



# Inflection Point: Renewed Hiring, Leasing Start to Lift Nation's Office Markets

William Gary, MBA, MIM  
ITRA | MacLaurin Williams  
2020 Arapahoe Street, Suite 1150  
Denver, CO 80202  
Phone 303-294-0277  
Fax 303-294-0278  
Email: [wgary@MacLW.com](mailto:wgary@MacLW.com)  
Web Site: [www.MacLW.com](http://www.MacLW.com)

April 14, 2010



*International Tenant  
Representative Alliance*

**MACLAURIN WILLIAMS**

*Services & Solutions for Users of Commercial Real Estate*



April 14, 2010

Written by Randyl Drummer (rdrummer@costar.com)

---

## Inflection Point: Renewed Hiring, Leasing Start to Lift Nation's Office Markets

*Vacancy Rates Have Plateaued and Lease Transactions Are Picking Up, but Declining Rents and Operating Income Continue to Challenge Office Landlords*

More companies that occupy office space began hiring again during the first quarter and tenants are beginning to renew leases and make other occupancy decisions postponed during the past two-and-a-half years of economic dislocation. The increase in transaction activity resulted in plateauing office vacancy rates across many U.S. office markets during the past quarter.

However, the increase in leasing activity is still well below peak levels and the vacant space in buildings is expected to fill gradually, with net absorption remaining fairly flat in coming quarters. Office rents are expected to finally begin rising in most U.S. markets by the middle of next year, but many landlords won't see significant growth in property net operating income for several years.

Still, first-quarter numbers compiled by CoStar Group show promising signs amid the lingering pain for the commercial real estate industry, including projections of more than 100 million square feet of leasing during the first three months, which would rank as one of the strongest leasing quarters of the last several years.

"We appear to be at an inflection point," Andrew C. Florance, founder and CEO of CoStar Group Inc., said recently during the company's First Quarter 2010 Office Review and Outlook webinar. "We're seeing a lot of signs of recovery."

Economy.com and U.S. Bureau of Labor Statistics data suggests that the U.S. will see significant employment gains over the next three years, including jobs in the office sector, added Dr. Norm Miller, vice president of analytics for CoStar, who presented the overview of market conditions, along with Florance and Jay Spivey, senior director of analytics.

"Professional business service jobs continue, over the last two quarters, to be positive. When you net out the financial jobs that were lost and the information services jobs that were lost, we still have a net positive of 78,000 [office] jobs," Miller said.

Miller cited forecasts that the nation would add a net total of 230,000 office jobs this year, resulting in the take-up of an additional 46 million square feet of space.

Miller acknowledged that there's a lot of slack in the market and not all of the space taken would translate right away to positive absorption. But it will start to chip away at the shadow space plaguing office landlords and tenants, empty space in buildings that companies haven't yet put back onto the market for direct or sub-lease.

"If the economy continues to move in the direction it's moving, we're coming out of the woods here on the leasing marketplace, and it's fairly good news," Florance said. "Any new absorption we see will cause vacancies to go down."

First-quarter 2009 was the worst three-month period for leasing in a decade as tenants, realizing that demand was shrinking and rents were headed downward, delayed decisions to sign or renew leases.

## **CONTINUED: Inflection Point: Renewed Hiring, Leasing Start to Lift Nation's Office Markets**

---

However, "we have now seen four solid, sequential quarters of increase in total leasing activity in the United States," Florance said. "People are out there taking advantage of what they think are good deals, or they've delayed as long as they can."

By the time all the leases are tabulated and accounted for, "given what we're seeing currently for leasing activity in the quarter, we're anticipating and are confident that we're going to see one of the best quarters for leasing activity that we've seen in five years," he added.

Underscoring the boost in leasing activity is 20% year-over-year growth in CoStar Group, Inc.'s office, industrial and retail property listings in 2009 from the previous year, a jump Florance described as "remarkable." The Washington, D.C.-based company added 750,000 office, industrial and retail listings and removed 500,000 listings -- the majority of whom signed leases -- for a net increase of nearly 250,000 listings in 2009.

The stepped-up leasing activity and improving office employment numbers have yet to translate to overall gains in net absorption of office space. About half of the top 20 markets tracked by CoStar posted positive absorption while half continued to show a net loss of occupied space in the first quarter. Houston, continuing to benefit from the surging energy market, led all gainers with positive absorption of 1.4 million square feet, followed by the San Francisco Bay Area with 1.3 million square feet, South Florida at 800,000 square feet, Denver (700,000 sf), Phoenix (600,000) and Minneapolis (500,000). Northern New Jersey, Washington, D.C., Long Island and Boston also showed modest positive absorption.

Markets showing the highest negative absorption include New York City (-2.1 million square feet); Los Angeles (-1.3 million); Westchester/South Connecticut (-800,000); Chicago (-700,000) and Orange County, CA (-500,000)

While an improvement from 2009, when three out of four quarters showed negative absorption, CoStar is expecting flat absorption for the next few quarters as companies gradually work their empty space out of the system.

CoStar and its research and analytics subsidiary, Property and Portfolio Research, Inc. (PPR) are forecasting that the national office vacancy rate has peaked and will begin to fall to what is considered a healthy 10% by end of 2013 and into 2014. While 30-basis-point vacancy increases have been the norm in recent quarters, they've slowed to 10 bps, with the national office vacancy rate ending the first quarter at 13.54%. Availability, space offered but not yet actually vacant, is significantly higher at 17.7% and rising slightly faster, but it's leveling off as well.

New York City had the lowest vacancy rate among major markets at 7.9% -- high compared to the 2% vacancies a few years ago at the height of the era of hot financial services markets, which prompted rent spikes in Manhattan -- but in line with the 20-year NYC average.

Houston had a significant 0.5% decrease in vacancy and San Francisco Bay Area fell 0.4% in the first quarter vs. the fourth quarter, while demand for office space in Atlanta and Phoenix continued to erode, adding 0.6% and 0.4% to their vacancies rates. Phoenix's rate was the highest in the nation at 21.4%, followed by Detroit (18.7%), the fast-delivering Dallas-Fort Worth market (17.9%), Atlanta (17.4%) and Orange County (16.2%).

Rents will continue to pose a challenge for office landlords in coming quarters. Nominal rents adjusted for inflation have fallen every quarter since early 2008 and are now down 20% from a decade ago, from over \$24 per square foot to below \$19, sharply cutting into property net operating income.

As office vacancy rates fall and occupancy levels climb, rents will gradually begin to rise in a couple of markets and will be flat in many others. While rents in a number of metros are still falling, CoStar forecasts that overall U.S. office rents will be in growth mode by the middle of next year.

However, growth in average net operating income won't automatically follow. As leases signed in 2007 at

**CONTINUED: Inflection Point: Renewed Hiring, Leasing Start to Lift Nation's Office Markets**

---

record high lease rates come up for renewal, actual NOI will continue to contract until late 2014, with no significant growth in property income until 2015.

That said, if employment and economic growth matches up with analysts' expectations, investors will begin anticipating that NOI growth within a year or two.

"If we see three or four quarters of significant employment [growth] in the finance, insurance, real estate space, you can begin to anticipate significant value growth. That's an if," Florance cautioned.