Office First Glance

Pre-Release Analysis of Fourth Quarter 2018 Reis Findings in the Office Sector

2018 Quarter 4

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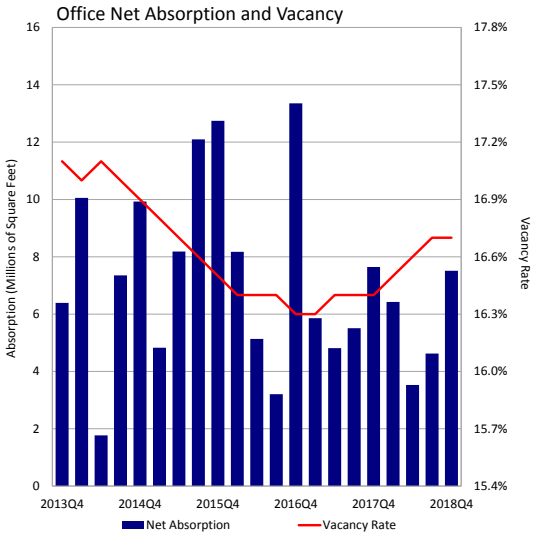
New York — January 15, 2019

Vacancies Are Rising for the Office Sector

The national vacancy rate for office properties ended 2018 at 16.7%. This represents a 30 basis point increase year-over-year. While vacancies also rose by 10 basis points over the course of 2017, at the time that appeared marginal and could have been interpreted as flatness. This year, we must ask why occupancies are showing a confirmed weakening trend.

That Middling Recovery

Objectively speaking, this was not much of a recovery for the office sector—specifically the single– and multi-tenant investment grade properties that Reis tracks. Vacancies topped out at 17.6% in late 2010 and began its gradual descent as the economy slowly recovered. Unlike the multifamily sector, however, occupancy improvements were never robust. The office sector hit what appears to be its cyclical low of 16.3% by the latter half of 2016. By any historical measure, a national vacancy decline of 130 basis points from peak to trough *over six years* can only be described as a mediocre recovery. By contrast, the *three years* of recovery from 2002 to 2004 that followed the tech bust and 09/11 saw office vacancies decline by 360 basis points; from 1992 to 1995, following the Savings and Loan crisis, office vacancies fell by 410 basis points.

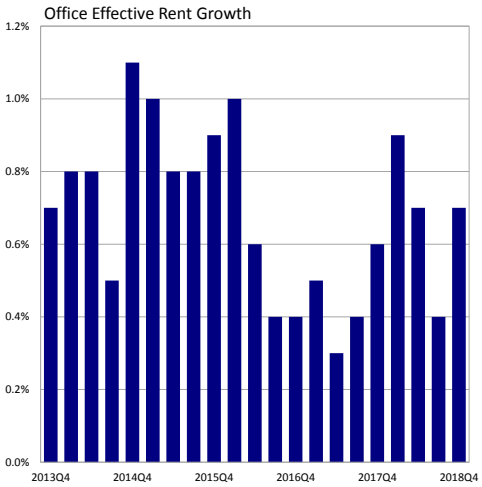


Office vacancies have begun to crest upwards once again as demand for office space—which never reached robust levels anyway, except for a handful of submarkets—flagged.

What Is Going On?

There are complex dynamics underlying these changes, but there are two main reasons for these trends. First, economic change: as the US economy transitions to producing services, industries that employed office-using employees have begun shifting their activities elsewhere, or have shrunk significantly. This has produced a stark divide between office space in central business districts, which are doing relatively well because finance, insurance, and real estate industries still demand space for their headquarters in major cities; and suburban office space, which housed jobs more vulnerable to trends like offshoring.

The other major change that accelerated in the late 1990s and the first decade of the 2000s was technology and its applications. While articles warning about the death of office space began appearing in the early 1990s, a facsimile machine still proved a poor substitute to actually being in an office space with its amenities. With reliable internet access and a plethora of telecommunications applications allowing employees to do their work remotely, demand for office space today remained subdued.



On the plus side, rent growth remains consistently positive, but unspectacular. Asking and effective rents both rose by 0.7% in the fourth quarter, and by 2.6% for 2018 as a whole. Effective rents rose for 74 out of Reis's top 82 office markets, even as occupancies improved in only 32.

Market Highlights

Fourth Quarter 2018 Market Performance
Improving Fundamentals / Flat or Declining Fundamentals

	Absorption		Occupancy		Effective Rent	
Q4 2018	48 +	34	32↑	50	74↑	8
Q3 2018	47 +	35	24↑	58	70↑	12
Q2 2018	41 +	41	24↑	58	77↑	5
Q1 2018	42 +	40	28↑	54	76↑	6
Q4 2017	50 +	32	33↑	49	74↑	8

Figures are based on 82 metro markets.

Metros with the highest vacancy rate increase in the quarter include Louisville, New Orleans, Colorado Springs, New Haven and Pittsburgh. The gap between metros with stronger office metrics and those with weaker ones narrowed in 2018 after widening a bit in 2017. In 2018, only one metro saw a year-over-year rent decline (Fairfield County) and only one saw rent growth above 4% (San Jose); while in 2017, three metros incurred a rent decline for the year, and three saw rent growth above 4%. Besides San Jose, metros with high effective rent growth for the year include Orange County, Kansas City, Raleigh-Durham, Charlotte, and Denver. For the quarter, six metros posted an effective rent decline: Little Rock, Fairfield County, Hartford, Lexington, New Orleans and Rochester. Metros with the highest quarterly effective rent growth rate were Los Angeles, Raleigh-Durham, Austin, Kansas City and San Jose.

At 8.3%, New York City still has the lowest vacancy rate along with the highest effective rent of $60.79 per square foot. New York saw the opening of 55 Hudson Yards (1.265 million SF) in the fourth quarter, which was 90% preleased. New York's effective rent grew 0.4% in the quarter and 2.8% over the year. San Francisco saw the opening of 250 Howard Street (760,000 SF) preleased by Facebook. San Francisco's effective rent growth for the year was 3.2%.

Office Outlook

The national office vacancy rate was once considered the most indicative measure of the overall state of the market. But when it has fallen only 90 basis points from a high of 17.6% in eight years of recovery, other metrics might prove useful in evaluating the relative health of specific markets. Rent growth has been steady throughout the last eight years, but the rate of growth has barely edged out the rate of inflation. Still, the quarterly rate of effective rent growth was higher in the fourth quarter than it was in any quarter in 2017 and most of 2016 as 2018 saw the strongest overall rent growth since 2015 – not bad for the eighth year of the recovery. There hasn't been much overbuilding—developers recognize that demand for office space has been slow. Office inventory has been considerably lower than in recent cycles, averaging 44 million over the last two years, down from an average of 122 million square feet in 1999 through 2001. With that said, completions will be higher in 2019 – close to 50 million square feet including 6.7 million square feet in Hudson Yards alone – while office employment is expected to decelerate. This should push vacancy rates up a bit, but rent growth should remain positive and in line with recent growth rates.