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Economic Fundamentals for Office Properties and Shifts in REIT Portfolios from 2007—2017

Office REITs have increased their holdings within secondary cities since 2012, in order to benefit from robust population and employment growth, and increase returns for investors.

Highlights

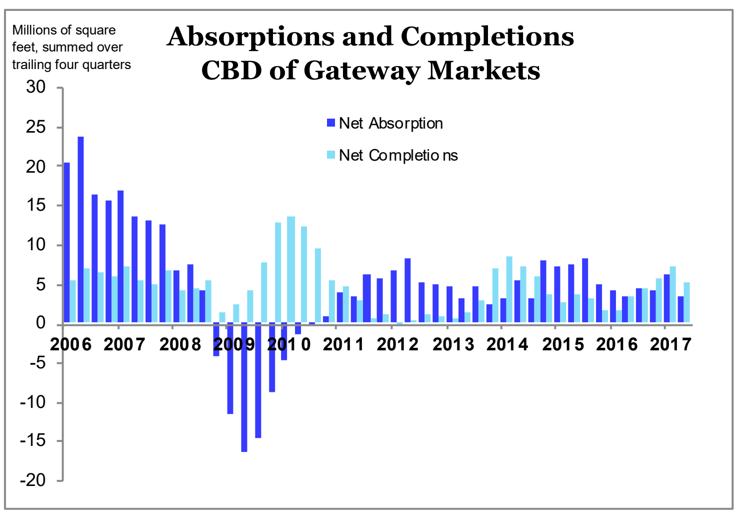
- **Demand has been robust in secondary markets, but modest in gateway cities**
- **Robust population and employment in these areas has supported demand**
- **REITs have taken advantage of fundamentals by increasing their investments in secondary markets**

Introduction

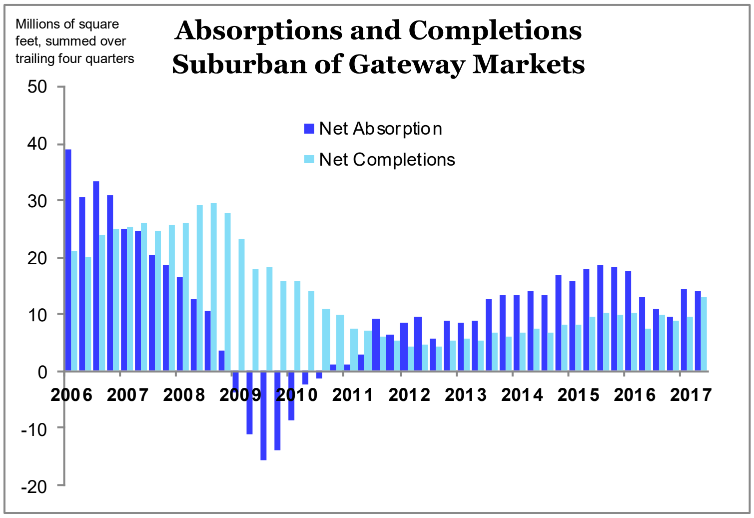
Gateway markets[1] have historically been a popular choice for commercial real estate investment. These markets hold high-value properties including iconic buildings, in areas with high job density and incomes. Gateway cities also have barriers to entry, either through zoning laws or geographic restrictions, that limit new supply and help protect the value of investments. REITs have historically focused their portfolio holdings on top quality properties located in cities like New York, San Francisco, and Chicago, with more limited investments in secondary and tertiary cities. For example, roughly 65 percent of REIT holdings of office properties, by market value, were within gateway markets at the end of 2016. Positioning themselves in strong locations has served the industry well, and has almost certainly contributed to the returns that REITs have delivered to investors over the years.

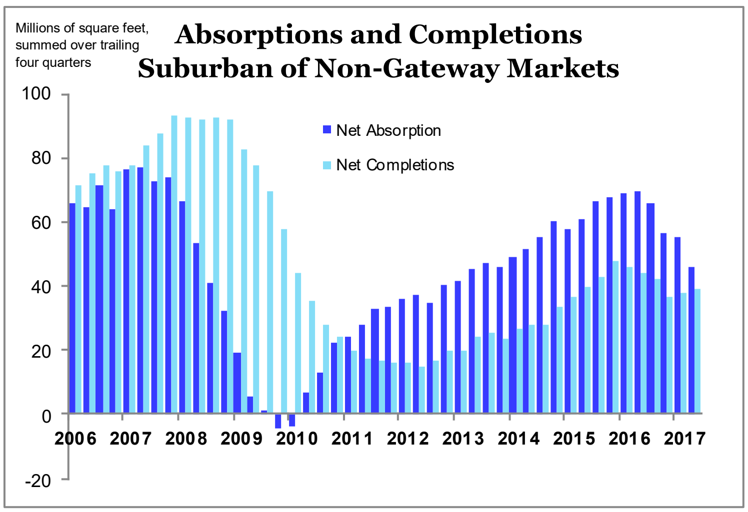
Since the financial crisis, however, office markets in other cities have gained prominence. Office properties in secondary metro areas[2] have enjoyed greater demand and rising occupancy rates relative to those in gateway cities. The growing demand for space in these markets is being driven by solid macroeconomic fundamentals, including faster population and employment growth.

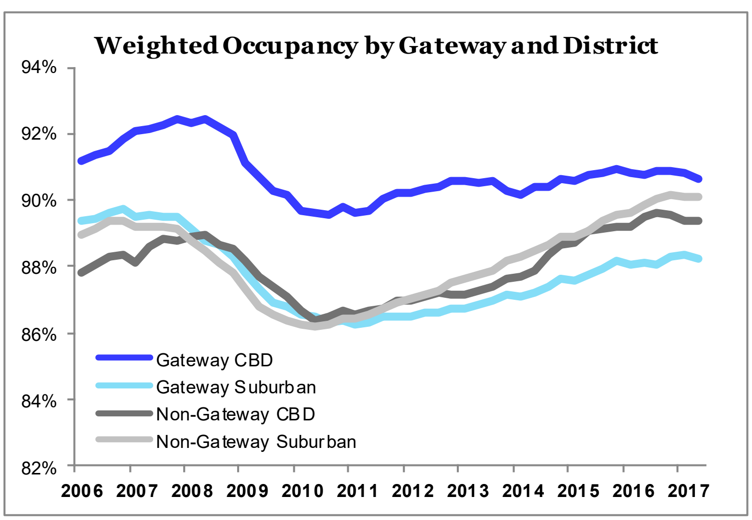
REITs have positioned themselves to benefit from this relative strength in secondary markets. Since 2012, REITs have increased their holdings of office properties in secondary markets by almost 30 million square feet, while REIT positions in gateway markets were essentially unchanged and their holdings in tertiary markets fell.



Source: Data from CoStar, S&P Global Market Intelligence and Nareit 2017.







These acquisitions of properties in markets with stronger demand while shedding holdings in weaker markets demonstrate how REITs' knowledge of local market conditions enable them to make well-informed investment decisions, and help add value for shareholders.

Data for this project were collected from CoStar and S&P Global Market Intelligence. The top 47 metro areas were examined and divided between gateway, secondary, and tertiary markets. The data were also analyzed by district, Central Business District (CBD) and Suburban.

Supply and Demand Conditions

Gateway cities enjoyed robust demand for office properties during the years before the financial crisis. Net absorption (demand) outpaced net completions (supply) by as much as 20 million square feet a year in the CBD section of Gateway markets (Chart 1). Demand was at its highest from 2005 to 2006, averaging 18 million square feet each year. Suburban areas in Gateway cities also experienced high levels of net absorption during this time period. In contrast to the CBD areas of these cities, however, construction surpassed demand beginning in 2007, due to there being fewer space constraints in the suburban areas. During the financial crisis, net absorption turned negative both in CBDs and the suburbs as more businesses vacated their office space than those starting new leases. This coincided with more supply entering the market, mainly from projects started well before the crisis, leading to an excess of unoccupied space.

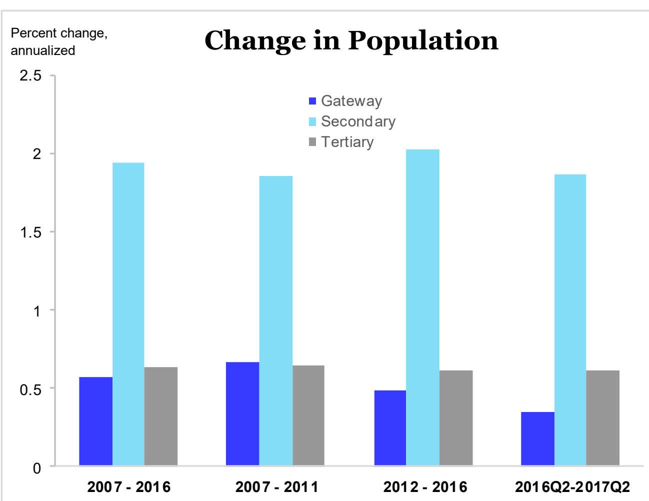
Office markets in Gateway cities began to recover by 2011, as demonstrated by the rebound in demand. Net absorption, however, has not returned to its pre-crisis levels in either CBD or suburban markets. For example, net absorption in CBD markets has not exceeded 8.2 million square feet each year, which is less than half of the peak reached in 2006. Demand

Source: Data from CoStar, S&P Global Market Intelligence and Nareit 2017.

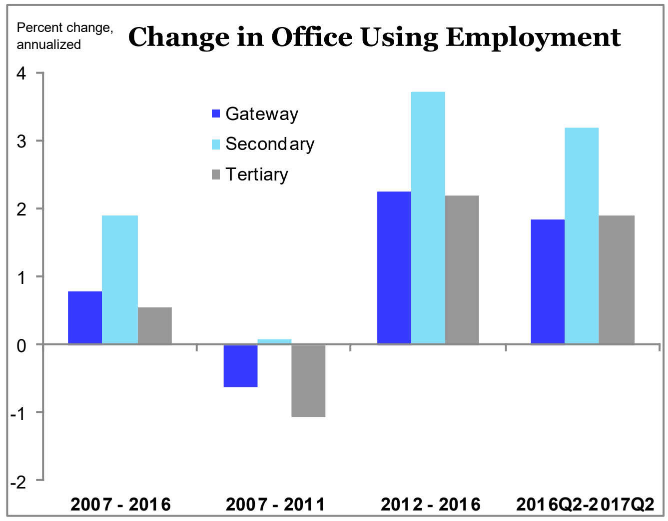
for office space the suburban areas of gateway markets has similarly fallen short of pre-crisis levels.

Demand in the Secondary and Tertiary metros, in contrast, has nearly returned to its pre-crisis levels while construction activity has lagged (Chart 3). After the Great Recession, demand in the suburban areas[3] of secondary and tertiary metros has only grown, and by the end of 2016, it had almost returned to pre-crisis levels. In addition, the amount of deliveries entering the market has decreased compared to the prior cycle, which has allowed for demand to outpace supply over the last five years.

The relative strength of excess net demand in these secondary and tertiary markets, compared to demand growth in the Gateway markets, has allowed occupancy rates to close much of the gap that existed prior to the financial crisis. Previously, properties in gateway CBD markets enjoyed occupancy rates that were three percentage points higher than in gateway suburban, secondary, or tertiary markets (Chart 4). This gap continued through the crisis but started to narrow in the early recovery. The stronger demand



growth in non-gateway suburban markets steadily pushed up occupancy rates, and by 2017:Q2, the gap between gateway CBD and secondary/tertiary suburban had narrowed to less than one percentage point. In terms of occupancy, there is no longer a significant difference between buildings in the downtowns of New York or San Francisco than the submarkets di-



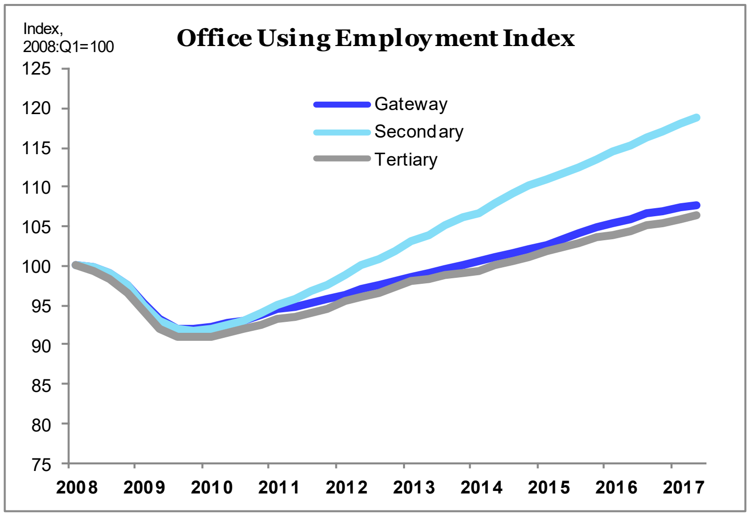
rectly outside of Dallas or Seattle. The closing of this gap indicates a significant shift in the overall office market.

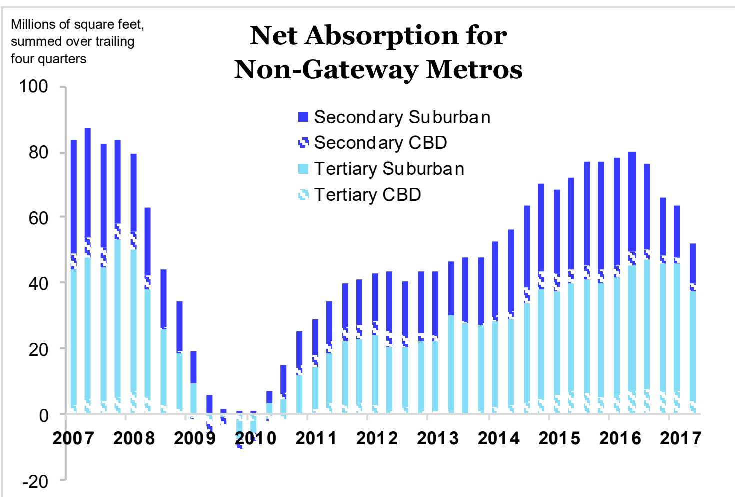
Economic fundamentals in the Gateway, Secondary, Tertiary markets

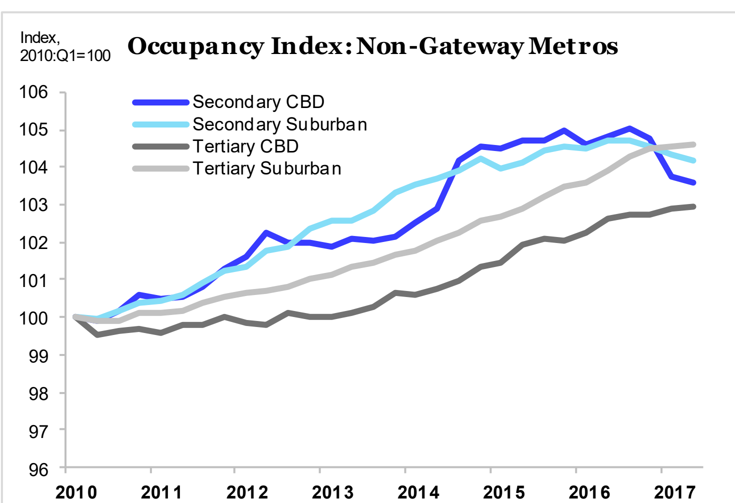
Solid economic fundamentals, in particular, the increases in population and employment, have driven the growing demand and occupancy outside the gateway metros. Population and employment growth have been particularly robust within the secondary markets after the financial crisis. For example, population growth in secondary metros exceeded growth in gateway and tertiary metros for the entire period of 2007 to 2016 (peak of prior cycle to present), as well as the sub-periods 2007 to 2011 (peak of prior cycle to early recovery), 2012 to 2016 (early recovery to present), and also over the past year (Chart 5). The population growth among secondary cities during the period from 2012 through 2016 stands out as the most rapid of any of these groups of cities for the periods examined. Population in secondary metros grew, on average, 2.0 percent each year. Population in gateway and tertiary metros, in comparison, only increased 0.5 percent and 0.6 percent each year, respectively.

Secondary metros also had faster employment growth[4] during the full 2007-2016 period as well as each of the sub-periods. Similar to population, em-

Source: Data from CoStar, S&P Global Market Intelligence and Nareit 2017.







ployment growth accelerated following the financial crisis, especially for the period since 2012. Growth for secondary metros stood at 3.7 percent each year while gateway and tertiary metros experienced 2.3 and 2.2 percent each year, respectively (Chart 6). Higher growth in secondary markets has allowed for employment to easily surpass its pre-crisis peak compared to gateway and tertiary markets (Chart 7). Secondary markets returned to pre-crisis employment 1-2 years before either gateway or tertiary markets. As of 2017:Q2, secondary markets were 18.9 percent above peak employment from the prior cycle while gateway and tertiary markets were only 6 percent above, on average.

Several other underlying factors have hurt demand for office space in the gateway metros, besides weaker employment growth. New development trends towards smaller space per worker, with floorplans featuring more cubicles as opposed to traditional enclosed offices. Law office libraries specifically don't need as much square footage as they used to due to books being converted to digital formats. Weaker employment growth along with other office development changes have reduced the need for more space, limiting net absorption.

The robust population and employment growth in the top nine metro suburban markets has supported the higher level of demand for office space post-crisis. These markets are home to around a third of the total combined stock in secondary and tertiary markets[5]. Since 2012, however, these markets represent approximately half of the total demand for non-gateway office space (Chart 8). The extra demand has allowed for occupancy rates to rise faster in secondary markets following the financial crisis. The increase in occupancy rates for secondary markets since 2010 was, on average, one to two percentage points higher than the increase in tertiary markets (Chart 9).

Source: Data from CoStar, S&P Global Market Intelligence and Nareit 2017.

Changes in the underlying fundamentals have caused demand for real estate to shift. Occupancy rates and demand have grown faster in secondary markets, increasing their prospects relative to the larger gateway markets. As we shall see in the next section, REITs anticipated many of these changes and began allocating more of their portfolios to properties within secondary markets ahead of the strengthening of underlying fundamentals.

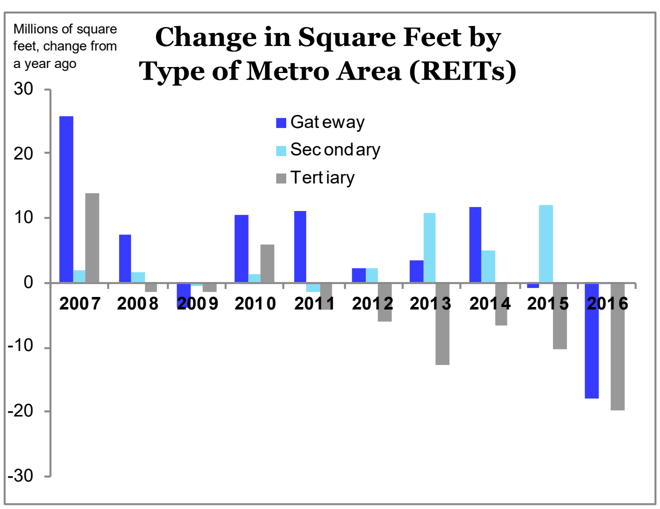
Portfolio activity by REITs

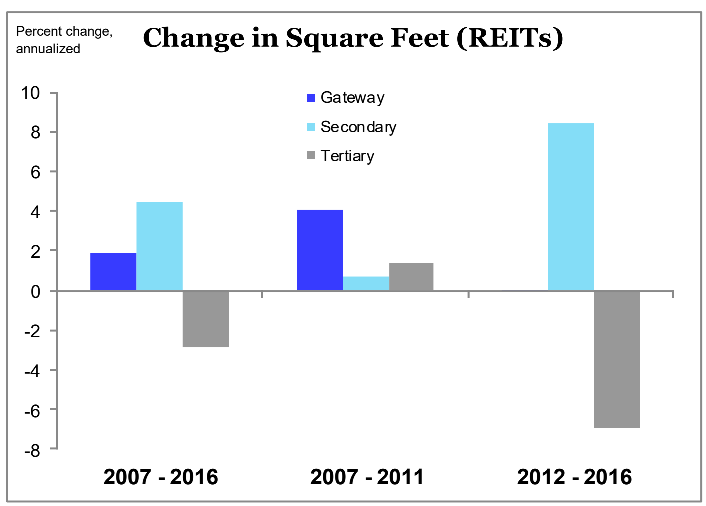
REITs moved early to focus their property acquisitions in these secondary markets that subsequently experienced greater improvements in fundamentals and demand. Before the crisis, the majority of office properties purchased by REITs were located in gateway metros (see blue bars in Chart 10, especially 2007 and 2008). In the immediate aftermath of the financial crisis, REITs made nearly all of their acquisitions within gateway markets, perhaps reflecting a "flight to quality", or taking advantage of fire sales by private investors (see blue bars, 2010 and 2011). This strategy allowed REITs to take advantage of lower priced assets in an environment that typically boasts a higher price point.

REITs turned their acquisition activity from gateway cities to the secondary markets in 2012, just as the underlying fundamentals in these markets began to gain momentum. From 2011-2012, REITs added about the same amount of properties in gateway and secondary metros. Over the next year, however, REITs added about three times the amount of square feet in secondary cities compared to gateway cities (see red bars, 2013).

The shift in REITs' portfolio activity can be seen more easily by comparing portfolio growth in each set of metro areas from 2007 to 2011 to the patterns of growth from 2012 through 2016 (Chart 11). From 2007 to 2011, REITs holdings in gateway cities rose 4.1, annualized rate, percent while holdings in secondary and tertiary cities increased only slightly, 0.7 percent. Holdings in tertiary cities rose 1.4 percent. Since 2012, however, REIT holdings of office space in secondary cities rose at an 8.5 percent, while holdings in gateway cities were little changed and REITs were net sellers in tertiary markets. REITs appear to have anticipated that the secondary markets would enjoy stronger fundamentals that boosted occupancy rates compared to other areas. Their ability to track the underlying fundamentals and act accordingly, showcases their knowledge of the industry.

REITs that shift their portfolio activity towards these secondary and tertiary cities that subsequently experienced more rapid growth posted superior stock market performance over this period. Seven REITs increased the portion of their office portfolio within secondary markets by 7.5 percentage points or more from 2012 to 2016. Most of these companies were Office REITs, but some Diversified REITs with large





Source: Data from CoStar, S&P Global Market Intelligence and Nareit 2017.

office portfolios also expanded their holdings within secondary markets. A weighted total and price return was calculated for the seven REITs over the same time period, using each company's market cap at the end of 2011.

Both the weighted total and price return of the REITs with greater investments in secondary markets outpaced the FTSE NAREIT All Equity REITs Index and the Equity Office Index (Table 1). The weighted total return outpaced the overall equity index by almost 60 percentage points. These REITs, on average, also had a higher dividend return to shareholders over the five-year period. Other factors do account for increases in total return, and not all seven REITs outperformed the broader indices. A majority of the individual REITs, however, did outperform the broader indices in both total and price return.

Conclusion

Office REITs have shifted their focus a bit in recent years away from the traditional gateway markets, to increase their holdings in secondary cities. Post financial crisis, secondary cities have experienced stronger macroeconomic fundamentals, such as robust employment growth, leading to stronger demand and growing occupancy rates within these metro areas. REITs with their knowledge of local markets were able to anticipate these changes in fundamentals, take action, and benefit from these trends in order to increase subsequent returns for their investors.

Index (Period observed: 2012-2016)	Total Return (percent)	Price Change (percent)	Dividend Return (percent)
FTSE Nareit All Equity REITs	76.1	46.9	29.2
FTSE Nareit Equity Office	72.1	46.8	25.3
Weighted Average[6]	135.3	99.0	36.4

[1] Gateway markets include Atlanta, Boston, Chicago, Los Angeles, New York, San Francisco, and Washington DC.

[2] Secondary markets include Austin, Dallas, Denver, Houston, Nashville, Phoenix, San Jose, Seattle, and Tampa. Tertiary are the next 31 largest metros.

[3] Secondary and tertiary markets are approximately 80 percent suburban, in terms of square feet. Gateway markets, in contrast, are 60 percent suburban. Because of the small sample size, demand in the CBD portions of secondary and tertiary metros was not discussed.

[4] The statistic presented here is office using employment, which includes financial and professional business services, as well as information and publishing. The excludes employment in construction, manufacturing, wholesale and retail trade, leisure and hospitality, health care, education and government.

[5] In terms of square feet.

[6] Weighted average is comprised of the top seven REITs in terms of portfolio expansion into secondary markets.

Source: Data from CoStar, S&P Global Market Intelligence and Nareit 2017.