted by the shift in leverage between employer and employees. The fear of alienating workers has kept work-from-home alive. In many companies, this has been transformed into a hybrid policy that has offices less than half-occupied on a daily basis.

"Coming out of the pandemic we have had supply chain issues, cost increases, rising interest rates, and we have companies embracing work from home as a way to keep employees during one of the deepest staffing shortages in many years. So not only did projects, which may have been contemplated before or during the pandemic, have their delivery date and costs upended, we have companies navigating a new way of working," says Daniel Delisio, principal at NEXT Architecture. "The challenge to think creatively increased to help solve these issues."

The hybrid model has had the most significant impact on workplace design, as it brings with it considerations for flexibility and differing kinds of collaboration among employees. A hybrid office also creates the potential for changing the footprint of the office.

"With teleworking options now commonplace, there is an expectation that most offices won't be as fully occupied as they once were, and thus the office must be designed with purpose; that is, there needs to be a reason for an employee to make the effort to leave his or her home," explains Eric Booth, president of Desmone Architects. "People are now more aware of how they want to work on a given task, and they have more decision power to find work settings that best fit their lifestyle. Though not new concepts, communal and 'neighborhood' spaces have gained popularity as a way to create places for collaboration. In that sense, the biggest changes for most offices are not in revolutionary breakthroughs in form and space, but that more companies are understanding the importance of features and strategies that high-performing companies have incorporated for quite some time."

"We have seen some changes. There is an increased interest in private offices, more flexible spaces, and the need to have settings and workstations that are more conducive to the now ever-present video conference," Booth continues. "But while issues like acoustics and backgrounds in a Zoom meeting are important, we're seeing that technology solutions – like headphones and blur filters in conferencing software – are often far easier and economical options than constructing lots of dedicated 'Zoom rooms'."

"There has been a surprising increase in the impact of virtual collaboration as it relates to the programming, planning, and design of a hybrid workplace environment," says Jennifer M. Pavlik, senior vice president and principal at DLA+ Architecture & Interior Design. "Hybrid work environments need to offer a variety of collaborative spaces with integrated technology solutions that support in-person and virtual collaboration. Specific design considerations include lighting, camera placement, site lines to the camera, multiple screen configurations, microphones, audio, and flexible furniture solutions."

"At the heart of collaboration diversity is technology," agrees Burns. "Most companies, prior to the pandemic, had one or two meeting rooms that could accommodate video conferencing. AV budgets were often slashed when project costs needed to be reduced. The number of meeting spaces, as well as budgets, that support video conferencing has increased significantly. Zoom meeting rooms are now a common request. With the increase in hoteling, staff who no longer have an office or permanent workspace, now need a place to participate in virtual meetings with their colleagues who are working remotely."

A hybrid home/office work model presents an opportunity for companies to recognize the decreased daily occupancy by reducing their physical footprint. It also presents a challenge to create an office that offers adequate resources without wasting space. The chance to reduce the leased footprint is a strong incentive to meet that challenge.

"Smaller office footprints have been a trend as businesses navigate the work from office/home balance. Office tenants are contemplating smaller footprints and trying to do more with less," notes Burns. "Smaller individual workspaces and hoteling allow for less square footage. However, with a resurgence of more in-person collaboration, a requirement for more diverse meeting spaces often balances that square footage need. Businesses are spending more in tenant improvements per square foot and looking for quality buildings with the amenities to attract workers back to the workplace and help with employee retention."

Delisio reports that NEXT's clients are mindful of how uncertain and fluid the occupancy demand has been.

"While hybrid office planning for remote and in-person work is still very prevalent, we're seeing that some companies are keeping the desk-to-person ratio at one-to-one," he says. "The unpredictability of hybrid work - being in or out of the office - is difficult to manage, and some companies aren't ready to fully give up that real estate just yet.

"We are also programming in a lot more amenity space to make offices more attractive and worth the drive from home. While that isn't surprising, sometimes the companies asking for these amenities are surprising. Amenities aren't just for tech companies anymore."

In terms of the response of designers to the pandemic, much changed between fall 2020 and fall 2022. In 2020, the thought leadership was about what physical changes would be adopted to improve occupant health and reduce the risk of future infections. In 2022, the focus on wellness has few physical manifestations, and the challenges come from how the office is and is not being used. It is hard to know what two more years will bring. Perhaps it is best that the changes to the office have been less dramatic than were feared in 2020.

"What's somewhat surprising from a design perspective is how relatively few significant changes we've seen to the typical office design. There are certainly exceptions: forward-thinking companies are challenging traditional practices and are incorporating workplace strategy and holistic employee wellbeing into their goals for new space," says Booth. "But the predictions of radically different workspaces, with permanent plastic dividers and fully transformable spaces, did not become mainstream. The casual observer may have a hard time distinguishing between a typical pre- and post-COVID office."

INDUSTRY & COMMUNITY NEWS

Mascaro's Rick Bowers (right) was honored as the Frontlines Worker of the Year by the March of Dimes at its annual Pittsburgh Transportation, Building & Construction Awards. Pictured with Bowers is Mascaro's Bob Breisinger.

March of Dimes honored The Assembly as the Building Project of the Year. Pictured from left are Jodi Rennie from construction manager Turner Construction, Mike Dembert from developer Wexford Science + Technology, and the chair of the awards committee, Tom Bice from Gannett Fleming.

(From left) Brooke Waterkotte from Easley and Rivers, Burns Scalo's Josh Hoskinson, Chris Pogue-Geile, Travis Raught, and PJ Dick's Dom Matarazzo at the Young Constructors Ax Throw on September 22.

(From left) Sam Reihs and Mike Innocenzi from Mosites Construction, with Ethan Yohe and Drew Lewis from Easley and Rivers.

(From left) Mascaro's Joey Mascaro, John A. Mascaro, Jessica Ramsey, Jacob Schwab, Joe Armbruster, Kara Ross, and Haley Turkovich.

Pennsylvania Builders Exchange held its annual Pig Roast to benefit the ALS Society of Western PA in honor of Brian McKay. From left are Harris Masonry's Adam Harris, Gene Brown from Allian Drywall, Bill Sullivan from Marthinsen & Salvitti Insurance, and Bill Wilson from Specified Systems.

Mascaro employees participated in the Walk to Defeat ALS Pittsburgh.

Mascaro participated in the Pittsburgh UNcathlon. The UNcathlon is a unique team challenge that embodies the goal of the Special Olympics Pennsylvania: inclusion and acceptance through sport. The team, paired with a Special Olympic athlete, took part in a fun day where they were tested on speed, strength, and endurance. Pictured with their Special Olympian are Matthew Zenk from Barton Malow, and Mascaro's Ed Hasis, Zach Brandy, and John A. Mascaro.

The 11th Annual Heinz History Center Bocce Tournament & Festival was held on Saturday, August 20. Chaired by Mascaro, this event invites sponsors to play in teams of four in a double elimination tournament. All proceeds from the event benefit the Italian American Program which is dedicated to preserving the history and culture of Italian Americans in Western Pennsylvania.

(From left) Jennifer Wahl from Karpinski Engineering, Mascaro's Mike Ellis, and Paul Messineo, Jr. from Allen & Shariff at the AIA Design Gala. Photo by Renee Rosensteel.

AWARDS & CONTRACTS

Meta awarded **Burchick Construction** a contract for its Virtual Reality Labs Research space on the second floor at District 15 in the Strip District. Gensler is the architect for the $12.6 million renovation.

Burchick Construction is renovating the main entrance to the Carnegie Library of Pittsburgh Main Library on Forbes Avenue in Oakland. Elagin Architecture is the architect.

The Veterans Administration Pittsburgh Health System selected **Rocky Bleier Construction Group** as construction manager for the $2.9 million site preparation phase of the new Fisher House at its Heinz campus in Aspinwall. The architect is Guidon Design.

Fox Chapel Borough awarded **FMS Construction** the general construction contract for the security and accessibility renovations at its borough administration building. The architect is Stephen Paxton Architect.

Mosites Construction was selected to build the new $4.5 million women's shelter for the Washington City Mission in Washington, PA. The architect is Rothschild Doyno Collaborative.

Kokosing Industrial Inc. was awarded an $82.3 million contract for the general construction portion of the Allegheny County Sanitary Authority's $97.9 million CSO Bypass Disinfection project, part of ALCOSAN's Wet Weather Equalization Plan. The engineer is GHD.

The U.S. Army Air Reserves awarded **Facility Support Services** a contract for the exterior renovations to Buildings B102, B103, B105, and B404 at the 171st Air Refueling Wing in Moon Township, PA.

Allegheny Health Network selected **A. M. Higley Co.** as construction manager for the renovation of its Breast Cancer Care Center in the Forbes Regional Hospital Professional Building 2. The architect is Stantec.

A. M. Higley Co. is the construction manager for the $1 million Behavioral Health Unit renovations in Forbes Regional Hospital's Emergency Department in Monroeville, PA. IKM Inc. is the architect.

Rycon's Special Projects Group is renovating the Bower Hill Road exterior entrance and landscape at St. Clair Hospital.

For a repeat financial client, **Rycon's** Special Projects Group is completing a $1.5 million, 12,000 square foot fast-track fit-out on the 14th floor of Cleveland's Key Tower, the tallest building in Ohio.

Rycon's Special Projects Group will soon begin renovation work to Altius, a restaurant located on Mt. Washington's Grandview Avenue.

In Encinitas and Ventura, California, **Rycon's** Special Projects will complete tenant improvements within two Hanger Clinic medical offices which provide orthotic and prosthetic services. Earlier this year, Rycon renovated a location in Crestview Hills, Kentucky.

A self-pour beer station is being built within the Hollywood Casino in York, Pennsylvania by **Rycon's** Special Projects Group. The project is occurring on an active gaming floor.

The $47.2 million second phase of BaumHaus Apartments was awarded to **Rycon's** Building Group as CM at-Risk. The new complex will be a 180,000 square foot precast plank building housing 198-units. Rycon was also the construction manager on the award-winning $27 million phase I built five years ago.

Rocky Bleier Construction Group has awarded **Independence Excavating Inc.** the site preparation contract for the VA Heinz Fisher House.

Independence Excavating Inc. was awarded the contract for the SR 910 Rawlins Run Culvert replacement by PennDOT on State Route 910 in Indianola.

KDKA selected **Massaro Corporation** to do a $2.7 million renovation to its Gateway Center office and studio.

Massaro Corporation is renovating facilities at 135 1st Avenue to be a center for women at risk for the Gift of Mary organization.

Magee Plastics awarded a contract to **Uhl Construction** to build a mezzanine in its office and plant in RIDC Thorn Hill Industrial Park in Marshall Township. The architect is RSSC Architecture.

PJ Dick Mid-Atlantic was selected by Georgian Court University to provide preconstruction and construction services for a new Nursing and Health Science building and renovations to the historic Casino Building. The 58,000 square foot Nursing and Health science building will house nursing skills labs, simulation labs, science labs, computer labs, general academic classrooms, and collaboration spaces, as well as faculty and administrative offices. The 65,000-square foot historic 1899 Casino Building will be reimagined as a modern student center to meet the needs of the 21st-Century student and increase accessibility to some of GCU's core support programs.

A. Martini & Co. broke ground on the new $9 million Excela Square medical office building in Connellsville, PA. The architect for the 18,000 square foot new facility is JPT Architects, P.C.

Philadelphia Protestant Homes selected **PJ Dick** Mid-Atlantic to assist them with their master planning efforts for their Senior Housing community by providing cost estimating services.

PJ Dick's Special Projects Group is renovating 44,000 square feet on the 39th and the 40th floors of One PPG Place to modernize the space, accommodate multiple business units, and include several unique support spaces.

PJ Dick's Special Projects Group provided construction services for the interior fit-out of Astrobotic's 3,000 square foot Moonshot Museum, the first space museum in Pennsylvania. The museum opened to the public on Oct. 15.

PJ Dick's Self-Perform Group was selected to provide construction services for a 28,000 square foot, one-level post-tension concrete podium associated with the construction of a new, six-story retail/apartment building adjacent to PNC Park.

Shannon Construction is the general contractor for the $8 million Vitalant Donation Center at Parkway Center in Green Tree. Jones Lang LaSalle is the owner's representative. The architect is IKM Inc.

FACES &

Dalton Moore has joined **Independence Excavating Inc.** as an estimator.

Chavis Lunceford has joined **Independence Excavating Inc.** as a senior estimator in its Pittsburgh Office.

The **Rycon** Pittsburgh office welcomes **Allie Csaszar** as accounts payable data entry clerk.

The **Rycon** Pittsburgh office is pleased to welcome **Michael Klena**, University of Pittsburgh alumnus, as assistant project manager within the Building Group.

Rycon's Pittsburgh Building Group is happy to welcome **Michael Moore** as QA/QC site manager.

Rycon's Pittsburgh Special Projects Group welcomes **Jordan Stone**, as director of special projects. He is a licensed professional engineer with a civil engineering degree from University of Pittsburgh Johnstown as well as an MBA from The University of Illinois, Geis College of Business.

Courtney Sullivan, alumna of Indiana University of Pennsylvania, joins **Rycon** Pittsburgh Building Group as project engineer.

In Rycon Pittsburgh's Building Group, recent promotions include **Kris Brice** to project executive, **Chris Davis** to project executive, and **Brandon McKee** to project executive.

Eliza 'Lizzie' Schoonmaker joined **Mascaro** as project administrator on September 12. A 2021 graduate of Ohio University, Lizzie earned a dual degree in Business & Sports Management and Marketing.

On September 19, **Dan Whipple** joined **Mascaro** as a quality manager. He started his career as a union laborer and has since acquired 23 years of industry experience.

Kelsey Smith joined **Mascaro's** accounting department on October 10. Originally from Ohio, Kelsey came to Pittsburgh by way of Geneva College where she played soccer until graduating in 2018 with a bachelor's in accounting.

Project Manager **Gary Reeser** joined **PJ Dick** Mid-Atlantic. He has 26 years of project management experience, including senior project management and operations management of new construction, renovations, and site development.

NEW PLACES

Project Manager **Ben Mercadante** joins the **PJ Dick** Mid-Atlantic office and the Harmony Senior Living project team. He interned with LF Driscoll on the $250 million Reading Hospital project before joining Wickersham Construction and Engineering in Lancaster, PA, where he's spent the past five years as a project manager. Ben studied construction management at Pennsylvania College of Technology and minored in business.

Turner Construction announced that **Brian Peglowski** has been promoted to operations manager in its Pittsburgh office. In 2021, Brian was promoted to deputy operations manager and project executive, and joined Turner's inaugural class of Master Builders.

Chris DiLorenzo has transitioned into a new role as manager of business development for **Turner Construction**. Starting his career with Turner as an intern in 2010, Chris has held several roles within the business unit, including project manager and operations manager, Special Projects Division.

With 22 years of experience in Building Information Modeling, **Chad Clark** has joined **Turner Construction** as VDC manager.

Scott Graves joined **Turner Construction** as field engineer. Scott is a recent college graduate from Tuskegee University.

Madison Mathers joined **Turner Construction** as a field engineer. Madison interned with Turner for two summers and is a 2022 graduate of Penn State University with a degree in civil engineering.

Martha Yanders joined **Turner Construction** as a field engineer. Martha is a recent college graduate from Penn State University.

Turner Construction announced that **Brian Bundy** has been hired as Interiors/Special Projects Division manager Brian has 13 years' experience as a project manager in the Pittsburgh market. He is a 2010 graduate of the University of Pittsburgh's Swanson School of Engineering.

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CLOSING OUT

DEMAND FOR OFFICE SPACE REMAINS AS WORKERS DEVELOP NEW WAYS OF WORKING
BY MARC SELVITELLI, CAE, NAIOP PRESIDENT AND CEO

Knowledge workers rapidly shifted their workspaces from in-office cubicles to home offices at the onset of the COVID-19 pandemic, leaving some office spaces largely unoccupied for close to two years. As the pandemic subsides and the sluggish return to the office continues, space needs are changing.

Instead of five full days in the office, hybrid schedules that split hours between home and the formal workplace are emerging as the new normal. This propels space users to evaluate everything from where offices are located to the configuration of floorplans that balance needs for both collaboration and privacy.

Most critically, users are reconsidering how much space they need to lease. Do they need more square footage that allows for solo offices and the social distancing we've all grown accustomed to, or will space needs lessen as the likelihood of entire teams of employees all being in the office on the same day wanes?

While the answers to these questions are yet unknown as employers continue to refine their office use, the fear that the office has become obsolete seems to be unfounded.

The NAIOP Research Foundation's Office Space Demand Forecast, published biannually in May and November, notes that the U.S. office market absorbed 21.6 million square feet from October 2021 through March 2022.

Leasing activity has increased year-over-year, signaling that firms are more comfortable making long-term commitments to office space. Notably, building owners have been willing to offer generous tenant improvement packages to motivate lease signings – a sign that tenants still have the upper hand in these negotiations. Together, these trends indicate a shift toward a more stable equilibrium as the office market finds its balance.

Class A buildings are driving net absorption rates in many parts of the country, such as the Sun Belt, and many firms consider quality office space necessary to attract skilled employees. Suburban markets, including Pittsburgh's, are on the upswing and life sciences hubs are gaining strength faster than the national average as employees return more regularly to the office. Kastle Systems reports office occupancy reached 47.4 percent in October across the 10 U.S. cities that the company tracks.

Given these trends and current economic conditions, the forecast's authors project net office space absorption in the remaining three quarters of 2022 to be 46.9 million square feet, essentially unchanged from 46.6 million square feet previously forecast. Total net absorption in 2023 is projected to be 47.3 million square feet, with an additional 6.5 million square feet absorbed in the first quarter of 2024.

Of course, this has a ripple effect on the economy. In Pennsylvania, development of ongoing operations of new office projects in 2021 contributed more than $4.1 billion to the state's economy and created nearly 27,000 jobs, according to the Economic Impacts of Commercial Real Estate report published annually by the NAIOP Research Foundation.

For office space not currently occupied or ripe for redevelopment, conversion to other in-demand property types, including life science, medical office, and multifamily housing, has potential. Earlier this year, the NAIOP Research Foundation commissioned a report to evaluate the risks and opportunities associated with these types of office building conversions.

The report stated that local market conditions and a building's existing design features determine whether it is a suitable candidate for conversion and which new use will provide the best return on investment.

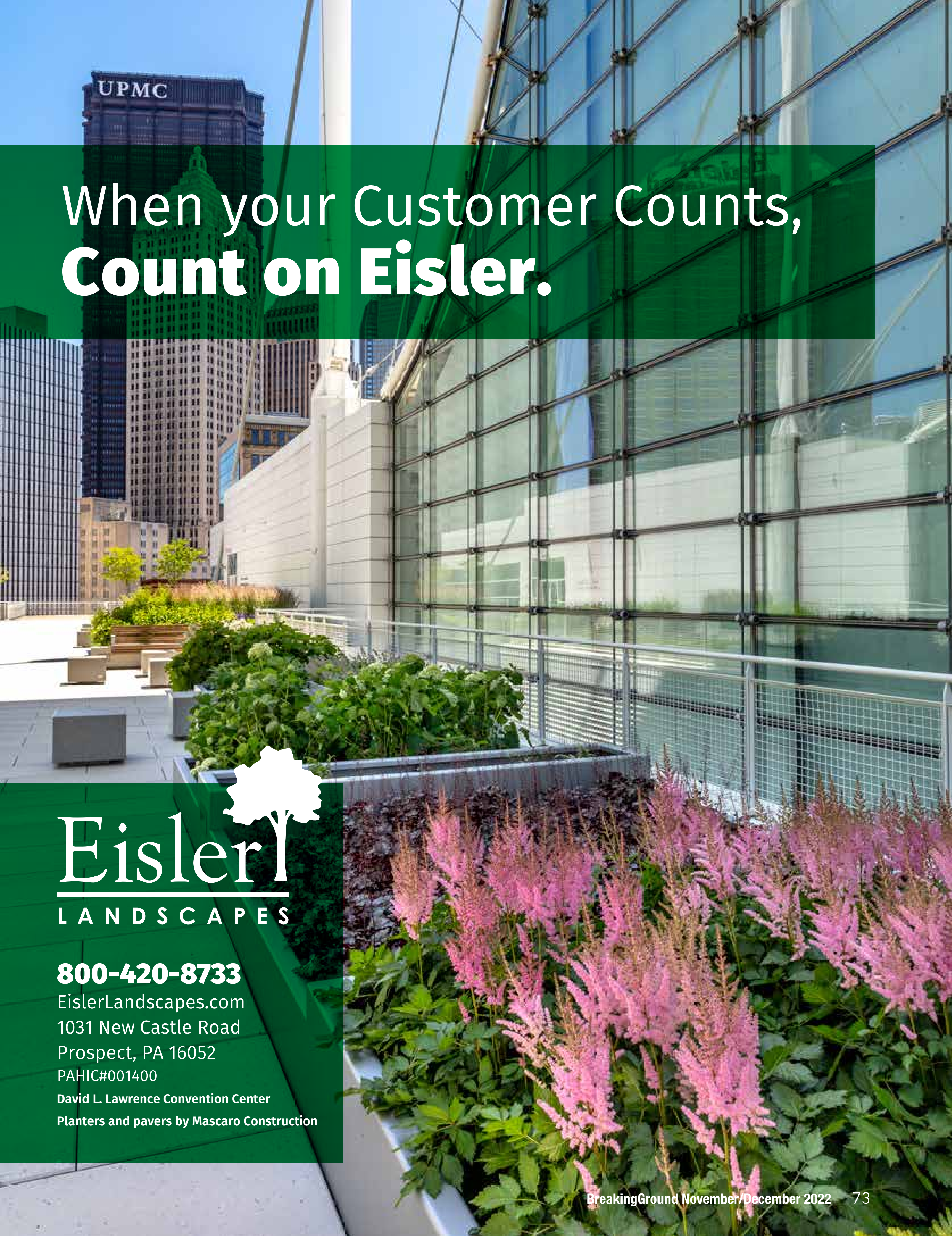
Multistory life science building conversions can produce strong returns but are generally limited to markets with an already strong life science sector, such as Pittsburgh. Office-to-multifamily building conversions occur largely in urban locations and with office buildings that are 50 years old or more. Office spaces located near hospitals and in areas with a growing population can emerge as good candidates for a full or partial conversion to medical office.

As office occupancy settles into its new normal and workers redefine how they're using the spaces available to them, it's clear that building owners and employers will be working to create workplaces with wellness and employee-centric considerations in mind to optimize productivity and collaboration.

Development magazine outlined several principles to achieve satisfying workplaces, including understanding how space design impacts productivity; integrating connective technologies; empowering employee choice with a variety of seating and huddle options; and infusing the brand through the workplace to fuel a cohesive culture.

The pandemic has certainly driven massive shifts in office space usage as well as prompted new appreciation of the workplaces that maximize employee wellbeing and productivity. NAIOP will continue to be your source for timely research on how to remain competitive in the changing office real estate sector..

Marc Selvitelli is president and CEO of NAIOP Corporate in Herndon, VA.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