Marcus & Millichap

Special Report

Suburban Office Challenging CBD

Midyear 2017

Often-Overlooked Investment Quietly Gathers Traction; Reinventing Suburban Office Sparks Refreshed Perspective

CBD led office recovery. Central Business District office markets garnered attention during the recovery as a variety of large companies announced relocations to downtown areas. Notable leaders in this movement included United Airlines, which moved its headquarters to downtown Chicago, and Expedia, which relocated to the Seattle waterfront from its suburban office location. As millennials entered the workforce, access to transportation, walkability and retail topped priority lists, further benefiting CBD office demand. This noteworthy shift sparked an urbanization trend and drove increased absorption of office space. Subsequently, CBD office rents and vacancy were quicker to recover from the Great Recession than their suburban counterparts.

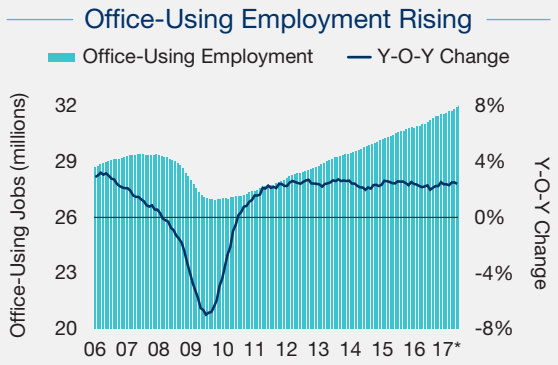
Suburban office gathering momentum. Following the recession, many employers relocated to the urban core, capitalizing on reduced downtown office rents while reinforcing the trend toward urbanization. As the economic growth cycle gained momentum and office rents in core locations recovered, suburban office space once again became a more affordable alternative for many companies. Though lower costs catalyzed a shift in where companies located, tightening labor markets have reinforced the value of locating near the substantial suburban labor force featuring 70 percent of the millennial population. Though many millennials favor an urban live-work-play lifestyle, for many young adults, commute time is also a significant consideration.

Evolutionary suburban office trends. The idea of working in an amenity-rich office location with walkable access to shopping, restaurants and other recreational activities remains attractive to many professionals and still favors urban office space. Numerous suburban office locations have become increasingly competitive, however, by clustering in walkable villages featuring many of the amenities and services of urban environments. These locations are generally more affordable than their urban counterparts while remaining attractive to employees seeking a variety of offerings that are within walking distance. Many of these areas are located on transit lines, allowing employers to draw from a broad labor force outside the urban core.

Investors shift focus. The urban core comprises approximately 31.6 percent of the total office space in major cities, but in the wake of the recession just 17.3 percent of the 2009 office transactions were in downtown areas. As the urbanization trend gathered momentum, sales of downtown office properties increased to comprise nearly one-fourth of the deals in 2014. Since then, investors have once again begun to focus on suburban options, restraining downtown activity to 21.7 percent of 2016 office sales. The flow of capital reflects the convergence of opportunity, yield and perceptions of future growth, and it appears investors' attention is once again moving beyond the core.

Key Observations

- **CBD Improvement Tapering.** While the CBD was quicker to recover from the Great Recession, improvements in office market fundamentals have begun to moderate. Vacancy remained flat in 2016, while the pace of growth in asking rents slowed.
- **Demographics Favor Suburban Demand.** Nearly two-thirds of households already reside in the suburbs, fostering demand for office space in suburban markets. Shorter commute times entice many workers to seek employment in suburban office locations.
- **Suburbs Evolve to Meet Millennial Tastes.** Suburban companies are seeking spaces in prime locations to cater to the lifestyle that many young professionals enjoyed in CBD areas. As a result, many suburbs are transforming into their own urban environments with walkability, entertainment, and retail and dining options.
- **Suburban Absorption Strong.** Net absorption has maintained a vigourous pace over the last six years, pushing vacancy down nearly 250 basis points to 15 percent since 2011 and driving steady rent growth.
- **Cap Rates and Pricing Show Suburban Upside.** First-year returns up to 100 basis points higher in the suburbs. Additionally, peak-to-trough pricing signals additional room for improvement in the suburbs compared with urban assets.



* Through second quarter

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Real Capital Analytics

Improving Demographics Will Shift Office Tenants And Investor Attention to the Suburbs

Well-located suburban office properties benefit from forward-looking demographics. In 2015, the majority of U.S. households, 64 percent, resided in the suburbs and that number should rise as urban millennials form families and move to larger living spaces in suburban locations. Many office tenants are tapping into this larger workforce already located within the suburbs, enticing employees with shorter commute times and revamped offices. Moving forward, attention should continue to shift to suburban office space as market demographics improve and absorption remains steady.

Suburbs Dominate Household Location, Attract Tenants

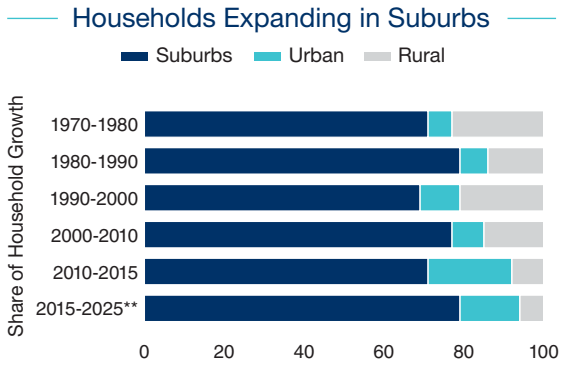
Office tenants seeking to capitalize on the many workers living in the suburbs have fueled net absorption of suburban office space. As a result of robust tenant demand, vacancy has fallen nearly 250 basis points during the course of the recovery to 15 percent in the first quarter of 2017. In an effort to recruit and retain these employees, suburban tenants have been scouring the market for quality available space in locations near retail and transportation options. Subsequently, suburban office construction has heightened during the last two years but remains far below the completions recorded during the previous cyclical peak. Minimal completions and steady absorption signal the potential for further vacancy improvement.

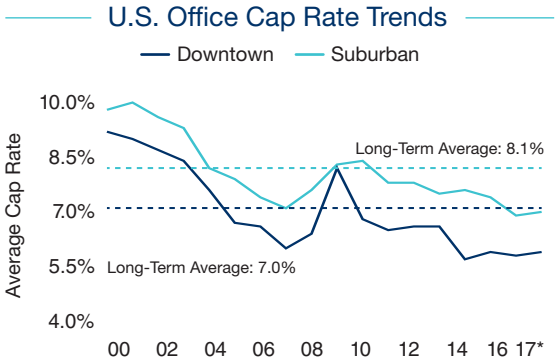
Healthy demand has also spurred rent growth with the average asking rent up 7 percent from the 2008 peak. Asking rent is roughly half of the average rent in urban office space, motivating tenants who may have been priced out of the urban core to move to the suburbs. The lower costs and relatively more land available in the suburbs have also resulted in the creation of large campuses catered to professionals. Many of these campuses offer on-site amenities like gyms or day care centers. Additionally, the cost savings allow some companies to renovate existing spaces into modern office concepts.

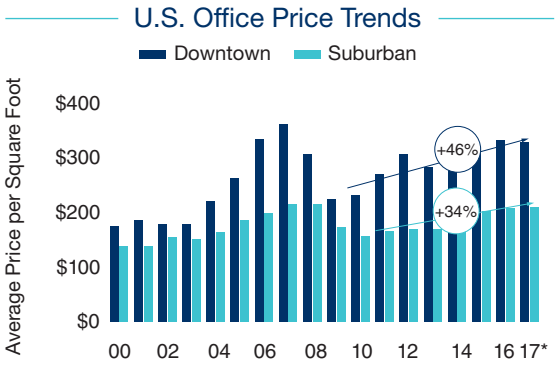
Cap Rate Trends Show Upside Potential of Suburban Office

Strengthening demand for office properties compressed the average first-year returns in both suburban and core office assets over the course of the recovery. Initial yields in CBD office space fell about 240 basis points from peak cap rates to the high-5 percent span in March. Cap rates in suburban properties descended 150 basis points to the low-7 percent area during this same time. Higher returns in the suburbs and consistent tenant demand should create attractive yield dynamics, particularly for buyers attracted to value-add properties where increasing amenities and renovating spaces to cater to millennials' tastes can increase marketable rents.

While average first-year returns higher than CBD properties are garnering attention for suburban assets, peak-to-trough pricing signals room for additional improvement. The average price per square foot for suburban assets is up 34 percent, while downtown properties are up 46 percent per square foot from trough to current peak. The lower prices in the suburbs provide potential opportunities for private investors who may have been priced out of core urban assets by institutional buyers. Additionally, as institutional foreign capital has typically gone to trophy CBD buildings, private foreign buyers are increasingly seeking out more affordable suburban properties.







* Trailing 12 months through first quarter
** Forecast

Suburban Office Landscape Changing to Meet Demands of New Workforce

Office markets in the suburbs are transforming to meet the live-play-work lifestyle in order to secure and retain the next generation of talent. New projects often reflect the changes that millennials have brought to office and work culture. On-site amenities including access to recreational activities, healthcare clinics and day care centers have cropped up in many new suburban office developments, helping create the work-life balance desired by many professionals. Additionally, companies are targeting spaces with nearby access to dining, retail and entertainment, further generating the sense of community that young professionals value.

Plano Texas Brings CBD Lifestyle to the Suburbs

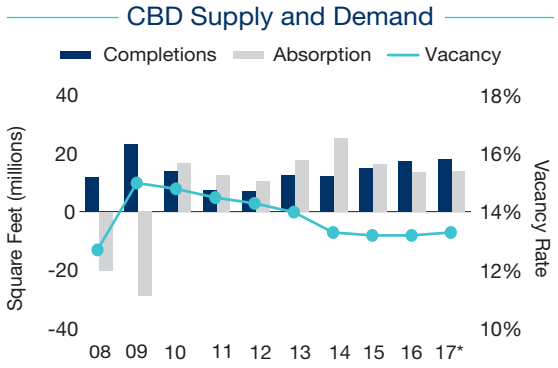
The evolution of suburban communities into amenity-rich environments is demonstrated in Plano, Texas. Located 40 minutes outside Dallas, Plano features numerous corporate headquarters including Toyota, Alliance Data, Frito-Lay, Pizza Hut and J.C. Penney. Residential and retail offerings, such as the Shops at Legacy, are available near these campuses to further augment a work-life balance. These types of shopping centers provide additional upscale dining and retail options to attract professionals in the area.

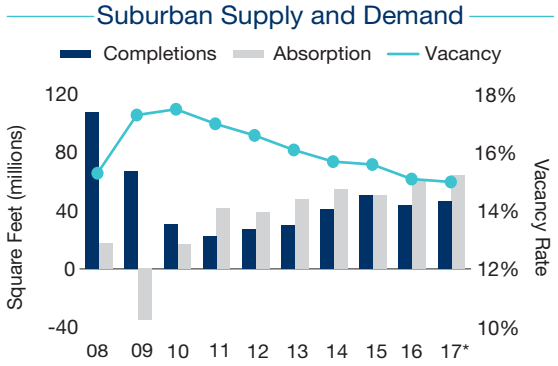
Many corporations are also revamping their spaces. Toyota recently moved its North American Headquarters to Plano from Torrance, California. The new campus is built with collaboration, health and efficiency in mind. All departments are internally connected and collaborative areas comprise roughly half the workspace. Employees can choose to have standing desks, some on treadmills, and large community tables. The campus also has a wide range of amenities including various dining options, a jogging track, a rock-climbing wall and a two-story gym.

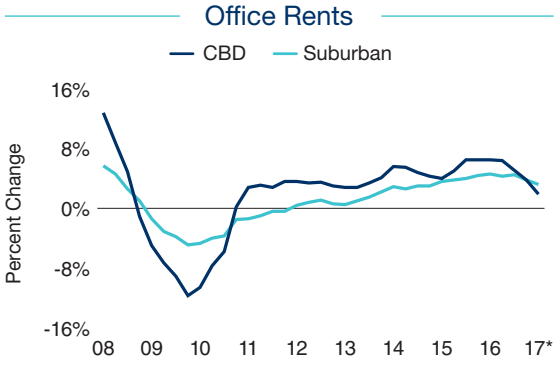
Tempe Arizona Engages Millennials

Tempe, a suburban college town east of Phoenix, Arizona, has a live-play-work environment that attracts millennials. Several large employers are there, including Honeywell and Freescale Semiconductor. Additionally, Insight, a b2b tech Fortune 500 company, has its headquarters within the city and JPMorgan is building a 67-acre campus. The area incorporates a large university, creating a recruiting pool for nearby companies targeting workers in the region. Tempe is filled with several high-rise residential developments that are within walking distance to local shops, dine-in establishments and events. For example, the Sixth Street Market is a Sunday morning pop-up that features shopping, art, brunch and yoga. Additionally, the light rail provides transportation to downtown Phoenix and Phoenix Sky Harbor International Airport.

Other companies have taken notice of the success in downtown Tempe, including State Farm, which recently built its new regional headquarters here with young workers in mind. The campus features restaurants, a fitness center and an on-site primary-care doctor's office. Additionally, break rooms that resemble coffee houses, wine bars, standing desks and conference rooms with 360-degree video-calling capabilities bring the collaborative environment young professionals desire. The company also recognizes the importance of a sense of community and hosts a free music festival every Thursday night in downtown Tempe called Beyond the Bricks.

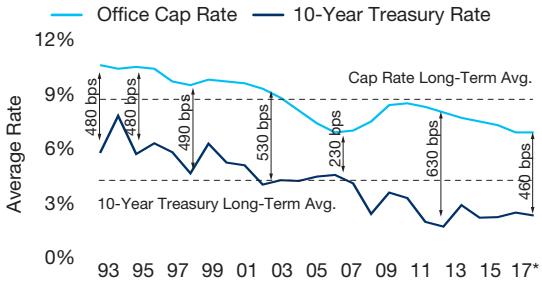






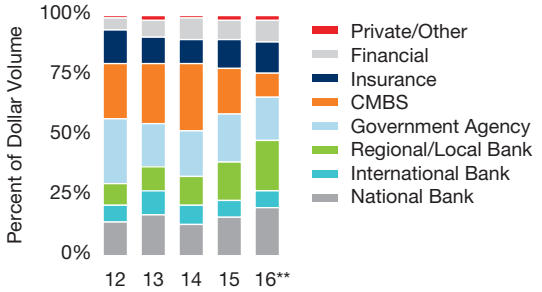
* Trailing 12 months through first quarter
Sources: CoStar Group, Inc.; Real Capital Analytics

Office Cap Rate Trends



Note: Sales $1M and above

U.S. Commercial Real Estate Lender Composition



* As of Julyl 25, 2017
** Estimate; Includes apartment, retail, office, industrial and hotel properties $2.5 million and greater

Debt Funding Availability Remains High; Fed Pushes to Normalize Rates

- **Monetary policy in transition.** Despite the Fed raising its benchmark short-term rate three times in seven months and signaling another rise before the end of the year, long-term rates have remained stable. The yield on the 10-year U.S. Treasury bond remained in the low- to mid-2 percent range throughout the second quarter of 2017. The Federal Reserve wants to normalize monetary policy and, in addition to rate hikes, will likely start paring its balance sheet.
- **Sound economy a balancing act for Fed.** With unemployment hovering in the low-4 percent range, the lowest level since 2007, the Federal Reserve will remain vigilant regarding the possible rapid increase in inflation if wage growth takes off. Additionally, business confidence sits close to its all-time high. Businesses finally have the confidence to expand their footprint after years of tepid growth following the Great Recession. Office properties stand to gain significantly from this expansion with increased hiring adding to occupancy, in addition to expanding economic growth. The Fed, however, must now balance economic growth and job creation against wage growth and inflationary pressures.
- **Underwriting discipline persists; ample debt capital remains.** Overall, leverage on acquisition loans has continued to reflect disciplined underwriting, with LTVs typically ranging from 60 percent to 75 percent for most office properties. At the end of 2016, the combination of higher rates, conservative lender underwriting and fiscal policy uncertainty encouraged some investor caution that slowed deal flow, a trend that has extended into 2017. A potential easing of regulations on financial institutions, though, could liberate additional lending capacity and higher interest rates may also encourage additional lenders to participate.

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Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; Real Capital Analytics; Standard & Poor's; U.S. Bureau of Labor Statistics.