Most U.S. Office Markets Firmly in Recovery, Expansion Mode

Robert Carr National Real Estate Investor - Apr 03, 2015

Researchers are now painting most national office markets as heading out of recession and into recovery. Due to high demand for space and tight supply conditions, owners are taking control back from tenants, signaling a warning sign for occupiers that rents will likely increase in the next few years.

For example, a recent report by commercial real estate services firm CBRE shows that since the recession, new demand and strong absorption have made the sector a good investment. Annual net office absorption totaled 52.7 million sq. ft. in 2014, the highest amount since 2007. National office vacancy, at 13.9 percent at year-end, was at its lowest level since 2008. According to CBRE, 48 of the 54 national markets recorded positive net absorption last year, led by markets with a lot of technology jobs.

The markets ranked by CBRE as having the most favorable conditions for owners, due to factors such as positive net absorption, stable or increasing occupancy, strong leasing activity, increasing rents or limited new supply, include Denver, Manhattan and Midtown South in New York City, San Francisco, Houston, Seattle, Atlanta, Boston, Chicago and Philadelphia. Markets ranked as most favorable for tenants, because of factors moving in the opposite direction, include Dallas/Ft. Worth, Washington, D.C. and Los Angeles.

Colin Yasukochi, director of research and analysis with CBRE, says further expected economic growth will boost office space demand during the next three years, with national vacancy expected to hit 12.2 percent by 2018. By next year, he says, 10 of the 14 major downtown markets and eight of the 13 major suburban markets will see rent increases.

“We generally feel that with the economy slowly improving, and the pick-up of more and more office jobs, the balance of power is shifting away from the occupiers,” Yasukochi says. “Thus follows the implied advice to tenants to make occupancy decisions sooner if possible, to get ahead of the cost increase in the future.”

Another geographic comparison has been released by consulting firm PwC. The “Q1 2015 Real Estate Investor Survey” presents highlights of the national commercial real estate markets. For office, the report is positive, classifying 32 downtown areas as being in the “expansion” phase, which includes strong demand, tight market conditions leading to low vacancy rates, robust rental growth and decreasing overall cap rates. These markets include most of the Northeast (except for Newark, N.J.), a good part of the Midwest and half of the South, including Miami, Dallas and Charlotte, N.C. However, only seven of the 18 markets in the West are ranked as being in expansion, including Los Angeles and surrounding markets, San Diego, Portland, Ore. and Salt Lake City.

An additional 12 markets mentioned in the report have recovered from the recession, but are just now heading toward expansion, and are classified as being in the “recovery” phase, characterized by tightening market conditions and a shift in the supply/demand balance leading to reduced vacancy rates, more balanced rental growth and a stabilization of overall cap rates. These markets include Cleveland, Minneapolis, Phoenix, Memphis, Tenn., San Antonio and Atlanta.

To round out the PwC rankings, there are only seven markets out of the 57 included that are classified as still being in a “recession” mode, including Cincinnati, San Jose, Calif., Ventura, Calif., Albuquerque, N.M., Newark, Houston and Washington, D.C. These markets have low demand for space combined with a lot of supply, and continue to display other negative market dynamics. Another seven markets are in the "contraction" phase, characterized by too much supply and a reversal of recovery. These markets include Honolulu, Riverside, Calif., Austin, Texas, Fort Worth, Texas, Nashville, Tenn., Seattle, and most surprisingly, San Francisco.

Mitch Roschelle, national practice leader, real estate advisory, for PwC, says that the national office market is really in good shape, with not a lot of recession pockets left. The past few years have seen only a 1 percent or less in additions to national supply, much lower than historically expected, he says.

"When you compare our new supply to previous recoveries, we've clearly oversupplied following recessions several times, as much as three times what we're adding today," Roschelle says. "It appears we're not overbuilding this time, which should lead to a relatively sustained recovery."