Q3 2019
Office First Glance

Pre-Release Analysis of Third Quarter 2019 Moody's Analytics REIS Findings in the Office Sector

SLOW AND STEADY FOR OFFICE FUNDAMENTALS

Vacancies stayed flat in the third quarter of 2019 at 16.8%. Vacancies have been creeping upwards since mid-2017, and we do not foresee a situation where vacancies will drop in an accelerated—or even sustained—fashion over the next few years. Economic and demographic change, technological improvements that allow people to work remotely, and shifts in the usage intensity of office space all contribute to the dampening of demand for this property type that led to a markedly slow recovery since the recession ended in mid-2009.

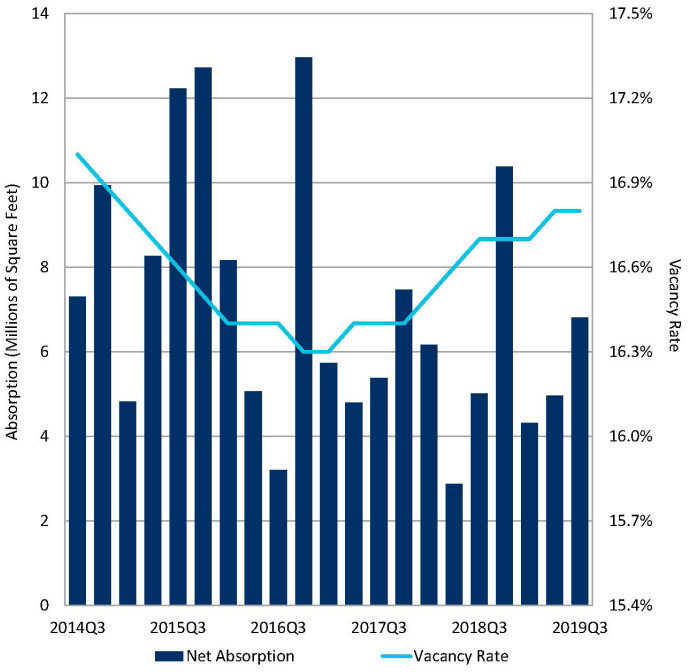
Net absorption came in at 6.8 million SF in the third quarter: quite in line with quarterly patterns over the previous two years. This comes over a base of new completions that clocked in at 7.0 million SF. Comparatively speaking, this is lower than last quarter's figure of 9.6 million SF, but higher than the 5.1 million SF added in the first quarter of 2019, which was the lowest figure for new deliveries of single- and multi-tenant market rate office space in six years. This quarter's figure falls below the quarterly average of 12.2 million SF added each quarter of 2018, which is consistent with the overall lack of developer enthusiasm for this property type. Office buildings are still being built, but they are concentrated in owner-occupied properties—more often than not commissioned by tech firms in tech-heavy metros.

DEVELOPERS HAVE RATIONAL EXPECTATIONS

With vacancies hovering at just 80 basis points below its cyclical peak of 17.6% in late 2010, there really isn't much to stimulate building. Asking and effective rent growth have been similarly muted, registering at 0.6% and 0.7% this quarter. Developers are looking at other property types—like multifamily—and devoting resources there.

On a year over year basis, asking and effective rents increased by 2.6% and 2.7%, respectively, which is in line with 2018

OFFICE NET ABSORPTION AND VACANCY



calendar year figures, and well below the 3.4% and 3.6% growth rates that the sector posted in 2015, a year that may well mark this property type's cyclical peak in terms of rent growth.

With vacancies mostly flat and rent growth in the low to mid-2s, it is no wonder that there hasn't been much of a building boom for office properties over the last nine years.

As discussed earlier, the office sector has been struggling with longer term trends that appear to be prompting employers to rethink their need for office space (and what type). The rise of industries driven by technology and social media suggest that traditional office space formats, which tended to require more space, need to be reevaluated: perhaps less space for actual office equipment, and more space for amenities that younger employees find desirable. The development of technology that allows workers to do their jobs remotely also

Q3 2019 Office First Glance

bolsters the argument that perhaps employers don't need to lease as much office space. Companies like WeWork position themselves at the forefront of "the new office space," catering to "the gig economy" as it evolves. Beyond WeWork's recent IPO struggles, a paper we published recently examines the effect of WeWork on nearby properties in New York City, to consider whether the coworking phenomenon has a measurable effect on rents and vacancies of nearby office and apartment buildings.*

However, the jury is still out on which format and offering will prevail. In the meantime, the rate at which office space was built from 2003 to 2008 was about half that from 1997 to 2002, and it has slowed further in the current period of economic expansion.

Absorption was positive in 56 out of Moody's Analytics REIS' top 82 markets, with occupancy improving in 43—up from 27 last quarter. Effective rents rose in a majority of markets (76 out of 82), but as discussed—the absolute numbers for rent growths were far from spectacular, and summed up to only 0.7% for the aggregate national figure.

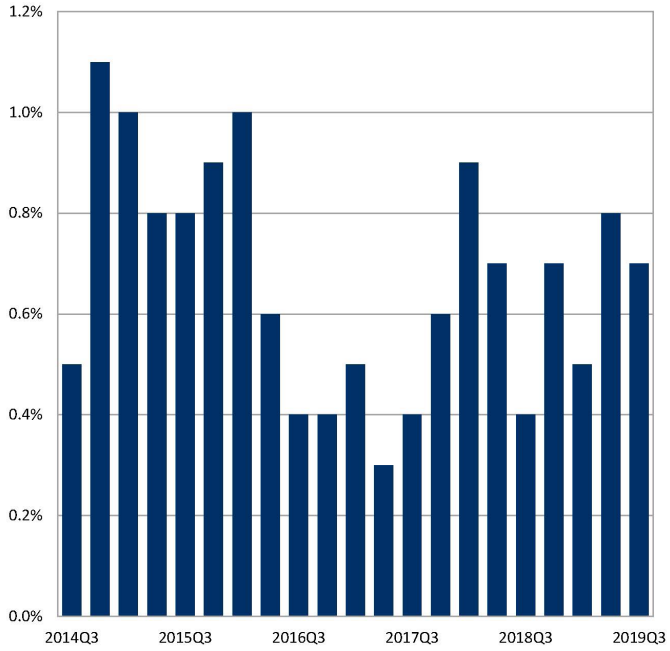
MARKET HIGHLIGHTS

Fewer metros saw a vacancy rate increase in the quarter: 30, down from 44 last quarter. Most of the increases were due to negative net absorption. Metros with the highest increases in vacancy include Providence, Wichita, Knoxville, Oklahoma City and Phoenix. Metros that saw the biggest decline in vacancy include Las Vegas, Columbia, San Antonio, Dayton and Austin. Some of these top 5 and bottom 5 metros have had strong job growth (Austin and Las Vegas) while others have not (Columbia). One can argue that the office property statistics are not highly correlated to office job growth.

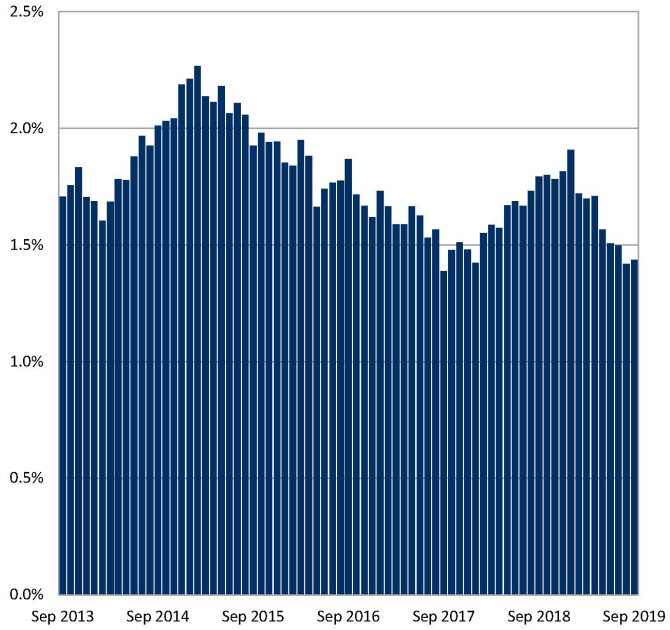
Rent growth was weaker in most metros as only 12 saw an increase in effective rent of 1.0% or more, led by Oakland-

* "The Effect of WeWork on Nearby Commercial Properties" (September 2019) - a white paper by the economics team of Moody's Analytics REIS. Downloadable via this link: https://www.reis.com/measuring-the-effect-of-wework/

OFFICE EFFECTIVE RENT GROWTH



12-MONTH CHANGE IN EMPLOYMENT



Source: Bureau of Labor Statistics

Q3 2019 Office First Glance

East Bay, Los Angeles, San Francisco, San Jose and Austin that had rent growth of 1.2% to 1.9% in the third quarter. Only four metros posted an effective rent decline in the quarter including Omaha, Hartford, Dayton and Houston.

New York City saw steady net absorption as vacancy declined 0.2% to 7.9%, still the lowest in the U.S.; the average effective rent grew 0.4% to $62.34 per square foot. At $53.76 per SF, San Francisco's average effective rent is approaching New York City's. San Francisco's effective rent growth for the quarter was 1.4% and for the year was 3.9%, New York City's average rent increased 3.1% for the year.

Third Quarter 2019 Market Performance

Improving Fundamentals / Flat or Declining Fundamentals

	Absorption		Occupancy		Effective Rent	
Q3 2019	56 +	26	43 ↑	39	76 ↑	6
Q2 2019	47 +	35	27 ↑	55	70 ↑	12
Q1 2019	51 +	31	38 ↑	44	64 ↑	18
Q4 2018	52 +	30	32 ↑	50	74 ↑	8
Q3 2018	47 +	35	23 ↑	59	70 ↑	12

Figures are based on 82 metro markets

OFFICE OUTLOOK

Moody's Analytics REIS does not expect the US economy to grow by more than 2.2% this year, and this in itself is a slowdown relative to the 2.9% growth rate in 2018 that was a recent high watermark (the last comparable figure was in 2014). While one can argue that 2018 growth numbers were 'sugar fueled' by the Tax Cuts and Jobs Act, any such boost in economic activity failed to materialize in stronger office fundamentals, so it is reasonable to expect flat to middling results for 2019. We have already seen this play out over the last three quarters.

This is not to say that there aren't pockets of stronger office activity in specific markets, related either to relatively strong job growth or the presence of active, growing industries like tech. But in a world of relatively flat fundamentals, the gap between strong and weak metros tends to be larger: for example, office fundamentals in central business districts have been markedly stronger compared to suburban neighborhoods. This all argues for greater care and diligence when evaluating opportunities and risks for this property type.

REIS®
Real Estate Solutions
by Moody's Analytics

Contact us for more information

Make better, faster decisions with data-driven CRE solutions.

reis.com | sales@reis.com | /reis_cre | /reis

Victor Calanog, PhD CRE® is the Head of Commercial Real Estate Economics at Moody's Analytics REIS. He and his team of economists and analysts are responsible for the firm's market forecasting, valuation, and real estate portfolio analytics services. He holds a PhD in Applied Economics and Management Science, trained by a dissertation committee composed of faculty from the Wharton School of the University of Pennsylvania and Harvard Business School.