Pandemic Dims Big Cities' Bright Lights

The future is uncertain for large urban areas and the companies that populate them.

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Grant Morgan started three companies in San Francisco, and he adores the city, especially its arts, culture and vibrant tech community. In the tech industry, "trying new things is really celebrated. Even failure is celebrated," says the California native who grew up outside Sacramento.

Yet Morgan is praising what he calls "one of the greatest cities in the world" from his new home in Salt Lake City. Morgan moved his latest startup, R-Zero Systems, to Utah's capital earlier this year because labor, housing and office space cost a fraction of their Bay Area equivalents.

On the other coast, health care software maker Phreesia let its New York City lease expire last year and moved the company headquarters from Manhattan to Raleigh, N.C., where it already had an office. Only about 100 of its roughly 900 employees were based in its New York City office, and many worked remotely even before the pandemic. Keeping the space didn't make economic sense, says Amy VanDuyn, the company's senior vice president of human resources.

Many metro areas are only starting to grapple with the pandemic's aftereffects. While companies are moving out of urban centers, individuals are leaving large cities, as well. The two-pronged exodus presents challenges for large metropolitan areas and the companies that populate them as economic activity slows. Developing a plan to navigate all the cross currents affecting the cities' futures will be a tough and lengthy exercise. How large metropolitan areas and the companies that remain in them will fare remains to be seen.

"Big cities are in for a rough three or four years," says Gay Cororaton, senior economist and director of housing and commercial research for the National Association of Realtors, a Chicago-based trade group. "Secondary cities will benefit. You will see bigger migrations there."

The Exodus

Phreesia's lease accounted for 20,000 square feet of Manhattan's 405 million square feet of office space. R-Zero, a maker of disinfecting systems founded during the pandemic, never even rented space in San Francisco before opting to move. Both cities' commercial real estate markets could easily withstand such losses.

JPMorgan Chase, New York City's largest employer and biggest occupier of office real estate, says its space needs will be significantly reduced due to hybrid schedules that allow employees to work from home part of the week. And companies such as Oracle and Tesla are leaving Silicon Valley.

But the departures are not happening just in coastal cities. Minneapolis-based retailer Target Corp. has said as more people work remotely, it would exit its headquarters and redirect other employees to other area offices.

Such separations are dealing a blow to city finances. And the corporate moves are compounded by individuals exiting New York and San Francisco, as well as other large cities, such as Boston and Los Angeles, according to several analyses. Remote work offers new options, and a pandemic spread through close contact seriously reduced the appeal of living in crowded, expensive cities. New York City's subway system was hardly beloved before COVID19 struck, but traveling in narrow underground tubes amid a pandemic brought new levels of anxiety.

In New York City, net moves rose 63 percent in 2020, according to an analysis of U.S. Postal Service change of address forms by Dallas-based real estate company CBRE. Still, New York City fared better than San Francisco, where the number of net moves out of the city doubled. Meanwhile, net moves out of Los Angeles jumped 33 percent.

The Economic Fallout

The combination of fewer companies and residents equals bad news for big-city economies. Fewer patrons for restaurants, bars, stores and services means fewer establishments can survive and fewer workers will be needed. It also means less sales tax is collected. Meanwhile, declining rents stifle building values, which, in turn, squeeze property taxes, which are based on appraisals. The pressure is on for city leaders to reinvigorate their downtowns

In an interview with Bloomberg TV, JPMorgan Chase CEO Jamie Dimon said, "New York could have a little bit of a difficult time. Already, real estate needs will come down. Most of us are going to go to more open seating because you don't need 100 seats for 100 employees—you're going to need like 60."

San Francisco and San Jose, Calif., are especially at risk. They have the highest number of people working in office buildings, says Tracy Loh, a fellow of the Metropolitan Policy Project at the Brookings Institution, a Washington, D.C.-based think tank. "They are super exposed to changes in office markets," she says.

Elizabeth Handler, a spokeswoman for the San Jose Office of Economic Development says the city is still focused on helping businesses recovery from the pandemic. "If only 50 percent of the people come back, it will be a problem," Handler says. "It is not one we are solving for right now."

Representatives from San Francisco didn't respond to requests for comment.

"You are going to see some realignment, some repurposing of some of those office buildings" in big cities, Loh says.

Many city-center towers are struggling. In Manhattan, overall vacancy for office towers at the end of the first quarter 2021 stood at 16.3 percent, the highest level since the third quarter of 1994 and up from 11.3 percent in 2020, according to real estate company Cushman & Wakefield. Overall, Manhattan office rents hit $72.41 a square foot earlier this year, the first time in three years they were below $73.

The situation was worse in San Francisco, where the vacancy rate at the end of the first quarter more than tripled to 18.7 percent from the same period one year ago. Sublease space, which is space that has been leased by companies that are trying to reduce their footprints, accounted for slightly more than half of all vacant space in the city. Overall asking rent was $73.76 a square foot, down 12 percent from its peak in the second quarter of 2020.

In Silicon Valley, office rates rose to 12.4 percent, up from 9 percent during the first quarter of 2020. New leasing activity hit a historic low since the pandemic began. Total gross absorption finished the first quarter at 455,000 square feet, less than half of what was recorded in both the third and fourth quarters of 2020.

Potential New Life

It's too soon to see evidence of widespread transformations as a result of all the movement, though signs of change are emerging. Boston Properties Inc., which is noted for owning Class A office buildings, announced during its first-quarter conference call that it was launching three new lab and research facilities for the life sciences sector. One of them involves converting an office tower to labs.

Redeveloping office towers for other uses isn't a simple undertaking. Potential roadblocks include local zoning laws and construction costs. It can be done, however. Government incentives have pushed landlords to repurpose outdated office buildings into apartment towers in downtown Manhattan, creating a lively new residential neighborhood. Additional enticements were given to foster rebuilding after the Sept. 11, 2001, attacks.

Whether once-bustling business districts that have turned into COVID-19 ghost towns will be reborn with a new purpose remains to be seen. The number of workers who return to the office is one major factor that will influence landlords' decisions about their buildings' fates. Many companies have said they will allow employees to work remotely at least part of the time. What's less clear is how often people will be onsite, and that piece of information is critical. It will determine how much space employers need and how many people will be around to frequent restaurants, bars and shops.

"We have to recalibrate the level of demand," says Scott Rechler, chairman and chief executive of RXR Realty, which owns 19 million square feet of space in Manhattan. "I think in 12 to 24 months, we'll have a better idea of how things are shaking out."

Rechler says landlords will need to be more creative when writing leases for retail tenants, to give office workers the amenities they seek, such as coffee shops and delis.

"We have to view those amenities like a partner while the economy is in flux," he says. For example, instead of charging retailers a flat rent, the landlord and tenant could enter into a revenue-sharing agreement.

Cities facing lower tax revenue don't have many options.

"Will they raise taxes on constituents or cut services?" asks Brian Zrimsek, an industry principal at Cleveland-based MRI Software, which makes products for real estate companies. "No one likes either of those options."

But big cities haven't lost their allure entirely. Amid the pandemic, Menlo Park, Calif.-based Facebook leased 730,000 square feet in the Farley Building, a massive structure in midtown Manhattan that's being redeveloped to include office and retail space. Menlo Park-based Google; Cupertino, Calif.-based

Apple; and Seattle-based Amazon have leased huge swaths of space in Manhattan over the last few years.

Location Options Multiply

So if some metropolitan areas are still appealing to growing companies, then what's changed? The number of cities on corporate executives' radar when they seek to establish a new business, relocate or expand has increased. Austin, Texas, has been a top pick for many tech companies in recent years, thanks to an educated workforce and a lively music scene that attracts young people. The capital city has been joined by locations such as Salt Lake City; Provo, Utah; Raleigh, N.C.; Phoenix; Indianapolis; and Denver.

"So many companies are going to Austin," says Morgan at R-Zero. "The tech scene is exploding. It's the same thing that happened in San Francisco. The cost of living is becoming astronomical."

That's why Morgan decided against relocating to Austin. Salt Lake City is the fourth best-performing large city for business in 2021, according to the Milken Institute, an economic think tank based in Santa Monica, Calif., that ranks metropolitan areas based on factors such as job and wage growth, broadband availability, and housing affordability. Roughly 45 miles from Salt Lake City, Provo and neighboring Orem ranked No. 1. The Palm Bay-Melbourne-Titusville area of Florida, the Austin area and Raleigh-Cary, N.C., round out the top five.

Salt Lake City, Provo and the surrounding areas make up what's called the Silicon Slopes for its large concentration of tech companies and world-class skiing and hiking. Provo-based Brigham Young University and Salt Lake City-based University of Utah annually churn out thousands of educated potential employees.

"San Francisco has the best tech talent in the entire world," Morgan says. "If you aren't doing cutting-edge research and development, you don't need it."

He estimates his labor costs are about 30 percent to 40 percent cheaper than they would be in San Francisco. Plus, his rented space costs him about $72,000 a year. Four years ago, that was the monthly rent for his office in San Francisco.

Smaller cities' allure extends beyond lower costs. "You get stability," says Heena Mistry, director of human resources at Celigo, a San Mateo, Calif.-based software integration company that announced earlier this year it was opening a hub in Indianapolis. She says the intense competition for talent in the San Francisco area leads employees to frequently job hop for a better salary. "That makes it difficult to develop a corporate culture and team spirit."

Indianapolis on the Rise

Celigo is still looking for office space but plans to hire up to 150 people by the end of 2024. The Indiana Economic Development Corp. offered the company up to $2.25 million in conditional tax credits and up to $250,000 in conditional training grants based on the company's hiring projections

Many cities and states dangle financial benefits in front of companies seeking new homes, and the perks can vary based on the size and industry of the enterprise being courted. Yet experts say the incentives are rarely a deciding factor in a company's decision.

Steve Sutter, Celigo's chief financial officer, says the most important reasons for choosing Indianapolis included the talent pool, developing tech scene and quality of life. "San Francisco is extremely stressful," he says. "There's a reason people want to move to Indy. It is the midwestern quality of life."

In 2003, a group of civic and business leaders in Indianapolis founded TechPoint, a nonprofit dedicated to bolstering the tech industry. Selling points include an ample supply of prospective job candidates from nearby schools including the University of Notre Dame, Purdue University and Indiana University. Professional sports teams such as the Colts and Pacers, as well as the Indianapolis 500, are a draw for sports fans.

One of TechPoint's programs invites tech executives to spend time in the city meeting potential employers, industry leaders and venture capitalists. Spring Rouhana and her husband attended such an event in 2019 and moved from San Mateo County, Calif., to Indianapolis last summer. The duo wanted to relocate so their son could be closer to his paternal grandparents but worried about their livelihoods.

"Jobs were the missing piece of the puzzle," Rouhana says. "We didn't know what kinds of opportunities we would have."

Family Motivates Moves

Rouhana says she was surprised that Indianapolis had such a rich tech scene. Through the TechPoint event, she got a job as chief financial officer and treasurer at DemandJump, a maker of digital marketing software. Her husband, Rudy, is joint venture cybersecurity head at Cummins, which designs, manufactures and sells products used in the power sector, such as generators and fuel systems. Their 8-year-old son, Noah, was thrilled to play in the snow.

Both Rouhana and her husband took pay cuts to leave the Bay Area, but it hasn't hurt their standard of living. They sold their California home for about $2 million and purchased a much larger one in an Indianapolis suburb for $700,000.

Still, leaving the Bay Area, with its rich cultural offerings and beaches, wasn't an easy decision. But Rouhana says she has been pleasantly surprised by the museums and performing arts options in Indianapolis.

"Culture isn't at the same level as San Francisco, and we do miss that," Rouhana says. "Here we have family and friends—and we put a high value on family and friends."

Theresa Agovino is the workplace editor for SHRM.