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OFFICE Market Outlook

As if the plodding pace of U.S. employment growth since the Great Recession weren't slow enough, changing work habits and a tendency among employers to increase productivity by using temporary workers and contractors rather than full-time hires have conspired to produce one of the weakest office recoveries in living memory. The influential Millennials (ages 20-34), the newest generation of professionals entering the workforce, prefer to work with mobile devices and in project groups rather than at traditional, permanent workstations. That has given employers the opportunity to further embrace shared workspaces, telecommuting and other efficiency measures, effectively slashing leased space requirements from an average of 250 square feet per person at the beginning of the century to as little as 110 square feet today. Within markets, young workers' desire to live, work and play in a vibrant urban environment has funneled office absorption into central neighborhoods and, where possible, central business districts themselves. With a few exceptions, suburban office buildings have lagged the core markets in absorption. Among properties, the newest young professionals place a greater importance on LEED certification, flexible layouts and amenities than their predecessors did, and tenants hoping to recruit and retain the best talent will pay a premium for such space. Most markets were able to dodge an overhang of supply, thanks to the near overnight cessation of lending and speculative construction that occurred during the credit crunch, and many markets are now enjoying mild increases in rents. As is always the case in the office sector, job growth is the most critical determinant of demand and rent trends, and the markets at the forefront of demand growth boast a firm stake in one or more of the sectors driving the economic expansion. Energy, for example, is fueling strong absorption in markets like Houston and Denver, while technology companies are driving office absorption in markets from Raleigh to Chattanooga, even spurring downtown office tower construction in Austin.

CHARLOTTE, NORTH CAROLINA

As the second-largest U.S. banking center after New York, Charlotte suffered a severe contraction in office demand following the onset of the financial crisis and is still in the early stages of recovery. Financial services is again a dominant sector, and rapid hiring has driven total employment beyond its pre-recession peak, while the 6.6 percent jobless rate reflects a steady arrival of new workers. The metro's population of Millennials, ages 20 to 34, will increase by nearly 15 percent over the next five years, or four times the national average. Office vacancy is declining but was still more than 13 percent at the end of 2013. A below-average cost of doing business, coupled with a large and growing pool of educated workers, promises to attract new employers and fuel hiring and office absorption as the national economy accelerates. Downside risks include potential impacts from consolidation in financial services. Properties able to provide flexible, high-density space with rich amenities–favored by Millennials–will be better positioned to attract tenants and grow net operating income.

10 OFFICE MARKETS TO WATCH

- CHARLOTTE
- CHATTANOOGA
- CHICAGO
- INDIANAPOLIS
- MILWAUKEE
- RICHMOND
- SACRAMENTO
- SALT LAKE CITY
- STAMFORD
- SAN ANTONIO

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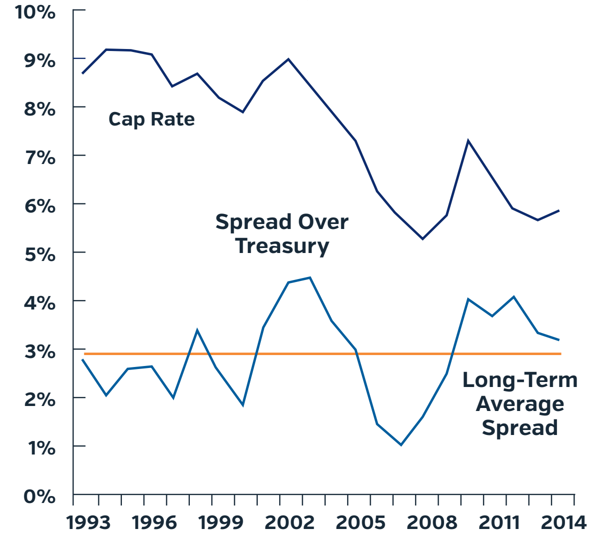
Key Office Market Trends in 2014

Office cap rates are near record-lows for the best-located trophy properties in gateway markets. These assets have dominated sales volume, pushing market average cap rates to cyclical lows and spreads towards their long-term averages. Smaller office properties have a wider cushion against rising interest rates provided they are growing income.

Office Cap Rates and Spreads Over 10-Year Treasury

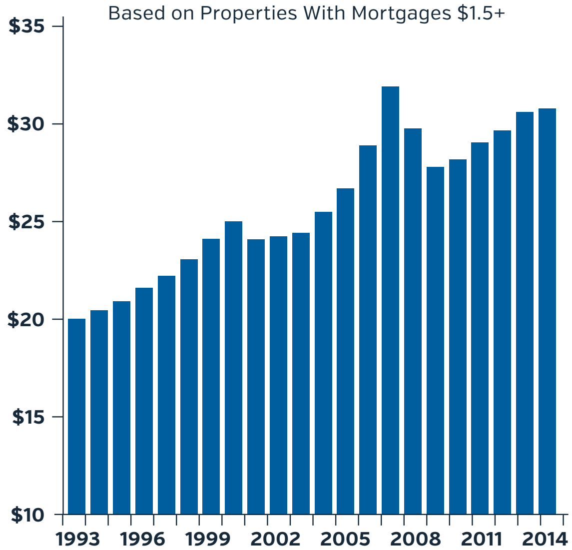
Source: Chandan, Federal Reserve



Office rents and occupancy rates are still below their pre-crisis peak levels. Absorption has been weak, largely on account on disappointing office-using employment trends. The job market is projected to improve over the next year, supporting new leasing activity. But changes in telecommuting and space-use patterns are a wildcard for the sector.

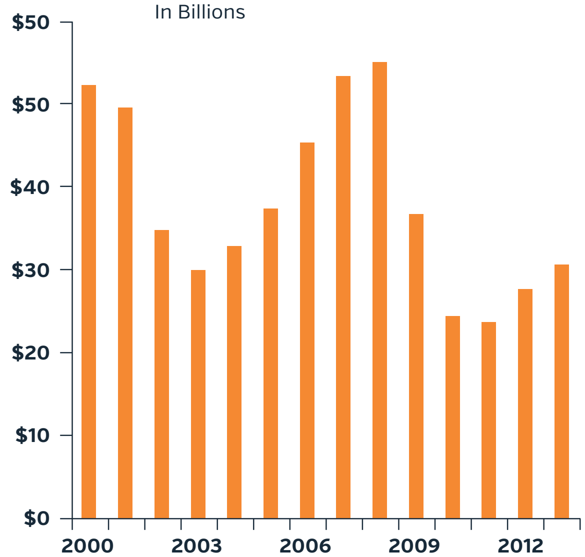
Office Asking Rents

Source: Chandan
Based on Properties With Mortgages $1.5+



Office Construction Spending

Source: Chandan, Commerce
In Billions



The office recovery has been aided by a dearth of new construction. In some of the largest markets, property prices are now well above replacement cost, prompting large-scale development. New York City is a case in point; Manhattan is on the cusp of the biggest office building boom in a generation. That threatens to displace some older properties that will struggle to compete for tenants.

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CHATTANOOGA, TENNESSEE

When many American cities were still reeling from the effects of the Great Recession, Chattanooga invested in a fiber-optic infrastructure that now delivers internet data at the lightning speed of one gigabit per second, earning the network its moniker of “The Gig.” Priced at less than $70 per month, the taxpayer-owned network offers one of the least-expensive gigabit-level services in the nation. That fabulous connectivity and pricing is attracting employers eager to tap the network’s capabilities, and those new arrivals and homegrown startups are fueling an urban renaissance in the local office market. Developers have converted several former industrial buildings into quirky office space, fashioning the lofts and urban workspaces popular with creative technology companies. Investors may find similar value-add opportunities among the warehouses and manufacturing spaces in this longstanding crossroads market, and there is the potential to attract major employers with the lure of low-cost gig connections.

CHICAGO, ILLINOIS

Elevated but improving unemployment of 8.3 percent is a reminder that Chicago is lagging other major markets on the road to economic recovery. The office sector entered 2014 with nearly a fifth of its office space available for lease or sublease, but leasing activity appears to be accelerating. The central business district is attracting tenants from the suburbs as the urbanization trend takes hold, with employers moving closer to employees that live downtown. Office rents are exhibiting the volatility typical at the bottom of a market cycle, and posted a slight year-over-year decline at the end of 2013. Chicago’s diverse economy positions it for accelerated hiring as the national recovery gains momentum, but that growth is unlikely to bring substantial absorption of office space in 2014. For office investors seeking a bargain on assets in a top tier city, non-trophy assets in Chicago may harbor good opportunities with the potential to increase value as the local economic recovery finds its stride.

INDIANAPOLIS, INDIANA

A growing technology cluster has put Indianapolis on many investors’ watch lists. Employment growth is occurring in key office-using sectors, with professional and business services jobs expanding by 5.5 percent year-over-year in 2013, and financial services growing 1.9 percent over the same period. Unemployment stood at 5.8 percent at the end of the year, slightly better than Boston’s jobless rate and on a par with San Jose. That employment growth hasn’t translated into significant office absorption for Indianapolis, however. Occupancy gains in the suburbs in 2013 were largely offset by a contraction in occupied space downtown, and downtown properties will likely lose more tenants before tightening in the suburbs drives users into the CBD. Submarkets enjoying the greatest demand are the Keystone and North/Carmel suburbs. Those neighborhoods have seen their vacancy rates drop into the middle to lower teens while West Indianapolis grapples with a vacancy rate well over 30 percent.

MARKETS TO WATCH

NOT THE LARGEST or the most actively contested markets, the 2014 Office Markets to Watch are each at an important juncture that presents unique opportunities for investment. Together, they reflect the diversity of trends that is driving the economy and commercial real estate performance in markets across the country.

MILWAUKEE, WISCONSIN

Milwaukee's office absorption turned positive in 2012 and increased to more than 300,000 square feet last year. The city's small inventory of Class A properties is essentially full at less than 5 percent vacancy, but the citywide average for all office space is more than 20 percent. The office market will get a morale boost when Northwestern Mutual Life Insurance Co. completes more than 1 million square feet of lakefront office space for its own use, and developer Irgens has announced plans to construct more than 350,000 square feet of space in a downtown tower a block from Northwestern Mutual's project. Milwaukee's unemployment rate of 6.2 percent is below the national average of 6.5 percent and the market will soon reach a job count equal to its pre-recession peak, but a high vacancy rate and limited demand for office space pose investment risks.

RICHMOND, VIRGINIA

Hiring that pushed Richmond's jobless rate to a post-recession low of 5.2 percent in December 2013 also fueled brisk absorption of office space during the second half of 2013. The citywide office vacancy rate, which peaked at more than 24 percent in 2008, has returned to single-digit territory after years of methodical recovery in the market. Even in the central business district, where vacancies increased slightly in the early quarters of 2013, the supply of available offices tightened in the second half of the year. Rents have been flat for Class B office space, but average Class A rents have climbed above $20 per square foot and will likely go higher by the end of 2014. Office buildings downtown and in Northwest Richmond are outperforming the overall market, largely at the expense of landlords in the southwest, who have been losing tenants. Nearly a half million square feet of new space under construction, mostly in the CBD, will do little to undermine the current trajectory. Value-add investors are more likely to find bargain pricing in the southwest.

SACRAMENTO, CALIFORNIA

The economic recovery in California's capital city has lagged those in Los Angeles, Phoenix and other markets that it has followed more closely in the past. The jobless rate ended 2013 at 8 percent, better than the statewide rate of 8.3 percent, but Sacramento hasn't yet recovered the number of jobs it lost in the last recession. An office vacancy rate in the middle teens has been falling slowly and began 2014 down about 300 basis points from its peak in 2011. Mildly positive absorption over the past two years contributed to a bottoming out in rental rates in 2013 and the beginnings of a turnaround in rent levels in early 2014. Developers have shown restraint in adding new supply, and fundamentals should improve incrementally this year. While its slow job growth elevates risk, Sacramento offers investment opportunities at higher cap rates than are available in many California markets experiencing a more rapid recovery.

SALT LAKE CITY, UTAH

One of the nation's job-growth leaders since the end of the recession, Salt Lake City boasts a diverse economy with rapid hiring in high tech, finance and other office-using jobs. The unemployment rate of 3.5 percent is one of the lowest in the nation. In 2013, the expanding economy resulted in more than 1 million square feet of net office absorption. A 12 percent vacancy rate at the start of 2014 was the lowest point since 2007, and although rental rates haven't found a bottom, landlords have gained sufficient pricing power to slash concessions in recent months. Developers appear confident of future demand, however: A 144,000-square-foot tower is already under construction in downtown and a project breaking ground later this year will measure 450,000 square feet. All told, Salt Lake has roughly 1.7 million square feet in the pipeline for the CBD alone, equivalent to a quarter of the downtown inventory. That volume of additional space should raise a red flag among investors, especially since the vacancy rate is already higher downtown than in outlying submarkets.

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STAMFORD, CONNECTICUT

Stamford has grown its diverse technology cluster into a bulwark of the local economy. Recruiters have discovered that the same advantages that first lured firms to move their headquarters here from New York City in the 1980s and 1990s have an equal appeal to technology companies and the highly educated, skilled workers those firms want to hire. Competitive office rents, excellent retail amenities and proximity to Yale University and the New York City tech community have attracted a diverse assortment of high tech employers and startups, ranging from digital media to research and consumer resources for online shopping and travel. Adding to the established office-using employment base of corporate headquarters and professional services, Stamford's technology cluster promises to attract additional tech workers, who in turn will draw new employers and fuel office demand in a dynamic cycle of growth.

SAN ANTONIO, TEXAS

Nearly 2 percent annual population growth and a diverse employment base are propelling San Antonio's economy at a healthy clip, but the market lags the performance and rising profile of the other major Texas metros of Houston, Dallas/Fort Worth and Austin. San Antonio's longstanding strength in the military and aerospace sectors, coupled with close proximity to Austin's high tech cluster, has fostered an important cyber security sub sector. Located less than an hour's drive south of Austin, the Alamo City has also captured a large piece of the Eagle Ford Shale energy boom emanating from South Texas, while its business-friendly climate, thriving tourism and manufacturing jobs attract new residents and fuel home sales. Office tenants were still giving back space in 2012 but absorption turned positive here in 2013. Delivery of several new office projects slowed rent growth and pushed the office vacancy rate into the middle teens last year without softening conditions enough to hamper rental rate growth. More construction is likely to begin in 2014. For investors who missed the opportunity to acquire office assets in Houston, Dallas or Austin at the bottom of the market cycle, San Antonio offers acquisition and development opportunities in a market that is in the early stages of appreciation.

IT'S A DIFFERENT WORLD OUT THERE.

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