RESEARCH

Newmark Knight Frank

NATIONAL
2Q17 OFFICE MARKET

STURDY PERFORMANCE CONTINUES

The U.S. office market experienced healthy conditions during the second quarter of the year. Absorption was stout, but vacancy edged higher as deliveries continue to exceed net new demand for space. Rents proceeded to tick up as tenants remain attracted to newer space.

Absorption Sturdy

Tenants absorbed 4.0 million square feet in the second quarter, up from negative 1.1 million square feet in the first quarter of 2017 but below the quarterly average of 13.4 million square feet over the previous five years. Tenants in many major markets continue efforts to consolidate and find ways to reduce their occupancy costs through densification.

Absorption leaders included Atlanta, Austin, Charlotte, and Phoenix – mid-sized markets that have sustained a steady path of job creation. Baltimore and Indianapolis also posted strong performances. Laggards included Silicon Valley and Oakland/East Bay, which are markets that have a disproportionate concentration of tech tenants. Many tech firms are engaged in right-sizing after a period in which some firms expanded their workforce too rapidly.

ABSORPTION REMAINS HARDY AS THE GROWTH CYCLE MATURES

Fifteen of the 53 office markets tracked by NKF recorded negative second-quarter absorption. Silicon Valley reduced occupancy by 1.1 million square feet, as technology tenants exercised caution. Minneapolis and Houston also shed occupancy during the second quarter, with Houston continuing to be beleaguered by contraction in the energy industry and a temporary global oversupply of oil.

The largest leases of the second quarter were dominated by financial services tenants. Blackrock signed for 847,000 square feet at the new Hudson Yards development on Manhattan's west side. HSBC Bank renewed for 548,000 square feet in Midtown Manhattan, while Bank of America signed for 533,210 square feet at 110 North Wacker Drive, a planned tower along the Chicago River that is due to deliver in 2020.

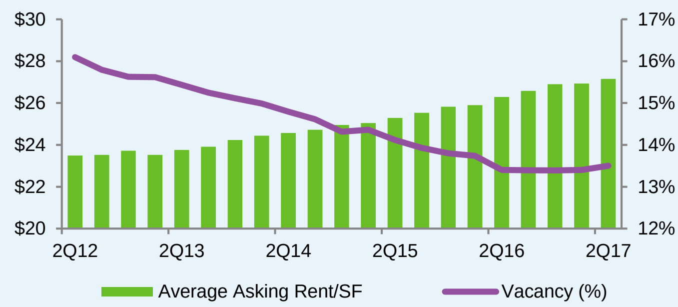
Nationally, absorption was positive even as vacancy ticked higher. Tenants occupied more space than in the prior quarter but deliveries added vacant space to the market, pushing the vacancy rate higher.

Current Conditions

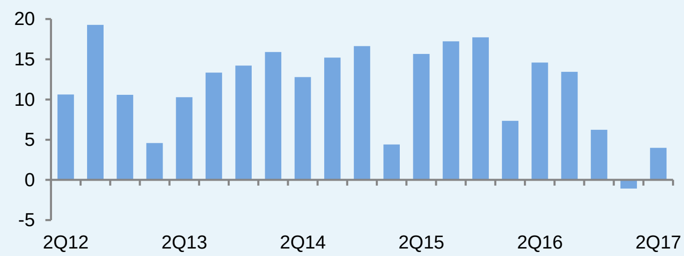
- Absorption was healthy, though several key markets posted weaker performance due to decelerating job growth.
- The construction pipeline remains robust, though lenders are becoming more cautious.
- Vacancy ticked higher as completions outpaced absorption for a third consecutive quarter.
- Rents continued to edge higher during the second quarter.

Market Analysis

Asking Rent and Vacancy



Net Absorption
Square Feet, Millions



Market Summary

	Current Quarter	Prior Quarter	Year Ago Quarter	12 Month Forecast
Vacancy Rate	13.5%	13.4%	13.4%	↔
Net Absorption*	4.0	-1.1	14.6	↔
Average Asking Rent/SF	$27.15	$26.93	$26.29	↑
Under Construction*	80.4	72.8	77.4	↑
Deliveries*	8.9	11.4	13.5	↔

* Square feet, millions

Construction Continues

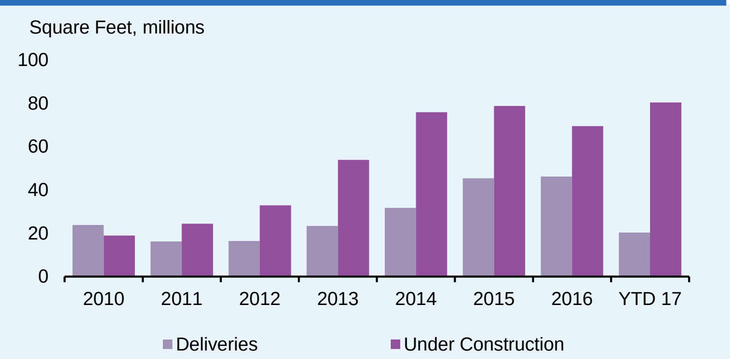
Completions outpaced absorption for a third consecutive quarter, totaling 8.9 million square feet. So far in 2017, completions total 20.3 million square feet. However, space under construction remains significant, at 80.4 million square feet, up from 77.4 million square feet in the second quarter of 2016. Typically, construction remains too robust as a cycle matures. Regulators would like to see construction reined in to perpetuate a better supply/demand balance in the years ahead.

CONSTRUCTION REMAINS SIGNIFICANT, CHALLENGING PROSPECTS FOR A HEALTHY SUPPLY/DEMAND BALANCE IN THE YEARS AHEAD

Overall, U.S. office construction remains under control, at 1.7% of standing inventory. However, some markets exceed this threshold and bear watching, including Manhattan, Atlanta, and Silicon Valley.

Manhattan continues to lead all markets with 11.4 million square feet in the pipeline, followed by Washington, DC, San Francisco and Dallas. A number of notable projects are ongoing, including Salesforce Tower in downtown San Francisco; the expansion of Amazon's downtown Seattle campus; and several towers and boutique buildings in Manhattan. Interestingly, while much has been made of the millennial workforce preferring center-city workplaces, some suburban markets continue to thrive by activating their campus settings. Some financial services firms, in particular, are locating operations outside traditional downtown areas in order to reduce occupancy costs. For more information on this trend, please see our recent NKF white paper on the evolution of the financial services industry and its impact on U.S. office space.

Construction and Deliveries



Source: CoStar, NKF

Vacancy Edges Higher

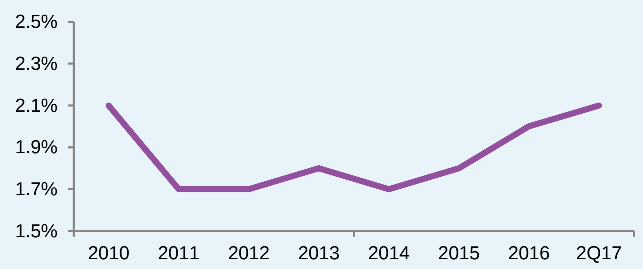
With absorption stout but down from the peak of the cycle in 2014-16, and with construction levels still high, the vacancy rate edged up by 10 basis points to end the second quarter at 13.5%. Eleven markets recorded single-digit vacancies, led by San Francisco at 6.3%, while Northern New Jersey posted the nation's highest vacancy rate at 22.7%, followed by two other markets with 20%-plus rates: Oklahoma City and Houston. A recent NKF white paper explores the options for property owners in Northern New Jersey who may be seeking to repurpose or raze obsolete space.

The 10-basis-point increase in the second-quarter vacancy rate does not necessarily mark the beginning of a steady increase. There has been little movement in vacancy over the past four quarters, suggesting the market has been near equilibrium for some time. Absorption may be past its peak, but construction starts may also have peaked. Further, office jobs (the sectors of information, finance, and professional and business services) continue to grow steadily. Overbuilding is not yet a concern in a macro sense, but some markets may soon be challenged if demand remains at current levels and groundbreakings continue.

SUBLET VACANCY IS EDGING UP BUT REMAINS LOW BY HISTORICAL STANDARDS

The second quarter ended with 102.8 million square feet of available sublease space, equal to 2.1% of the total office inventory. This is up from the cyclical low of 1.7% of inventory in the second quarter of 2014, However, the sublet vacancy rate remains low relative to the 2.7% peak during the financial crisis and the 5.4% peak after the dot-com bust. Manhattan has the largest supply of available sublease space on an absolute basis, at 11.8 million square feet, but Houston has the most on a percent-of-inventory basis, at 5.3%.

Sublet Vacancy Rate



Source: CoStar, NKF

Rents Continue to Advance Modestly

The uptick in the vacancy rate combined with the deceleration in absorption has been slowing rent growth recently, but that slowdown paused during the second quarter. The average asking rent across the U.S. ended the quarter at $27.15/SF gross, up 1.4% from the first quarter. Year-over-year growth was a staunch 4.3%. Silicon Valley's office market registered 10.0% rent growth during the past four quarters, notwithstanding concerns about oncoming supply. Phoenix also experienced asking rent growth of 10.0% during the past four quarters and has few supply concerns.

YEAR-OVER-YEAR ASKING RENT GROWTH WAS A STAUNCH 4.3%

Houston stands out among major markets for its asking rent declines; the average is down 0.9% during the past four quarters, though the rate of decline is decelerating. Houston property owners are offering significant concessions, pushing effective rents 20% to 25% below asking rents on larger leases.

The Outlook

The macroeconomic outlook for the U.S. remains unclear, which presents some challenges for the office market. Employment growth remains healthy at an average of 180,000 new jobs per month during the first half of 2017, on par with last year's pace of 187,000. If the labor market can sustain this level of hiring, it will support leasing activity and absorption as the year progresses. However, GDP growth remains tepid, at 1.4% on an annualized basis, and the Federal Reserve has been lowering its growth forecast. Combined, these conditions suggest additional room for growth in office space demand, but a cautious approach to new development.

THE ECONOMIC OUTLOOK SUGGESTS A FORECAST OF ADDITIONAL DEMAND FOR OFFICE SPACE BUT A CAUTIOUS APPROACH TO NEW DEVELOPMENT

Tighter lending standards had been keeping new supply in line with demand, but construction is once again elevated, which is likely to slow rent growth. Several markets are experiencing additional construction, but others are experiencing a reduction of their construction pipelines, as deliveries outpace groundbreakings. The overall balance between supply and demand suggests the U.S. office market still has room to expand.

Select Leasing Transactions

Tenant	Market	Building	Type	Square Feet
BlackRock, Inc.	New York, NY	50 Hudson Yards	Direct New	847,000
HSBC Bank	New York, NY	452 Fifth Avenue	Direct Renewal	548,000
Bank of America	Chicago, IL	110 North Wacker Drive	Direct New	533,210
F5 Networks Inc.	Seattle, WA	801 5th Avenue	Direct New	515,000
Apache Corporation	Houston, TX	2000 Post Oak Boulevard	Direct Renewal	355,506

Select Sales Transactions

Building	Market	Sale Price	Price/SF	Square Feet
245 Park Avenue	New York, NY	$2,210,000,000	$1,282	1,723,993
1 Federal Street	Boston, MA	$705,000,000	$638	1,105,064
85 Broad Street	New York, NY	$652,000,000	$583	1,118,512
44 Montgomery Street	San Francisco, CA	$474,200,000	$688	688,902
110 East 9th Street	Los Angeles, CA	$440,000,000	$232	1,900,000

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Market Statistics

Market	Inventory SF	SF Under Construction	SF Absorbed This Quarter*	SF Absorbed YTD*	% Vacant	Average Asking Rent/SF
Atlanta	145,436,806	3,891,799	526,769	272,089	17.2%	$24.85
Austin	59,173,871	150,668	593,309	574,054	10.5%	$33.69
Baltimore	80,534,502	1,026,596	308,925	621,878	12.5%	$22.89
Boston	182,750,844	2,649,442	65,568	7,199	11.9%	$34.08
Broward County, FL	33,163,454	507,710	72,860	52,245	10.9%	$26.79
Charlotte	69,648,245	2,669,372	561,692	556,783	11.0%	$24.50
Chicago	251,918,748	2,245,960	69,043	457,848	17.5%	$27.37
Cincinnati	58,673,637	175,000	-152,066	-340,015	12.9%	$16.81
Cleveland	36,336,060	324,575	29,592	305,549	16.4%	$18.06
Columbus	56,718,342	614,000	120,068	73,188	9.7%	$18.02
Dallas	229,447,708	5,218,277	-243,957	147,803	19.3%	$24.27
Delaware	16,453,875	308,016	68,835	157,835	15.5%	$24.75
Denver	95,340,209	3,522,908	228,754	385,414	15.1%	$26.12
Detroit	75,047,256	91,220	-143,348	232,728	17.3%	$19.23
Fairfield County, CT	41,492,665	0	-147,929	-814,660	16.3%	$38.09
Fresno	19,691,125	74,436	-56,745	-7,077	12.1%	$28.42
Houston	203,759,586	2,329,674	-640,642	-1,477,290	21.2%	$28.19
Indianapolis	61,930,292	675,000	349,098	646,910	9.4%	$18.44
Inland Empire, CA	31,211,134	0	23,634	216,880	11.3%	$19.72
Jacksonville	31,360,919	0	349,494	343,457	12.2%	$19.25
Kansas City	81,200,270	210,000	592,628	856,050	10.2%	$18.95
Las Vegas	35,335,031	139,605	241,576	449,342	17.2%	$20.61
Long Island	54,422,475	120,109	62,238	13,208	10.0%	$26.18
Los Angeles	195,293,417	1,819,875	437,843	666,807	14.2%	$37.92
Manhattan	441,877,776	11,446,767	-434,570	-3,906,855	8.1%	$76.06
Memphis	34,136,179	150,571	468,434	327,762	15.6%	$16.75
Miami	47,157,704	879,094	218,535	458,551	11.6%	$35.24
Milwaukee	46,568,616	22,000	-63,388	33,928	9.8%	$16.83
Minneapolis	130,584,097	546,500	-1,261,900	-489,791	9.3%	$20.14
Nashville	51,938,432	1,493,642	115,866	-259,270	6.8%	$26.57
New Jersey Northern	168,934,767	769,929	91,480	-811,433	22.7%	$28.14
New Jersey Southern	16,715,724	472,376	-103,977	-53,271	15.7%	$21.10
Oakland/East Bay	73,026,585	596,767	-579,970	-339,422	9.9%	$33.00
Oklahoma City	13,772,307	692,520	127,480	-257,235	21.3%	$18.22
Orange County, CA	92,153,023	1,373,688	232,298	547,587	10.7%	$30.91
Orlando	68,542,974	134,000	181,402	739,067	7.5%	$21.11
Palm Beach	25,848,196	0	95,127	95,059	15.0%	$30.75
Philadelphia	108,323,640	2,744,143	261,684	-275,018	14.4%	$27.55
Phoenix	86,932,958	1,085,264	772,130	1,607,847	19.6%	$25.19
Pittsburgh	53,783,765	233,000	82,327	334,860	16.3%	$22.92
Portland	57,745,672	1,359,155	51,928	4,581	10.5%	$26.07
Raleigh/Durham	53,076,771	2,513,006	153,101	643,911	9.6%	$23.35
Sacramento	68,761,552	417,892	449,834	533,282	14.6%	$21.84
Salt Lake City	62,770,849	439,840	106,342	-36,215	8.0%	$21.16
San Antonio	36,077,832	989,618	-13,983	88,015	12.1%	$20.92
San Diego	70,398,577	875,368	110,003	122,285	13.0%	$31.75
San Francisco	78,790,888	6,161,185	-1,941	-246,533	6.3%	$71.95
Seattle	125,038,986	2,340,057	295,518	312,891	10.3%	$31.77
Silicon Valley	82,058,504	4,827,247	-1,070,093	-2,237,292	12.6%	$51.48
St. Louis	79,073,270	470,000	305,447	376,202	10.4%	$19.00
Tampa/St. Petersburg	64,201,581	131,350	-128,386	124,061	11.0%	$22.69
Washington, DC	363,642,021	8,427,511	107,992	889,196	16.2%	$37.61
Westchester County, NY	27,670,122	0	100,288	176,812	19.2%	$26.43
National	**4,775,943,839**	**80,356,732**	**3,986,247**	**2,901,787**	**13.5%**	**$27.15**

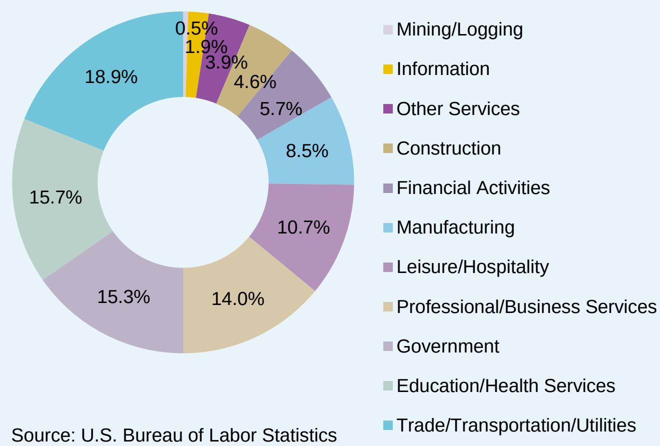
* Absorption is the net change in occupied space over a period of time. These numbers may not match totals in some NKF metro reports due to different local methodologies.

ECONOMIC CONDITIONS

The economy grew at an annual rate of 1.4 percent in the first quarter of 2017 according to the Bureau of Economic Analysis's third estimate, released in June. This rate is down from 1.6% for all of 2016. Despite sluggish GDP growth, hiring has been brisk considering the expansion is now eight years old. The jobless rate, 4.4% in June, reflects an economy near full employment. Employers added 222,000 new jobs in June and an average of 180,000 per month during the first half of 2017, on par with last year's pace of 187,000. Fed officials felt confident enough to raise short-term interest rates by a quarter-point in March and by another quarter-point in June. However, inflation remains weak, which may forestall additional rate increases this year. The stock market has continued to rise, notwithstanding downgraded economic growth estimates by the Federal Reserve and a lack of action by the Congress on tax reform and infrastructure spending. The issue of whether the Affordable Care Act will be repealed, replaced, or patched also remains unresolved.

Employment By Industry

United States, 2016 Annual Average

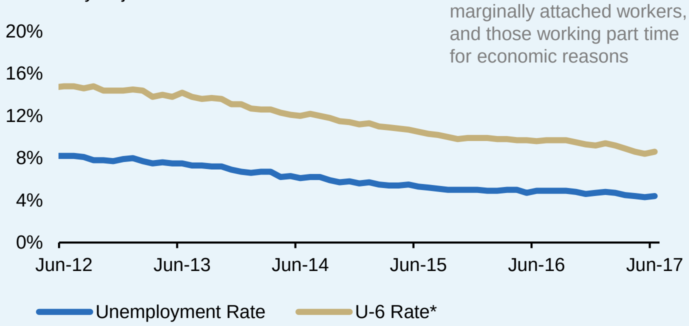


Source: U.S. Bureau of Labor Statistics

Unemployment Rate

Seasonally Adjusted

* Includes total unemployed, marginally attached workers, and those working part time for economic reasons

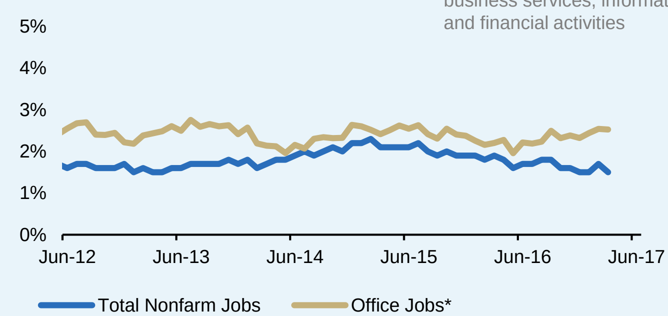


Source: U.S. Bureau of Labor Statistics

Payroll Employment

12-Month % Change, Not Seasonally Adjusted

* Includes professional and business services, information, and financial activities

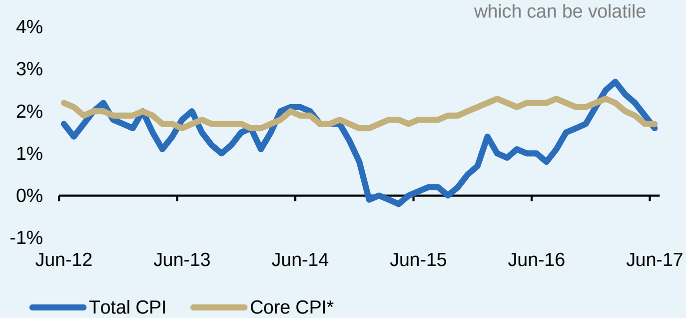


Source: U.S. Bureau of Labor Statistics

Consumer Price Index (CPI)

12-Month % Change, Not Seasonally Adjusted

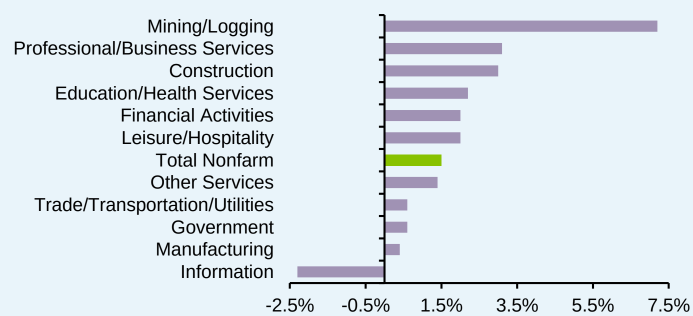
* Excludes food and energy, which can be volatile



Source: U.S. Bureau of Labor Statistics

Employment Growth by Industry

June 2017, 12-Month % Change, Not Seasonally Adjusted



Source: U.S. Bureau of Labor Statistics

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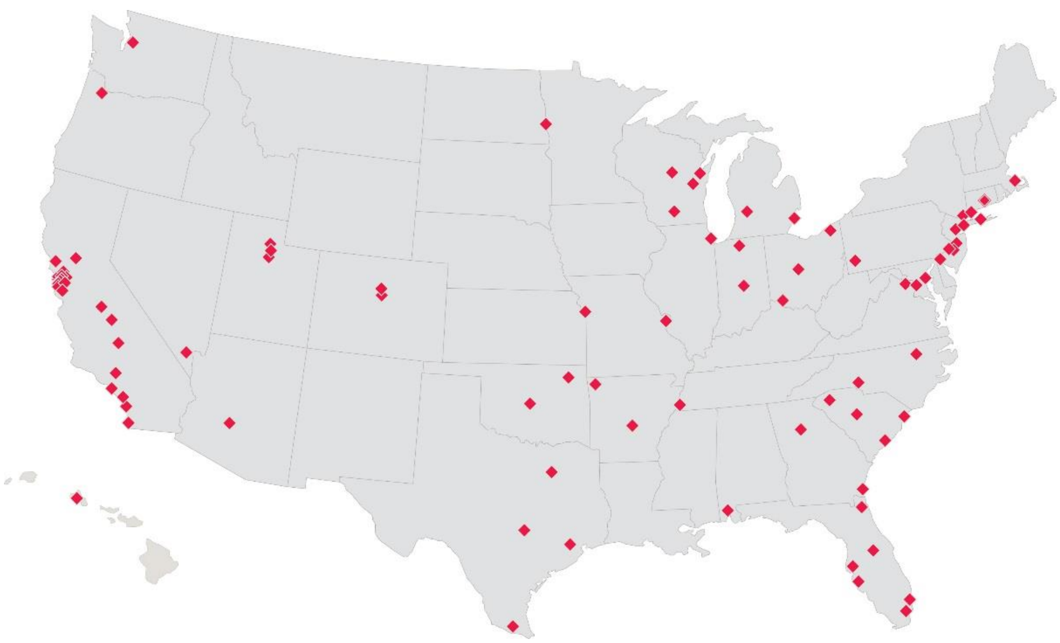

Newmark Knight Frank has implemented a proprietary database and our tracking methodology has been revised. With this expansion and refinement in our data, there may be adjustments in historical statistics including availability, asking rents, absorption and effective rents.

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