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MINNEAPOLIS/ST. PAUL

OFFICE HOME – JULY 2013

Vacancy Edges Lower, But Slowdown in Activity Casts Mid-Year Shadow over Office Market

- Positive absorption indicates a continuing recovery
- Activity slowed noticeably in the second quarter
- Rental rate increases taking hold in core class A properties

Overview

Activity in the Twin Cities multi-tenant office market slowed in the first half of 2013. The market seemed to take a deep breath in the wake of the nearly 1 million square feet (msf) of absorption that occurred in 2012. The recovery is still underway, albeit at a slower-than-anticipated pace.

Tepid demand limited the decrease in overall vacancy to just a 0.5% downward tick, resulting in a mid-year market-wide vacancy rate of 17.5% for direct space, 18.7% including available sublease space. The market is on track to record a third consecutive year of declining vacancy.

Positive Absorption in Nearly All Submarkets

The West submarket was again the top performer, posting 198,000 square feet (sf) of absorption. The Southwest delivered 125,000 sf of absorption. In all, six of the seven Twin Cities submarkets recorded positive absorption—the lone exception being the Minneapolis Central Business District (CBD), which confounded expectations with negative 104,000 sf of absorption.

Demand for Space Lethargic

A lot of deals were made at the low ebb of the market a few years ago when the market was basically on sale. Companies took advantage of the downturn to lock in low rates and longer-term leases. Now the market is feeling the effect of that bargain-based leasing approach, in the form of lower space demand. It helps explain why the leasing market was so sluggish during the first half of the year.

Small space users also remain sidelined, unwilling or unable to move. The high cost of relocation is keeping them in place. Submarkets such as the Southwest and the South/Airport have yet to see their small-space users come back into the market since the Great Recession. That's not the case in the Northeast submarket, which has experienced renewed demand from smaller space users—potentially a harbinger of things to come for other submarkets. For the Northeast, the biggest challenge is a dearth in demand from larger space users. The submarket has a significant number of large space options available for users.

Even among larger space users, demand is unusually slow so far this year. The West submarket posted the best overall results, 198,000 sf of positive absorption, yet much of that was attributable to the Wells

Fargo lease at Metropoint signed in 2012 with the actual occupancy occurring in 2013. Larger space users have limited options among class A properties in the West, which boasts an 11.2% class A vacancy rate and a 12.7% vacancy rate overall—the lowest in the Twin Cities.

Class A Rental Rates Inching Upward

Rental rates are on the rise in select class A buildings throughout most of the Twin Cities submarkets, including the Minneapolis CBD. New owners of some of the CBD's premier office buildings are pushing for higher rates and achieving them. Rate growth is also happening among the premier class A properties in submarkets such as the West, Southwest and St. Paul CBD. The proof is in the numbers: quoted class A rates (net) were up $0.54 per square foot (psf) in the past six months, rising to $15.74 psf at mid-year. Quoted rates for class C properties ticked down to $8.60 at mid-year from $8.75 at year end.

Outlook

The Twin Cities office leasing market is off to a slower-than-anticipated start this year. It now appears that total absorption for the year will be in the neighborhood of 675,000 sf, versus an earlier projection of 1.3 msf. Since January 2013, Twin Cities employers have added more than 20,000 jobs in areas critical to the health of the office market—financial services, business and professional services and information technology—compared with adding only 13,000 jobs in the same areas for all of 2012. It will take several more quarters of solid job growth to rekindle more robust demand. Economic uncertainty is also tamping down demand as corporate America continues to take a conservative view of economic trends.

Many companies are rethinking how they use their office space—in particular, allocating less space per employee. Some major employers in the Minneapolis CBD have taken that approach, which means that even if their head count stays the same, they still need less space when their leases come up for renewal. This trend could significantly affect the multi-tenant office market for some time.

One more trend to watch in coming months is the repurposing of outdated office properties to other uses. It's happening in both of the CBDs, where some existing office buildings are being converted to residential uses, for example. Flexibility may be a key to survival for some landlords.