Office First Glance 2015 Quarter 1

Pre-Release Analysis of First Quarter 2015 Reis Findings in the Office Sector

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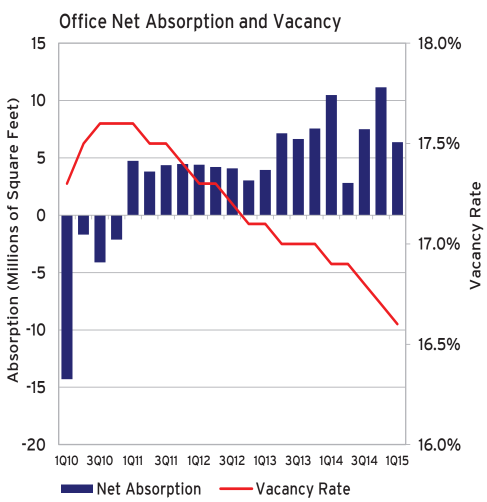
Vacancies Decline by 10 Basis Points

The slow but steady progress of office fundamentals continued in the first quarter of 2015, with national vacancies declining by 10 basis points to 16.6%, its lowest level since the third quarter of 2009. Any improvement in national vacancies has been choppy at best, but optimists will point out that this is the third consecutive quarter of vacancy declines (as opposed to the numbers holding flat), and improving employment growth (notwithstanding the most recent numbers from the Bureau of Labor Statistics) should continue to support rising demand for office space.

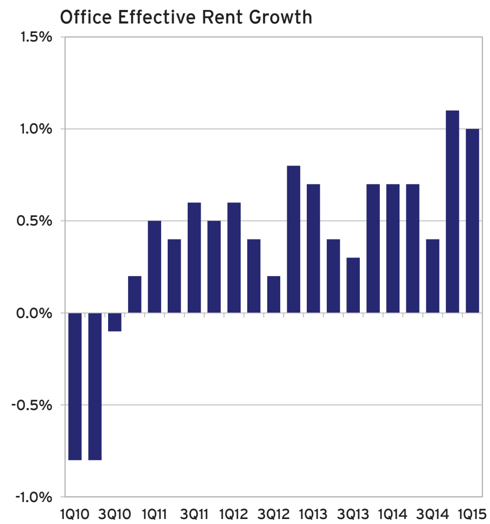


Occupied stock rose by 6.4 million square feet in the first quarter, driven by lease-ups from existing buildings as well as about 4.5 million square feet of new office space that came online. Interestingly, although central business districts (CBDs) have been the darling of analysts over the last few years (with the much heralded Millenial demographic age group supposedly preferring to live in the cities versus the suburbs), it actually has been the suburbs where a large number of new buildings have been coming online over the last few years; suburban areas have also been posting positive net absorption for the last 16 consecutive quarters.

The recovery in CBDs has been well documented, with vacancies hovering at several hundred basis points lower than suburban areas. CBD vacancies stand at 13.4% in the first quarter, much lower than suburban vacancies at 18.3%. It is difficult to compare absolute trends in net absorption in CBDs versus Suburbs because inventory in suburban areas also amounts to about twice the stock in CBDs (the majority of new office building efforts from 1990 to 2010 occurred in the suburbs). The main point of this analysis is that recovery in the office sector appears to be moving from a story of coasts and gateway markets to something more broad-based, with suburbs posting decent numbers as well.

Rents Rise, at a Somewhat Healthier Pace

Asking and effective rents rose by 0.9% and 1.0%, respectively, during the first quarter. This is the eighteenth consecutive quarter of asking and effective rent growth. It is worthwhile to note that effective rent growth has been showing increasing strength over the last couple of quarters (which is evident from the chart on the right). Year-over-year growth rates have been hovering at around 3%, but annualized effective rent growth has been at 4% over the last couple of quarters. If the job market continues its healthy trajectory of recovery this year, and office vacancies decline at a faster pace, effective rent growth should be able to maintain what can be considered a relatively robust showing, given that national vacancy levels are still relatively high. Usually we do not see much of an acceleration in effective rent growth until national vacancies fall below 14%.



Market Highlights

The share of markets posting fundamentals that have improved, versus those that registered flat or declining numbers, remained comparable to previous quarters. Over 50 of our top 82 office markets posted positive net absorption, with 49 showing an increase in occupancies. 74 out of 82 markets managed an increase in effective rents, up from an average of 68 markets in 2014 (see chart below).

First Quarter 2015 Market Performance
Improving Fundamentals / Flat or Declining Fundamentals

	Absorption	Occupancy	Effective Rent
Q1 2015	52 + / 30	49↑ / 33	74 ↑ / 8
Q4 2014	55 + / 27	38↑ / 44	73 ↑ / 9
Q3 2014	53 + / 29	34↑ / 48	62 ↑ / 20
Q2 2014	52 + / 30	34 ↑ / 48	69 ↑ / 13
Q1 2014	51 + / 31	40 ↑ / 42	68 ↑ / 14

Figures are based on 82 metro markets.

Low Energy Prices Hurt Markets like Houston

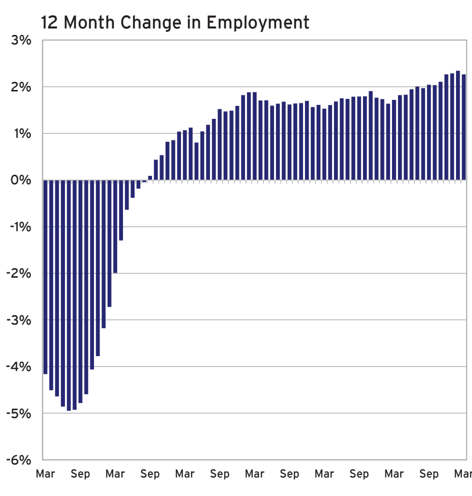
Despite the fact that Houston's employment base has diversified from basic energy exploration, the local office market was still not spared from a dampening in demand from low energy prices. Net absorption in Houston was barely positive over the first quarter (and monthly data shows that it was actually negative in February and March). Moreover, given the relatively robust figure for new completions during the quarter (Houston had the highest level of completions across our major markets), vacancies increased by 70 basis points to 15.1% - the highest level since the third quarter of 2011. Effective rent growth remained relatively strong, coming in at 1% for the quarter, but some measures of fundamentals clearly experienced downward pressure given the impact of low oil prices, as we expected.

Washington, DC and New York remain the two tightest markets in the country as measured by vacancy rates. Washington, DC has a vacancy rate of 9.3% while New York has a vacancy rate of 9.6%. Once again, these remain the only two markets with vacancy rates below 11%. San Francisco ranks third at 11.3% and continues to gain ground on the top two since vacancy compression is much stronger in San Francisco than either New York or DC. Effective rent growth was also strongest in the technology- and energy-oriented markets.

This quarter's clear leader was Seattle, which saw effective rents grow by 3.3% during the first quarter. For perspective, effective rent growth for the nation grew by 3% over all of last year.

Office Outlook

The key issue for the office market is whether employment growth will continue to recover, or flag somewhat. First quarter figures are difficult to extrapolate: the New York Times reported that March job growth of 126,000 represented an "abrupt slowdown in hiring"*, but this period was complicated by a somewhat prolonged winter that brought record snowfall to places like Boston. It is useful to recall that first quarter economic growth and job creation figures in 2014 were also similarly mild—but we ended 2014 with a decent 2.4% increase in GDP, and an average monthly job creation figure of 260,000.



We continue to expect the labor market to create between 250,000 to 275,000 net new jobs per month, with potential upside if the economy grows by more than the 2.6 to 2.7% that we expect. This should support downward pressure on vacancies and support for rent growth. Most risks to the US economy lie outside the borders, and domestic demand from new businesses appears to be picking up. We expect national vacancies to fall by roughly 50 basis points in 2015, and effective rents to grow in the mid 3s. That would be a decent showing for an office market that has been in recovery mode for several years— actually, it will represent an appreciable uptick if it comes to pass.

*"US Economy Gains 126,000 Jobs in March, an Abrupt Slowdown in Hiring," *New York Times*, April 3, 2015.