Is the Office Sector Reaching a Plateau?

The office sector is experiencing contrasting levels of demand among different employment sectors and markets. On the positive side, the technology sector remains the leading driver of demand, and has made major leasing contributions in multiple "tech hub" markets. JLL reports that 24.4% of office leasing activity in the US is credited to expansion within the tech sector. Markets experiencing this "robust expansion" of more than 2% in annual occupancy growth include Austin, Silicon Valley, and Seattle.

There has also been a significantly large growth of registered occupancy among secondary markets, which is a potential indication that employers are seeking to expand in cost-efficient areas. The JLL report reflects that office investment in secondary markets "accounted for nearly 50% of fourth-quarter deal flow and 39% of full-year 2016 activity," with Atlanta, Dallas, and Philadelphia posting the largest transaction volumes.

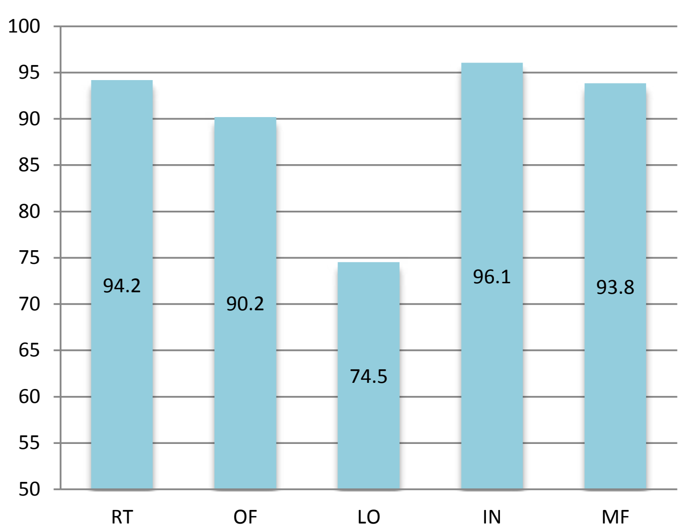
However, much of this growth was offset by the decline in tenant demand within the legal and financial services sectors in primary markets. New York City and Washington, D.C. had the greatest drops in net absorption, at -1.4 million and -308,000 square feet, respectively.

CMBS Trends

As the economy is nearing full employment, expansion in the office market has shown signs of deceleration. According to JLL's Office Outlook Q4 2016, net absorption came in at just 6.5 million square feet, during the fourth quarter which is the lowest quarterly occupancy growth that the US has seen over the past two years. Within private-label CMBS, average office loan occupancy increased by a mere 0.41% year over year from 2015, topping off at 90.0% in 2016. Occupancy for CMBS office loans came in at 90.2% last month, the second-lowest rate of all major property types.

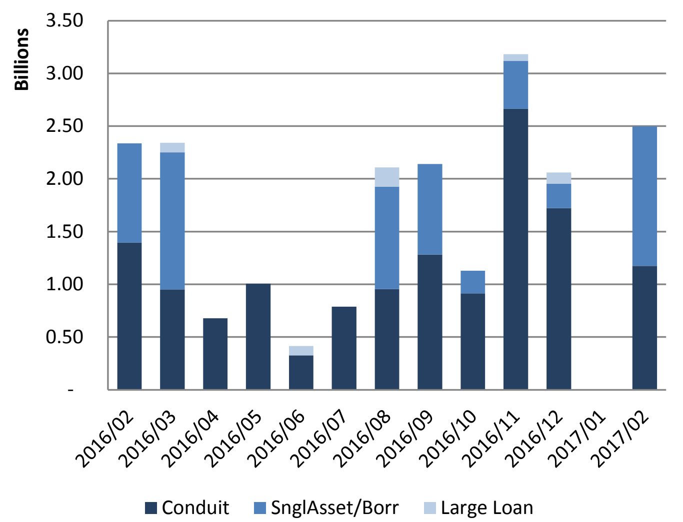
These occupancy trends could indicate shifting consumer preferences that Deloitte predicts will "redefine" office space usage in its Commercial Real Estate Outlook 2017. Millennials' preference for open, flexible work space may redirect demand towards mixed-use developments that contain office space, as consumers "prefer to 'live, work, and play' in proximity."

Figure 1: Current Average Occupancy by Property Type



Source: Trepp

Figure 2: Office Issuance by Deal Type

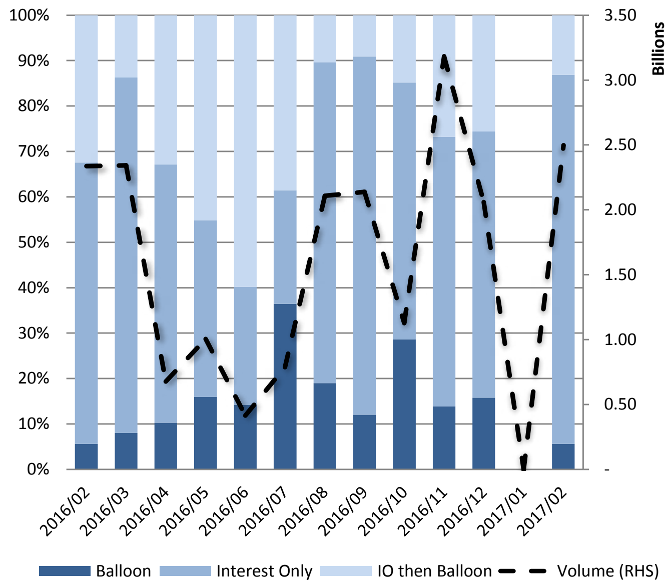


Source: Trepp

Issuance

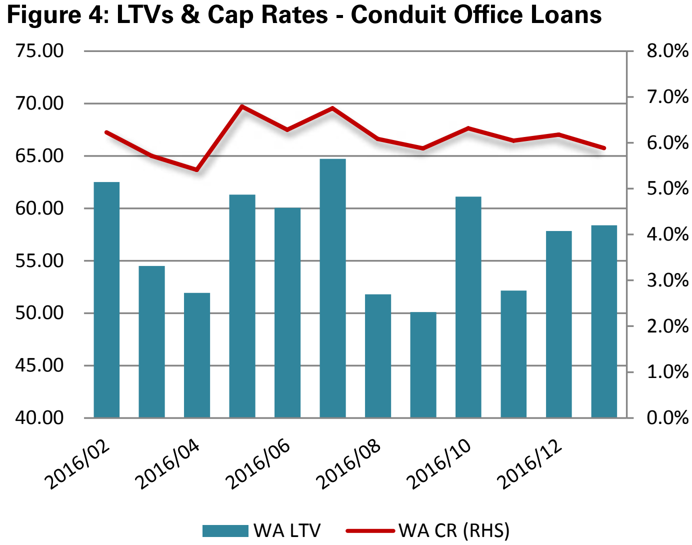
While no private-label office loans were securitized in January, two were issued in February. Historically, CMBS issuance has been dominated by conduit loans, which represented 70.0% of 2016 office securitizations. Single-asset/single-borrower and large loans accounted for 27.0% and 2.9% of the total, respectively. In terms of amortization type, interest only loans (both partial and full) comprised 85.5% of the office balance issued over the last 12 months, compared to 14.5% in balloon payment loans.

Figure 3: Office Issuance by Amortization Type



Source: Trepp

Figure 4: LTVs & Cap Rates - Conduit Office Loans



Source: Trepp

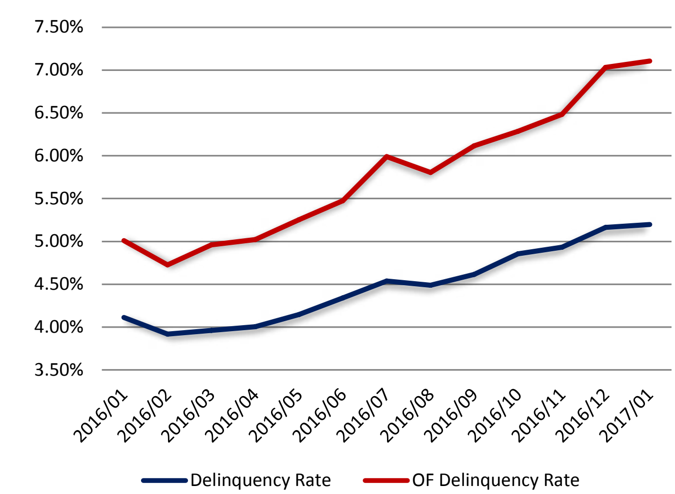
LTVs and Cap Rates

Securitized LTVs for new conduit office loans have remained relatively low, as the weighted average LTV clocked in below 65% over the last 18 months. However, shifting acquisition trends may put office pricing under pressure and weaken liquidity in certain markets going forward. Cap rates for conduit office loans exhibit signs of plateauing. After steadily compressing to around 6.0% over the past several months, the average cap rate for office notes has fallen to 5.88% thus far in February.

Delinquencies

The office sector currently features the highest delinquency rate of all major property types, as the sector's reading was 7.11% last month. In comparison, the national CMBS delinquency rate dropped five basis points month over month to 5.18% in January. The national delinquency rate has still been on an upward trend since April 2016, when it swung back over the 4.0% mark. As the "wall of maturities" continues to be digested by the market, the delinquency rate—including the delinquency reading for office loans—is expected to remain on an incline as a large portion of those 10-year loans issued from 2005-2007 were aggressively underwritten with weak credit standards. As office loans contribute roughly 27.2% of the outstanding CMBS debt, the delinquent balance has a high impact on the national delinquency rate, and will likely continue to pull it upwards in the months to come.

Figure 5: Office Delinquencies



Source: Trepp

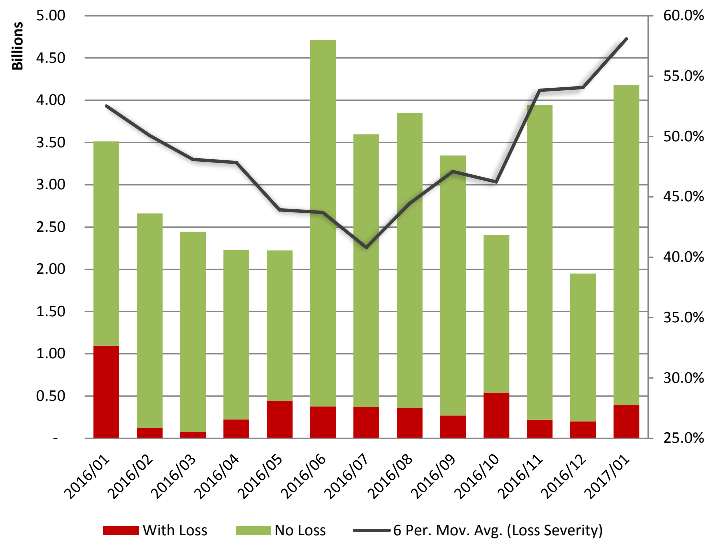
Figure 6: Five Largest Newly Delinquent Office Loans by Balance - January 2017

Property Name	Balance	Bloomberg Name	City	State	Delinquency Status
Hercules Plaza	$65.1M	WBCMT 2006-C25	Wilmington	DE	30 Days
Silver Spring Metro Center II	$65.0M	CD 2007-CD4	Silver Spring	MD	Non-Performing Beyond Maturity
Gateway Center IV	$56.9M	MSC 2006-IQ12	Newark	NJ	Non-Performing Beyond Maturity
AON Office Building	$43.2M	WBCMT 2005-C16	Glenview	IL	30 Days
5200 West Century	$40.0M	MLCFC 2007-6	Los Angeles	CA	Non-Performing Beyond Maturity

Source: Trepp

The largest office loan to become newly delinquent in January was the $65.1 million Hercules Plaza loan, which represents 45.1% of the remaining balance behind WBCMT 2006-C25. The note is now 30 days delinquent, and was transferred to special servicing back in July due to imminent monetary default after struggling with cash flow issues. The collateral is a 518,409-square-foot office in Wilmington, Delaware that is currently 75% occupied with a DSCR (NCF) of 0.95x. Another loan of similar size to turn delinquent was the $65.0 million Silver Spring Metro Center II loan. This note was backed by a Silver Spring, Maryland office that defaulted at its January maturity date, but has since paid off in full.

Figure 7: Monthly Office Loan Liquidations & Losses



Source: Trepp

Losses

A total of $4.2 billion in office loans paid off last month, which is more than double the amount liquidated in the month prior. Loans disposed with losses comprised 9.50% of January's total office liquidation volume, which is just short of the target for the 12-month average of 9.60%. Average loss severity, which has risen each month since October, came in at 62.1% last month. The six-period moving-average for loss severity continues to escalate from its year-low of 40.81% in July, and increased to 58.11% in January.

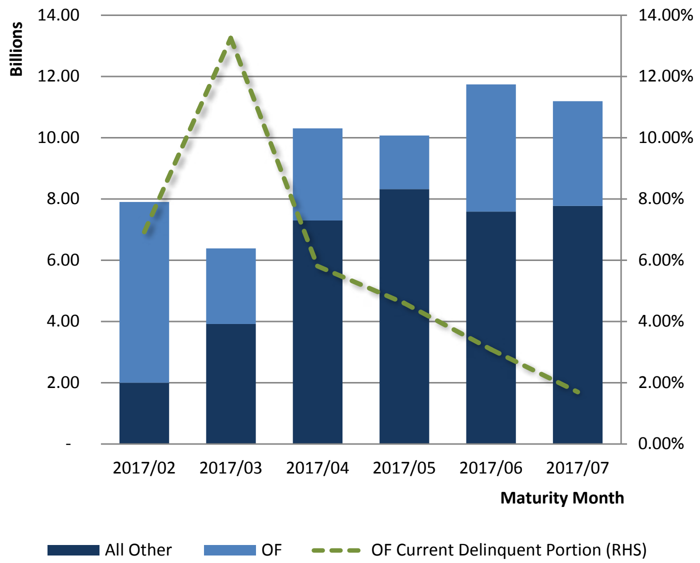
Looking Ahead

Office loans make up the largest percentage of CMBS loans maturing over the next six months, comprising 35.9% of the total maturing balance. 13.2% of the debt that comes due in March is currently listed as delinquent, the highest such mark out of the next six months.

Despite the observed moderation in leasing demand—particularly in major markets, and legal and financial sectors—JLL reports that overall construction volumes have risen significantly, posing a risk of future oversupply. Construction volumes are currently at a cyclical high of 110.5 million square feet, and completions for 2017 are expected to exceed demand for the first time in the current cycle.

These trends, coupled with the shifting consumer preferences brought on by millennials, may indicate that the office landscape will be reshaped in the years to come. With lower-cost, secondary markets and a booming tech industry driving occupancy growth, we may see some investors begin to veer away from traditional office properties in some major gateway markets. Vacancy rates for these areas could potentially inch up as a result, should this trend of more selective, targeted office acquisitions persist. However, the office sector still posted stable activity in 2016 at large, reaching $143.0 billion in transactions over the full year, including roughly $18.4 billion issued in CMBS office loans. Furthermore, consumer confidence is high, and the new administration is expected to move public policy towards deregulation—both of which are positive for real estate fundamentals. Thus, investors continue to be cautiously optimistic about the office sector.

Figure 7: Maturing Office Loans



Source: Trepp

For inquiries about the data analysis conducted in this research, contact press@trepp.com or 212-754-1010.
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