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OFFICE FUNDAMENTALS REBOUND WHILE INVESTMENT RETURNS MODESTLY DECLINE

Office market fundamentals rebounded in the second quarter of 2018 with net absorption more than doubling over the prior quarter to 15.5 million square feet per CBRE Research data. Office construction completions of 11.1 million square feet during Q2 represented the eighth consecutive quarter that new deliveries exceeded 10.0 million square feet. With strong demand for both existing and newly-delivered space, CBRE data indicated that overall office vacancy rates fell by 10 basis points to 13.0% in Q2 representing the first quarterly vacancy decline in four quarters. At the same time, rental rates continued to moderate in Q2 with CBRE reporting average office rent increases of 1.3% year-over-year and 0.4% quarter-over-quarter reflecting the continued relative balance between supply and demand.

After a strong start in the first quarter, NCREIF office total returns declined by 26 basis points during Q2 to reach 1.54%. Income gains were more than offset by appreciation declines resulting in the net decrease in total returns. One-year total returns for office properties of 6.55% continue to place the sector in second place behind industrial properties with 14.0% annual returns.

After trailing CBD properties in terms of investment performance during most of the current real estate recovery and expansion cycle, suburban office properties have rebounded over the past 24 months experiencing higher overall returns in many parts of the country including in the eastern and western regions. The income component of total returns continues to account for the largest share of returns over appreciation for both suburban and CBD office properties.

Consistent with the locations of CBRE Research’s top 20 markets for office-using job growth, the Southeast, Southwest and Pacific areas of the country had the highest overall office returns for both Q2 and for the past 12 months. Total office returns exceeded 2.0 percent during Q2 and 8.0 percent annually in all three locales.

On an MSA basis, the strongest total return markets annually for office properties continue to be Austin (13.09%), Oakland (12.72%), Dallas (10.12%) and San Jose (9.39%). Austin, San Jose and Dallas reside within CBRE’s top 12 markets for office-using job growth, San Jose benefits from having the highest year-to-date office space absorption of any market at more than 3.06 million square feet through Q2, and Oakland had the third lowest office vacancy rate in Q2 of any MSA at 7.0% per CBRE.

Office sales continued their downward trend in Q2 2018 experiencing a year-over-year decline of 17% per data from Real Capital Analytics (RCA). Suburban office buildings significantly outperformed their CBD counterparts registering a decline in deal volume of only 1% from a year earlier. Per RCA, the quarter represented the second strongest Q2 in history for single asset sales of suburban offices. At the same time, prices for suburban office buildings grew 7.9% year-over-year in Q2 while CBD office prices fell 1.0%. While RCA data indicated that Q2 cap rates remained essentially unchanged from a year earlier for both product types, average CBD office cap rates of 5.4% and suburban offices of 6.9% remain near historic lows.

Scott Hileman
Managing Director
Deloitte Advisory Real Estate