

OFFICE INDEX

OFFICE RETURNS CONTINUE TO LAG DESPITE IMPROVING FUNDAMENTALS

Total returns on office properties in NPI totaled 1.6% in the first quarter, the lowest of the four major property types. Appreciation nudged up just over half a percentage point in the quarter, 50 basis points lower than retail properties and a fraction of the appreciation accrued in the industrial and apartment sectors. Within the office sector, asset values fell in the Midwest, were up just eight basis points in the East, but rose more strongly in the South and West regions where appreciation came in at just over 1% in each.

Within the office properties in NPI, the significant disparity between older and newer properties continued in the first quarter. Indeed, the occupancy rate of office properties in NPI that are 10 years old or younger was 96.7% in the first quarter. That was down a tad from a record 97.1% in the fourth quarter of 2021 but still 11.5 percentage points higher than office properties that were more than 10 years old. Historically, the difference in occupancy rates between older and new office properties in NPI averaged a narrower 4.1 percentage points.

While newer properties are clearly winning tenants, the flight to quality story may be a bit more oversold than the data indicate. Since total net absorption in the office market turned positive in the third quarter of 2021 according to CoStar data, it has averaged 13.1 million SF per quarter. That is still well below the 24.5 million SF quarterly average from 2012-19 but what is somewhat surprising is that lower classes of office space are experiencing positive demand growth. In fact, over the past two quarters, Class B properties (3-star properties in CoStar's classification) have absorbed 11.3 million SF of net tenant demand compared to 6.2 million SF in trophy office properties with 5-star designations. Even Class C and D properties have posted positive absorption but the one class that appears to still be struggling is the Class A sector (4-star properties) which has experienced negative net absorption in two of the past three quarters, likely as a result of tenants trading up to newer trophy properties. Unfortunately, many of these older, once-trophy but now merely Class A office properties dominate the NPI dataset as the average age of office properties in ODCE is now well above 30 years. It is likely that many of these properties will need significant capex in order to remain competitive in a post-Covid environment.

The stabilization and improvement in office fundamentals overall compares favorably to prior downturns in the office market. In the prior three downturns, office fundamentals continued to deteriorate seven to eight quarters after the downturn began but despite falling harder during the first four quarters of this particular downturn, fundamentals found a bottom four quarters in and have begun to improve over the past year. As a result, eight quarters after their pre-pandemic peak, they are in better shape than they were in prior corrections.

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OFFICE TOTAL RETURNS

	Total NPI	Total Office	East	Midwest	South	West
1st Q 2022	5.33	1.60	1.05	0.40	2.29	2.18
4th Q 2021	6.15	1.68	1.59	0.89	1.73	1.90
One Year	21.87	6.75	5.33	4.17	8.11	8.36
Three Years	9.60	4.72	3.38	2.98	5.20	6.43
Five Years	8.54	5.48	3.97	3.95	6.19	7.28
Ten Years	9.61	7.55	6.08	5.85	8.07	9.41
Twenty Years	8.89	7.41	7.41	5.19	7.03	8.19

OFFICE INCOME RETURNS

	Total NPI	Total Office	East	Midwest	South	West
1st Q 2022	0.99	1.06	0.98	1.08	1.24	1.09
4th Q 2021	1.03	1.06	1.03	1.06	1.17	1.05
One Year	4.18	4.42	4.16	4.44	5.00	4.52
Three Years	4.28	4.43	4.15	4.44	5.04	4.54
Five Years	4.41	4.48	4.16	4.76	5.22	4.56
Ten Years	4.83	4.77	4.46	5.44	5.57	4.75
Twenty Years	5.70	5.72	5.53	6.27	6.28	5.65

OFFICE APPRECIATION RETURNS

	Total NPI	Total Office	East	Midwest	South	West
1st Q 2022	4.34	0.54	0.08	-0.68	1.05	1.09
4th Q 2021	5.12	0.63	0.55	-0.17	0.56	0.86
One Year	17.16	2.26	1.14	-0.25	3.00	3.72
Three Years	5.16	0.29	-0.75	-1.41	0.15	1.83
Five Years	4.00	0.97	-0.18	-0.78	0.93	2.63
Ten Years	4.61	2.69	1.58	0.40	2.41	4.50
Twenty Years	3.06	1.61	1.80	-1.04	0.71	2.43

OFFICE INDEX—QUARTILE RANGE OF RETURNS

