Office First Glance

2018 Quarter 3

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

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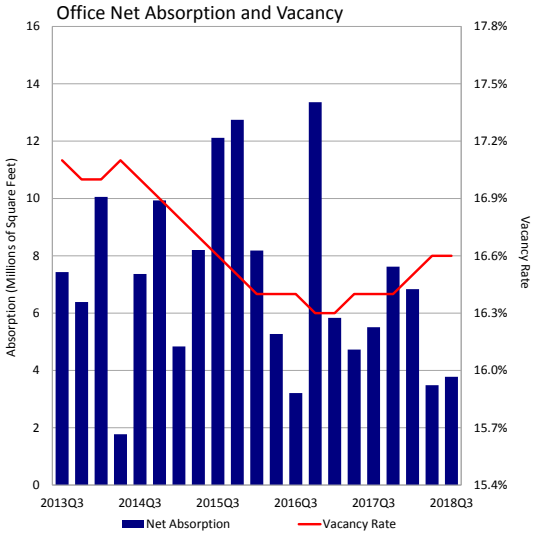
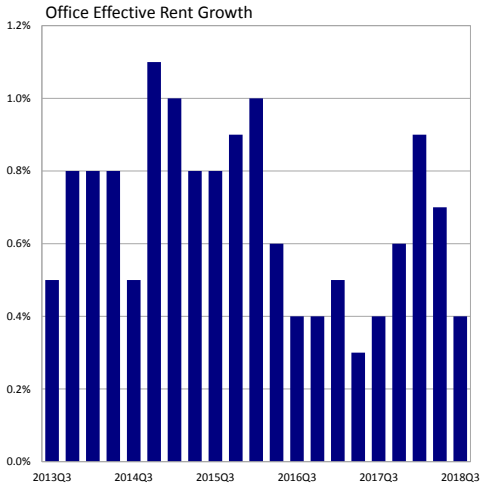
Office Vacancies Trended Flat

The national vacancy rate for office properties ended the third quarter at 16.6%, unchanged relative to the second quarter (although if you want to be precise about it — you can detect a slight increase from 16.58% to 16.61%). Vacancies have drifted upwards on a year-over-year basis, rising by 20 basis points relative to 16.4% four quarters ago. This has been an exceedingly sluggish 'recovery' for the office sector. Vacancies peaked in late 2010, about 18 months after the recession ended, cresting up to 17.6%. For national vacancies to decline by only 100 basis points over eight years means that I am being very kind when I call this recovery 'sluggish.'

It is, however, a recovery indeed. Supply growth has been modest, consistent with developer enthusiasm dampened by less than robust occupancy gains. Completions hit 44.7 million square feet in 2017, and deliveries will likely only increase marginally this year — to 48.3 million square feet. Some areas do enjoy slightly more construction activity — rezoned areas in the west side of Manhattan, for example; or downtown Detroit, which apparently has a handful of spec office buildings under construction in line with its nascent 'rebirth,' — but these represent the exception more than the rule. Absorption has in general followed construction patterns; positive every single quarter since 2011, but not impressive. Occupied stock has been increasing steadily but very slowly for the sector as a whole.



Asking and effective rents have also increased at a (very) subdued pace every quarter. Asking rents and effective rents both rose by 0.4% in the third quarter, for example. On a year-over-year basis, asking and effective rents have risen by 2.5% and 2.6%, respectively. Reis expects asking and effective rent growth for calendar year 2018 to track these trends, growing in the mid-to-low 2's. This represents a slight improvement over 2017, when asking and effective rents both rose by only 1.8%.



Should We Expect More from the Office Sector?

Pessimists (who consider themselves realists) suggest that it is difficult to expect more from the office sector when the US economy has been growing by only slightly above 2.0% since the recession ended (this year's blowout 3.0% GDP growth, notwithstanding). It is likely, however, that office absorption is also being held down by technological and labor market shifts that have been developing for decades. As the US economy shifts to services, and as office employers continue to optimize their use of office space — taking advantage of technology and infrastructure that allow more employees to work remotely, for example — actual office space occupied per office-using employee has declined steadily over the last three decades. As usual, however, it becomes a tale of have and have-nots once you peer underneath national figures. Office properties in central business districts, recently revitalized and favored by service firms for their headquarters, have tended to perform better than suburban office space.

Amidst sluggish figures overall, 69 out of Reis's top 82 office markets saw an increase in effective rents, and a slight majority (42 out of 82) posted an increase in occupied stock. Occupancy rates tended to be flat, however, with only 25 out

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

	Absorption		Occupancy		Effective Rent	
Q3 2018	42 +	40	25↑	57	69↑	13
Q2 2018	41 +	41	24↑	58	77↑	5
Q1 2018	42 +	40	28↑	54	76↑	6
Q4 2017	50 +	32	34↑	48	74↑	8
Q3 2017	47 +	35	35↑	47	70↑	12

Figures are based on 82 metro markets.

of 82 markets registering improvements.

Office Outlook

Labor markets are tight, wages are increasing, and the US economy is expected to grow by anywhere from 2.8% to above 3.0% this year. All this should provide positive headwinds for the office sector, but any improvement in office fundamentals are likely to be muted given the factors previously discussed. Some markets will outperform the national average significantly — where industries are flourishing and jobs are plentiful, office markets will likely be relatively more vibrant compared to the national average. The office market statistics still reflect the gap between the haves and the have-nots: larger markets in the West, South Atlantic and larger Northeast cities with healthy occupancy and rent growth offset by tepid growth or declines in smaller, suburban markets in the Midwest or in less densely populated areas.