CoStar Group Real Estate Information

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Office Market Nears Rent Growth Tipping Point

Positive Absorption, Vacancy Trends Hold Up Despite Soft Patch In Economic Recovery

The rebound in office-using jobs is spreading to smaller businesses, which dominated office leasing activity during the first quarter of 2012. The continued positive absorption, coupled with dwindling supply of available space, is setting the stage for resumed rent growth in U.S. markets over the next few years, CoStar Group reported this week in its First-Quarter 2012 Office Review & Outlook.

Though weaker than in recent quarters, office space absorption in the U.S. held steady at 11 million square feet in the first quarter while the national office vacancy rate fell 10 basis points to 12.7%, according to the report presented to CoStar clients by Walter Page, director of research for Property and Portfolio Research (PPR), CoStar's analytics and forecasting division, and Jay Spivey, CoStar senior director of research and analytics.

While overall job growth has been less than expected, the economy is converting the number of temporary jobs to permanent fulltime jobs at a faster clip and employees are working a greater number of hours on average, trends that bode well for office demand and rent growth over the next three years, the CoStar economists reported. If job forecasts hold up, the unemployment rate will fall to its long term of average of below 6% by 2015.

For the first time in several years, none of the top 20 U.S. office markets reported job losses, with hiring especially strong in energy markets such as Houston and Dallas/Fort Worth, and technology markets such as San Francisco, San Jose and Denver.

Meanwhile, rising energy prices are causing a parallel increase in construction costs. This trend, combined with higher interest rates required to support new office construction, will likely curtail the level of new supply until rents begin to justify new supply, buying more time for vacancies to decline further, Page said.

The 11 million square feet in total absorption, while comparable with historical average, declined over the last couple of quarters and remains far below levels from the mid-2000s, when 30 million to 40 million square feet per quarter in office space absorption was routine. Despite solid job growth, office landlords and their tenants continue to hold a large amount of so-called shadow space, unused but not officially listed as vacant.

Gross leasing activity, the type of metric broker commissions are based on, is projected to be nearly 120 million square feet in the first quarter.

"Rents have come down, space is cheap relative to history, and companies are taking advantage of that to move, upgrade or expand into new space, and we've seen steep increases from the bottom of the market in 2009," Spivey said. "These leasing levels rival what we saw in the 2000 dot-com period."

Leasing is now dominated by smaller tenants, with over 50% of transactions involving blocks of space measuring 2,000 square feet or less in 2011. At the same time, large tenants are very rare in the market, with transactions over 50,000 square feet representing less than 1% of total activity, according to new data generated by PPR and CoStar.

"Roughly half of the tenants in the CoStar database occupy between 2,000 square feet and 20,000 square feet, and that's the sweet spot of liquidity within the office sector," Page said.

Tenants are also becoming more efficient in their real estate usage, with footprints on new leases down 6% over the last 10 years. While Class A tenants have seen a modest 3% increase in square footage, the amount of Class B space taken is down by 5% and Class C space down 13%.

CoStar and PPR project the national vacancy to decline to 10.5% by the end of 2015, with the corresponding increase in occupancy leading to boosts in NOI, rent growth and other factors that tend to boost property values. Meanwhile, the supply pipeline will remain at low ebb until 2015, and occupancies should continue to rise ever in the event of a spike in energy prices or a meltdown in the European economy.

Tenants, finding a scarce supply of Class A property, are starting to gravitate to Class B buildings, and smaller tenants are back in the market -- both indications of a broadening of the recovery that’s helping more employers hire more workers.