OFFICE SECTOR: LOWER RETURNS REFLECT MARKET TRANSITIONS

Total office sector returns begin 2019 by continuing the trend of positive but lower returns. Everyone likes higher returns, but it could be argued that the office sector is mirroring transitions that are occurring in the economy and behaving in a way that could be expected at this point in the real estate cycle.

Total returns of 1.63% in the first quarter resulted in a 1 year return of 6.66%. Appreciation returns were 0.53% for the quarter and 2.10% for the year, while the income component came in at 1.09% for the quarter with the 1 year return of 1.63%. Total and appreciation returns were down slightly from the final quarter of 2018. Income returns were up slightly quarter over quarter, but still trailed the 2018 annual average.

While there has been a significant amount of discussion about how this economic/real estate cycle has been different, office sector returns have behaved in a fairly traditional fashion. The office sector delivered an average return of nearly 11.5% in the recovery years of 2010 – 2015 as confidence in the economy and the sector rebounded from the Global Financial Crisis. The drop in the average total office return to 6.4% for the last three years could be attributed to a natural transition into the next phase of the real estate cycle, but is it more than just the expected slowdown in demand and increase in supply that is slowing income and appreciation return growth?

In a typical cycle, if there is such a thing, we would begin to see demand slow at this point, and the new supply would begin to outpace demand pushing up rents and creating headwinds for rent growth. From 2010 – 2015, when the office sector experienced double digit returns, demand averaged around 3.9 million square feet a year. Demand during the recent period of slowing returns, however, have been higher, averaging an annual 4.7 million square feet. New supply, which certainly has a built-in lag period, is increasing. From 2010 – 2015, new supply averaged 2.1 million square feet of new supply. Well below the pace of demand. While over the last three years, new supply has matched the pace of demand at an average of 4.7 million square feet. The dynamic between demand and supply has resulted in rising occupancy rates and real rent growth. Looking at this evidence, fundamentals aren’t the whole story behind recent slower returns.

Office investors will have a lot to ponder over the investment horizon. As we begin 2019, there are a number of significant issues beyond fundamentals to consider. How will the sector respond to the consensus forecasts for slower economic and employment growth? What will the ultimate impact be from the rise of co-working locations? Not to mention what will monetary policy do in the coming years. Against a background of past stability, investors will need to be diligent in their analysis of the future.

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