Cover Story

Office Optimism

Energy and healthcare markets shine brightly through the economic gloom.
By Jennifer Norbut

There are many reasons why today's national office market is inching along at a snail's pace compared to the lightning speed it was moving at less than 12 months ago. The credit squeeze, economic turbulence, and capital market volatility are just a few. These factors and others pushed up the national office vacancy rate to 14.0 percent in 2Q08, the second consecutive quarterly increase in more than four years. Office sales, which totaled just $6.8 billion in January and February 2008, dropped 90 percent from the same period last year, according to Grubb & Ellis.

But there is an upside to the office market's downturn. After record-breaking sales price run-ups during the past few years, many industry experts believe that fundamentals are heading toward an inevitable correction that may be far less devastating than previous contractions, such as the 1990-91 recession that took a steep toll on commercial real estate. "The silver lining is that a recession, if one is upon us, is likely to be short and shallow thanks to strong exports, continued global growth, low levels of corporate debt, and aggressive moves by [the federal government] to loosen the credit markets," says Robert Bach, senior vice president and chief economist for Grubb & Ellis.

However, job growth historically has had the biggest influence on the office property market. And nationwide approximately a quarter-million office-using jobs were shed in the first half of 2008, with further employment losses predicted for the next several quarters, Grubb & Ellis reports. But at least one employment trend equals good news for the office market: An increase in the number of professional- and service-sector jobs.

While the housing and financial crises have reduced the number of finance, insurance, and real estate, or FIRE, jobs nationwide, professional- and service- sector employment has continued to grow, according to Torto Wheaton Research. Flourishing segments, including management and technical consulting, engineering, accounting, and research and development, have increased from 66 percent of total office employment in 1990 to 71 percent today, TWR reports. While previous recessions saw large quantities of service job cuts, recent gains in this sector have allowed office rents to grow in some markets amid the residential and financial market meltdowns and economic uncertainty. The top 10 forecasted rent growth markets nationwide are cities with high concentrations of professional services and information-based employers. (See "Top 10 Forecasted Rent Growth Markets.")

Top 10 Forecasted Office Rent Growth Markets

Market	Two-Year Annualized Rent Growth (%)	Location Quotient* (professional & business services)	Location quotient* (information-based industries)
Pittsburgh	7.8	1.04	1.06
Newark, N.J.	6.1	1.24	1.59
Dallas	6.1	1.18	1.80
San Antonio	5.8	0.96	1.15
Indianapolis	5.7	1.06	0.84
Charlotte, N.C.	5.4	1.20	0.95
Raleigh, N.C.	4.8	1.21	0.54
Wilmington, Del.	4.7	1.16	0.86
Hartford, Conn.	4.5	0.84	0.98

Salt Lake City	4.5	1.12	1.06

Source: Torto Wheaton Research Office Outlook XL, Summer 2008

*Location quotient is the ratio of a sector’s share of employment in a given market to that sector’s share of employment across all markets. Quotients of 1.0 or higher indicate markets are net exporters of goods or services; quotients of less than 1.0 indicate markets are net importers of a sector’s output.

High-growth industries are another driver of commercial office market activity. Two top-performing industries in particular — healthcare and the energy sector — are contributing to several office market hot spots nationwide. The country's growing demand for healthcare and related services, which long has been a driver in top-tier and Sun Belt markets, is contributing to the office sector's health in smaller metropolitan areas around the country. While the U.S. Bureau of Labor Statistics expects employment in the utilities industry to decline 6 percent by 2016, the country's energy and fuel demands continue to rise. As a result, office-using jobs related to these industries are pumping life into a handful of South Central U.S. markets.

Energy Is Hot

"It is a good time to be in the energy capital of the U.S.," says Henry W. Hagendorf, CCIM, a senior investment adviser with Sperry Van Ness in Houston. "Houston has 5,000 energy-related companies, including many of the country's top oil and gas exploration and production firms." Last year, Houston's employment rate grew 2.4 percent, double the national average, according to CresaPartners. Texas also is home to 32 of *Fortune*'s 2007 100 fastest-growing companies, the majority of which are energy-related corporations. While the pace of employment growth in Houston is slowing — 2008 is expected to top out around 2 percent, CresaPartners reports — the office market remains buoyant thanks to the energy sector.

Class A and B office properties recorded positive absorption in several Houston submarkets, including the Katy Freeway/Energy Corridor, which posted a 6.6 percent 2Q08 vacancy rate, according to Grubb & Ellis. Though marketwide full-service Class A asking rents are dropping, "leasing rates in some submarkets continue to increase," Hagendorf says. For instance, in Houston's central business district, Class A rents jumped to $38.89 per square foot in 2Q08. Marketwide rents are expected to increase 6.3 percent this year, according to Marcus & Millichap.

"There will be some softness in certain submarkets as 7.4 million square feet of new construction is delivered by year-end," Hagendorf notes. But investors have little to worry about: "[The softness] is expected to be temporary because of the overall strength in the local economy, positive job growth, and no slowdown in energy demand for the foreseeable future."

Sometimes referred to as energy suburbs of Houston, markets such as Beaumont, Texas, and Oklahoma City, also are experiencing positive office activity due in large part to the profitable energy, oil, and gas industries.

In Beaumont's MSA, which has nearly 400,000 people and is located about 90 minutes east of Houston on the Gulf of Mexico, the unemployment rate has dipped below 5 percent due to a concentration of energy-related industries, according to Lee Y. Wheeler III, CCIM, founder of LWIII Group and associate broker with Foxworth Real Estate Co. in Beaumont. The sector has invigorated the local office and industrial markets. "In the first quarter of 2008 alone, we completed 85 percent of [our total sales] for the past 12 months. We will surpass the 2007 numbers in the second quarter," Wheeler says.

In a recent local transaction, Charles D. Foxworth Jr., CCIM, SIOR, principal of Foxworth Real Estate Co., represented Motiva Enterprises and TE Products Pipeline in ongoing land acquisitions for a $7 billion expansion project. The company's Port Arthur, Texas, refinery project is in its early stages, but eventually expects to employ approximately 6,000 workers per day. Ancillary businesses are leasing and buying commercial space to accommodate these crews all over southeast Texas, according to Foxworth Co.'s Web site.

Further north in Oklahoma City, which historically has struggled with high office vacancy rates, oil and gas corporations are fueling the market and keeping vacancy to a low 5 percent for class A space, says Susan Davis Jordan, CCIM, office specialist with NAI Sullivan Group in Oklahoma City. International corporations such as Devon Energy, which pioneered efforts to tap into the Barnett Shale formation in north Texas, are very active in the market. Devon recently announced plans to construct a high-rise tower in downtown Oklahoma City. "The new building will cause some vacancy in the next few years, but it will be a huge part of revitalizing our downtown," Davis Jordan says.

Located along Houston's Energy Corridor, Energy Center I and II are home to major tenant Foster Wheeler, an international engineering, construction, and project management contractor that serves the energy sector. Photo credit: Trammell Crow Co.

Last year SandRidge Energy purchased Oklahoma City's 30-story Kerr-McGee building and several other properties from Chesapeake Energy Corp. These types of sales represent a shift from leasing to buying that is occurring across the South Central U.S. "Oil and gas companies as well as the companies that support them are transferring from leasehold interests in buildings to ownership because of their strong balance sheets," says Aaron Thielhorn, principal of Trammell Crow Co. in Houston. In fact, oil and gas companies are driving much of the region's new development. "Occupancy costs are less for owners than tenants, so they can control expenses and also design the buildings that increase productivity, including large floor plates and sustainability components," he adds.

MOBs Make Sense

Similar to the country's increasing demand for energy, healthcare and related services are expected to grow at a breakneck pace in the next decade. As a result, medical office buildings are improving the prognosis of many office markets across the country.

By 2020, more than 55 million Americans will be age 65 or older, and by 2050 this segment will comprise almost 21 percent of the U.S. population, according to the U.S. Census Bureau. The "graying of America" has led to explosive growth in medical office leasing in regional markets, such as central Florida, says Stevens E. Tombrink, CCIM, regional vice president of real estate services for Equity in Tampa. "Unlike in some parts of the country where the medical office market has become somewhat saturated, there is still significant room for growth in Tampa," he says.

Markets with large concentrations of aging Americans, including Florida, Southern California, and Arizona, are rife with private and even institutional investors seeking strong-performing MOBs to add to their portfolios.

And recent mega deals, such as the nearly $55 million sale of a four-story Beverly Hills, Calif., MOB, illustrate the robust prices buyers are willing to pay in large metros. But a number of smaller markets across the country are experiencing unprecedented MOB activity as well.

For instance, in Raleigh, N.C., "development has been substantial the last several years and appears to be continuing unabated," says Gary W. Lyons, CCIM, SIOR, ALC, managing director of Sperry Van Ness in Raleigh. Four major hospital systems are driving transaction activity and increasing demand for more office space to support various medical specialties.

The majority of MOB activity in Raleigh is "developer-driven partnerships with local medical groups," Lyons says. These often are multitenant properties ranging between 20,000 sf and 50,000 sf with a percentage leased to the owner's practice. Last year Lyons represented Duke Health Systems in the sale of a 12,000-sf single-story property to a local 1031 buyer. "As far as we could tell the sale set a market record in Raleigh for price per square foot," Lyons says.

The Duke Health Systems Medical Building in Raleigh, N.C., sold to a private investor for $273 per square foot, setting a record-high medical office building sales price in Raleigh. Photo credit: Sperry Van Ness/AIM Real Estate Advisors

The strong hospital system and an influx of residents — and physicians — from the Northeast make Raleigh an ideal market for sizable healthcare-related office transactions. "Our sweet spot to date has been $1 million to $5 million MOBs, however our platform will yield the greatest increase in absolute returns to owners of larger buildings," he says. But "at times it can be difficult to get all the physicians in a large practice to agree on a sale-leaseback transaction."

While hospitals and universities are key MOB development drivers, a great deal of new construction also is emerging in rapidly growing suburban markets that ring many of the country's large metros. For instance, outside Chicago in Will County, Ill., one of the fastest-growing counties in the U.S. according to the Census Bureau, an influx of young families and new businesses is increasing demand for healthcare services. Alter+Care's new Surgery Center of Joliet at Madison Medical Plaza in Joliet, Ill., combines a variety of medical specialists and technological services under one roof and "brings the one-stop-shopping approach that has dominated current business models to healthcare," says John Driscoll, president of Alter+Care, a healthcare development affiliate of The Alter Group in Skokie, Ill. The developer also recently broke ground on a mixed-use healthcare facility in Huber Heights, Ohio, a growing northern suburb of Dayton whose residents lacked convenient access to a full range of healthcare services.

The Surgery Center of Joliet, constructed by healthcare developer Alter+Care, houses medical office space and specialized surgical facilities under one roof. Photo credit: Alter+Care

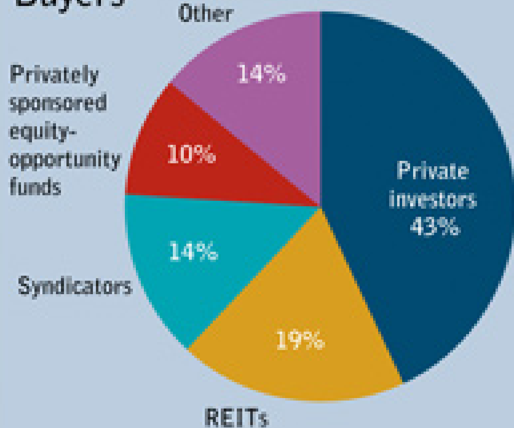
Medical offices are attracting more and larger investors in the current market because in many ways the sector is "somewhat recession-proof," Tombrink says. While traditional office property rents increased an average of 1.3 percent per year from 2000–07, MOB rents grew 2.8 percent per year, according to Grubb & Ellis' 2008 *Healthcare Properties Outlook*. Vacancies tend to be lower as well — the MOB market ended 2007 with a 10.4 percent vacancy rate nationwide, 2.6 percent lower than traditional office space. Longer lease terms, which typically run 10 or more years versus five or less years for traditional space, make it easy to see why investors are hot for MOBs.

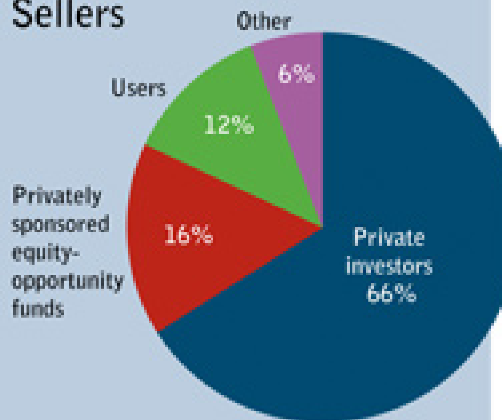
Investors purchased $4.7 billion in MOBs with a sale price of $5 million or higher last year, an increase of 8 percent over 2006, according to Real Capital Analytics. While private investors comprise the majority of MOB buyers, institutional-level investors are stepping up allocations to this property type. (See "Who's Buying and Selling MOBs?")

Due to solid performance and growing demand, which is expected to increase substantially during the next 10 to 15 years, according to Marcus & Millichap's 2008 *National Office Overview*, MOB prices and competition are likely to keep rising. Going forward, location will be the wild card for investors and buyers. "The need for affordable, accessible space, an increasing focus on outpatient services, and an evolving regulatory climate have prompted a renewed focus on ... strategic locations for medical service providers," Tombrink says.

Who's Buying and Selling MOBs?

A breakdown of medical office building investment transactions in 2007





Source: Grubb & Ellis' *2008 Healthcare Properties Outlook*

What's Next?

Though developers are expected to deliver approximately 98 million sf of new office space this year, according to Grubb & Ellis, industry experts believe supply should not drastically outweigh demand. "Based on national aggregates, it would appear as though the national office market has avoided a serious overbuilding situation," says Scott Ian MacIntosh, senior economist for the National Association of Realtors. Rising construction costs, which have helped to keep supply in check, and tighter underwriting restrictions also may work in the office market's favor.

Past economic downturns have proved to be far worse for the national office market. "Leading up to the 2001 recession, aggressive rent growth and historically low vacancy rates led to a bloated construction pipeline that the market was unable to absorb," says Arthur Jones, an economist for TWR. "Economic and commercial real estate cycles peaked simultaneously and the result was a painful office recession with a hangover effect that lasted far longer than the general recession." (See "Office Market Performance in Slow Cycles.")

Office Market Performance in Slow Cycles

Business Cycle Phase	Time Period	Avg Vacancy Rate (%)	Rent Growth (%)
	1990		
Pre-recession	3Q89 to 2Q90	18.1	0.2
Recession	3Q90 to 1Q91	18.5	-1.0
Office recession	3Q90 to 3Q92	18.8	-8.9
	2001		
Pre-recession	1Q00 to 4Q00	8.4	10.6
Recession	1Q01 to 4Q01	12.0	-5.4
Office recession	1Q01 to 3Q03	14.7	-17.2
	2008*		
Pre-recession	1Q07 to 4Q07	12.5	9.6
Recession	1Q08 to 3Q08	13.3	1.6

Office recession	1Q08 to 4Q09	14.7	1.3

Source: Torto Wheaton Research
*Forecast begins 2Q08

The office market's frenetic price wars and subsequent flips, which reached a pinnacle in mid-2007, have made the sector arguably the most susceptible to value declines, according to Jones Lang LaSalle's Spring 2008 *U.S. Investment Market Report*. Office values have dropped between 10 percent and 15 percent since 3Q07, Jones Lang LaSalle estimates.

Industry analysts point out that it's important to keep in mind that overall commercial real estate transaction volumes remain favorable, reverting to approximately 2004 levels, in comparison to long-term historical volumes. In addition, average rent growth is expected to remain positive, even if nominally so, TWR's Jones predicts. While this may not be a utopian environment for office market players, the current conditions do present some opportunities.

"Expect more properties to be offered for sale in 2008, including distressed sales, which will create the best buying opportunity in years for investors with cash to spend. Tenants also will see the best opportunities in years," Bach notes. The flip side is that office property owners must be ready for a challenge: "Landlords will need to focus on property management, work to retain tenants, and get aggressive to fill vacancies early in the cycle rather than chase the market lower."

Though no one takes comfort in the midst of a turbulent market, the office property sector's future isn't so bad. "The outlook may be less than stellar and, sure, the performance of this asset class in 2008 will not resemble 2007," TWR's Jones says. But "compared to prior economic slumps, the commercial real estate market — office in particular — is in good shape to absorb what the economy is going to throw its way."

2008 Office Market Leaders

Marcus & Millichap's National Office Property Index ranks 43 U.S. markets on a series of 12-month supply and demand projections

Market	2008 Rank	2007 Rank	2007-08 Change in Rank
Seattle	1	4	+3
New York	2	1	-1
Boston	3	5	+2
San Francisco	4	16	+12
Los Angeles	5	3	-2
Washington, D.C.	6	2	-4
Oakland, Calif.	7	9	+2
Riverside-San Bernardino, Calif.	8	8	0
Las Vegas	9	12	+3
Orange County, Calif.	10	6	-4

Source: Marcus & Millichap

Houston's Discovery Tower, a 30-story class A office building under development by Trammell Crow Co. and Principal Real Estate Investors, will harvest wind energy with 10 built-in turbines. Photo credit: Trammell Crow Co.

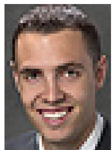
Office Market Opinions

Local factors, such as population shifts, job growth/losses, and economic drivers play a significant role in office market performance. Industry experts from several markets around the country offer a look into their local office market's current conditions and predict how the sector should fare through year-end.

Cleveland

"Class A is very strong with at least 2.5 million sf of downtown spec buildings coming on line. Class B is tightening, while class C is suffering miserably. People are upgrading to better buildings [during the downturn] to take advantage of the attractive deals." — Terence P. Coyne, CCIM, SIOR, Grubb & Ellis

Pleasanton/East Bay, CA.



"Tenants are tepid and landlords have to give many concessions to lure them. The best performing office buildings are those with easy BART [public transportation] access. With high gas prices, many employers find it beneficial to promise employees public transportation access. The next six to eight months will be a period of stabilization in rents and building prices and then it should return to a landlord's market with rising rents." — Gabe Stephenson, Lee & Associates

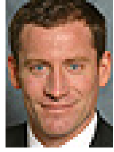
Toronto, Ontario

"A strong local economy and solid employment gains are driving office demand. Finance, insurance, legal, and to a lesser extent, technology and life sciences industries are the primary drivers. Class A vacancy has reached its lowest point since 2001 and tenants are more educated than ever on market trends and conditions." — Christopher J. Brown, CCIM, DTZ Barnicke

Las Vegas

"Most planned office building construction will not occur until the 4 million sf of new and under-construction shell space is leased up. A major factor in the leasing slowdown of new shell space is the difference between the tenant improvement allowance owners can afford to give to tenants and the actual TI build-out costs, as owners look to tenants to make up the difference. Therefore, tenants are looking more at second-generation and sublease space." — Charles W. Witters, SIOR, Lee & Associates Nevada

San Diego and Orange County, CA


"Office market fundamentals have eroded over the past two years. Vacancies have increased to approximately 15 to 17 percent. Construction completions, mortgage industry correction, and a tentative user base have contributed to this. There is some limited new demand from software, engineering, and medical administration companies. The market will experience recovery after this sharp correction, but it will take three to four years to reach stabilization." — Lars P. Platt, CCIM, MAI, Capital Markets Group, Cushman & Wakefield

Industry Expert Insight

"I expect to see vacancies increase modestly and rental growth, particularly asking [rents], will be flat to down in many cases. This being said, a lack of overbuilding, more efficiency built into the job market to start, and Federal Reserve actions combined with an improving economic outlook by late 2008 to early 2009 should provide cause for improving office fundamentals by mid- to late 2009. The primary caveats that could alter the recovery schedule are a housing market downturn that lingers well into next year and significant inflationary pressure caused by the incredible surge in food and energy costs."— Alan Pontius, senior vice president and managing director of Marcus & Millichap's National Office and Industrial Properties Group

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Jennifer Norbut is the senior editor of *Commercial Investment Real Estate*.

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