OFFICE INDEX

TECH DRIVEN OFFICE MARKETS CONTINUE TO SURGE

Headlines about WeWork’s failed IPO may present a dismal outlook, however the office sector remains a steady performer as third quarter fundamentals were generally flat. Unemployment is at record lows, office vacancy is at the lowest since 2001, annual rent growth is 2.5% and deliveries are above the 5 year average. Noting that office and multifamily have followed similar patterns since 2013, currently office returns are slightly outpacing multifamily.

After realizing 1.45% total returns for the quarter, quarterly office returns have now outperformed the NPI for the last two quarters. Year to date income returns of an annualized 4.46% are consistent with the prior three years, however appreciation returns were 36 bps, a 33% decrease from last quarter. Combined, this resulted in 1.43% total returns for the quarter, which is a slight decline from last quarter. Still, the returns this quarter are roughly equal to the average since 2016, with the sector’s income component being lower. Regardless, the year to date annualized returns are still 8 bps over the average of 6.38% since 2016, a period marked by steady economic growth.

Consistent with post-recession patterns, the West outperformed other regions, marked by exceptional appreciation returns in the Pacific division. The South and Midwest regions performed moderately better and worse, respectively, relative to the office sub-index. The East region suffered, experiencing their first quarter of negative appreciation returns in over a year at -0.25% offsetting the 0.28% appreciation on the first half of 2019.

Despite CBD office having much lower vacancy rates, Suburban office is well on track to outperform CBD office for the fourth consecutive year. Suburban currently leads CBD by 1.37% in year to date returns, attributable to both income and appreciation. However 2019 is the first year of Suburban consistently outperforming CBD in appreciation. This Suburban outperformance is correlated to Pacific outperformance, as over 70% of the Pacific index is concentrated in the Bay Area, LA and Seattle MSAs, all of which are technology centers. These markets also have a majority of their office classified as Suburban. Contrarily, over 85% of the East region is concentrated in the NY, Boston and Washington DC MSAs, of which, over 85% is classified as CBD. These east coast anchors are soft right now, suffering from oversupply.

While NOI per square foot is plateauing across the NPI, office continues to see a stable growth rate that has trended since 2012. Despite office vacancy rates reaching a cyclical low of 10.8% this quarter (equal to the previous cycle low), future office performance is projected to be stable or slightly decelerating, based on a slowing economy and a pipeline of new completions.

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