The Office Campus is Back and (Mostly) Doing Fine

Urban and Even Suburban Office Parks, Written Off by Investors Just a Couple Years Ago, Appear to be Gaining Favor as Build-to-Suit Activity Increases

CoSTAR - By Randyl Drummer February 17, 2016

Tampa, FL, which was hurt as severely as any U.S. metro by job losses and the housing market collapse in the wake of the Great Recession, might not have appeared on the radar of most investors looking to buy a large corporate office campus, much less a property that includes a significant speculative development play.

After recording a 10-year low office vacancy rate of 8.2% in 2007, the Tampa-St. Petersburg metro's office vacancy rate shot up to 14% by early 2010. Housing prices plummeted by nearly 46% and the area lost nearly 141,000 non-farm jobs.

But after a slow and gradual economic recovery, Tampa's office vacancy rate could finally slip back into single digits in the first quarter of 2016 for the first time in eight years, according to CoStar data. With virtually no new buildings delivered during that time, large blocks of available office spaceare in increasingly limited supply. The favorable market conditions was a major reason cited by the principals of Vision Properties, a Mountain Lakes, NJ-based commercial real estate firm, which acquired its first Tampa property, a five-building, 573,053-square-foot master-planned suburban corporate office campus along Henderson Road north of Tampa International Airport.

Vision Properties paid more than $100 million for the Renaissance Park property, sold as part of the disposition of non-core assets and exit from the Tampa market by Malvern, PA-based Liberty Property Trust (NYSE: LPT), which is also exiting South Florida and several other markets.

According to the buyer, spec office development may be in the property's future. The 71-acre campus includes a permitted development pad for construction of an additional 111,600-square-foot building. With a dearth of large blocks of available space for large tenants in the densely populated Tampa suburbs, Vision Properties' founder, managing partner and chief operating officer Fred Arena expects to break ground on a new building within the next 12 months.

"We would be willing to break ground on Building 6 on spec, given our confidence in the Tampa market," Arena tells CoStar.

Will Bertolero, vice president of asset management for Vision Properties, said he has observed an uptick in suburban office construction in the company's markets, mostly driven by the need for large contiguous space. Vision currently manages a 5 million-square-foot office portfolio with buildings in Charlotte, NC; East Rutherford and Basking Ridge, NJ, and Atlanta.

"In a lot of markets we operate in, we are seeing build-to-suit construction activity being driven by corporate relocations," Bertolero said.

Development is clearly a key part of the play for Vision in the Renaissance Park acquisition. Like other former housing bust markets in the South such as Atlanta, Miami and Raleigh, Tampa has seen office-using employment growth and rising occupancy rates. Demand growth in Tampa’s office market has outperformed other office markets in recent quarters through a combination of job growth, robust net absorption, tax incentives and lower costs of doing business.

"Those metrics played a role in our decision," confirmed Arena. "Over the past 36 months, there has been a lot of large tenant activity in Tampa."

The Vision Properties executives said they've already responded to several RFPs and preliminary inquiries on the property, where the existing buildings are currently 100% leased.

New Supply Reaching More Office Markets

With the recession in the rear-view mirror, Tampa is among a handful of U.S. office markets, a group that also includes San Diego, Atlanta, Pittsburgh, Raleigh, Miami, Phoenix and even Washington, D.C., where the amount of new supply remains well below their average norms, with demand growth clearly outstripping available supply, according to CoStar's recent 2015 office market review and outlook.

Other markets such as Austin, Philadelphia and Los Angeles are at or near average construction levels, while fast-building metros such as Dallas, Denver, San Francisco, Seattle and San Jose are seeing development activity that's well above average annual growth levels.

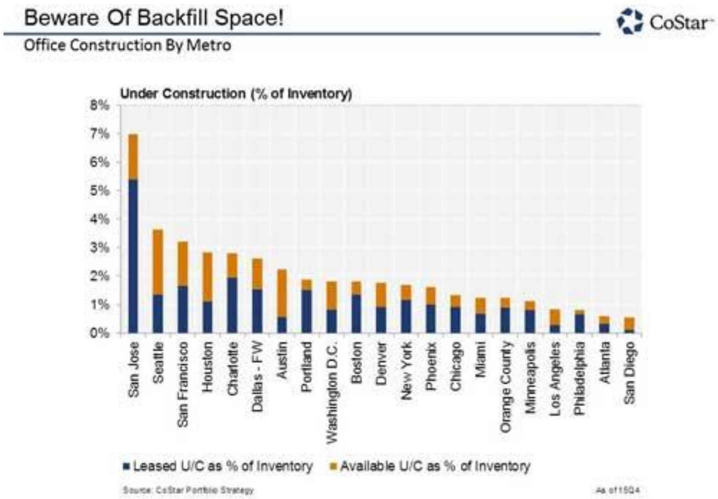
In total, two-thirds of U.S. office markets had above-average levels of office construction at the beginning of 2016.

"When we look at office construction, we're seeing a clear sign that office campuses are back," said Walter Page, CoStar director of U.S. office research, citing large build-to-suit corporate headquarters under construction such as tire and rubber company Bridgestone America’s 514,000-square-foot, $220 million tower and campus under construction in downtown Nashville; and Toyota Motor Corp.’s 2.1 million-square-foot, $350 million corporate campus headquarters on 100 acres in Plano near Dallas, expected for delivery in 2017.

More corporate campuses and expansion will likely be added to the mix in coming year, including plans for the relocation of General Electric Co. headquarters relocation from suburban Connecticut to the Boston waterfront. One of the nation’s largest insurers, Farmers Insurance, earlier this month announced plans to significantly expand operations from about 500 full-time employees to more than 1,500 in a new building in North Phoenix.

The Farmers expansion comes as State Farm begins moving the first of an expected 8,000 employees into a new regional headquarters in nearby Tempe, AZ, one of three new employment hubs that also include large facilities in the Atlanta and Dallas markets.

Spec office campus construction is ramping up in such hot tech markets as Seattle, where Seco Development just announced it will formally break ground on a $350 million office development with three buildings totaling 730,000 square feet in Renton, WA, the largest development in South King County. CoStar is tracking significant levels of office buildings under construction without signed tenant in most of the 20 largest office markets, with spec as a particularly high percentage of total construction under way in Seattle, Austin, Houston, San Francisco, Los Angeles, Washington, D.C. and Denver.



Page noted that build-to-suit activity such as the current slate of large office campus headquarters projects typically signals the first stage of significant office construction, followed by increased spec development. Tampa to date has not yet had much speculative construction because office rental rate have been too low to justify it, Page said.

"However, when a tenant is willing to pay a premium, this type of large-block construction is often the first thing constructed in the market," Page said. "As office rents continue to rise, the willingness and ability of developers to start speculative buildings increases, which is why the tech markets of San Francisco and San Jose lead the nation in all forms of office construction, while construction in many other markets is likely to require a higher level of pre-leasing activity."

Not all suburban office markets are thriving. Page noted that several office campus properties remain vacant in Northern New Jersey, where buildings were constructed for pharmaceutical firms or other previous occupiers in such a way that the space may not appeal to other types of tenants.

"If an investor in a new office campus is wise, they should think about being able to adapt to future needs, which includes the possibility of not having that particular firm or tenant in the campus," Page said.

Exxon Mobil, for example, built a series of buildings in the same area within Houston for its new headquarters, allowing the firm to either add space to the campus or lease out excess space as necessary.

"By contrast, the worst move a company could make is to build one large building, like Apple is building in Cupertino, and not have the ability to add or remove space from its control," Page said. "If Apple ever desired to convert its future headquarters to multi-tenant use, it would be very difficult and very expensive."

Large Available Spaces Hard to Find

Blocks of space are disappearing in the wake of solid demand growth for newer 4- and 5-Star office space of 2.5% year over year, more than double the demand growth for lesser quality space. Tenants are willing to pay a premium for the newer space, averaging $33.60 per square foot, compared with an average $22.90 for 3-Star and $17.90 for 1- and 2-Star buildings.

The improving economy and rising office demand, along with a slower level of new construction activity compared with past cycles, has resulted in a diminishing number of large blocks of office space of 100,000 square feet or greater that are available in many markets across the U.S., creating challenges for occupiers seeking large footprints, according to a recent study by CBRE Group, Inc.

For example, Philadelphia had just six blocks of 100,000 square feet or greater of contiguous space in existing or under-construction buildings as of the third quarter of 2015, the lowest among all U.S. downtown markets, followed closely by San Francisco with seven and Midtown South Manhattan with 10, according to CBRE.

San Francisco had only four options for a tenant in immediate need of a large block in an existing building, with five options each in Seattle and Philadelphia, the lowest among both downtown and suburban U.S. markets.

Heavy preleasing has ensured that even in constrained downtown office markets with new projects under construction, increasing supply is often insufficient to meet demand by large space users. In San Francisco, for example, nearly all of the space slated to come on line over the next 12 months is pre-leased. In Chicago, the number of large, available blocks is expected to decrease over the next six months due to rapid tech expansion and the in-migration of tenants from the suburbs and other states, while Atlanta has just one large block under construction, according to CBRE.

Crane-dotted downtown skylines in Seattle, Boston, Downtown Manhattan and Midtown Manhattan will likely see the number of available blocks tick up as new supply comes on line in coming months. On the other hand, downsizing by law firms and government and the movement of federal government tenants into GSA-owned space is expected to swell the number of large blocks in Washington, D.C.

"Despite the improving economy and dearth of large available blocks of space, rent levels do not justify new construction in many markets, particularly given rising development costs, which has limited the options for tenants requiring large footprints," noted Andrea Cross, Americas head of office research for CBRE.

Houston's suburban market also had an eye-opening 89 large available blocks of office space, reflecting weakness in the energy industry as well as increased sublease availability and ongoing new construction. New Jersey, with a large amount of vacant outmoded corporate campus and other suburban space, had the highest amount of available large blocks as a percentage of total inventory at 9.7%.