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MARKET REPORT: U.S. Office Occupancy On the Wane

Net Absorption Dips into Negative Territory, Ending Five Years of Expansion

If the trend of the first two months of the year holds, U.S. office markets will see their first quarter of contraction since beginning a remarkable period of expansion during the economic recovery that followed the bursting of the Internet bubble at the start of the century.

Nationally, net absorption of office space dipped into negative territory in January and February with tenants giving back about 4.5 million square feet of office space, according to an early quarterly analysis of CoStar Group Inc. data.

While March deals are still to be reported, current economic and leasing trends are pointing toward the negative trend continuing. The economy has lost jobs for two months in a row and CoStar data shows that the amount of office space tenants are putting on the market for sublease has started to increase. Historically, when sublet vacancies start to increase, the actual vacancy also increases.

Tenant rep Diana L. Nash, associate director of Newmark Knight Frank in Detroit, one of the hardest-hit office markets in the country in the current downturn, is seeing the impact across her client base.

"We are finding that most corporate tenants need to downsize substantially in this market, thereby reducing their operating costs, given the ongoing reduction in their income," Nash said. "Getting their balance sheets back in line so that they can maintain the business that they have is critical. Growth is not typical in this market for corporate clients."

"We are assisting clients to reduce those costs via methods such as: lease negotiations with their current landlord to bring them to market rates and establishing a new base year; relocation with one month of free rent per year for the full term of the lease and negotiation of lease rates substantially lower than what they are currently paying; performing lease audits to ensure that the tenant is being charged as originally agreed to for operating expenses, and workspace optimization planning," Nash said.

(Editor's Note: Let us know what you think. What are the current conditions in your market and how are tenants responding to those conditions? You can reach me by clicking on the byline above or e-mailing me at Mark Heschmeyer)

Frank Carone, president of RE/MAX Commercial Brokerage in Santa Monica, CA, is seeing and hearing the same thing in Southern California.

"It appears that the office market is showing signs of softness; including reduced landlord pricing power," Carone said. "Concerns about the economy are driving tenants' reluctance to expand and possibly release space to the market via sublets. Clearly, the office, retail and industrial markets are not enjoying the leasing bonanza and pricing power they had over the last 24 months. Look for signs of sublease activity and the resurgence of landlord concessions as indicators of the market's true strength."

According to CoStar Group analysis, the amount of office space listed for sublease has gone up more than 2 million square feet since the start of the year. That would be the largest quarterly increase in six years.

The contraction of office space is widespread across the country and the market has not seen negative net absorption since the second quarter of 2003.

Of 62 office markets analyzed, CoStar is showing that more than half (35) were showing negative net absorption. The list of cities includes major markets such as New York, Northern New Jersey, Los Angeles, Orange County, Chicago, Washington and Detroit.

It is also evident across midsized and smaller markets as well.

"In our market (Middle Tennessee) we have a lot of new product coming on line, which is creating negative absorption," said Cheri Thomas, MBA CCIM, a broker with NAI Nashville. "These projects were started in '06 and '07, and are coming to fruition, and it will take a little while for the market to catch up."

"In Orlando, with our massive residential overbuild, we are seeing residential-related office uses either going dark or shrinking (or trying to sublease). Primarily mortgage companies, builders, title companies and Realtors," said Mark Squires, a broker with Coldwell Banker Commercial NRT in Maitland, FL. "Our local Realtor board (residential) has lost 2,000 members in the last one to one-and-a-half years. Even surveyors, inspectors, pool builders, various subcontractors are going out or shrinking … Leasing deals are rampant, free rent, build out, incentives."

The number of layoffs in the United States in January, the most recent month for which data is available, increased to 144,111 workers. That was the fifth-straight monthly increase.

"There is substantial evidence that the problems of unemployment are at least as bad now as they were at the beginning of the economic slowdown of the early 1990s or the early 2000s, both recessions when extended benefits were enacted," Rebecca M. Blank, the Henry Carter Adams Professor of Public Policy and Professor of Economics, University of Michigan and a visiting fellow at Brookings Institution in Washington, D.C., testified last week on Capitol Hill.

"Recent months have shown a marked slowdown in employment growth," Blank said. "From January 2006 through January 2007, employment grew by 2%. Over this past year, from January 2007 through January 2008, employment grew only 0.2%. The number of people employed has actually declined in a few recent months."

The semi-annual Manpower Employment Outlook Survey for the United States released this week shows the weakest employment prospects since the first quarter of 2004.

According to seasonally adjusted survey results, employers in nine of the 10 industry sectors surveyed expect the hiring pace to remain stable or decline during the second quarter. Only transportation/public utilities employers anticipated improved conditions for job seekers in the coming quarter.

For the second quarter, mining, construction, durable and non-durable goods manufacturing, wholesale/retail trade and public administration employers foresee a decrease in hiring pace. Hiring is expected to remain relatively stable in the finance/insurance/real estate, services and education sectors.

Employers in the West anticipate a considerable decrease in hiring pace while Midwest employers anticipate a moderate decrease. Employers in the Northeast and South were predicting hiring conditions to remain about the same as they are currently.

Stuart G. Hoffman, chief economist, and Robert A. Dye, senior economist of The PNC Financial Services Group in Pittsburgh, PA, put it this way: "The approximate time of death for the economic expansion was January or February 2008. The cause of death was "natural" causes from ingesting too many lethal subprime mortgage loans and collapsing house prices that clogged the economy's credit arteries, aggravated by toxic high energy price pressures. This is the way we would complete the death certificate for the 2002-2007 economic expansion, although the official pronouncement by the National Bureau of Economic Research (NBER) is many months away."

Marty Schiffman, managing director of Carl Marks & Co. Inc. in New York also tied the current conditions to the credit markets.

"With banks having already written of $140 billion since September ’07, and the credit markets seized up, it is inevitable that business demand for space will shrink," Schiffman said. "Whether it is real estate, or inventory financing for widgets, we are an economy that lives on credit for much of our capital needs. In real estate alone, take away the credit and you lose on average 75% of the capital needed for every transaction. You simply cannot take all of this money away from an economy and not expect businesses to shrink. Henceforth, space needs will shrink."

While the softness in the office leasing market is widespread, there are still pockets of strength both in products and geography.

Boston, Dallas/Fort Worth, Philadelphia and Westchester/Southern Connecticut were all showing net absorption of 500,000 square feet or more so far this year.

Mark Squires of Coldwell Banker Commercial NRT said niche product such as medical and bioscience project are bucking the leasing dullness.

Harry Looknanan, a broker with Sperry Van Ness in Fort Myers, FL, said he is seeing national tenants looking to make some changes in their current leasing arrangements during the next three to six months.

"The leases I have signed in the past two months were a result of my efforts since the end of the fourth quarter of 2007. These tenants were national and did not want to pursue anything until the beginning of the year. Obviously they see something the rest of Southwest Florida does not see, because they wanted to get a lease going as soon as possible," Looknanan said. "My sense is that as we approach summer, lease rates on the various classes of property would have been adjusted to reach market equilibrium and we will see deals being done."

In San Diego, which is showing positive net absorption so far this year, Jeff Solomon, a broker with Major League Properties, said it is hard to find good quality space under 1,50 square feet.

"If landlords made smaller spaces available, you would see a faster absorption. But they are not building new projects where you can have 800 to 1,500-square-foot spaces due to the large floor plates. The right product needs to be available and many developers do not want to take the risk. Knowing the tenant profile for the space is key."

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