Office market fundamentals continued to improve during 4Q as rents rose in the core areas of all top ten markets we track. Vacancies fell or were flat in nine of the markets. The overall vacancy rate for these market areas fell to 11.5%, down 10 basis points (bps) from 3Q and 40 bps from a year ago.

Absorption trends were generally positive, with leasing in the core areas in seven of the ten markets high or level this quarter. Even in markets such as Manhattan and Seattle where absorption slipped, leasing was still healthy, though down from very robust activity in 3Q, in part because declining space availability limits leasing options, which may weigh down leasing volumes near term until new supply is added.

Strong recent absorption can be partly attributed to early leasing by large tenants with lease expiration dates still years away. While some tenants look to consolidate space and/or lock in deals early as cost-containment measures, an equal driver is the ability to configure space into a more modern, collaborative, “work by choice” layout that employees desire.

Tech continues to drive leasing in several leading markets, though corporate relocations in Chicago, Atlanta, and Dallas, and professional services in most markets, account for a growing share.

Rents are still below their prior peak Class A asking rent in six of the ten markets (at the metro level), while seven of the ten are still above their prior trough in vacancy rates, suggesting room for continued gains.

Looking forward, the U.S. economy should continue its moderate growth in 2016 – notwithstanding recent turbulence in financial markets and the global economic slowdown – giving more loft for U.S. property markets. Thus, we expect both occupancy and asking rents will continue to grow in all of our top markets (except Houston), although at a more moderate pace than the record growth we saw during 2015 in the hottest markets.
LOCAL INSIGHTS

- The diversification of tenants has helped drive the Downtown submarket. Consumer goods tenants such as Hugo Boss and Hudson’s Bay as well as law firms, media and engineering firms moving into the submarket have decreased reliance on the financial sector.

- Midtown continues to be strong as the submarket has not yet reached its previous peak in asking rents. More than four million square feet of office construction is underway or in the pipeline in Midtown to compete with the 19 million square feet being constructed in the neighboring Hudson Yards/Manhattan West area of Midtown South. The Hudson Yards/Manhattan West area has seen significant commitments in buildings being developed by Related and Brookfield while other developments await anchor tenants.

- While the third quarter saw technology, advertising, media and information services (TAMI) firms overtake financial services, insurance and real estate (FIRE) companies in terms of total square footage leased in Manhattan, the fourth quarter saw the FIRE sector regain the top spot with 36% of total leasing vs. a 23% share for TAMI. Of note was WeWork’s 900,000 square feet of leases in 2015, which accounted for 3% of all Manhattan leasing and 9% of all FIRE sector leasing. The TAMI sector did register the largest deal of 2015, however - a 582,000 square foot renewal/expansion by Publicis Groupe at 1675 Broadway.

- While tech firms have gravitated to areas such as Santa Monica and Silicon Beach, further development opportunities are limited. Seeing the success other metros have had redeveloping older building stock for tech tenants, developers in the Arts District of Downtown Los Angeles have been rehabbing that area’s older B-stock and functionally obsolete industrial buildings in hopes of becoming a new tech hub.

- Co-working firms have been active across the market, from Pasadena to Downtown Los Angeles. They provide an affordable alternative with short-term commitments for companies focusing on growing their business before transitioning to traditional office leases.

- Absorption remains positive, although there has been a slowdown in momentum. Vacancy rates have been decreasing, but they haven’t been decreasing sharply enough to justify the continuing 3 to 3.5% annual escalations in rent.

- Firms that need access to the federal government and lobbying activities concentrate in the downtown areas of the CBD, East End and Capitol Hill in the District. Local tech firms also prefer to be located in these downtown submarkets, enabling them to take advantage of the experienced talent pool.

- Just outside of the District, Tysons Corner in undergoing a renaissance as the federal government contracting industry enjoys the proximity to both Washington, DC and Dulles International Airport. In addition, new buildings such as 1775 Tysons Boulevard are incorporating a more collaborative environment (concierge services, Wi-Fi social lounge, elevated terraces, health club, etc.) to lure tech tenants.

- For the first time in several years, law firms are not contracting. While there aren’t strong signs of expansion yet, the maintaining of their current footprints is a step in the right direction.

- Corporate migration into the CBD is the biggest driver of activity. Recent relocations include ConAgra Foods from Omaha, NE and Motorola Solutions from Suburban Chicago. CBD locations help in recruitment of young talent who live Downtown and want access to public transportation for commuting.

- The phase-in of an 18% property tax increase over the next four years to address shortfalls in public pension funding could deter future corporate headquarters relocations, as the city is no longer offering tax breaks to lure firms.

- While tech tenants have generally preferred the River North area in recent years, Google’s converted storage facility in the Fulton Market submarket is attracting more development geared to the needs of tech firms. Shared office space companies are very active in all submarkets, signing leases of between 50,000-80,000 square feet.

- Professional services firms and corporate headquarters relocations are the major drivers of activity in the area. Mercedes Benz is constructing a 250,000 square foot facility for its U.S. HQ relocation from New Jersey and Porsche, relocating from nearby Sandy Springs, GA, recently opened its new $100 million HQ facility near the Hartsfield-Jackson Airport.

- The growing tech presence has been concentrated in the Midtown submarket. A top example is the conversion of a former Sears Roebuck warehouse and regional office into Ponce City Market, a successful 2.1 million square foot mixed-use live/work/play redevelopment that appeals to tech firms and their employees.

- Competition for prime, Class A space has driven rents up to new heights across the Central Perimeter, Midtown and Buckhead submarkets. Asking rents in Buckhead are up by 24% from 2014. However, new construction to satiate demand is limited, with only one spec development currently under construction.

- The Q4 rise in vacancy in San Francisco is attributed to the delivery of 1.2 million square feet of new construction – all of which is preleased, but won’t be occupied until Q1/Q2 2016 – rather than a softening of the market. It was a record year as Class A effective rents in the city increased over 12% year-on-year and Class B rents increased over 20%. Further growth is expected in 2016, albeit at a more moderate pace. Many tech tenants remain willing to pay these elevated rents to stay in the area rather than migrate out of state.

- With vacancies under 1% in key tech submarkets of the Peninsula, companies are turning to purchasing land in order to expand, such as Apple’s purchase of 98 acres in Cupertino to build a second campus. Large tenants are pushing out smaller start-ups either by paying more or buying buildings and absorbing space as existing leases expire.

- Issues to watch include: whether or not sizeable amounts of sublease space will hit the market as firms move to newly constructed HQ’s; the impact on expansions if venture capital funding pulls back measurably from its current record levels; and concern regarding housing affordability and its impact on attracting talent.
Corporate relocations remain one of the main drivers in Dallas. Many firms relocating to Texas cite the low cost of living, steady population growth, available workforce and quality education as factors. Over 500 companies have relocated their corporate headquarters to Texas over the last five years.

The affordability of housing is also a major draw for these companies in retaining employees. For example, with Toyota’s relocation from Torrance, CA to Plano, TX, the company can keep employee pay at the same level and those employees benefit from housing costs that are roughly one-third those of California.

General population growth combined with corporate relocations are driving massive development. On the border between Plano and Frisco, approximately 30 minutes north of downtown Dallas, there are several mixed-use developments totaling $7 billion either announced or underway within a three-mile span which includes Frisco’s “$5-billion mile”.

Traditional boundaries with respect to submarket location preferences according to tenant industry have blurred and pricing has played a role in that transition. Tech firms began moving to the Financial District after being priced out of Cambridge, and life sciences companies who traditionally desired the Kendall Square and Cambridge neighborhoods are now looking elsewhere as rents have risen on what limited space is available.

Public transportation remains a key factor in these moves. The Financial District is only three stops from Cambridge on the Red Line, for example. The areas around North Station, a major transit hub, as well as the Seaport, are up and coming for tech firms as they have the edgy, creative, loft space that these firms desire.

Law firms have stabilized head counts and space requirements after several years of downsizing. Shared workspace companies are active and growing, and in some cases leasing space that hadn’t seen a lot of interest from other firms.

Tech growth continues to drive the Seattle area. Amazon expanded its global headquarters during Q4 2015 by delivering the first of three 1.1 million square foot office towers. These developments increase Amazon’s total commitments to roughly 11 million square feet in the Downtown Seattle submarkets of Lake Union and Belltown. Many Silicon Valley-based tech firms such as Facebook, Google, Apple, Oracle, and Salesforce have expanded their Seattle satellite offices to tap into the area’s deep engineering talent pool and high quality of life.

Demand for space in core urban submarkets remains strong as tech companies leverage prime office space to attract and retain the millennial workforce that has gravitated to living in these areas. As the availability of creative loft-style space has dried up, landlords are modernizing traditional Class A towers; adding amenities such as amenity rich lobbies, fitness centers, and even bicycle lockers in order to compete for the growing demand from tech firms. This competition for space has driven Class A asking rents up 9.7% year-on-year.

One area of potential concern is the millions of square feet of speculative projects under construction and planned to be delivered over the next 18-36 months into the CBD. Will the fast pace of absorption over the past 24 months continue unabated, or could broader headwinds that face the tech sector slow the pace of expansion plans in Seattle?

As goes the energy market, so goes the office market in Houston. The sustained low levels in oil pricing have precipitated rounds of layoffs and corporate downsizing as sublease space is flooding the market. The strong correlation between the WTI Spot Price and Class A vacancy rates is undeniable, as $120+ per barrel prices led to sub-10% vacancy in 2008 while the current $30 per barrel prices have driven vacancy up to the 15% range.

One of the bright spots in the market is a booming petrochemical industry, reaping the rewards of low-priced raw materials. The housing market is also performing well now, as developers barely kept pace with demand during the last boom, and there is not an abundance of excess housing stock.

Looking forward, vacancy rates are anticipated to rise as major energy firms leave leased space and move into new owner-occupied developments that continue to work through the construction pipeline. This leaves opportunity for firms seeking to upgrade their offices at an affordable price as landlords are renovating many of these vacated buildings to attract new tenants.