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Think
BIG
A recessionary mindset is squeezing the office market.
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Think BIG

A recessionary mindset is squeezing the office market.

The national office leasing market that emerged from the recession was a vastly different animal than the one that entered it in 2008. The years of downturn transformed how corporate tenants around the country define their use of space, and that fact has contributed to a leasing recovery that, while progressing, has to date been slower than other areas of commercial real estate. For comparison, just look at the capital markets, which by most accounts are fully back on track.

Make no mistake. Leasing has stabilized, to the point that some regions even boast construction starts to absorb the demand. What's more, as the recovery continues to take hold, corporate America is beginning to move beyond its doing-more-with-less mentality to start doing more with, well, more. That means expansion.

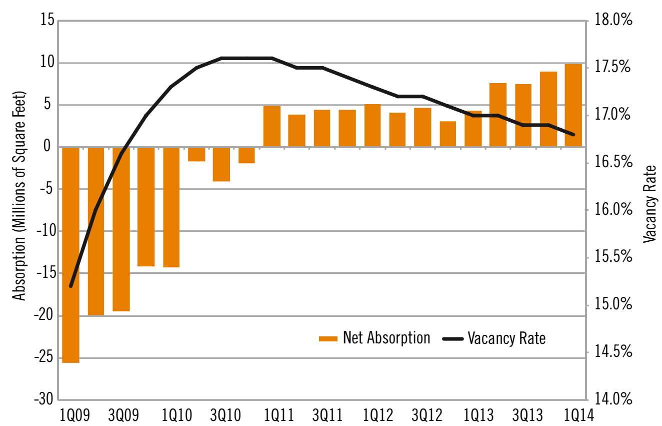
Recessionary Thinking

"The job numbers have been disappointing," says Hessam Nadji, senior vice president and chief strategy officer for Calabasas, Calif.-based Marcus & Millichap. "But the No. 1 job-creating structure in the U.S. since the recession has been professional and business services." In fact, Nadji points out there have been nearly 700,000 jobs added in this sector during the past 12 months. Nevertheless, the office vacancy decline has been minimal. Why?

"Every recession leaves a permanent mark," Nadji says. "Leasing was very aggressive during the growth cycle. The permanent mark from this recession is a reversal of that — an ultra-conservatism about space

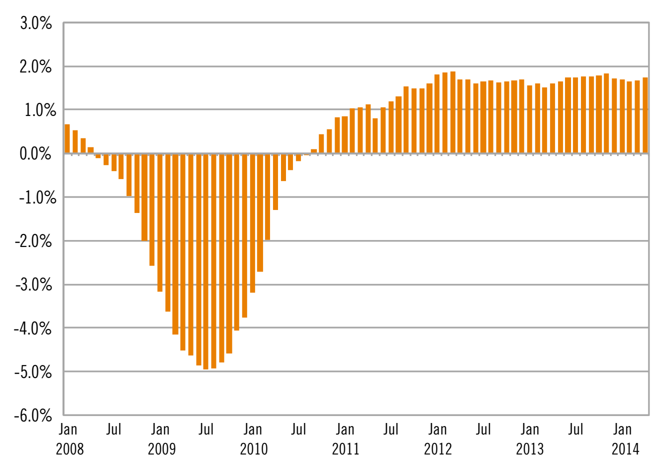
by John Salustri

Office Net Absorption and Vacancy



Source: Reis

12-Month Change in Employment



Source: Reis

utilization — and it is here to stay. Tenants are completely rethinking their use of office space with the goal of consuming less space and becoming more efficient."

The squeeze is definitely on. According to CoreNet Global research, the average square foot per person dropped from 225 square feet to 176 sf between 2010 and 2012. That is expected to shrink to 100 sf by 2017.

Matt Eckert, a CBRE vice president in Kansas City, Mo., sees that dynamic playing out daily. "Our clients are looking very closely at how much space they use," he reports. "Some of the larger law-firm tenant improvement projects currently underway here reflect a reduction in office sizes of roughly 33 percent."

But Nadji believes that many corporate offices have reached capacity. "The worst of this disconnect between job growth and space consumption is over," he notes. "More companies are looking at the need to grow."

Eckert is seeing that as well in Kansas City, reporting that CBD vacancies are whittling down, due both to a hike in leasing and a conversion of older office assets to residential use. "The CBD/Crown Center market is at 21.6 percent vacancy with little differential between class A and B product," he reports. The vacant inventory got a big boost when the General Services Administration selected Two Pershing for its 150,000-sf requirement late last year, "as well as from a handful of long-standing office buildings that have announced a residential conversion."

A Bipolar Market?

As we stand at the tipping point between stabilization and full-bore recovery, the leasing market seems almost bipolar. CCIMs we talked with express both post-recession highs and, if not lows, at least concern about what the next months will bring, sometimes both in the same market.

"It's getting better, but it's slow and we're moving at glacial speed," says Thomas C. Aguer, CCIM, SIOR, president of NAI Aguer Havelock in Sacramento, Calif. Ironically, that's a vastly different picture than the one taking place in white-hot San Francisco, just 90 miles to the west, or even the suburb of Roseville, Calif., a mere 20 miles to the east.

In Sacramento, "We're seeing the private sector generally squeezing more people into less space, creating extremely high headcounts," he says. "Sacramento rents are running at $21 psf to just over $22 psf per year with the CBD topping out at $24 psf." By comparison, along Roseville's Douglas Boulevard, rents can match the Sacramento CBD.

Phoenix is another metro area with one foot in stabilization and another in growth. Andrew Cheney, CCIM, SIOR, a principal at Lee & Associates, reports that in the Chandler and Tempe, Ariz., submarkets, there is actually office construction taking place, to the tune of nearly 2 million sf, 18 percent of which is spec. And yet, the overall vacancy "is still 22 percent, causing downward pressure on rents."

He predicts that if the market can absorb at least 2 million sf this year, "we'll break into the 19 percent vacancy range and begin to see a different Phoenix office market." That's highly doable if the market can continue to attract deals such as the one forged with Rural Metro, a national provider of private ambulance and fire-protection services. Rural took 90,000 sf in the Pima Office Pavilion in Scottsdale, Ariz., making it the largest lease of the first quarter. "We have some wind at our backs. Let's see how strong it stays," Cheney says.

Capital vs. Leasing

Interestingly, despite such mixed reviews, building values have continued to increase. But that's not likely to continue until leasing catches up. (See Investment sidebar.) Happily, that time is near at hand.

"There are two market cycles that don't necessarily speak to each other," says Dan Fasulo, managing director of New York City-based Real Capital Analytics. "There are the leasing markets, and then there are the capital markets. The capital markets have basically seen a full recovery from the downturn. The space markets have not." However, Fasulo is quick to acknowledge that rents are starting to rise and vacancies dip. He says that this is due in part to the fact that "we haven't built anything in five years." (See Pipeline sidebar.)

Investors, hungry for higher yield, are going to be challenged to wring more from their assets. "That game is over," Fasulo says. "The capital is already here, and interest rates are at an all-time low. You can't get any more money from that part of the equation. So the space markets are going to become an increasingly important factor in the increase of prices. You're going to have to get higher rents and you're going to have to have fully leased office buildings."

The statistics reveal the slow transition of leasing from stabilization to growth. Reis reports that the national vacancy rate fell to 16.8 percent in first quarter 2014, a 10 basis-point decline from 4Q13. Since vacancies peaked at 17.6 percent in 2010, there hasn't been a decline larger than that.

Of Reis's top 82 markets, only 24 had a 1Q14 vacancy rate below 16 percent. For the most part, these were the obvious choices, the major gateway cities, such as Washington, D.C., at 9.7 percent; New York City, which logged in at 9.9 percent; and San Francisco at 12.8 percent.

However, 32 of the markets, many of them secondary and smaller, showed a 20 bp to 90 bp drop in vacancy rates from 4Q13 to 1Q14, and several had significant YOY vacancy rate drops, including Charleston, S.C. (-140 bp), Colorado Springs (-160 bp), Palm Beach, Fla. (-200 bp), and Portland, Ore. (-110 bp), indicating a broadening of the recovery.

The same dynamic holds true in rental rates. Rents have risen now for 14 consecutive quarters, totaling a 1.6 percent increase in 2011, 1.8 percent in 2012, and 2.1 percent last year. Asking and effective rents on a national basis grew by 0.7 percent and 0.8 percent respectively in 1Q14, Reis reports. The top three cities in 1Q14 rates were, again, New York at $62.30, which edged out Washington, D.C., at $50.58, and San Francisco at $44.68.

Who's driving the uptick in leasing? Technology and energy companies were the prime drivers of these reductions in "eight of the top 10 markets ranked by effective rent growth," says Reis vice president of research and economics Victor Calanog in

SECONDARY CITIES TAKE THE INVESTMENT SPOTLIGHT

Hungry investors searching for yield are starting to look beyond the country's top-tier cities. Real Capital Analytics managing director Dan Fasulo describes the pull of capital away from gateway cities such as New York and San Francisco as "almost like gravity" to the opportunities found in Atlanta (which ranked No. 6 in RCA's 2013 list of Top 40 markets with $10.6 billion in sales); San Jose, Calif. (No. 10 with $7.3 billion); or Denver (No. 12 with $6.8 billion).

"If you are REIT or a pension fund," says Fasulo, "you need a certain going-in yield to return what you promised your capital providers. And you can't do that in Manhattan anymore."

But don't fret for the major markets. Manhattan still ranked first on the list, with $36.3 billion; Los Angeles came in second at $24.5 billion; and Chicago third at $14.5 billion.

On an overall basis, sales of what RCA terms "significant" office properties totaled $22.6 billion in the first three months of 2014, a 31 percent jump year-over-year. In addition, "Prices continued to strengthen and cap rates trended lower," the report revealed.

Nationally, sales volume was up significantly for the nation's CBDs, but not so much for the suburbs. CBD volume was up 60 percent in 1Q14, RCA reports, while in the suburbs it increased 10 percent. "Nationally, average cap rates moved sharply lower for CBD properties while the suburban average was relatively unchanged," the report states. "Top quartile cap rates declined 25 basis points for both and currently average 4.8 percent for CBD and 6.3 percent for suburban."

the firm's 1Q14 First Glance report. These include San Jose, Calif.; San Francisco; Dallas; New York; Austin, Texas; Seattle; and Oklahoma City.

Real Capital Analytics is located in Manhattan's Midtown South, a traditionally lackluster submarket hidden in the shadow of always-hot Midtown. Today Midtown South is a tech hub and one of a couple of Big Apple neighborhoods that calls itself Silicon Alley. Fasulo reports that "Prices are maybe 50 percent above peak levels. It's really gotten very hot very quickly."

Indeed, Google, which helped establish New York's tech hub in 2010 by buying 111 Eighth Ave. for $1.8 billion, is reported to be looking for as much as 600,000 sf of additional space in Midtown South.

Simons R. Johnson, SIOR, MCR, CCIM, a principal in the Charleston, S.C., office of Colliers International, reports that tech-related groups indeed dominate. Tech firms and defense contractors, he says, have been signing the larger deals, between 20,000 sf and 40,000 sf.

But on a national basis the after-effects of the recession still linger, even as markets pick up. "Landlords appear to have little leverage over tenants," Calanog writes. "With concession packages being pulled back very slowly, effective rent growth is not much faster than asking rent growth."

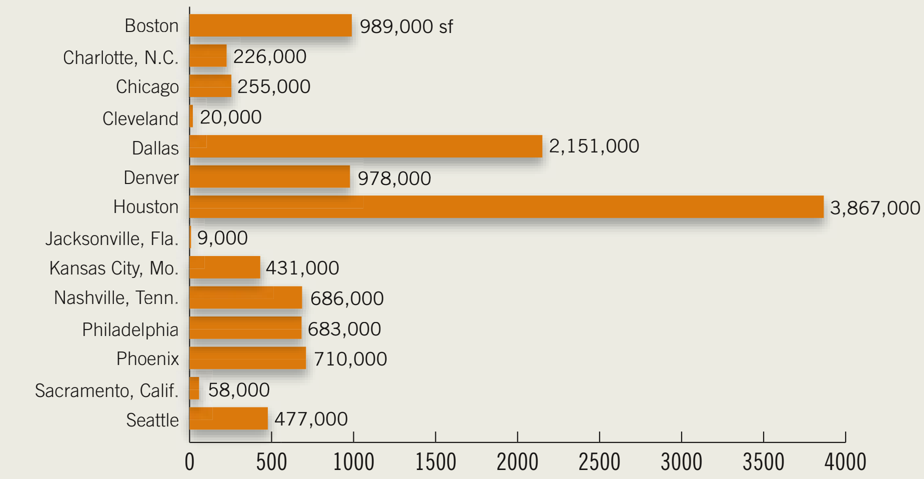
The good news here is that, if Nadji's theory proves true (and barring any surprises in the economic picture), more office-filling jobs are on the horizon. At some point the firms stuffing workers into available space will have to call their brokers once again.

Calanog says that's a possibility this year. "If the predicted monthly average of 200,000 to 250,000 jobs for the year does come to fruition," he writes, "we fully expect to record the first meaningful acceleration in vacancy declines and rent growth this year."

As a result, he's predicting a 3.0 percent jump in asking rents and a 3.5 percent hike in effective rents. And no economic surprises — so far — "have caused us to alter our outlook significantly."

1Q 2014 Office Construction Pipeline

Multi- and single-tenant assets combined



Source: CBRE Econometrics

A **PIPELINE** WAITS FOR FUNDAMENTALS

Of all the commercial real estate sectors, construction is the last to recover. "Lack of demand will have lowered rent levels and operating income, and slackened space utilization will make it harder to lease up existing assets," says Arthur Jones, senior managing economist at CBRE Econometric Advisors in Boston. Plus new builds can take up to five years to lease up, putting the sensible money on shoring up existing assets with in-place revenues.

Jones characterizes the current pipeline as "relatively subdued, but changing." That change is a reflection of the recovering fundamentals, leading to a construction pipeline that is "moderate and drawn out in comparison to historical norms."

It will still take some time before a national construction boom can be declared, given the spotty nature of those fundamentals. "Most markets are not ready to support construction levels anywhere near their historical norms," he says. "With rents well below their replacement-cost thresholds, in many markets it makes more sense for capital to pursue existing assets than to assume the risk of developing and leasing up from scratch."

There are exceptions, and for the most part these follow the new age of leasing trends with a focus on tech in such cities as Austin, Texas; San Francisco; and San Jose, Calif.; and energy in places like Houston. Then there's the nearly constant draw of the gateways, such as Boston and New York, neither of which, Jones points out, can be clearly defined as energy or tech hubs. "They have strong fundamentals and highlight a trend among more mature markets in which a combination of older stock and demand for modern space is pushing development into underdeveloped and underutilized submarkets." Going forward, Jones sees moderation as the watchword for new builds.

John Salustri is an award-winning freelance journalist who has covered the commercial real estate market for more than 25 years.