Rents Hold Steady Despite Softening Fundamentals

Featured Highlights

- Rents remained strong in the top U.S. office markets in the fourth quarter, with 50 percent of the markets we track continuing to see growth in rates.
- The cyclical slowdown continued, with more than half the markets seeing an increase in vacancy amid slowing leasing activity.
- While most metros saw positive absorption in the fourth quarter, overall net absorption is down year-over-year. Growth, albeit slowing, is expected to continue this year, with U.S. office-using employment growth projected to fall from 2.4 percent in 2016 to 1.4 percent in 2017. Expect Financial Insurance and Real Estate (FIRE) and tech firms to continue to dominate leasing activity.
- Relocations to CBDs—mostly from suburban locations—were a marked trend in 2016. Hiring activity remained a key driver, with firms wanting to attract talented millennials who exhibit a strong preference for urban living.
- The Trump administration portends the most significant shifts in economic policy in a generation, creating a climate of considerable uncertainty. While the details are unknown, expected proposals for reducing regulations and lowering business taxes, if implemented, could boost investment and hiring, with the financial services industry being a major beneficiary. However, this should be tempered against the likelihood of inflation, rising interest rates and a weakening dollar.
- Despite a flat vacancy rate, New York performed strongly throughout 2016, recording its second-highest annual leasing total in the last 10 years.
- The San Francisco Bay Area remains the tightest of the top 10 markets with a 5.6 percent vacancy rate. In core Silicon Valley markets vacancy is as low as 2 percent. Seattle was the strongest performer in 2016, with the largest fall in vacancy and growth in absorption and rents.

### MARKET CORE CBD INVENTORY (SF) CORE SUBMARKETS ABSORPTION (SF) AVG RENT ($) VACANCY RATE

<table>
<thead>
<tr>
<th>MARKET</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</td>
<td>506,126,142</td>
<td>Manhattan: Midtown, Midtown South, Downtown</td>
<td>-1,773,115</td>
<td>$73.24</td>
<td>6.4%*</td>
</tr>
<tr>
<td>L.A. County, CA</td>
<td>200,589,600</td>
<td>Downtown Los Angeles, West Los Angeles, Tri-Cities</td>
<td>750,400</td>
<td>$35.88</td>
<td>15.0%</td>
</tr>
<tr>
<td>Washington, D.C.</td>
<td>177,359,043</td>
<td>DC: CBD, East End, Capitol Hill, NoMa, Capital Riverfront NOVA: R-B Corridor, Tysons Corner SubMD: Bethesda</td>
<td>788,776</td>
<td>$46.07</td>
<td>13.4%</td>
</tr>
<tr>
<td>Chicago, IL</td>
<td>1,427,717,618</td>
<td>West Loop, Central Loop, River North, East Loop</td>
<td>560,889</td>
<td>$38.00</td>
<td>11.4%</td>
</tr>
<tr>
<td>Atlanta, GA</td>
<td>99,041,859</td>
<td>Midtown, Buckhead, Central Perimeter, Cumberland/Galleria</td>
<td>429,250</td>
<td>$27.10</td>
<td>12.7%</td>
</tr>
<tr>
<td>San Francisco Bay Area, CA</td>
<td>92,753,479</td>
<td>Financial District (North Financial District &amp; South Financial District), SOMA (West SOMA &amp; East SOMA), Palo Alto, Mountain View, Sunnyvale</td>
<td>698,095</td>
<td>$72.46</td>
<td>5.6%</td>
</tr>
<tr>
<td>Seattle, WA</td>
<td>71,439,833</td>
<td>Seattle CBD, Lake Union, Pioneer Square, Belltown, Queen Anne, Ballard, Northgate</td>
<td>1,788,501</td>
<td>$37.03</td>
<td>8.2%</td>
</tr>
<tr>
<td>Dallas, TX</td>
<td>66,972,707</td>
<td>Uptown &amp; Far North Dallas</td>
<td>333,241</td>
<td>$30.12</td>
<td>13.0%</td>
</tr>
<tr>
<td>Boston, MA</td>
<td>66,745,452</td>
<td>Back Bay, Financial District, Charlestown, Cross-town, Fenway/ Kenmore, South Station, North Station, Seaport</td>
<td>137,467</td>
<td>$54.30</td>
<td>11.3%</td>
</tr>
<tr>
<td>Houston, TX</td>
<td>42,990,104</td>
<td>Houston CBD</td>
<td>29,984</td>
<td>$41.42</td>
<td>16.8%</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 build-out within 12 months.
Conversely, the largest rise in vacancy occurred in Boston, which is becoming an increasingly bifurcated market. Tenants from both downtown and the suburbs are moving to newer space in Seaport. After several tough years, Houston is starting to stabilize. Deregulation in the energy sector could provide a further boost.

LOCAL INSIGHTS

- At 33.1 million square feet, Manhattan leasing activity in 2016 was 5.5 percent higher year-over-year and was the second highest annual total seen in the past 10 years. Private sector job growth in New York City is tracking the national rate of 1.7 percent, adding around 60,000 new jobs in 2016.
- Demand was led by the FIRE sector, which accounted for 40 percent of net absorption. Media & entertainment, tech and law firms dominate leasing activity. In addition to almost doubling their Santa Monica footprint, Oracle Corp. paid a reportedly record price to acquire 2700 Colorado Avenue where it will occupy 100,000 square feet.
- Asking rents between $85 to $95 per square foot in the CBD and East End and $55 to $65 per square foot in the suburbs are being quoted for top-end new construction. Landlords are offering hefty concession packages to achieve these rents.
- While vacancy fell over the past 12 months, the LA market is reaching equilibrium with little movement in key indicators in the fourth quarter. There is still the possibility of more rent growth in 2017, but we are unlikely to see a repeat of 2016’s pace.
- Development activity is slowing down and is heavily front-loaded with 75 percent (2.6 million square feet) of space under construction due to come online this year. Most of these projects are taking place in West LA, focused on highly desirable locations such as Marina Del Ray and Santa Monica. Conversely there is no sizeable construction underway in Tri-Cities which was hit by Warner Music’s decision to relocate its headquarters to 257,000 square feet in the newly restored Ford Factory building in Downtown’s Arts District.

- Manhattan asking rents edged upwards in 2016. At an average of $73.24 per square foot, asking rents were 2.4 percent higher than year-end 2015. There was 1.5 million square feet of lease transactions with starting rents north of $100 per square foot. Rents in Midtown South and Downtown are at record highs.
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- Still, Manhattan vacancy was virtually unchanged over the year at 6.4 percent. While several of 2016’s largest transactions saw tenants choosing to remain in their current space, the impact of pending new supply and over 11 million square feet of relocations could push vacancy up. There is 33 million square feet of potential development in the pipeline. However, just under half of this total is currently scheduled or under construction. The 20-million-square-foot Hudson Yards redevelopment in Midtown South continues to grab tenants and headlines. Luxury handbag firm Coach took 694,396 square feet at 10 Hudson Yards, which was the largest new lease signed in 2016.
- Net absorption was negative 3.79 million square feet, the first full year of negative absorption since 2009. This past year, in part, the combination of strong leasing with negative absorption was the result of several large deals closed with no impact on either vacancy or absorption. The four largest lease transactions in 2016 were renewals or sale-leasebacks.
The Atlanta market is stabilizing. Vacancy is moving downward and rents are up by more than $2 per square foot from a year ago. Rents have now increased over 12 consecutive quarters. The year closed out with almost 1 million square feet of positive absorption in the second half. Encouragingly, demand is spread across a range of sectors led by finance, insurance and law firms.

Tenants remain focused on Midtown and Cumberland/Galleria, which collectively accounted for 50 percent of leasing across the city in 2016.

The fourth quarter saw State Farm move into a combined 635,000 square feet of new space. The State Farm deal provided a needed boost to the Central Perimeter submarket. Additionally, Mercedes-Benz will be moving to a 225,000-square-foot headquarters in the submarket upon its completion in 2018.

Construction is slowing and, for now, developers are taking a wait and see approach. After an expected 1.8 million square feet is due to come online this year at the end of the current cycle, there are only three projects underway—all of which are build-to-suits led by NCR Corps., 485,000-square-foot new headquarters in Midtown.

The core San Francisco Bay Area market remains the tightest across the top 10. Vacancy fell by 20 basis points in the fourth quarter to 5.6 percent. Rents are the second highest at an average asking rent of $72.46 per square foot, less than a dollar below those in Manhattan. While it is now below the 10-year average, net absorption remains solid and still dominated by tech. The largest fourth quarter lease transactions in Downtown San Francisco involved Adobe (207,000 square feet), Slack (229,000 square feet) and NerdWallet (105,000 square feet).

Signs point to a decrease in leasing activity in 2017. Development opportunities, becoming even scarcer, and the pace of office-using job growth is forecast to fall to 1.5 percent this year—less than half the expected 2016 level. Only three deliveries above 100,000 square feet are anticipated this year. By far the largest of these is the 1.4-million-square-foot Salesforce Tower, which is 60 percent pre-leased.

Vacancy in the core Silicon Valley markets is even lower. Palo Alto’s 2.3 percent vacancy rate results in the highest average asking rents across the Bay Area at just over $90 per square foot. Net absorption in the Valley has now been positive for six years with an increasing share coming from tenants taking occupancy of build-to-suits and newly completed projects. In addition to moving into 1.6 million square feet at Moffett Place in Sunnyvale, Google also signed two more leases totaling 900,000 square feet.

This pattern is set to continue with over 6 million square feet of pre-committed space under construction in Silicon Valley. Half of this is accounted for by Apple’s 3.1-million-square-foot “spaceship” campus in Cupertino. In addition, Palo Alto Networks will occupy 950,000 square feet in Santa Clara. Other big names—including LinkedIn, Google and Netflix—remain in expansion mode.

Seattle continues to be the city of Amazon. During Q4 2016, Amazon moved into its brand new 1-million-square-foot office tower and completed tenant improvements on a 380,000-square-foot office building that it leased nearby. Amazon also leased a further 480,000 square feet in South Lake Union and purchased land for the future site of a fifth office tower.

Other tech firms continue to get in on the act, led by Facebook, which pre-leased 380,000 square feet in South Lake Union during the fourth quarter. Firms such as Google, Zillow, DocuSign and Pokémon are also expanding. There is a steady stream of tech firms relocating from the heady costs of the San Francisco Bay Area and looking to Seattle for more affordable rents and a similarly strong tech environment. The overall effect is a shortening supply of large block availability.

While rents continue to inch up and vacancy remains tight, the market looks set to plateau. Pre-leasing of new CBD construction stands at only 12 percent, compared to 65 percent on the eastside in downtown Bellevue. Rents may have reached their peak (there was a slight dip in Q4 2016) as supply and demand move toward equilibrium. As such, it will be important to monitor the sublease office market going forward. The amount of vacant sublease space available quarter-over-quarter has increased significantly.

Dallas office vacancy continues to shift upwards in modest increments. Absorption turned positive in Q4 2016 and should get a boost from tenants taking occupancy of new space currently under construction. Less than 35 percent of space delivered in 2016 is still available. Reflecting the tightness in Uptown, the 530,000-square-foot McKinney & Olive is already over 90 percent leased less than six months after completion.

Vacancy now stands at 13.0 percent, up by 110 basis points from 12 months ago. However, rents are still inching upwards, increasing by $1.13 per square foot over the past year to $30.12. Class A assets in prime locations have seen rents break through the $40 per square foot barrier, with some deals reportedly achieving upwards of $50 per square foot.

Development remains focused on the Far North Dallas and Uptown submarkets, with 5 million square feet due for completion this year. The vast majority of this space is pre-committed, including 3.2 million square feet in build-to-suits for Toyota and Liberty Mutual. Competitive rents, land availability and healthy job growth should help this trend to continue. A further 1.6 million square feet should be completed in 2018, which is currently 45 percent pre-committed.
Overall signals for the Boston office market are mixed. Rents are holding steady at around $55 per square foot. Absorption returned to positive territory in the fourth quarter, but is considerably lower than a year ago. Vacancy moved up by 230 basis points over the past 12 months, due to a combination of new supply, tenant moves and a growing amount of sublease space.

There is also marked bifurcation between submarkets, most notably the Financial District and Seaport. The former saw negative (800,000 square feet) of absorption in 2016, with vacancy especially high in the upper floors of tower buildings. Seaport is the principal beneficiary, attracting tenants from the Financial District and suburbs alike. Goodwin Proctor is moving in to 375,000 square feet alongside tech firms such as LogMeIn, Autodesk and Continuum and apparel manufacturer Reebok looks set to follow.

Houston’s office market remains challenged, but is showing early signs of stabilization and even possible growth in the year ahead. Absorption in the CBD turned modestly positive in the fourth quarter of 2016 after being deep in to the red in the prior quarter at negative 542,282 square feet. Vacancy—at 16.8 percent—is 100 basis points higher than a year ago, but the pace of upward growth is slowing.

In a marked shift, Q4 2016 witnessed several energy companies remove available sublease space as they began to shift out of contraction mode and started looking forward again. Even so, two-thirds of sublease space available is of secondary quality.

No new buildings delivered during Q4, but 1.8 million square feet of the 3.0 million square feet in the market-wide construction pipeline is scheduled to deliver in Q1 2017. This is led by Hines Securities Inc.’s 1.05 million square foot, 48-story, 609 Main St. in the CBD. The property is 50% pre-leased to United Airlines, which is consolidating from two other CBD properties, to take 225,000 square feet in the new tower.