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As Good As It Gets? Office Market Moving Into Sweet Spot In Recovery

CoStar Portfolio Strategy's Third Quarter Analysis Finds More Markets Seeing Rent and NOI Growth Driven by Strong Demand and Constrained Supply

By **Randyl Drummer** October 22, 2014

Conditions in the U.S. office market are aligning in a way that office investors have dreamed about. A serendipitous combination of falling vacancy, rising net absorption and a controlled supply of new office space is creating broad-based opportunities to increase rents and reap higher property incomes on their office property investments.

The U.S. office market has reached just such as sweet spot in the market cycle, according to the CoStar Portfolio Strategy economists who presented CoStar's Third Quarter 2014 Office Review and Outlook this week.

“If we look at the map in terms of which markets are doing well in office-using employment, it is full summer across most of the country,” noted Hans Nordby, managing director of CoStar Portfolio Strategy. “This is the prettiest picture you're likely to see in this economic cycle. If you're waiting for 'as good as it gets,' it's probably today in terms of year-over-year office employment growth being so pervasive.”

"The tipping point of the recovery is here," agreed Walter Page, CoStar Portfolio Strategy director of office research. "As an investor, the last one-third of the recovery is where it's at -- occupancy growth continues, rent growth is pretty strong and NOIs are catching up to that growth, so you have a broader base on which to build. It's a great time to take occupancy risk," Page added, noting that the U.S. vacancy rate is expected to continue trending down to dip below 11%.

About 57 million square feet of net office space was absorbed from the beginning of the year through the third quarter, a full onje-third increase from 43 million square feet of office space absorption a year ago, said Page, who noted that the country is on target for a very strong 74 million - 80 million square feet of net absorption for 2014 as both CBD and suburban office markets experiencing strong leasing activity.

Meanwhile, the U.S. office vacancy rate has declined to 11.6%, down 50 basis points from 12.1% a year ago. Vacancy rates across all of the markets are exceptionally strong, with only six major markets posting rates of over 15%, and a number of large markets under 9%.

Nearly two-thirds of U.S. office submarkets are seeing declining vacancy rates, the best during the recovery, and 35% of U.S. markets are seeing vacancy rates today that are tighter than they were in the previous 2006-07 peak, encouraging strong rent growth across the country, said Aaron Jodka, manager of U.S. research for CoStar Portfolio Strategy.

Average U.S. rents have increased 3.6% year over year -- much stronger than the 2.5% increase recorded in third-quarter 2013 for the previous four quarters. Free rent is diminishing in many markets where concessions were rampant a few quarters ago. For example, within the Orange County, CA, John Wayne Airports submarkets, free rent is down to exceptionally low levels.

The 29 million square feet of new space delivered year to date is 12% higher than a year ago. That said, 101 million square feet is under construction, up 28% from the 79 million square feet under construction in third-quarter 2013. While construction is still below the long-term average of about 120 million square feet per year, "we're inching up and we've doubled the amount of construction from the low point during the cycle," Page said.

The 77 million square feet of absorption expected for this year should rise to nearly 90 million square feet forecast for the next two years, due to expected good job numbers and the fact that office net absorption is only growing at a 1.1% annual rate compared to 2.6% growth in office-using jobs. Eventually, CoStar expects supply to catch up with demand, but for now the level of construction is expected to trail net absorption through 2016, according to CoStar's forecast.

In addition to the traditional energy and technology tenants that have driven the office recovery in large markets from San Francisco to Houston to Boston, medical office and educational facilities have emerged strongly as demand drivers. The vacancy rate for medical office properties is 8.9%, compared to 11.6% for all U.S. office properties.

"In the office market in particular, anything that is health care-related has really good demand and is actually recession resistant," Page said, noting that the medical office vacancy rate has never been above 10% in CoStar's national index since 2007. "We consistently see superior [medical office] occupancy by at least 2 percentage points on a nationwide basis. In nearly every market, even in challenging markets, medical office tends to do well."