SummerStreetAdvisors

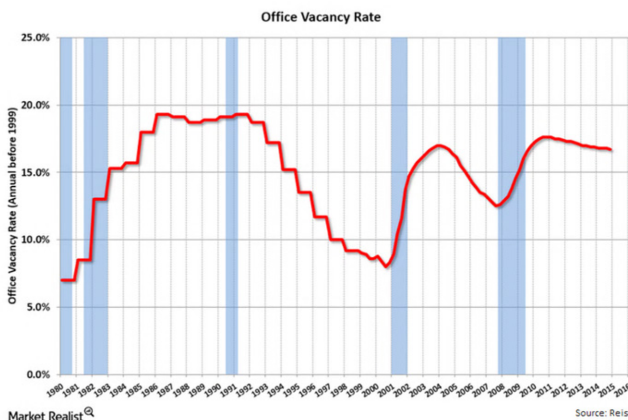
Look at Office Space Demand Before You Leap for Joy at the Market's Strength

February 2015

The office market had a banner year in 2014, with declining vacancy rates, rising rents, high prices paid by investors and the highest net absorption since 2007. New development, some of it speculative, has started up in many markets. In its third-quarter analysis, CoStar noted that the office sector was "moving into the sweet spot" for investors and asked: "Is this as good as it gets?"

But it doesn't bode well for the office market if this is indeed as good as it gets. A closer look at the numbers suggests that office space demand hasn't been as strong as it should be in the current economic climate. That could mean the market's ripe for a boom, but it could also point to a fundamental change in the relationship between job growth and space demand. It could be dangerous for investors to assume that office space demand will follow the same path it has in previous market cycles.

Although everybody agrees that the market is moving in the right direction, how fast and how far is open to debate. CBRE reports that the national vacancy rate fell about 100 basis points in 2014, ending the year at 13.9 percent. But according to REIS, the year-end rate was 16.7 percent and had come down only 20 basis points since 2013—or 90 basis points since the 2010 peak of 17.6 percent. The gap is due to different methodologies, but looking at historical rates through Reis' consistent methodology, we see that vacancies have not yet begun to fall at the pace of past recoveries. Why not?



Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

The problem is hardly one of job growth. Some 10 million jobs have been added to the economy in the past five years, compared to less than 8 million jobs between 2003 and 2007. Office jobs make up at least half the total new jobs—tech companies have driven job creation, and the financial sector has returned to pre-2008 employment levels. But this time around, strong job growth doesn't seem to have translated into increased demand for space at the same pace of previous cycles. Why not? There are several trends that should factor into any prediction on the strength of office demand.

• **Densification** – Companies are getting better at reducing the amount of space needed per employee. For instance, law firms renewing their leases are taking about one-third less space per employee due to more efficient layouts and less need for paper file storage. Other professional and business sectors are also shrinking; for instance, CBRE's new corporate headquarters in Los Angeles cut its average space per employee nearly 40 percent in part by replacing dedicated offices with a flexible system offering 15 types of work space.

CoreNet Global, an association of top corporate real estate departments, polled its membership to find average space per office employee falling from 225 square feet in 2010 to 176 square feet in 2012 to an estimated 151 square feet by 2017. This goal may be more aspirational than rational, but many companies that densify are happy with the results, which are more about employee perception and collaboration than occupancy cost savings. If companies across the board can thrive with 30 percent less space, the implications to the office market could be dire.

• **Live-work-play neighborhoods** – Office job growth has been strongest in the technology sector, but these companies often bypass CBD locations and instead renovate old warehouses in urban live-work-play neighborhoods. The strategy is to attract Millennials who gravitate to affordable areas with places to socialize and good transit options. Most traditional office markets have little in the way of nightlife, let alone apartments.

Take Chicago, which boasted the country's sixth-best growth rate in tech jobs in 2012 and 2013, coming in ahead of Seattle, Boston and Raleigh-Durham. The city's biggest tenant last year was Google, which has committed to more than 300,000 of former warehouse space in the Fulton District market adjacent to River North. Many other large and small tech tenants have also chosen that off-CBD neighborhood for its attraction to young people as a fun, affordable place to live and work. But tech firms aren't the only companies seeking young talent: Suburban-based McDonald's announced in the fourth quarter that it would open a large satellite office in Fulton as well. Meanwhile, CBD vacancies remain high at 17.1 percent, and asking rents average $27 per square foot, according to Newmark Grubb Knight Frank.

• **Mobile workers** – Less work is being done in traditional offices as more people work from home, in small satellite offices or at coffee shops and restaurants. A laptop and a smartphone are the only office tools many workers need to be productive—so who needs an office, anyway? U.S. Census Bureau data shows that about 4.3 percent of employees work mainly from home, up from 3.6 percent just five years earlier. As technology evolves and Millennials become a larger share of the workforce, mobility is going to be a bigger issue going forward.

Fueling this trend, companies are getting rid of full-time employees wherever possible, turning instead to independent contractors for many non-core activities. Enactment of the Affordable Care Act may accelerate this trend as well—previously, employees cited the inability to get healthcare insurance as a primary reason why they could not strike out on their own.

Taken together, these factors are likely to dampen office space demand for the foreseeable future. The news that speculative development is under way in many markets with vacancies over 12 percent may be further cause for caution. Is new development really predicated on space demand, or is it partially a response to the flood of investment capital looking for a landing place? Investment managers note that cap rates are as low as they were before the recession, and risk-adjusted return calculations often don't consider the cultural shifts noted above.

None of this means the office sector is necessarily headed for a major disaster. There will continue to be some great performing buildings and markets. 2015 looks like a great market. But after five years of steady economic growth, statistically, we're only a few years away from the next recession. Investors who think the party is just starting may be surprised at how late it really is.

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