Office Markets Remain Solid as Rents Peak and Vacancy Levels Off

Speculative construction still taking place in select markets as developers bet on high-end space.

Featured Highlights

- Major office markets in the U.S. largely remained strong during the second quarter, with no broad change in momentum. Rents were flat in six of the top 10 metro markets tracked in this report, while rising in the other four.

- At the same time, two key factors point to upward pressure on vacancy rates: tenant downsizing and new supply. In Q2 2017, absorption rose in six of the 10 markets and fell in four. Taking into account new supply, vacancy rose in four markets, fell in three and remained unchanged in three — about the same as in Q1 2017.

- Three markets — Manhattan, the San Francisco Bay Area and Seattle — have office vacancy rates well under 10% and saw no increases in the second quarter. These rates are substantially lower than those in the other seven markets. Rents appear to be close to peaking in San Francisco and are at record highs in two of Manhattan’s three submarkets. Tech demand shows no signs of abating in Seattle.

- Concerns over the impact of new supply in San Francisco and Seattle are receding, but two markets — Los Angeles and Washington, D.C. — remain exposed to construction risk.

- Overall office vacancy is rising in the Chicago market, though confidence in trophy Class A space located downtown remains strong. In addition to construction kicking off on another major office tower, Blackstone is investing more than $500 million to upgrade and reposition the Willis Tower.

- Office leasing in Manhattan shows little sign of abating and remains on par with activity in the first half of 2016. Although new supply will be entering the market, this is not a concern given the shortage of large blocks available for lease.

### Table: Office Market Snapshots Q2 2017

<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 (D.C.), East End (D.C.), Capitol Hill (D.C.), NoMa (D.C.), Capitol Riverfront (D.C.), Carlyle (D.C.), R-B Corridor (NOVA), Tysons Corner (NOVA), Bethesda (SubMD)</td>
<td>617,580</td>
<td>$73.24</td>
<td>6.2%</td>
</tr>
<tr>
<td>Washington, D.C. 185,044,474</td>
<td>CBD (D.C.), East End (D.C.), Capitol Hill (D.C.), NoMa (D.C.), Capitol Riverfront (D.C.), Carlyle (D.C.), R-B Corridor (NOVA), Tysons Corner (NOVA), Bethesda (SubMD)</td>
<td>-277,545</td>
<td>$47.51</td>
<td>13.4%</td>
<td></td>
</tr>
<tr>
<td>Chicago, IL 145,562,743</td>
<td>West Loop, Central Loop, River North, East Loop</td>
<td>-484,271</td>
<td>$38.52</td>
<td>14%</td>
<td></td>
</tr>
<tr>
<td>Houston, TX 118,370,334</td>
<td>CBD, Katy Freeway, West Loop (Galleria), Westchase</td>
<td>-832,675</td>
<td>$35.02</td>
<td>20.1%</td>
<td></td>
</tr>
<tr>
<td>L.A. County, CA 112,267,400</td>
<td>Downtown Los Angeles, West Los Angeles, Tri-Cities</td>
<td>305,100</td>
<td>$44.15</td>
<td>15.4%</td>
<td></td>
</tr>
<tr>
<td>Atlanta, GA 99,956,393</td>
<td>Midtown, Buckhead, Central Perimeter, Cumberland/Galleria</td>
<td>512,697</td>
<td>$32.20</td>
<td>13.2%</td>
<td></td>
</tr>
<tr>
<td>San Francisco Bay Area, CA 92,877,637</td>
<td>Financial District (North Financial District &amp; South Financial District), SOMA (West SOMA &amp; East SOMA), Palo Alto, Mountain View, Sunnyvale</td>
<td>59,778</td>
<td>$74.81</td>
<td>6.1%</td>
<td></td>
</tr>
<tr>
<td>Dallas, TX 74,935,722</td>
<td>Uptown, Preston Center &amp; Far North Dallas</td>
<td>669,778</td>
<td>$30.51</td>
<td>12.6%</td>
<td></td>
</tr>
<tr>
<td>Boston, MA 69,208,358</td>
<td>Back Bay, Financial District, Charlestown, Cross town, Fenway/ Kenmore, South Station, North Station, Seaport</td>
<td>197,202</td>
<td>$56.13</td>
<td>10.6%</td>
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</tr>
<tr>
<td>Seattle, WA 61,330,459</td>
<td>Seattle CBD, Lake Union, Pioneer Square, Belltown, Queen Anne, Ballard</td>
<td>821,496</td>
<td>$38.94</td>
<td>7.7%</td>
<td></td>
</tr>
</tbody>
</table>

* A quarterly rent change of +/-1% or less, is judged to be flat.
> Boston and Dallas remain on solid ground. Office rents in Dallas have risen to an all-time high and leasing volume for Class A space in Boston’s Financial District has picked up considerably.

> The Houston office market remains challenged. Vacancy is back above 20% and there is no appreciable leasing traction on the large inventory of sublease space. Any turnaround in the market is dependent on a rebound in oil prices.

LOCAL INSIGHTS

> The Manhattan office market remains solid. Absorption returned to positive territory in the second quarter while rents remained steady and the already-tight vacancy rate fell to 6.2% — the second-lowest among the top 10 markets. Leasing activity is holding up with 8.6 million square feet of leases signed in Q2 2017, bringing the total for the first half of 2017 to 17.8 million square feet — directly on par with the first half of 2016.

> Class A asking rents in Midtown South are reaching parity with those in Midtown at $82.90 and $84.40 per square foot, respectively. Class A rates for the combined Manhattan market are $78.61 with a 17% discount Downtown, where Class A rents are closer to $65 per square foot.

> So far in 2017, the FIRE sector (finance, insurance and real estate) is leading tenant demand in all three Manhattan submarkets and accounted for three of the four largest leases signed in the second quarter. In the largest lease transaction of 2017 to date, BlackRock pre-committed to 846,990 square feet at 50 Hudson Yards but will not take occupancy until 2022. Also in the Hudson Yards/Manhattan micro-market, JP Morgan Chase expanded its current space by 305,365 square feet at 5 Manhattan West. The largest renewal was at 452 Fifth Avenue in Times Square, where HBSC recommitted to 548,170 square feet.

> There are 14.7 million square feet of office space under construction or undergoing major renovation in Manhattan, half of which is pre-leased. While more than 7 million square feet of available space may be a cause for concern in some markets, it represents less than 1.5% of inventory in the Manhattan market, which still faces a shortage of immediate large-block availability.

> Deliveries in 2017 are expected to total 1.7 million square feet. More than 60% of this space is already occupied or pre-leased. Deliveries are set to ramp up to 6.9 million square feet in 2018, 57% of which is pre-committed. The largest delivery expected in 2018 is Silverstein Properties’ 2.9-million-square-foot 3 World Trade Center, where 1.8 million square feet remains available. Other than this, major construction activity is dominated by the Hudson Yards project, where three properties totaling 6.4 million square feet are underway.

> Washington, D.C.’s office market continues to show signs of softening. Absorption remained negative in the second quarter as vacancy increased to 13.4%. Average asking rents held steady at $47.50 per square foot. This marked only the second time in five years that absorption has been negative for two consecutive quarters in the D.C. market. Only one lease over 100,000 square feet was signed in Q2 2017, with the Department of Homeland Security renewing its 119,719-square-foot lease at 1120 Vermont Avenue NW in the East End.

> Construction activity in the District is more than three times higher than three years ago, with no signs of easing. For the second quarter in a row, more than half a million square feet of space broke ground in the District. However, the largest project to commence in Q2 2017 — the 286,850-square-foot One Freedom Plaza at 1301 Pennsylvania Avenue NW — is 70% pre-leased to law firm Kirkland and Ellis.

> Developers appear to be betting on tenants’ continued preference for new high-end space and are willing to risk short-term vacancy to capture these occupiers. Unless there is an unforeseen surge in demand, this is likely to come at a cost in terms of generous incentives that could exert downward pressure on rents for second-generation Class A space.

> The Northern Virginia submarkets (Rosslyn-Ballston Corridor and Tysons Corner) tracked in this report are seeing similar pressure. Only one of the 10 largest leases signed in Northern Virginia in the second quarter occurred in these two submarkets. Vacancy in the Rosslyn-Ballston Corridor, which is immediately adjacent to the District, stands at 18.3%. Although asking rates are $10–$15 per square foot lower than in core Washington, D.C., this is unlikely to cause many tenants to move across the Potomac while there is a surfeit of quality space in the District.

> On the surface, the Chicago office market looks to be cooling. Absorption was negative in Q2 2017 and vacancy has increased by 1.8 percentage points over the past 12 months to 12.7%, with the highest vacancy rate (14.8%) occurring in Downtown Chicago’s most prestigious submarket — the West Loop. Average asking rents remained flat over the quarter and stand at $38.50 per square foot.

> A deeper dive into the numbers shows that the negative absorption, which was largely a result of tenant move-outs, is not an immediate cause for concern. The second quarter total of negative 484,000 square feet is equivalent to a mere 0.3% of market inventory.

> Move-outs and downsizing should continue to impact the market. Deloitte, CNA Financial and Mayer Brown have committed to a combined 863,000 square feet of space in the West Loop. However, all of these moves involve significant downsizing. For example, Deloitte is reducing its footprint by 200,000 square feet. There are already 2.7 million square feet of directly available blocks of 100,000 square feet or larger in downtown Chicago, the majority of which are in the West Loop.
Houston

While construction activity is modest by historical standards, on a positive note, the three largest lease transactions in Q2 2017 were in the core submarkets, led by Apache Corporation extending its lease on 524,000 square feet at Post Oak Central in West Loop/Galleria.

Perhaps the most interesting play in the Chicago office market is Blackstone’s $547 million overhaul and repositioning of the iconic 1.45-million-square-foot Willis Tower. Approximately 350,000 square feet of office space have already been leased in 2017 but at a cost. Tenant improvement allowances at the property are significantly above general market levels. In addition to upgrading the office space, there is a $100 million overhaul of the elevator system plus the creation of 200,000 square feet of retail space.

Houston’s fortunes are inextricably tied to the energy sector. With global oil futures trading below $50 a barrel (compared to $100 a barrel in 2013), the office market remains challenged. Vacancy has moved up to more than 20% and there was more than 800,000 square feet of negative absorption in Q2 2017.

Large blocks of sublease space, formerly occupied by energy firms, continue to cast their shadow across the market. All but two of the 15 largest sublease availabilities in the metro — totaling a combined 3.9 million square feet — are in the submarkets covered by this report. The potential to lease this space is restricted by landlords’ reluctance to do smaller lease deals and their preference for capturing large occupiers.

On a positive note, the three largest lease transactions in Q2 2017 were in the core submarkets, led by Apache Corporation extending its lease on 524,000 square feet at Post Oak Central in West Loop/Galleria.

While construction activity is modest by historical standards, Skanska USA broke ground in the second quarter on the 778,344-square-foot Capitol Tower in the central business district (CBD), which is scheduled for completion in 2019. This was driven by a 200,000-square-foot pre-commitment by Bank of America. However, this isn’t all good news as the bank will be downsizing its net office footprint in the market by 50% when they move out of 400,000 square feet at 700 Louisiana Street.

Key indicators showed little change in the Los Angeles office market in Q2 2017. Rents and vacancy remained virtually static from the previous quarter at $44.15 per square foot and 15.4% respectively, while absorption moved back into positive territory at 305,000 square feet. West LA remains the premier and most active submarket with 1.4 million square feet of leasing activity in the second quarter. Average asking rates in West LA stand at $53.50 per square foot, which is more than 40% higher than the average for LA County as a whole.

Construction deliveries are set to put upward pressure on vacancy. There are a combined 4.1 million square feet of construction underway in new projects and major renovations across Downtown and West LA, all of which are set to deliver in the next 12 months. The degree to which this space leases up quickly could impact rents.

West LA could face significant challenges in the short-to-medium term as less than 10% of the new space underway has been pre-leased. This includes four projects totaling 1.1 million square feet (two each in Culver City and Santa Monica) set to deliver before the end of the year. The second-largest of these, IDS Realty Group’s 281,000-square-foot C3 project, is making some headway with 96,000 square feet being pre-leased in the second quarter.

Downtown is facing a similar situation with vacancy at 20.4% and 1.9 million square feet due to deliver by Q1 2018. Class A vacancy is currently 15.8% but is set to increase, particularly in the Financial District and the Arts District. Downsizing continues, with Marsh and McLennan Companies reducing its footprint by 30% when it moves into 633 W. Fifth Street.

In Q2 2017, the Atlanta office market witnessed its highest level of net absorption in 18 months. However, the vacancy rate continues to rise due to new deliveries. Eleven buildings, totaling 1.5 million square feet, were delivered across the metro in the second quarter. One-third of this total was accounted for by the 506,647-square-foot Three Alliance Center in Buckhead, which is 61% leased.

Average asking rents stand at $28.20 per square foot, up by 3.3% over the previous quarter. While this is mostly attributable to new product entering the market, this gain is markedly stronger than most of the other top 10 markets (though starting from a low level). The Central Perimeter and Midtown areas are seeing the strongest rental growth among the submarkets tracked in this report. The highest asking rates, which are approaching $50 per square foot, are being sought for prime Class A space in Buckhead and Midtown.

Overall office vacancy stands at 13.2%, up by 30 basis points in Q2 2017 from the previous quarter. Buckhead vacancy spiked to 13.2% from 10.4% over this time period, largely due to the delivery of Three Alliance Center. At 10.2%, Midtown has the lowest vacancy rate by a considerable margin and is the most active leasing market, experiencing two of the three largest leases signed in Atlanta in the second quarter. Equifax and Honeywell have also started to move into their new Midtown locations.
San Francisco

The Dallas office market remains strong. Average asking rents Second-quarter absorption in Silicon Valley was modest San Francisco's fundamentals continue to support new Tenant demand remains healthy in San Francisco with 2 The San Francisco Bay Area has the lowest vacancy rate and the highest average asking rent of the 10 office markets and the highest average asking rent of the 10 office markets covered in this report at 6.1% and $74.80 per square foot respectively. While market indicators are strong in both San Francisco and Silicon Valley, the highest rents and tightest vacancy are found in the latter's principal submarkets. For example, Palo Alto has a 2.3% vacancy rate and average asking rents of $97.10 per square foot.

Tenant demand remains healthy in San Francisco with 2 million square feet of leasing activity in the second quarter. There are an estimated 7.1 million square feet of tenant requirements in San Francisco, more than 40% of which are by tech firms. The largest leases signed in Q2 2017 reflect this, with three of the top four involving Salesforce, Otto (Uber) and Affirm. Salesforce took an additional 149,000 square feet in its namesake tower at 415 Mission Street and is now the largest private occupier in the city and the single largest tenant downtown, with a total footprint of 2.4 million square feet.

San Francisco’s fundamentals continue to support new construction with 4 million square feet underway in the Financial District, over half (55%) of which remains available. The majority of space under construction is in the South Financial District (3.6 million square feet).

Second-quarter absorption in Silicon Valley was modest at 170,000 square feet, with activity centered in East Palo Alto. While development activity is mostly focused on build-to-suit projects for firms such as Palo Alto Networks, AMD Corporation, Apple and Google, there are six fully speculative projects underway. These projects total 1.7 million square feet with the majority of space scheduled to deliver by the end of the year. While this is not sufficient to trip the market, it could act as a short-term curb on further speculative development starts.

The Dallas office market remains strong. Average asking rents across the Dallas-Fort Worth metro have broken through $25 per square foot for the first time on record. Focusing on the core submarkets covered by this report, average asking rents are holding steady at $30.50 per square foot and vacancy has moved down to 12.6%. Far North Dallas — and the Upper Tollway/Plano area in particular — remains the place to be with 638,000 square feet of net absorption in the second quarter.

Absorption in Far North Dallas is being driven by tenants moving into new properties that were pre-leased and are now being delivered. Toyota’s phased move-in to its new 1.7-million-square-foot, two-building headquarters has started with 400,000 square feet of this space being occupied in the second quarter. Two more major pre-let properties are set to deliver in Far North Dallas in Q4 2017 for a combined 2.5 million square feet. JP Morgan Chase & Co. will occupy 1.4 million square feet and Liberty Mutual’s new 11-million-square-foot headquarters is set to deliver in Q4 2017.

The submarkets of Uptown/Turtle Creek and Preston Center continue to garner the highest rents for Class A space at around $40 per square foot. Both have sub-10% vacancy rates, which is limiting absorption. Two major projects are set to deliver in Uptown/Turtle Creek in the first half of 2018 and may be the last for some time given a lack of development sites in the area. The 494,300-square-foot PwC Tower at 2121 Woodhall Rodgers Freeway and 418,132-square-foot The Union at 2300 N. Field Street are both 45% pre-leased.

In the Q1 2017 U.S. Top Office Metros Snapshot report, we commented on the potential for the Dallas CBD to see renewed activity due to greater availability and significantly lower rents than its northern neighbors. The only two leases signed in Dallas in the second quarter for more than 100,000 square feet were both located in the CBD, and more tenants are reported to be considering the submarket.

The latest indicators for the Boston office market are encouraging. Absorption stayed positive in Q2 2017, while vacancy remained flat and average asking rates rose by 1.6% to $56.10 per square foot. Boston has the third-highest asking rents among the top 10 markets, behind the San Francisco Bay Area and Manhattan.

While it is too early to be defined as a shift, the big story of the second quarter for Boston is that traditional Class A properties may be back in vogue after the recent trend of core downtown Class A buildings losing out to newer generation, creative space in the Seaport district. In Q2 2017, demand was driven by Class A space in the Financial District, which saw almost 260,000 square feet of positive Class A absorption from a combination of small- to mid-sized leases.

The rental gap between Class A and Class B space is narrowing, causing some prospective tenants to consider moving to Class A buildings. Landlords able to inject capital and reconfigure space to more flexible and efficient layouts are seeing success by providing turnkey options.

While demand is becoming more widespread across industry sectors, tech continues to attract the headlines. Amazon leased 150,000 square feet at 253 Summer Street in the Seaport area in the second quarter and other tech companies are actively in the market for space. LogMeIn, Cengage Learning and Spotify are all seeking leases of up to 100,000 square feet.

Boston
> Despite some new supply on the horizon, the core Seattle office market remains strong. Absorption rose to a healthy 821,000 square feet in the second quarter with average rents and vacancy remaining stable at around $39 per square foot and 7.7% respectively. Class A rents in the Seattle CBD and Bellevue CBD markets are virtually the same, approaching $44 per square foot.

> With its expansion into new business areas, such as the planned acquisition of Whole Foods, Amazon is exceeding its own growth expectations. The internet giant was involved in the two largest lease commencements in Seattle in the second quarter: 440,000 square feet at Troy Block North in South Lake Union and 330,000 square feet at Midtown 21 in the CBD. In addition to 1.85 million square feet still under construction at its South Lake Union campus — which will bring its Seattle footprint to 12 million square feet — Amazon is also rumored to be a potential anchor tenant for a 700,000-square-foot project adjacent to the Rainier Tower in the CBD.

> Concerns over the impact of excess new supply are receding. There are 5.9 million square feet of office space under construction in Seattle, three-quarters of which are pre-committed. However, there will be one immediate test in the CBD from Schnitzer West’s 746,000-square-foot Madison Centre, which is due to deliver in Q3 2017. The project is currently only 27% leased.

> There is only one large, fully speculative development underway — the 650,000-square-foot 2 & U, also in the CBD. However, this project is almost two years away from its expected completion date. Tech and biotech tenants — including Google, Seattle Children’s Hospital, Big Fish Games and Facebook — have pre-leased most of the remaining space underway.