CBRE

Spring 2017

A Macro Perspective: Where Are We Now?

Key Takeaways

- Due to improving tenant demand and low overall levels of new supply, the U.S. suburban office vacancy rate has not increased for 27 straight quarters. The vacancy rate was 14.1% in Q4 2016, just 20 basis points (bps) above the pre-recession low in Q2 2007.
- Many previously lagging suburban markets—including multiple Florida markets, Detroit, Milwaukee, Phoenix, Long Island, Inland Empire and Los Angeles—posted year-over-year vacancy rate decreases of 200 bps or more in Q4 2016, underscoring the geographic breadth of the suburban recovery.
- CBRE Econometric Advisors projects positive net absorption and continued rent growth for the North American suburban office market through 2018. Submarkets with high-quality amenities and efficient buildings capable of handling denser employee layouts will likely perform the best.
- Despite evidence that Canadian companies have been relocating to downtown markets to attract millennial talent, the Canadian suburban office market recorded positive absorption and only a slight uptick in vacancy in 2016.
- Due to the struggling energy sector and new suburban supply coming on line, the Canadian office vacancy rate is expected to hover around 16% overall this year. However, the suburbs will continue to attract tenants seeking a more experienced workforce, in addition to new office space at lower rents.

The so-called downfall of the suburban office sector has been a common narrative in recent years. In CBRE's Suburban Office Trends series, we determine the validity of this claim in the U.S. and Canada by analyzing suburban office performance this cycle. We also explore the characteristics of successful suburban office markets/submarkets, the adaptation of 20th century office markets and buildings for 21st century tenants, and the impact of long-term demographic shifts on suburban office demand.

INTRODUCTION

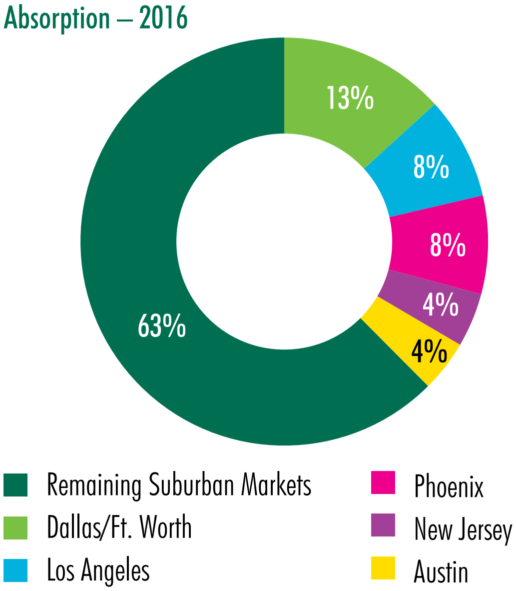
With the migration of many millennials to urban environments, some industry observers have forecast a significant decrease in demand for suburban office product. In this first installment of CBRE's Suburban Office Trends series, we set the stage with a macro look at the overall suburban office market, concluding that its aggregate performance in the U.S. and Canada in recent years has been better than the common perception. We also highlight suburban markets that are performing particularly well. Finally, we provide our outlook for the overall suburban office market in the next few years.

United States

Since the end of the Great Recession, the U.S. suburban office market has tightened at a steady clip, boosted by improving demand and low overall levels of new supply compared with previous cycles. The suburban vacancy rate has not increased for 27 consecutive quarters through Q4 2016 and stands at 14.1%—450 basis points (bps) below the cyclical peak of 18.6% in Q2 2010. The vacancy rate is now just 20 bps above the previous low of 13.9% in Q2 2007. The suburban market has registered positive absorption for 27 consecutive quarters as well, underscoring its consistent improvement since early 2010. By comparison, the suburban market recorded a shorter stretch of positive absorption (23 consecutive quarters) between 2003 and 2008.

Most suburban markets strengthened in 2016. Among the 58 suburban markets tracked by CBRE Research, 50% recorded positive absorption for the year, including 15 with more than 1 million sq. ft. of absorption. The Dallas/Ft. Worth suburbs alone accounted for 13% of suburban absorption and 11% of total office absorption among the U.S. metros tracked by CBRE Research (see Figure 1). In addition, just 13% of suburban markets registered vacancy rate increases last year. Many markets that have lagged during the current expansion due to particularly severe housing busts, overbuilding or other factors—including multiple Florida markets, Detroit, Milwaukee, Phoenix, Long Island, Inland Empire and Los Angeles—posted year-over-year vacancy rate decreases of 200 bps or more, underscoring the geographic breadth of the suburban recovery (see Figure 2).

Figure 1: Share of U.S. Suburban Office Net Absorption – 2016



Source: CBRE Research, Q4 2016.

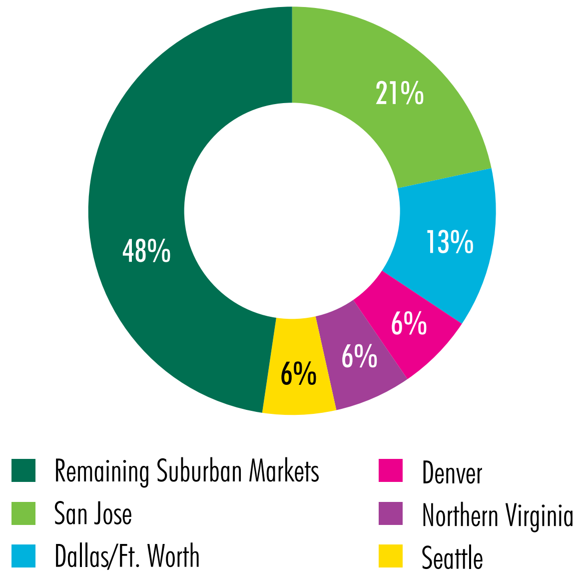
Figure 2: Largest U.S. Suburban Office Vacancy Rate Decreases – Q4 2015 vs. Q4 2016

	Vacancy Rate (%)		
Market	Q4 2015	Q4 2016	Change (bps)
Orlando	15.4	10.5	-490
Tampa	13.4	10.2	-320
Ft. Lauderdale	15.9	12.9	-300
Walnut Creek/I-680 Corridor	10.5	7.8	-270
Detroit	20.1	17.6	-250
Milwaukee	15.9	13.4	-250
Palm Beach County	18.9	16.5	-240
Charlotte	10.2	7.9	-230
Phoenix	18.9	16.6	-230
Long Island	13.4	11.2	-220
Inland Empire	14.7	12.5	-220
Wilmington	16.4	14.2	-220
Los Angeles	14.2	12.1	-210
Columbus	14.8	12.9	-190
Cincinnati	22.7	20.8	-190
Tucson	17.6	15.7	-190
Cambridge	5.6	3.8	-180
Philadelphia	18.8	17.0	-180
Cleveland	18.3	16.8	-150
Minneapolis/St. Paul	16.8	15.3	-150

Source: CBRE Research, Q4 2016.

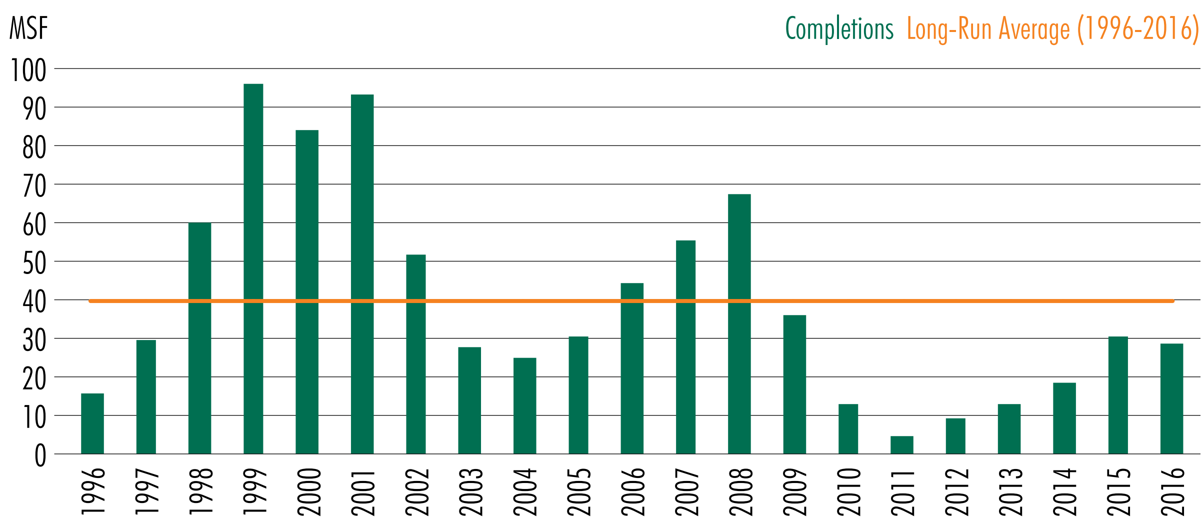
Total suburban construction has been well below peak levels of previous cycles due to the moderate rate of expansion and rent levels that remain below those required to build new product in many suburban submarkets. Developers delivered an average of 29 million sq. ft. of office space per year in 2015 and 2016, compared with previous cyclical peaks of 67 million sq. ft. in 2008 and 95 million sq. ft. in 1999 (see Figure 3). Construction has been highly concentrated in a small number of leading markets in which rent growth is strong enough to justify development activity. The top five markets for square footage underway account for more than half of all suburban construction occurring in the markets tracked by CBRE Research, fueled by robust demand (see Figure 4). Half of the suburban markets have less than 200,000 sq. ft. underway, including 15 markets with no construction activity. Although significant variations exist depending on quality of building and location, the lack of new supply is causing increasingly competitive leasing conditions in many tightening suburban markets.

Figure 4: Share of U.S. Suburban Office Construction Underway – Q4 2016



Source: CBRE Research, Q4 2016.

Figure 3: U.S. Suburban Office Construction Completions

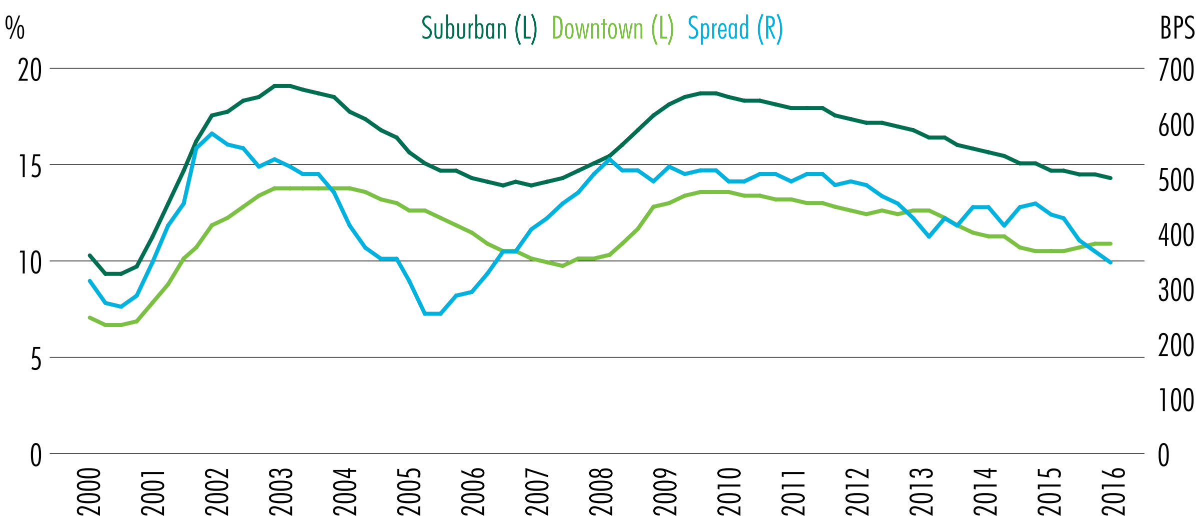


Source: CBRE Econometric Advisors, Q4 2016.

Reflecting the modest rate of tightening in the market, suburban office rents—as measured by the CBRE Econometric Advisors (CBRE EA) Rent Index—have grown at a measured pace, averaging 2.6% annually between 2011 and 2016. This is below the 4.6% average annual rate of the last cycle but represents a longer stretch of growth than the four years of increase in the mid-2000s. Consequently, the CBRE EA Rent Index surpassed the pre-recession peak in early 2016 and rose further throughout the year.

Downtown office markets have garnered much attention for its strong performance this cycle, and by several metrics this indeed has been the case. Average annual rent growth has been stronger than in the suburbs since 2011, and the downtown vacancy rate is lower (although this is typically true of downtown markets). Leading downtown markets with particularly strong tech-tenant demand, such as San Francisco, Manhattan, Boston, Seattle, Austin, Oakland and Portland, are among the tightest in the nation. However, the suburban market has strengthened relative to the downtown market by several measures in the past few years. The suburbs account for approximately two-thirds of office inventory but represented a disproportionate share of net absorption in 2015 and 2016 at 80% on average. Also, the downtown vacancy rate started to tick up in 2016 due to higher levels of completions and moderating demand in several markets, contributing to a shrinking gap in vacancy between the downtown and suburban markets (see Figure 5). The suburban vacancy rate is currently 340 bps more than the downtown vacancy rate, less than the long-run average gap of 430 bps since 2000.

Figure 5: U.S. Suburban vs. Downtown Office Vacancy Rate

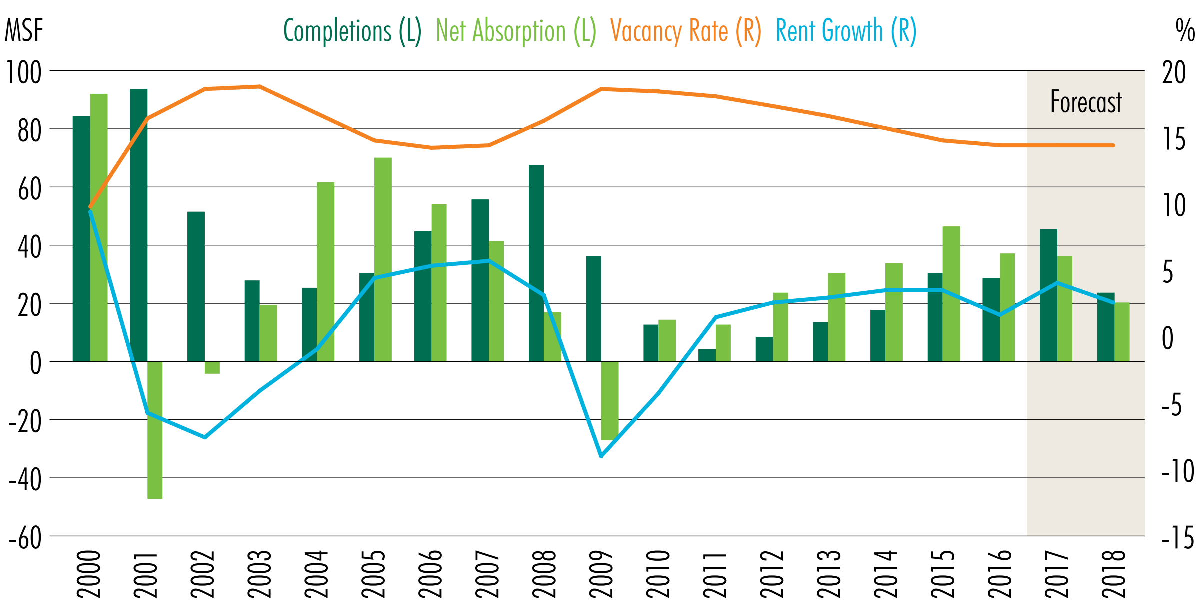


Source: CBRE Econometric Advisors, Q4 2016.

U.S. OUTLOOK

Although suburban office demand is expected to moderate in the next few years, CBRE Research believes that the market still has further room to run. Due in part to higher construction completions, particularly in 2017, we expect the suburban vacancy rate to remain essentially flat at 14.2% through 2018 (see Figure 6). Net absorption is forecast to slow but remain positive in the next two years, supporting rent growth of 4.0% and 2.6% in 2017 and 2018, respectively. Construction is low in many suburban markets that recorded the largest vacancy rate decreases in 2016. The 10 markets with the largest vacancy rate decreases accounted for 6% of square footage under construction in Q4 2016, well below their 13% share of existing national suburban inventory. Thus, many of these markets are positioned for further occupancy and rent gains due to continued demand and lack of available supply, especially newer, high-quality product.

Figure 6: U.S. Suburban Office Outlook



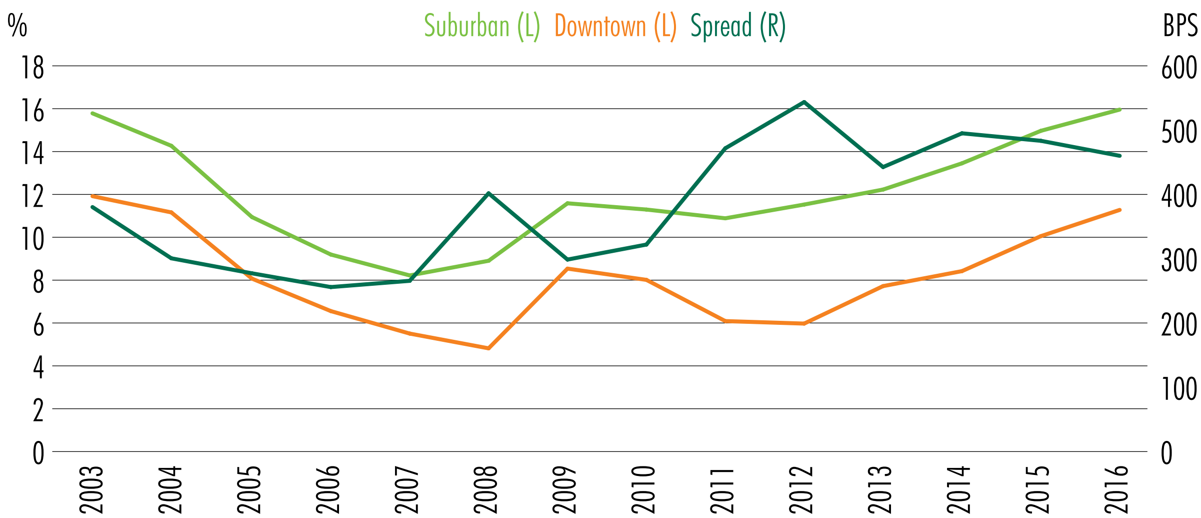
Source: CBRE Econometric Advisors, Q4 2016.

Canada

Increased competition within Canadian downtown cores has made suburban markets a viable outlet for tenants seeking new space for lower rents. As downtown markets continue to thrive, especially in Toronto and Vancouver where office vacancy rates are among the lowest in North America, it is often misconstrued that this is at the expense of suburban markets. We have observed the opposite: Suburban office markets are benefiting from the strength of their downtown counterparts. Despite slight upticks in year-over-year vacancy rates for several Canadian markets in Q4 2016, and for the nation as a whole, there has been a noticeable spillover effect as tenants seeking lower rents and newer and larger blocks of space are choosing suburban markets. Many established companies are moving to the suburbs to attract an older, more experienced workforce.

Overall vacancy rates in Canadian suburban office markets have been consistently higher than their downtown counterparts. Since 2012, however, the spread between the suburban and downtown market vacancy rates has steadily declined at a rate of approximately 20 bps per year. This decrease in vacancy spread is illustrative of the growing competitiveness among Canadian suburban office and downtown markets. On a national basis, suburban office markets have registered an average annual vacancy increase of 98 bps versus 101 bps in downtown office markets for the past five years. Underpinning this trend is the sluggish energy sector that has driven up vacancy rates in Alberta and caused an increase in the national vacancy rate. At year-end 2016, the overall downtown office vacancy rate was 11.2%, while the overall suburban office vacancy rate reached 15.8%.

Figure 7: Canadian Suburban vs. Downtown Office Vacancy Rate



Source: CBRE Research, Q4 2016.

Most Canadian markets recorded increases in suburban vacancy last year, with the exception of Toronto, Winnipeg, London and Halifax. The most dramatic increases were in Alberta, as Edmonton and Calgary continued to struggle from the softening energy sector. Vancouver also had an increase in vacancy due to three large projects coming on line. This new space is almost fully leased, however, and it is expected that the older space left by these tenants will be backfilled without difficulty. Vacancy rates in Ontario's major markets remained mostly steady with the exception of Waterloo. Blackberry's former Waterloo campus went on the market, resulting in a vacancy increase of 370 bps. Nevertheless, this rise in vacancy is attributed to only one building and is not indicative of the market's overall strength. Toronto's suburban office market vacancy rate did not change last year, despite the addition of 1.2 million sq. ft. of space. Toronto currently boasts the lowest overall downtown office vacancy rate among major markets in North America.

Leasing activity within Canadian suburban markets remains active. Much of this activity is due to existing suburban tenants staying within the suburbs but moving to newer-quality space. These lateral movements of tenants are particularly relevant, as highly specialized companies, such as pharmaceutical and logistics firms, are clustering within established industry nodes. This shuffling of tenancies across suburban office markets is also pressuring Class B landlords to improve their existing assets, or to provide favorable tenant inducements.

Figure 8: Canadian Suburban Office Vacancy Rate Change – Q4 2015 vs. Q4 2016

	Vacancy Rate (%)		
Market	Q4 2015	Q4 2016	Change (bps)
Edmonton	14.2	18.4	420
Waterloo Region	13.4	17.1	370
Calgary	19.1	21.4	230
Vancouver	12.2	13.8	160
Montreal	17.7	18.4	70
Ottawa	11.4	11.9	50
Toronto	14.7	14.7	0
London	8.8	8.7	-10
Halifax	15.5	13.7	-180
Winnipeg	10.7	8.4	-230

Source: CBRE Research, Q4 2016.

Figure 9: Canadian Suburban Office Construction Completions

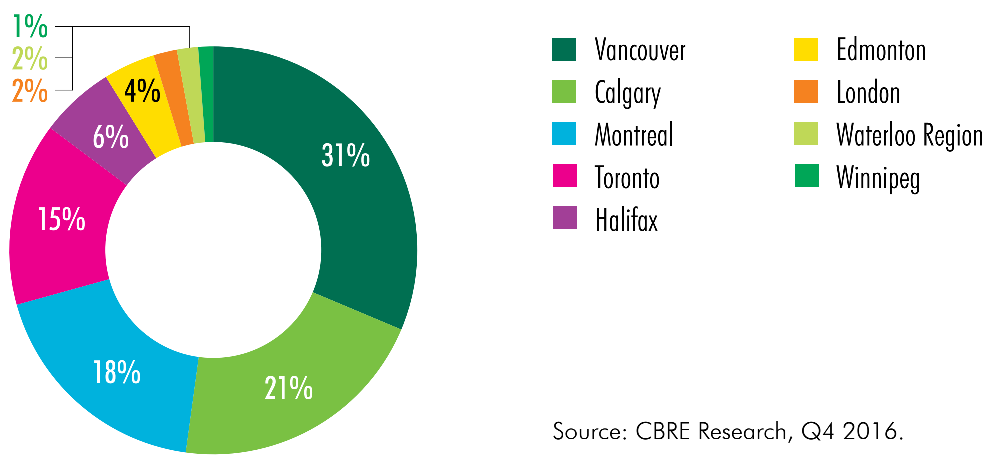
Source: CBRE Research, Q4 2016.

Moreover, deliveries to Canadian suburban markets totaled 4.4 million sq. ft. last year, well above the 10-year annual average of 3.5 million sq. ft. Toronto and Montreal received more than 50% of this new suburban office supply. Unlike downtown markets, these suburban developments were built largely on spec. These deliveries, combined with the fact that many suburban tenants are undergoing a flight-to-quality, while consolidating space in certain instances, explain the recent uptick in suburban vacancy rates.

There is currently 2.7 million sq. ft. of suburban office space under construction nationwide, 85% of which is located in four markets: Vancouver, Calgary, Toronto and Montreal (see Figure 10). As a result of Canada's weak energy sector, we anticipate that the 500,000 sq. ft. of new office inventory under construction in Calgary will only be absorbed when the energy sector begins to recover. Conversely, demand for this product remains strong in Vancouver, Toronto and Montreal given the rental-rate advantages of suburban markets and the lack of availability for quality product in downtown cores.

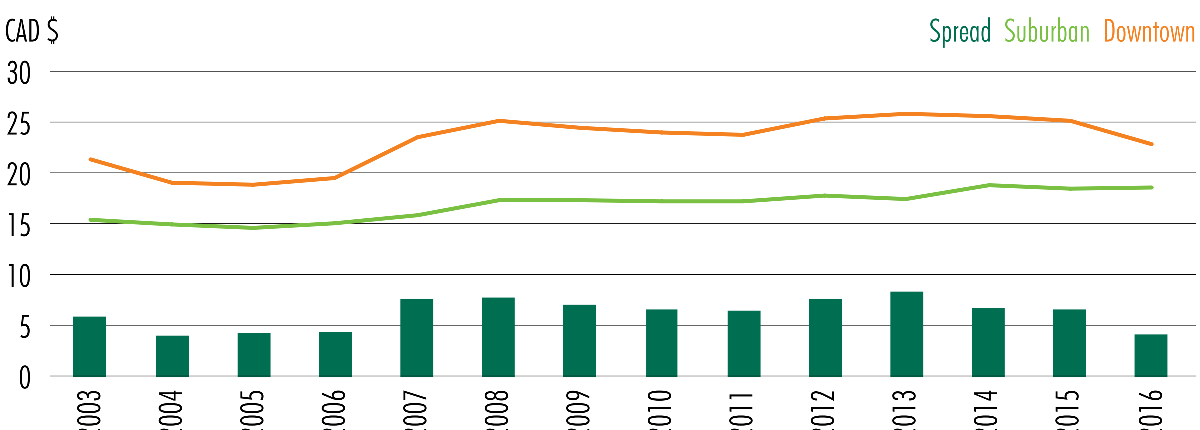
The new supply of suburban office product has driven the suburban Class A net rental rate to C$18.50 per sq. ft., representing a gain of 0.5% last year. Conversely, rental rates for Canadian Class A

Figure 10: Share of Canadian Suburban Office Construction Underway – Q4 2016



Source: CBRE Research, Q4 2016.

Figure 11: Canadian Class A Net Rental Rates – Suburban vs. Downtown



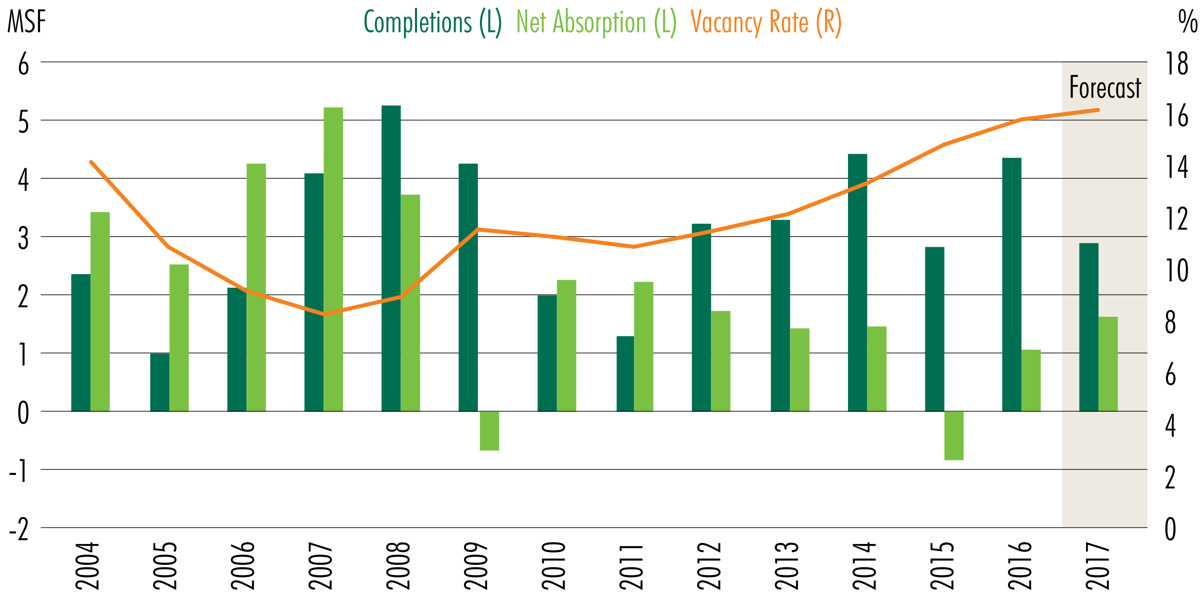
Source: CBRE Research, Q4 2016.

downtown office space declined by 9.4% to C$22.64 per sq. ft., largely as a result of Alberta's weakening energy sector. When excluding the energy sector, Canadian Class A downtown office space declined a lot less sharply. This has caused the spread between downtown and suburban office rents to compress to a new 10-year low of C$4.13 per sq. ft. (see Figure 11). Canadian office tenants increasingly view the suburban office market as offering quality product at a more affordable price.

CANADIAN OUTLOOK

Although suburban vacancy rates increased in many Canadian markets last year, we expect this trend to begin to slow in 2017. Alberta will continue to drag on Canada's overall office vacancy, as its economy recovers from the recession brought on by a weak energy sector. However, two new major oil pipeline projects will begin construction in 2017, which will be a positive catalyst for its economy and the suburban office market. Elsewhere in Canada, suburban office vacancy rates should decline this year due to three key factors: less construction in the suburbs, an inadequate amount of large-block availabilities in many downtown markets, and the shift of downtown tenants seeking a live-work-play lifestyle for millennial employees.

Figure 12: Canadian Suburban Office Outlook



Source: CBRE Research, Q4 2016.

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