Regional Markets for Office and Industrial Space

FEELING PAIN: REGIONAL MARKETS FOR OFFICE AND INDUSTRIAL SPACE

I've never seen anything like this in 36 years.
– Sharon Ryals-Taylor, Thalhimer Commercial Real Estate

Real estate professionals usually divide the commercial real estate market into five sub-markets: (1) multifamily housing; (2) office; (3) industrial; (4) retail; and (5) hotels and casinos. Last year, we examined the hotel market. This year, we focus on the office and industrial space market segments, which have been going through difficult times.

Our primary data source for the office space and industrial space markets is CoStar Group Inc., the most prominent provider of information, marketing and analytic services to commercial real estate professionals. CoStar offers its customers online access to the most comprehensive database of commercial real estate information in the United States, as well as the United Kingdom and France. Founded in 1987 and headquartered in Bethesda, Md., CoStar employs 1,400 people and has what is believed to be the largest professional research organization in the industry. Its national database includes records on approximately 2.8 million properties containing 69.1 billion square feet of space.

Our focus here is on the existing inventory of space (supply), occupied space (demand), property availability rates and quoted monthly rental/lease rates for office and industrial space, all between 2005 and 2009. Note that quoted monthly rental/lease rates do not include any concessions offered to tenants. Such information would be very interesting, but is not available. We compare Hampton Roads to Charlotte, Raleigh-Durham, Jacksonville, Richmond and Savannah. Our choice of the time period 2005 to 2009 primarily reflects the availability of data, though it also very nicely spans years when the market was booming to recent years when the market has been depressed.

Some words of caution are in order. Data reported here are from the *fourth quarter* of the year and were extracted from CoStar's database on May 14, 2010. The numbers shown here are subject to change because CoStar's database is live, dynamic and constantly being revised. CoStar Market Reports are best viewed as a snapshot taken at a point in time; this picture will be different over time. For example, when buildings are added to the database, or delivery dates on buildings change, this alters CoStar's data set.

CB Richard Ellis and CoStar are the two major providers of historical information on office and industrial markets, and their data definitions differ slightly. We rely upon CoStar's definitions here.

Employment is a very rough thermometer of the health of the commercial real estate market, since firms that have no employees do not need commercial real estate space. Here, we examine office employment in our six comparable metropolitan regions. (Employment in manufacturing, trade, transportation and utilities is included in industrial employment.)

Table 1 reports employment levels and growth trends in three areas: non-farm employment, industrial employment and office employment. We focus on our six regions from 2005-07 and 2007-09. **One can see in Table 1 that all of the other markets saw larger increases in non-farm**

employment, industrial employment and office employment than Hampton Roads between 2005 and 2007. However, the onset of the recession produced negative employment growth in all three categories for 2007-09. Indeed, in the industrial employment category, losses were particularly severe and wiped out all the gains observed from 2005 to 2007. In several cities, this also was true for office employment.

What is the absolute size of the commercial real estate markets in the six metropolitan areas? Table 2 provides some notion of relative size in 2007, which was the historical peak. Now, in 2010, employment levels are below those of three years ago.

TABLE 1

CHANGES IN TOTAL NON-FARM, INDUSTRIAL AND OFFICE EMPLOYMENT, 2005 to 2009

	Percent Growth in Total Non-Farm Employment		Percent Growth in Industrial Employment		Percent Growth in Office Employment	
	2005-07	2007-09	2005-07	2007-09	2005-07	2007-09
U.S.	2.91	-4.85	0.81	-9.08	3.93	-7.28
Charlotte	8.68	-5.78	4.18	-9.43	11.01	-7.25
Raleigh-Durham	9.21	-2.38	5.18	-8.76	10.15	-4.20
Hampton Roads	1.91	-4.63	0.00	-9.24	2.17	-6.19
Jacksonville	4.99	-7.57	3.31	-9.20	3.33	-10.02
Richmond	2.86	-4.61	1.32	-9.71	3.65	-6.59
Savannah	7.74	-6.20	4.32	-7.89	12.30	-16.25

Sources: Bureau of Labor Statistics, U.S. Department of Labor and the Old Dominion University Economic Forecasting Project

TABLE 2

NON-FARM, INDUSTRIAL AND OFFICE EMPLOYMENT IN SELECTED MARKETS, 2007

	Total Non-Farm Employment		Industrial Employment		Office Employment	
		Rank		Rank		Rank
Charlotte	859,900	1	261,800	1	233,000	1
Raleigh-Durham	803,000	2	203,200	2	185,500	2
Hampton Roads	775,300	3	201,200	3	159,900	4
Jacksonville	633,800	4	171,800	4	164,600	3
Richmond	633,300	5	160,700	5	156,200	5
Savannah	161,400	6	50,700	6	28,300	6

Sources: Bureau of Labor Statistics, U.S. Department of Labor and the Old Dominion University Economic Forecasting Project

The Office Market

Graph 1 displays the supply of available office space as measured by existing inventory in square feet, 2005-2009, for our six chosen markets. The Charlotte and Raleigh-Durham office markets are the largest and the Savannah market is the smallest. Note that the supply of office space trended modestly upward in all six markets through 2009 despite the cooling of the economy. It's little wonder, then, that problems have emerged in these markets and rental rates have begun to fall.

Graph 2 displays "availability rates" for office space in the six markets. Availability rates are not the same as vacancy rates because they take into account space that might currently be occupied, but shortly will become available, as well as new space that shortly will become available and therefore can be rented. Vacancy rates, on the other hand, trace only space that is unoccupied and do not address space that is "available" for rental or lease.

Availability rates are preferred because they are slightly more sensitive measures than vacancy rates of what is actually going on in commercial real estate markets. Note that availability rates ordinarily will be higher than the vacancy rates. **In 2006, availability rates began to climb in all six markets and by 2009 vastly exceeded those in 2005. Savannah's availability rate in 2009 (19.97 percent) was particularly elevated and was substantially higher than that in Hampton Roads (14.68 percent), even though the growth of Savannah's port traffic outstripped Hampton Roads from 2005 to 2009.**

What impact did these rising availability rates have upon rental rates for office space? Graph 3 provides quoted "full-service rental rates" for each of the six metropolitan area office markets between 2005 and 2009. Full-service rental rates are inclusive of all operating expenses such as utilities, electricity, janitorial services, taxes and insurance. One can see that these rates increased in every market from 2005 to 2008, but declined in 2009 in every market except Jacksonville. Quoted rents are lowest in Richmond and generally highest in Charlotte and Raleigh-Durham. Through 2007, Hampton Roads had the second-lowest rental rates among the six regions, but beginning in 2008, the glut of available space in Savannah pushed rates there below those in Hampton Roads.

Table 3 brings together several important measures of office space activity. Included in the table are changes that have occurred in the existing inventory of office space, office space actually occupied and quoted rental rates for office space in the six metropolitan regions between 2005 and 2009. Because of the recession, we have divided the time period into two segments, 2005-07 and 2007-09. We can summarize these data as follows:

- The supply of office space increased in each of the six markets from 2005 to 2009 and by fully 12.46 percent in Hampton Roads.
- Office space actually occupied by tenants increased in every market, 2005-09, but declined in three of the six markets, 2007-09. In Hampton Roads, occupied space increased only .7 percent between 2007 and 2009.
- Quoted rental rates for office space rose in all markets, 2005-09, and increased by 10.75 percent in Hampton Roads. This rate tapered off to 3.23 percent in Hampton Roads from 2007 to 2009. Note, however, that in Graph 3, we found that between 2008 and 2009, quoted rental rates declined in five of six markets. Hence, supply and demand were strongly out of balance by 2009 and landlords dealt with this by reducing their rates. In Hampton Roads, the average per-square-foot full-service rental rate declined from $18.40 in 2008 to $18.23 in 2009. This sharp reversal from previous years' increases underlines that by 2009, the office space market in our region had transitioned from high levels of occupancy and rising rates to much less bountiful times for landlords and more attractive times for renters.

TABLE 3

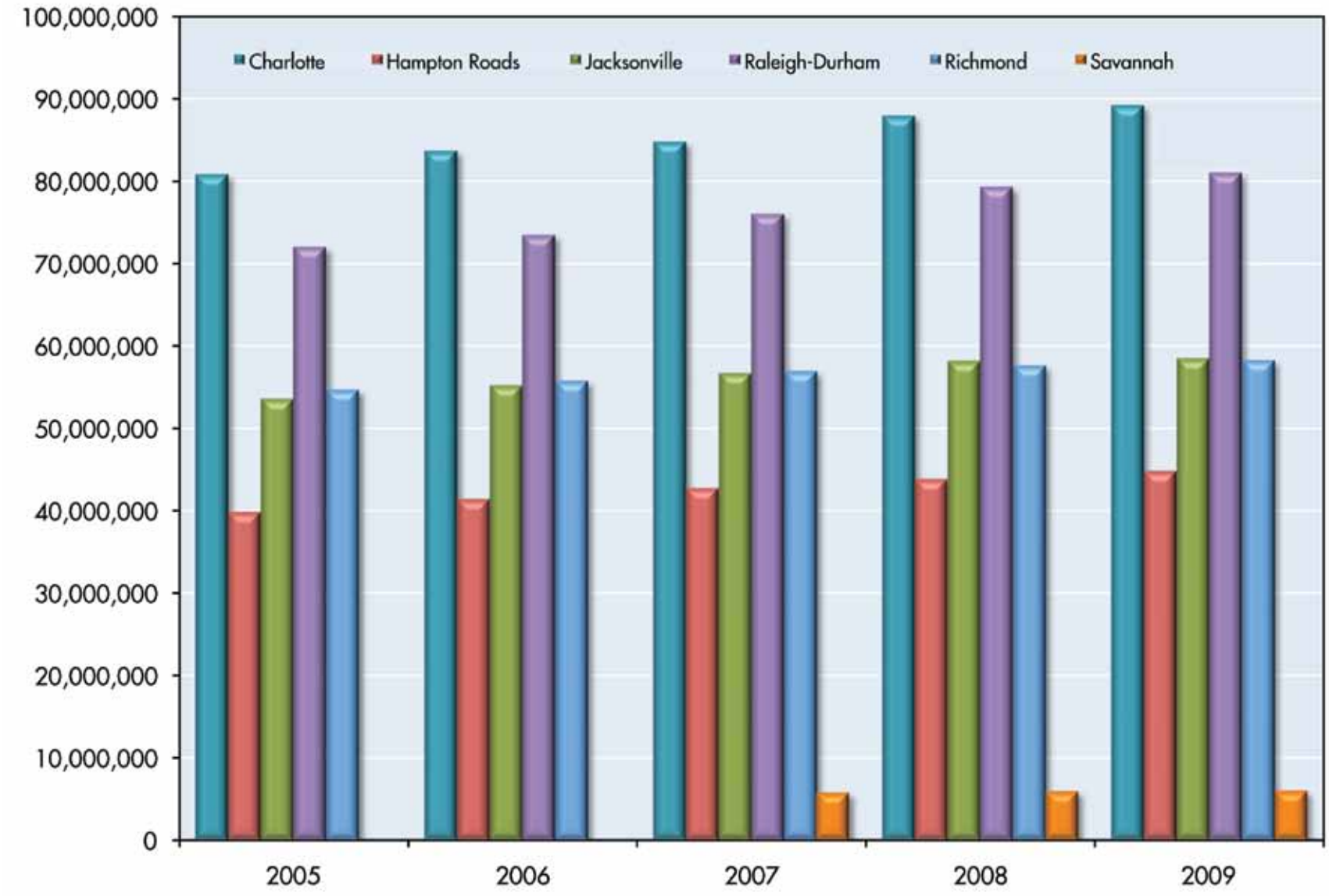
CHANGES IN SUPPLY, DEMAND AND QUOTED RENTAL RATES FOR OFFICE SPACE, 2005-2009

	Percent Growth in Existing Inventory			Percent Growth in Occupied Space			Percent Growth in Average Quoted Rental Rate			2009 Existing Inventory in Square Feet	Rank by SF
	2005-09	2005-07	2007-09	2005-09	2005-07	2007-09	2005-09	2005-07	2007-09		
Charlotte	10.36	4.91	5.20	8.10	6.88	1.14	7.52	4.09	3.29	89,213,662	1
Raleigh-Durham	12.48	5.54	6.58	11.04	6.79	3.98	8.88	10.34	-1.42	80,998,667	2
Jacksonville	9.20	5.86	3.15	6.50	7.70	-1.12	12.19	9.04	2.89	58,446,708	3
Richmond	6.56	4.17	2.29	3.53	5.61	-1.97	7.41	5.37	1.94	58,253,821	4
Hampton Roads	12.46	7.29	4.83	5.78	5.05	0.70	10.75	7.29	3.23	44,750,034	5
Savannah	N/A	N/A	3.91	N/A	N/A	-0.58	N/A	N/A	-3.15	5,980,608	6

Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

GRAPH 1

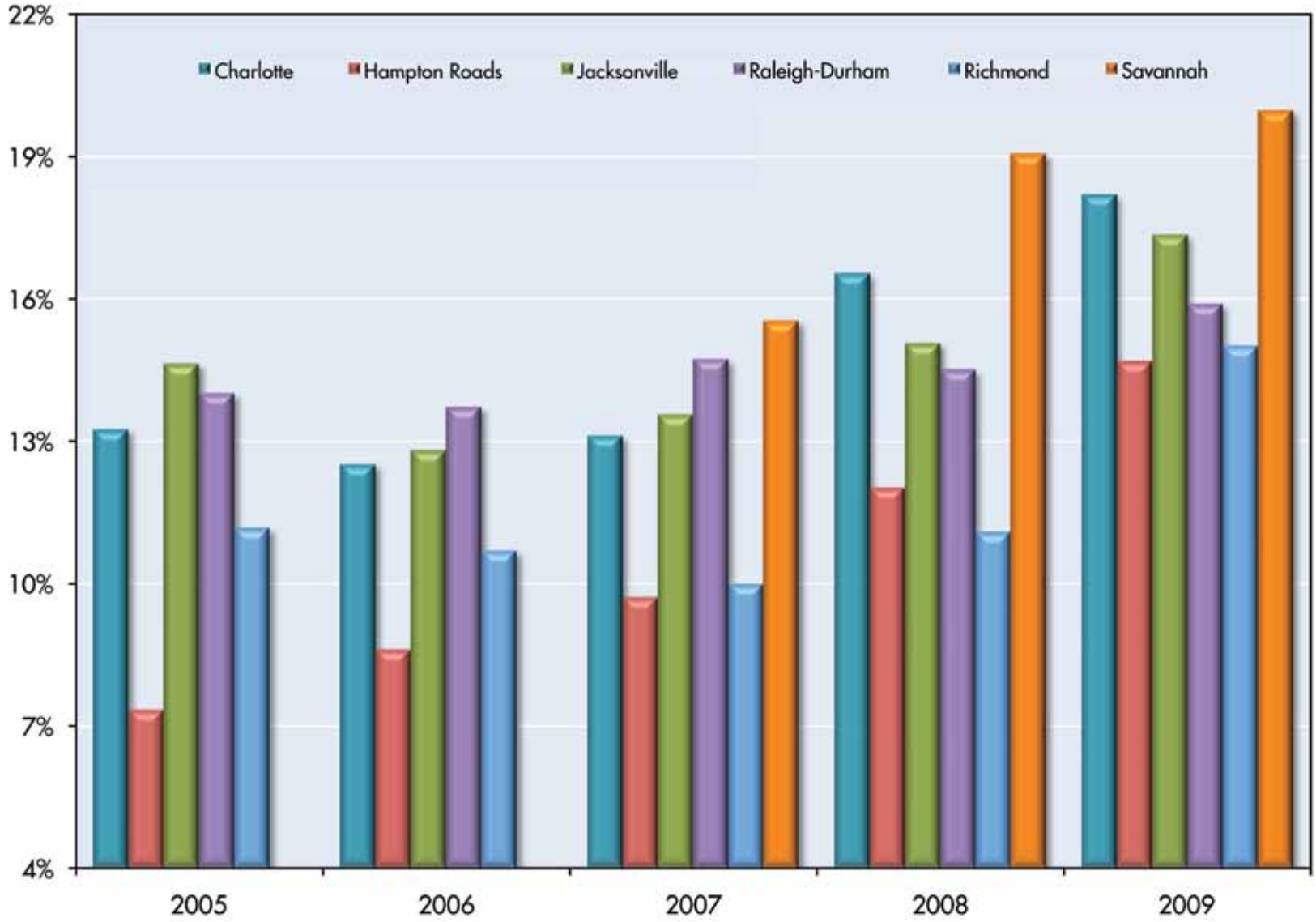
SUPPLY OF OFFICE SPACE MEASURED BY EXISTING INVENTORY (SQUARE FEET), SIX METRO AREAS, 2005-2009



Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

GRAPH 2

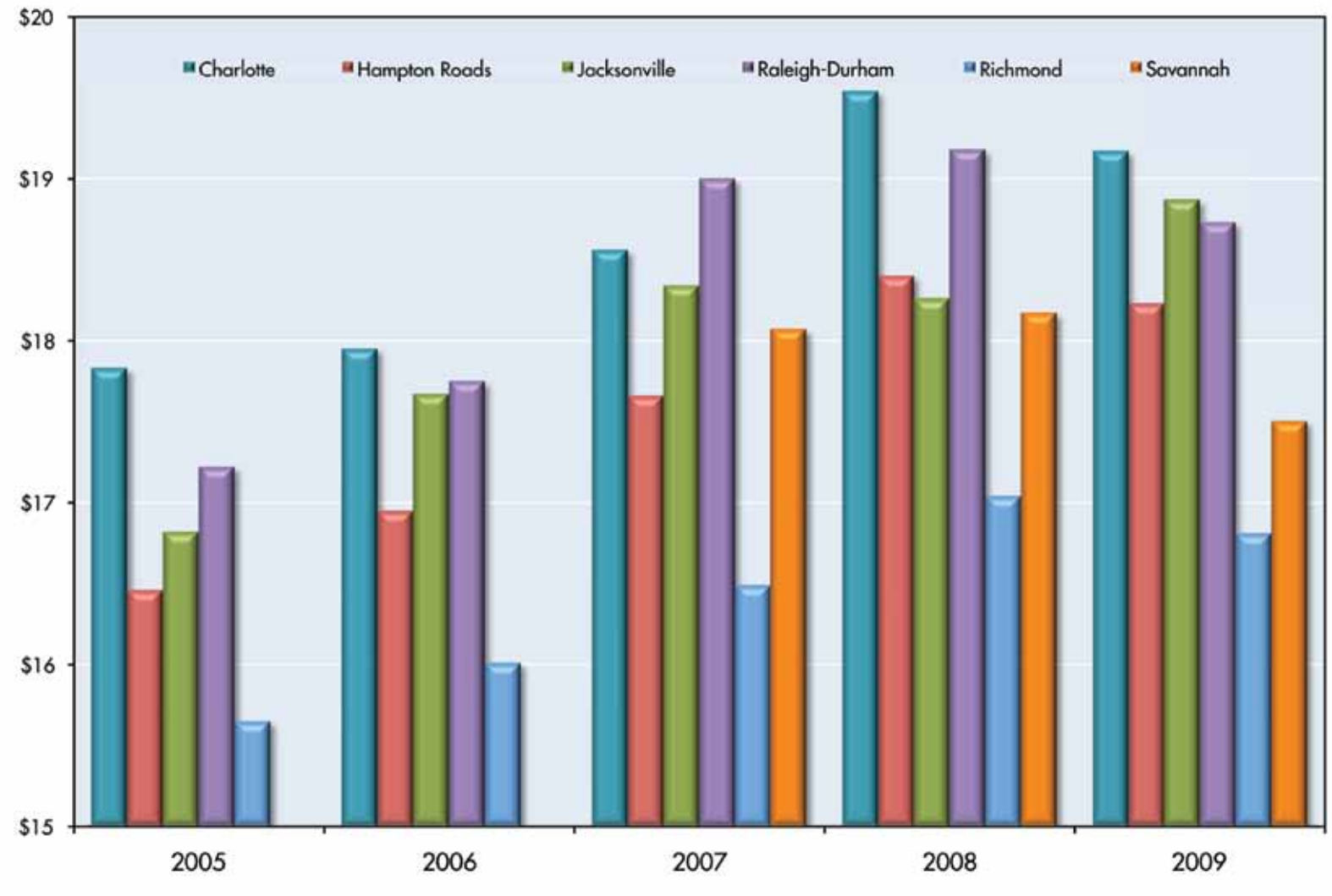
AVAILABILITY RATES FOR OFFICE SPACE, SIX METRO AREAS, 2005-2009



Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

GRAPH 3

AVERAGE QUOTED FULL-SERVICE RENTAL RATE OF OFFICE SPACE, SIX METRO AREAS, 2005-2009



Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

The Industrial Market

What about industrial commercial real estate space? Graph 4 displays the supply of available industrial space from 2005 to 2009 as measured by existing inventory. Because the Charlotte industrial market is more than twice as large as any of the other markets, its supply is not shown here. The supply of industrial space increased in all the six markets, 2005-09, though sometimes only modestly. In Hampton Roads, for example, the supply of industrial space increased by 8.1 percent from 2005 to 2009, while the comparable growth rate in Charlotte was only 3.6 percent.

Graph 5 gives availability rates for industrial space in these markets. Except for Hampton Roads, availability rates declined in the metropolitan areas between 2005 and 2007. Thereafter, availability rates increased, usually substantially (to more than 41 percent in Savannah in 2009). Hampton Roads, however, is the outlier in this arrangement. **The availability rates for our industrial space never declined in the boom years from 2005 to 2007 and actually rose every year from 2005 to 2009. In our region, then, the market for industrial space has been glutted and suffering for at least half a decade.**

Graph 6 provides information on average quoted "triple net lease" rates for industrial space in the six markets, 2005-09. In a triple net lease, each tenant is responsible for her proportionate share of property taxes, property insurance, common operating expenses and common area utilities related to the property in which they are located. Tenants are further responsible for all costs associated with their own occupancy, including personal property taxes, janitorial services and all utility costs. In all six markets, triple net lease rates increased from 2005 to 2006, but then began to decline in most of the markets. **By 2009, rates were declining in every market and many were below the 2005 level. In Hampton Roads, for example, triple net lease rates in 2009 had fallen to $4.88 per square foot, 11.5 percent below the 2005 level.**

Table 4 brings together data for the industrial space markets in the six metropolitan areas. Included here are changes in existing inventory (supply), occupied space (demand) and quoted lease rates, all for 2005 through 2009. One can summarize these results as follows:

- The supply of industrial space grew in each of the six markets (Charlotte, Jacksonville, Richmond, Hampton Roads, Raleigh-Durham and Savannah) between 1.57 percent and 8.05 percent.
- The supply of industrial space grew most rapidly in Hampton Roads (8.05 percent).
- Space actually occupied, however, declined in one of the six markets between 2005 and 2009 and in five of the six markets between 2007 and 2009.
- Occupied industrial space grew in Hampton Roads by .78 percent from 2007 to 2009, but as noted below, this required significantly lower rental rates.
- Quoted triple net lease rental rates declined in one of the six markets between 2005 and 2009, but in all six markets between 2007 and 2009.
- **Hampton Roads experienced the greatest decline in triple net lease rates, -10.29 percent from 2005 to 2009 and -13.63 percent from 2007 to 2009. It is apparent that the significant increase in the supply of industrial space in our region required landlords to offer substantially lower rental rates.** Only Savannah, among the other metropolitan regions, has faced similar circumstances.

TABLE 4

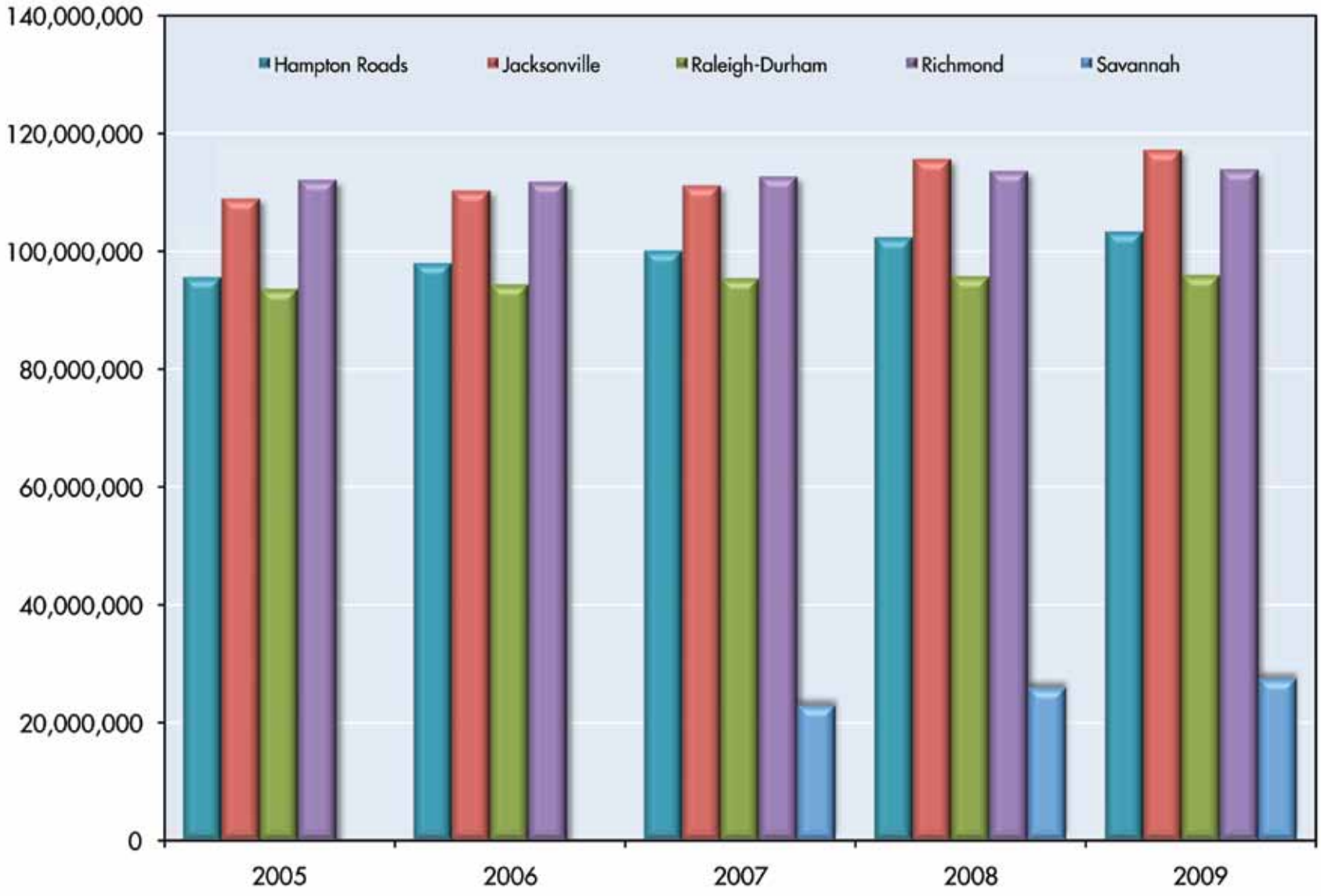
CHANGES IN SUPPLY, DEMAND AND QUOTED LEASE RATES FOR INDUSTRIAL SPACE, SIX METRO AREAS, 2005-2009

	Percent Growth in Existing Inventory			Percent Growth in Occupied Space			Percent Growth in Average Quoted Rental Rate			2009 Existing Inventory in Square Feet	Rank by SF
	2005-09	2005-07	2007-09	2005-09	2005-07	2007-09	2005-09	2005-07	2007-09		
Charlotte	3.59	2.24	1.31	2.54	3.31	-0.75	3.76	11.29	-6.76	276,233,005	1
Jacksonville	7.55	2.02	5.42	2.73	3.13	-0.38	10.71	21.17	-8.63	117,173,443	2
Richmond	1.57	0.49	1.07	-2.20	1.39	-3.54	3.21	7.80	-4.26	113,807,016	3
Hampton Roads	8.05	4.67	3.23	0.50	-0.28	0.78	-10.29	3.86	-13.63	103,305,791	4
Raleigh-Durham	2.50	1.93	0.56	1.89	6.36	-4.20	0.00	12.26	-10.92	95,847,164	5
Savannah	N/A	N/A	19.80	N/A	N/A	-8.52	N/A	N/A	-3.86	27,419.765	6

Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

GRAPH 4

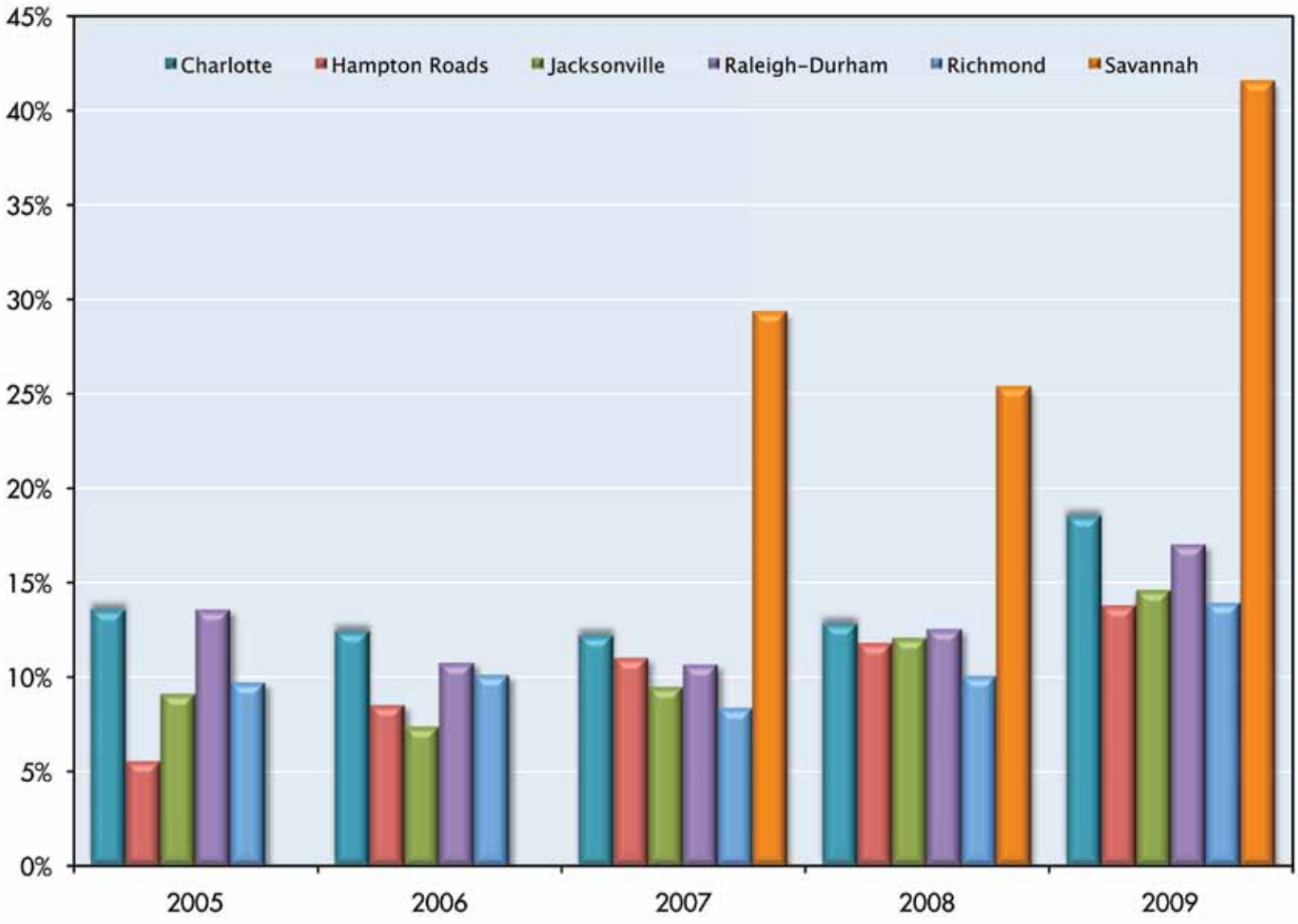
SUPPLY OF INDUSTRIAL SPACE (SQUARE FEET), FIVE METRO AREAS, 2005-2009



Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

GRAPH 5

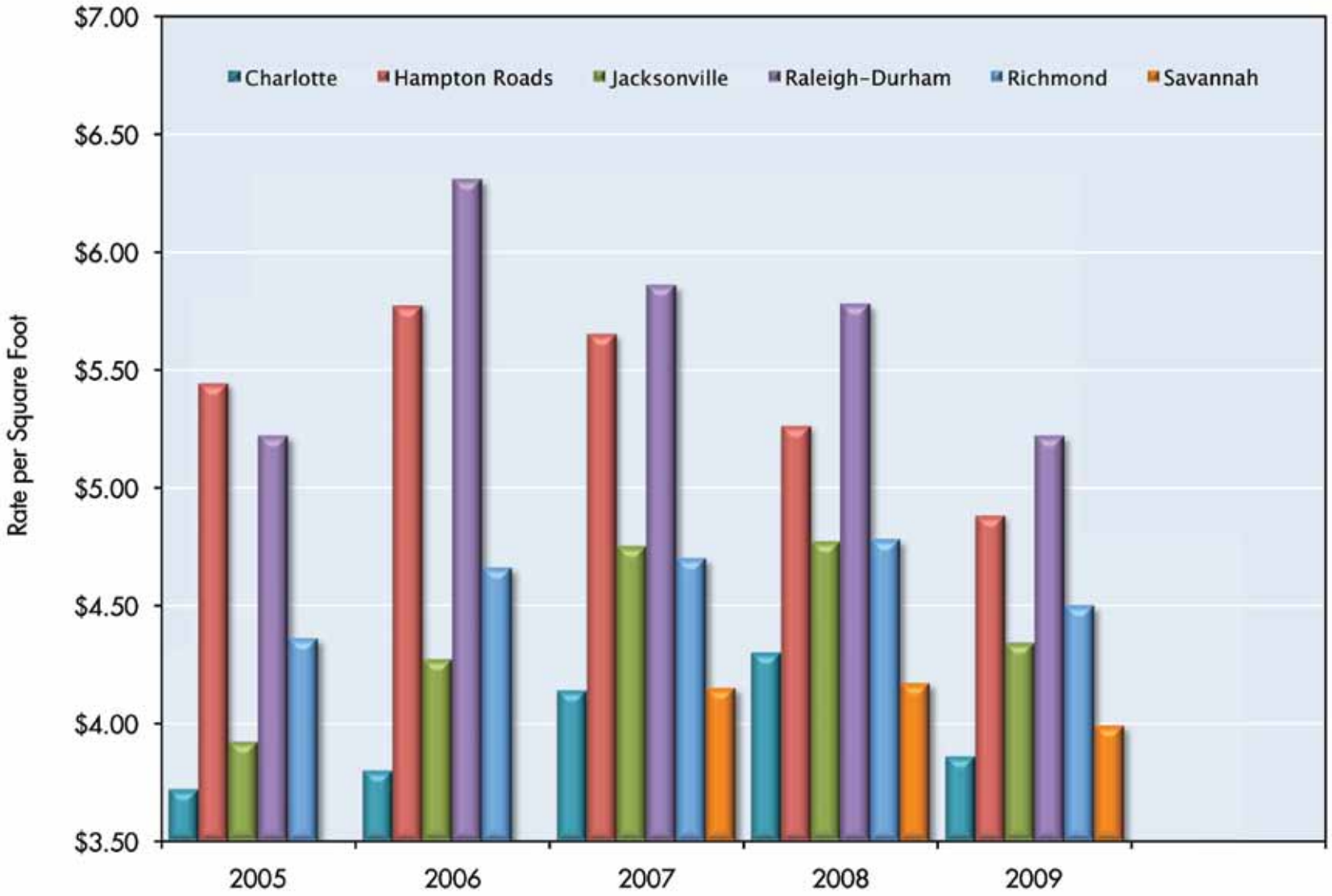
AVAILABILITY RATES FOR INDUSTRIAL SPACE, SIX METRO AREAS, 2005-2009



Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

GRAPH 6

AVERAGE QUOTED TRIPLE NET LEASE RATES FOR INDUSTRIAL SPACE, SIX METRO AREAS, 2005-2009



Sources: CoStar Group Inc. and the Old Dominion University Economic Forecasting Project

Summing It Up

In this chapter, we have examined the markets for two types of commercial real estate – office space and industrial space – and have done so by **comparing Hampton Roads to five other roughly similar southeastern U.S. metropolitan areas. It is fair to say that the shine has come off both the office space and industrial space markets, but the industrial space market has endured the most difficult times. This is true in each of the six regions – Charlotte, Raleigh-Durham, Jacksonville, Richmond, Hampton Roads and Savannah.**

Here in Hampton Roads, availability rates for office space have increased every year since 2005, at least partially because additional space has become available. In simple terms, the supply of office space is outstripping the demand for it, and this stimulated a decline in office rental rates between 2008 and 2009 after several years of healthy growth.

The market for industrial space has been disrupted substantially in Hampton Roads. The availability rate of industrial space within our region has increased every year since 2005, a direct implication of additional space coming online in a time of economic recession. The pain of adjustments in the regional industrial space market has been more severe than in the office space market. Between 2007 and 2009, triple net lease rates fell 13.63 percent in Hampton Roads, a sign of a glutted market in which supply and demand are well out of balance. Triple net lease rates in our region fell to only $4.88 per square foot in 2009, well below the $5.44 rate that reigned in 2005, and it seems likely that further declines are in store. It is a good time to be a lessee and a bad time to be a lessor.

How long will this last? Much depends upon the speed of national economic recovery. An expanding national economy would be quite helpful to regional commercial real estate markets. However, while necessary, this may not be sufficient. Hampton Roads is heavily dependent upon Department of Defense spending; approximately 45 percent of our regional economic activity relates directly and indirectly to defense spending. If this spending decelerates, or aircraft carrier groups are moved out of the region or the mix of defense spending changes to the detriment of the U.S. Navy, then the regional economy could remain in a torpor for years to come. Transportation problems and water inundation challenges will only exacerbate the situation.

It is fair to say that the market for office space in Hampton Roads is closer to recovery and equilibrium than the market for industrial space. Seasoned commercial real estate professionals label this the most severe contraction since the Great Depression of the 1930s. We can only hope that our experience over the next decade does not imitate that period in history because then it took more than 15 years for the commercial real estate markets to show substantial recovery.

Appendix: Some Definitions

Office Space: The CoStar Office Report, unless specifically stated otherwise, calculates office statistics using CoStar Group's entire database of existing and under-construction office buildings in each metropolitan area. Included are office, office condominium, office loft, office medical, all classes and all sizes, and both multi-tenant and single-tenant buildings, including owner-occupied buildings. Excluded is office space on federal government properties (e.g., military installations) and at other governmental facilities (e.g., Norfolk International Terminals, Newport News Marine Terminal and Portsmouth Marine Terminal). All rental rates reported in the CoStar Office Report have been converted to full-service-equivalent rental rates. Office space data used in this report include all types of space: Class A, Class B and Class C.

Industrial Space: The CoStar Industrial Report calculates statistics using CoStar Group's database of existing, under-construction and under-renovation industrial buildings in each given metropolitan area. All industrial building types are represented regardless of size, including warehouse, flex, research and development, distribution, manufacturing, industrial showroom and service buildings. The report also gives statistics for both single-tenant and multi-tenant buildings, including owner-occupied buildings. A flex building is designed to be versatile, and may be used in combination with office (corporate headquarters), research and development, quasi-retail sales and, including, but not limited to, industrial, warehouse and distribution uses. At least half of the rentable area of the building must be used as office space. Flex buildings typically have ceiling heights under 18 feet, and are zoned as light industrial.

However, the data exclude industrial areas such as airports, airplane hangars, auto salvage facilities, cement/gravel plants, chemical/oil refineries, contractor storage yards, landfills, lumberyards, railroad yards, self-storage, shipyards, flex telecom hotel/data hosting, industrial telecom hotel/data hosting, utility substations and water treatment facilities. Also excluded are industrial facilities on federal government properties and at other governmental facilities. All rental rates reported in the CoStar Industrial Report are calculated using the quoted triple net (NNN) rental rate for each property.

Existing Inventory: To be included, buildings must have received a certificate of occupancy and be able to be occupied by tenants. Generally, this measure includes a percentage of common areas including all hallways, main lobbies, bathrooms and telephone closets. It does not include space in buildings that are either planned, under construction or under renovation.

Vacant Space: This is defined as space that is not currently occupied by a tenant, regardless of any lease obligation that may exist. Vacant space could be space that either is available, or not available. For example, sublease space that is currently being paid for by a tenant, but not occupied by that tenant, would be considered vacant space.

Occupied Space: This represents the difference between existing inventory and vacant space.

Available Space: This is the total amount of space that is marketed as available for lease in a given time period. It includes any space that is available, regardless of whether the space is vacant, occupied, available for sublease or available at a future date.

Availability Rate: This is the ratio of available space to total rentable space, calculated by dividing the total available square feet by the total rentable square feet, as measured by existing inventory.

Vacancy Rate: This measurement is expressed as a percentage of the total amount of physically vacant space divided by the total amount of existing inventory.

Full Service Rental Rate: This is a measure of rental rates for space reported to be office space, including all operating expenses such as utilities, electricity, janitorial services, taxes and insurance.

Industrial Building: This is a type of building adapted for such uses as the assemblage, processing and/or manufacturing of products from raw materials or fabricated parts. Additional uses include warehousing, distribution and maintenance facilities. The primary purpose of the space is for storing, producing, assembling or distributing a product.

Triple Net Lease (NNN): In a triple net lease, tenants are responsible for their proportionate share of property taxes, property insurance, common operating expenses and common area utilities. Tenants are further responsible for all costs associated with their occupancy, including personal property taxes, janitorial services and all utility costs.


www.cbre.com
For Lease
757 490 3300
15,488 to 41,846 SF
Ashton Williamson
Worth Remick
Blake Dozier
CBRE
Swim Ways
5816