Office Markets Nearing Peaks as Rent Growth Slows

Strength in some markets countered by rising vacancies. New supply to challenge West Coast markets.

Featured Highlights

- More than half of the 10 markets tracked in this report witnessed office rent growth in the first quarter. However, a marked slowdown in the rate of rent appreciation is already underway, and growth is likely to continue to slow as we near the top of the current market cycle.

- Seven markets saw office vacancy rise modestly and five witnessed negative absorption. Weak GDP growth could be restraining demand, but other indicators — such as rising income growth, increased spending and faster global growth — suggest possible absorption upside.

- Notable bright spots remain in the top metros, including Manhattan’s strong start to 2017 with high leasing volume, record rents and sustained tight vacancy.

- In Chicago, pre-leasing of new trophy office towers remains strong. The rapid take-up of this space is allowing landlords of existing trophy assets to push rents.

- West Coast markets — including Los Angeles, the San Francisco Bay Area and Seattle — are seeing an increase in speculative supply that will likely suppress rents and cause vacancy to rise. However, there is still healthy lead-in time for some projects to pre-lease.

- In some markets — notably Washington, D.C. — asking rents are rising due to new product entering the market. Expect the gap between asking and effective rents to widen as concessions increase.

- Tech firms continue to be a significant driver of office leasing activity and market shifts. For example, tech demand is fueling Boston’s Class B space and conversions to outperform prestigious Class A towers.

<table>
<thead>
<tr>
<th>MARKET 1-YR OUTLOOK</th>
<th>METRO CORE CBD INVENTORY (SF)</th>
<th>CORE SUBMARKETS</th>
<th>ABSORPTION (SF)</th>
<th>AVG RENT ($)</th>
<th>VACANCY RATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manhattan, NY 500,918,568</td>
<td>Manhattan: Midtown, Midtown South, Downtown</td>
<td>CBD (DC), East End (DC), Capital Hill (DC), NoMa (DC), Capitol Riverfront (DC), Carlyle (DC), R-B Corridor (NOVA), Tysons Corner (NOVA), Bethesda (GaMD)</td>
<td>-127,859</td>
<td>$73.92</td>
<td>6.5%*</td>
</tr>
<tr>
<td>Washington, D.C. 185,039,614</td>
<td>West Loop, Central Loop, River North, East Loop</td>
<td>-490,941</td>
<td>$47.07</td>
<td>13.2%</td>
<td></td>
</tr>
<tr>
<td>Chicago, IL 145,247,654</td>
<td>CBD, Katy Freeway, West Loop (Galleria), Westchase</td>
<td>-680,643</td>
<td>$34.62</td>
<td>19.5%</td>
<td></td>
</tr>
<tr>
<td>L.A. County, CA 112,137,400</td>
<td>Downtown Los Angeles, West Los Angeles, Tri-Cities</td>
<td>-1,207,800</td>
<td>$44.23</td>
<td>15.6%</td>
<td></td>
</tr>
<tr>
<td>Atlanta, GA 98,772,984</td>
<td>Midtown, Buckhead, Central Perimeter, Cumberland/Galleria</td>
<td>-216,317</td>
<td>$27.31</td>
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<tr>
<td>San Francisco Bay Area, CA 92,817,218</td>
<td>Financial District (North Financial District &amp; South Financial District), SOMA (West SOMA &amp; East SOMA), Palo Alto, Mountain View, Sunnyvale</td>
<td>-455,193</td>
<td>$71.98</td>
<td>6.1%</td>
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<tr>
<td>Dallas, TX 74,178,858</td>
<td>Uptown, Preston Center &amp; Far North Dallas</td>
<td>-657,433</td>
<td>$30.54</td>
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<tr>
<td>Boston, MA 69,300,211</td>
<td>Back Bay, Financial District, Charlestown, Crosstown, Fenway/ Kenmore, South Station, North Station, Seaport</td>
<td>-386,014</td>
<td>$55.23</td>
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<tr>
<td>Seattle, WA 60,369,199</td>
<td>Seattle CBD, Lake Union, Pioneer Square, Belltown, Queen Anne, Ballard</td>
<td>240,053</td>
<td>$38.88</td>
<td>7.7%</td>
<td></td>
</tr>
</tbody>
</table>

*The Manhattan office market typically cites supply based on the availability rate, which is now 10.3%. The availability rate is actively marketed space scheduled for tenant built-out within 12 months.
Local Insights

Manhattan

Manhattan hit the ground running in 2017 and fundamentals remain strong. Average asking rates stand at an all-time high across the market ($73.92 per square foot) and in Midtown South and Downtown, while vacancy (6.5%) is the second-lowest among the top 10 markets. First quarter leasing activity totaled 9.2 million square feet — a 25% increase from Q4 2016 and well above the 10-year average.

The TAMI (technology, advertising, media and information services) and FIRE (financial services, insurance and real estate) sectors accounted for two-thirds of first quarter leasing volume. In the quarter’s largest lease transaction, 21st Century Fox renewed its lease at 1211 Avenue of the Americas and expanded their footprint to 777,000 square feet in Midtown. In addition, News Corp renewed its lease for 444,000 square feet in the same building. Other notable Q1 2017 leases include Live Nation Worldwide (99,588 square feet) and Estée Lauder (75,000 square feet) in Midtown South and Royal Bank of Canada (402,807 square feet) and Spotify (378,243 square feet) in Downtown.

Six of the 10 largest lease transactions in Q1 2017 saw tenants taking new space. However, a shortage of large blocks of available space above 250,000 square feet persists and average asking rents for this segment are close to $90 per square foot.

There are currently 16 million square feet of office inventory under construction or under major renovation across Manhattan, of which 9 million square feet are available. Deliveries set for 2017 are focused on boutique properties in Midtown South and are generally modest, with nothing over 200,000 square feet scheduled to complete.

Larger properties are due to come online in 2018 with 3 World Trade Center (2.9 million square feet) and 55 Hudson Yards (1.6 million square feet) set to deliver, with a combined 2.4 million square feet currently available. Even so, this is equal to less than 0.5% of market inventory and there is still a full year in which to garner pre-commitments. Also, as tenants move into new properties, large blocks of existing space will become available.

Despite a stable first quarter, pressure on D.C. office market fundamentals continues with speculative construction and tenant downsizing as the key concerns. All but one of the 10 largest leases signed in the District in Q1 2017 involved a reduction in occupied space, with large law firms and the federal government leading this activity.

Development has ramped up sharply with current construction activity almost double the amount seen at the same point in 2015. There are 5.7 million square feet of office space under construction across the District — only half of which is committed, mostly to tenants already in the area. As these firms move into their new premises, commodity space vacancy will increase. Six projects totaling 1.7 million square feet are scheduled to deliver in the remainder of 2017, and 1 million square feet of this total is available.

While asking rents can be as high as $90 per square foot for new trophy space in the central business district (CBD) and East End, concession packages are among the most generous of the markets covered in this report. Average asking rates for existing Class A space in these locations range from $55 to $60 per square foot. Despite markedly lower rents, locations just outside the District remain challenged. For example, vacancy in the Rosslyn-Ballston corridor is close to 21%.

Following two properties that delivered 2.4 million square feet in 2016, another major trophy office property has been added to Chicago’s downtown skyline: 150 North Riverside in the West Loop. The 1.28-million-square-foot property delivered in Q1 2017 at 83% preleased. Tenants include William Blair & Co. and Hyatt’s new world headquarters.

Pre-leasing success at these properties has led to the first fully-speculative project of this cycle. While smaller in size, White Oak Partners and CA Ventures are constructing 625 West Adams Street (434,934 square feet), due for completion in Q2 2018. Average asking rates at the new towers range from $55 to $60 per square foot. Class A+ vacancy in the West Loop is extremely tight at less than 4%, and the prior generation of trophy towers are able to command rents only slightly below their new peers.

The trend of major relocations to downtown continues. GE Healthcare is moving its operations from the suburbs to 500 West Monroe, where GE Transportation is already headquartered, resulting in more than 1,000 jobs at that location. Canadian engineering firm, EXP, is consolidating into one location (205 North Michigan Avenue) by bringing 150 employees from Toronto. Further moves of this nature are anticipated, with Bank of America’s 500,000-square-foot requirement being the most prominent.

As of this report, we have expanded our coverage of Houston’s office core beyond the CBD to include three more leading submarkets: Katy Freeway, West Loop (Galleria) and Westchase.

In examining these areas, Houston’s challenged office market looks to be stabilizing. While prospects for growth remain beyond the immediate horizon, the market is steadying itself. The slowdown in development activity is helping, with space under construction at half of the level that it was 12 months ago. However, there is still a modest amount (463,000 square feet) of speculative space underway in three separate projects.

Sublease space remains the dominant story. Even though some energy firms have been taking space back, available sublease space is still largely drawn from the sector. Seven of the 10 largest sublease availabilities are in the core submarkets covered in this report. Averaging 389,500 square feet per sublease, the top 10 list is headed by 801,990 square feet available from Shell Oil at One Shell Plaza in the CBD.
Los Angeles

Class A rents in Houston’s premier properties are broadly in the $45 to $52 per square foot range. The CBD represents the upper end of the range even though the submarket saw a significant uptick in vacancy during Q1 2017. With the exception of West Loop (Galleria) at 15.9%, vacancy across the submarkets is around 20%. Notable leases signed in Q1 2017 include Targa Resources Corporation (127,734 square feet) in the CBD and IHS Global (91,414 square feet) in Katy Freeway.

Speculative construction is impacting the Los Angeles office market, particularly Downtown and in West LA. Los Angeles is one of a small number of markets — mostly on the West Coast — where developers have been confident enough to build on a selective basis without pre-commitments. Combined, Downtown and West LA account for 90% (3.6 million square feet) of office construction across Los Angeles County. Only 10% of space underway in West LA is pre-committed.

A combination of sublease space, move-outs and downsizing has pushed absorption into the red. Net absorption in all of Los Angeles County totaled a negative 473,900 square feet in Q1 2017. However, in the submarkets covered by this report the total was a negative 1.21 million square feet, with West LA accounting for the lion’s share. Rent growth has stalled and rates should stay flat until the current pressures shake out.

Despite the surge in new supply, renewals are on the rise, particularly among finance and professional firms located Downtown. Law firm Paul Hastings LLP renewed its lease at 515 South Flower Street but plans to downsize from 300,000 square feet to 160,000.

Following last quarter’s departure of Warner Music, the Tri-Cities area lost two more notable tenants in Q1 2017: One West Bank and Le Cordon Bleu. A bigger blow is set to occur mid-year with Nestlé vacating 393,230 square feet at 800 North Brand in Glendale and relocating to Arlington, VA.

The core Atlanta office market has seen little fluctuation over the past 12 months. Vacancy rose by 30 basis points and average asking rates increased by just over $0.50 per square foot. Almost 5 million square feet are underway across the metro, including 14 projects of 100,000 square feet or greater. Eight of these, including the five largest, are located in the key submarkets addressed in this report. Construction is being driven by pre-commitments from firms including Mercedes Benz, Comcast and Synovus Financial Corp.

Low vacancy in Midtown and Buckhead, plus a 20% rent differential, is causing tenants to take a closer look at Downtown Atlanta. During Q1 2017, Coca-Cola completed its move out of 322,000 square feet of suburban space to consolidate all of its offices Downtown. However, developers continue to stay away with no construction underway in the Downtown submarket.

Average asking rates stand at $27.30 per square foot, but rents closer to $50 per square foot are being sought for prime Midtown and Buckhead space. Tenant concession packages have been holding steady, but expect these to come under pressure as new supply enters the market. The leading lease transaction in Q1 2017 involved Westrock taking 179,261 square feet at Northpark 400 in Central Perimeter.

The core San Francisco Bay Area office market remains tight. Despite a slight uptick, its 6.1% vacancy rate is the lowest among the top 10 U.S. office markets. Average asking rents are $71.98 per square foot, second only to Manhattan but down slightly from year-end 2016. Q1 2017 net absorption was negative — for the first time in more than six years — driven by a combination of company rightsizing and a lack of major move-ins.

Silicon Valley remains a tighter market than San Francisco, with lower vacancy and higher rents in its core submarkets. Vacancy in Palo Alto and Sunnyvale stands at 2.8% and 3.3% respectively, and both locations have average asking rates above $90 per square foot. Conversely, vacancy rates in the heart of San Francisco, in the North and South Financial Districts, are 9% and 6.7% respectively with rents just above $70 per square foot.

There are 6.4 million square feet of office space under construction in San Francisco — of which only 39% is pre-leased, leaving 3.9 million square feet uncommitted. The majority of this space is not scheduled to come online before mid-2018, leaving a year or more of lead-in time for pre-leasing to occur.

The largest projects are centered in the South Financial District, led by the 1.37-million-square-foot Salesforce Tower due for completion in Q4 2017. The property is leasing up steadily and now has only 400,000 square feet still available. Tech firms remain active. Notable leases signed in Q1 2017 include Google (166,460 square feet at Rincon Center II) and Adobe (103,640 square feet at 100 Hooper Street) in San Francisco and Amazon’s 350,663-square-foot lease at Moffett Towers II in Sunnyvale.

The success of Far North Dallas — especially Plano — continues to grab the headlines as more major firms flock to the area. The Legacy West development is set to complete this year and will be the new home for Toyota’s North American headquarters, JPMorgan Chase and Liberty Mutual. Boeing and Ryan LLC have also announced moves to the area.

The close-in submarkets of Preston Center and Uptown/Turtle Creek still garner the highest rents and Class A vacancy is well below the metro average. Prime Class A rents in these submarkets have broached $50 per square foot — double the metro average. But tenants’ options will remain limited in these areas as both submarkets are close to being fully built out. One small parcel remains in Uptown close to its premier address of The Crescent. With rising construction costs and inflated land prices, it is estimated that any office development on this site would need to achieve rents around $70 per square foot to justify construction.
With rents 30% lower than those in Uptown/Turtle Creek, the Dallas CBD may be worthy of reconsideration. A major boost came from AT&T’s announcement that they will invest $100 million in their four-building, two-million-square-foot campus, including street changes and new retail. Although not due until 2019, this could motivate other CBD owners to review their investments.

The Boston office market continues to shift, with growth in the TAMI sector driving the nature and location of demand. Rent growth in Class B properties is outperforming Class A and demand has moved to Seaport — just across the Charles River from the CBD — with its inventory of creative space.

Seaport’s vacancy rate of 9.2% is comfortably below rates in the traditional office locations of the Financial District and Back Bay. While some landlords are repositioning and reconfiguring their spaces, vacancy in the upper floors of the Financial District’s towers is elevated and Class A vacancy in the submarket is higher than for Class B. Co-working office providers are expanding. WeWork has a presence in the Back Bay — where Amazon has taken space — and is setting up a second location in North Station. Co-working company, The Yard, also took space in Back Bay in Q1 2017.

Reebok is the latest firm to relocate downtown, driven by a desire to reposition itself and be closer to its target workforce, shopper demographic and competition. The move to 220,000 square feet at the Innovation and Design building in Seaport was a major downsizing from their 500,000-square-foot suburban campus in Canton and puts them near New Balance and Converse.

Although there is new construction on the horizon that could change matters, the core Seattle office vacancy rate remains tight at 7.7% — one of only three of the top 10 metros with a sub-10% vacancy rate. Such strong conditions have attracted developers, with central Seattle being one of a handful of locations across the country where major projects have broken ground with no pre-commitments.

However, this confidence is about to be tested. Although 70% of the 5.4 million square feet of space under construction is pre-committed, 1.1 million square feet of vacant space is set to deliver in the CBD in the second half of the year. Schnitzer West’s 740,000-square-foot The Madison is due to deliver in Q3 2017 with 580,000 square feet still available. The Mark, a 528,000-square-foot joint venture between Daniels and Stockbridge, is slated to complete in the fourth quarter and is 100% available.

Amazon’s growth continues unabated. In Q1 2017, the internet giant moved into a combined 365,978 square feet at Urban Union and 428 Westlake in Lake Union and also signed a lease for 288,927 square feet at Tilt49 in the CBD. In addition, Redfin moved into 112,990 square feet at Hill7, also in the CBD.