

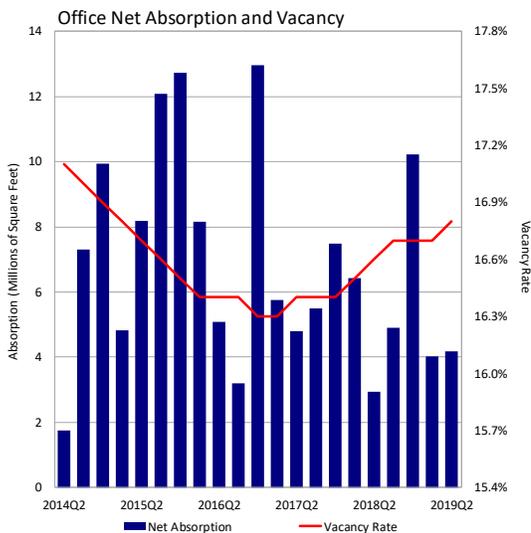


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General Flatness, Flaccid Rent Growth

Vacancies rose by 10 basis points in the second quarter of 2019, ending the period at 16.8%. This is no cause for worry - vacancies have been creeping upwards since mid-2017—nor do we expect an accelerated increase in vacancies over the next couple of years. Various forces have dampened demand for office space, well before the Great Recession of 2008-2009, and may gain greater ground given how GDP growth is widely expected to slow this year relative to 2018.



Net absorption came in at 4.2 million SF in the second quarter: in line with quarterly patterns over the previous two years, on a base of new completions that clocked in at just 8.4 million SF. This is higher than last quarter's figure of 4.8 million SF, the lowest figure

for new deliveries of single- and multi-tenant market rate office space in six years. This quarter's figure for new completions still falls below the quarterly average of 12.2 million SF added each quarter of 2018, which further supports the notion of the overall lack of developer enthusiasm for this property type.

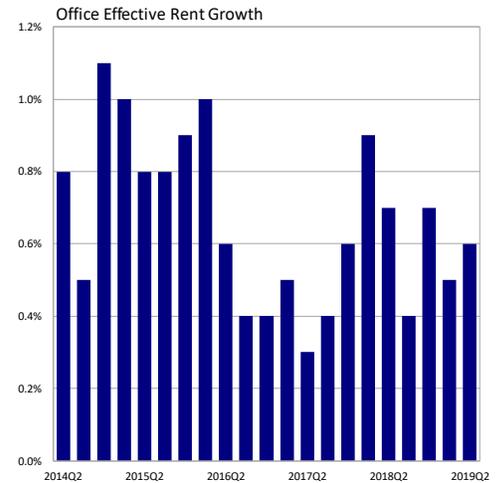
Not Much To Prompt New Development

With vacancies hovering at just 80 basis points below its cyclical peak of 17.6% in late 2010, there isn't much incentive for developers to build. Asking and effective rent growth was constrained, both rates registering at only 0.6% this quarter—quite in line with seven to eight years of lackluster rent growth.

On a year over year basis, asking and effective rents increased by 2.1% and 2.2%, respectively, which is in line with 2018 calendar year figures, and well below the 3.4% and 3.6% growth rates that the sector posted in 2015, a year that appears to

mark this property type's cyclical peak in terms of rent growth.

What is driving all this? The office sector has been struggling to cope with longer term trends, some of which began to gain ground in the 1990s, that are prompting employers to rethink their need for office space (and what type). Trends in technology like fax machines didn't do much to dent demand for office space in the 1990s, but the development of the internet, and platforms that allow cheap, reliable videoconferencing—or today's VPN, that allows workers to take command of their office computers from a remote location—support the argument that perhaps employers don't need to lease as much office space.



In a recent article,¹ *The Economist* makes the argument that the transition from manufacturing into service sectors for many large economies was a boon for job creation. This may well be true, but how many of those jobs need to be in offices? The relatively recent dominance of companies 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 (the functions of which might now be performed in off-shore locations) is in demand - and more space for amenities that younger employees find desirable is needed.

In last quarter's First Glance report, we mentioned how companies like WeWork position themselves at the forefront of "the new office space," catering to "the gig economy" as it evolves. In an environment where office vacancies remain elevated more than ten years since the recession ended, WeWork has been growing at a phenomenal rate since its founding in 2010. In a working paper we are currently finalizing, we find that WeWork actually does have an effect on how other office properties perform (stay tuned for the results) - suggesting that it is a disruptive force for the sector.² But the jury is still out in terms of which format and offering will prevail. Critics point out that WeWork has yet to turn a profit, and that its business model has not been tested by a major recessionary event (although WeWork claims that there is already such a test in progress: for its locations in Argentina). And its growth has been the exception: 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 (record-setting, in terms of length as of July) period of economic expansion.

Absorption was positive in 46 out of Reis's top 82 markets,

with occupancy improving in just 27. Effective rents rose in a majority of markets (70 out of 82), but as discussed—the absolute numbers for rent growths were far from spectacular, and summed up to only 0.6% for the aggregate national figure.

Reis does not expect there to be a recession in 2019, but economic growth will likely slow relative to 2018. All of this adds up to an expectation that the office rental market will not show much in terms of robust fundamentals: a whole lot of flatness, once again.

Second Quarter 2019 Market Performance Improving Fundamentals / Flat or Declining Fundamentals						
	Absorption		Occupancy		Effective Rent	
Q2 2019	46 +	36	27↑	55	70↑	12
Q1 2019	50 +	32	38↑	44	64↑	18
Q4 2018	52 +	30	32↑	50	74↑	8
Q3 2018	46 +	36	23↑	59	70↑	12
Q2 2018	40 +	42	24↑	58	76↑	6

Figures are based on 82 metro markets.

Notes:

¹"The rich world is enjoying an unprecedented jobs boom," *The Economist*, May 23, 2019.

²"A Pebble Cast Into A Pond: The Effect of WeWork on Commercial Property Performance," Working Paper, Moody's Analytics REIS, July 2019.

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Market Highlights

The gap between healthier metros and weaker ones has widened over the last few years. Forty-four metros saw an increase in vacancy over the quarter. Metros with the highest increases in vacancy include Nashville, Fort Worth, St. Louis, Milwaukee, and Denver. Metros that saw the biggest decline in vacancy include Fairfield County, Charlotte, Phoenix, Westchester and Ventura County.

Fourteen metros saw an increase in effective rent of 1.0% or more with Minneapolis, San Antonio, Seattle, Louisville and Austin leading the way. Nine metros saw a decline in effective rent with Rochester, Milwaukee, Chattanooga, Knoxville and Providence seeing the largest declines.

New York City (Manhattan) saw 882,000 SF added in the second quarter after approximately 53,000 SF in the first quarter. New York still boasts the lowest office vacancy rate of 8.1% and the highest effective rent of \$61.44 per square foot. Absorption was positive in the quarter.

Office Outlook

July 2019 marks a new record: we are now in the midst of the longest period of economic expansion in recent recorded history, beating the previous record expansionary period that ran from March 1991 to March 2001. Still, although the office sector formally began posting 'improvements' in fundamentals since 2010, progress has been painfully slow for single- and multi-tenant market rate rentals. For some geographies, driven by specific industries and companies—owner-occupied properties may be doing better: Facebook and Google have sprawling office campuses, but these are not considered competitive stock, the performance of which can be compared to market rate rentals.