

*Why is
this real
estate cycle
different
from
previous
real estate
cycles?*



Low Interest Rates and Densification

In 2017, the Effective Rent Index tracked by Savills Studley started to peak in many markets in the U.S., driven by landlord concession packages rising significantly in these markets. By now, following the six- to eight-year cyclical pattern established over the last 40 years, commercial rents should have started to drop as landlords struggle to fill an oversupply of available space. Instead, effective rents have plateaued in many markets.

There is no indication of a significant real estate downturn, despite the fact that the U.S. economy is now nine years past the end of the last recession. This paper explores the two main reasons the U.S. commercial real estate market is now experiencing the longest unbroken up cycle in the last 40 years: historically low interest rates and office space densification.

Even with the recent increases, the federal funds rate is historically low.

The commercial real estate market normally follows a six- to eight-year boom-and-bust cycle [see Chart 1]. Asking rents usually rise as expanding business activity drives demand for space. Rents then drop precipitously during recessions as landlords try to fill vacancies. What's different now is that landlords have been able to sustain higher rents by using low interest rates to fund up-front concessions to lure new tenants. Meanwhile, tenants have been able to afford higher rent by fitting into smaller footprints, e.g., densification.

Chart 1: Real Estate Up Cycles: Last 40 Years

Cycles	Length (years)
1983–1989	7
1993–2000	8
2002–2007	6
2010–?	?

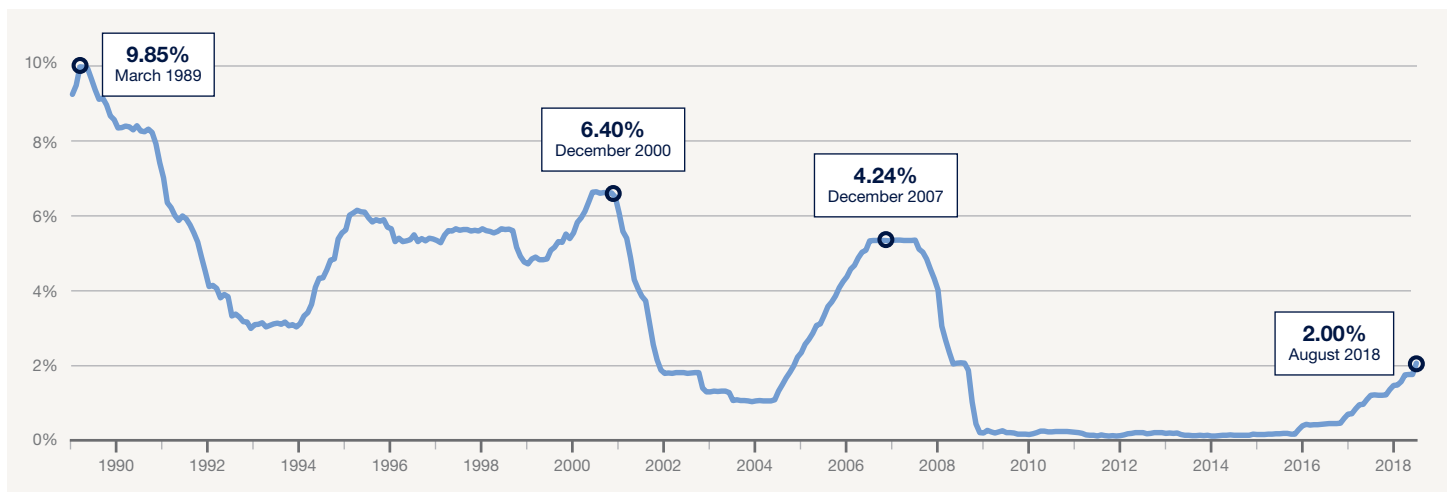
Source: Savills Studley Research

Low Interest Rates Fuel Higher Concessions

A major role of the Federal Reserve ("Fed") is to respond to economic downturns by loosening monetary policy, lowering interest rates to stimulate spending. As the economy recovers, the Fed raises interest rates to slow the rise of inflation.

What makes the current cycle unusual is that, in response to the 2008 financial crisis, the Fed lowered its Federal Funds Rate to effectively zero, the lowest rate in its history. Further, the Federal Funds rate remained near zero until December of 2015. Then, the Fed began incrementally raising its rate. Currently, the Federal Funds Rate is 2.00 percent. Even with the recent increases, the federal funds rate is historically low [see Chart 2].

Chart 2: Historical Federal Funds Rate at End of RE Up Cycles



Source: U.S. Federal Reserve

The present market's extremely low interest rates make it less expensive for landlords to aggressively increase concession packages to avoid slashing their gross rents. Examples of landlord concessions include (1) Tenant Improvement (TI) allowances, which tenants can apply toward design and construction costs when they sign or renew a lease, and (2) free rent for a number of months to over a year. In other words, higher concessions are an alternative way for landlords to stimulate demand.

By offering higher concessions, landlords have been able to increase, or at least sustain, most Negotiated (Gross) Rents in various markets by steadily increasing concessions packages [see Chart 3].

Chart 3: 2018/2017 Effective Rent Index¹

Market	Negotiated (Gross) Rent		Concessions		Tenant Effective Rent	
Chicago	\$50.49	0.3% ↑	\$129.00	6.6% ↑	\$33.64	2.6% ↓
Los Angeles: Downtown	\$44.69	6.4% ↑	\$105.00	6.4% ↑	\$30.98	6.6% ↑
Manhattan: Midtown	\$96.09	-7.0% ↓	\$181.69	8.5% ↑	\$72.36	11.2% ↓
Manhattan: Downtown	\$58.46	3.7% ↑	\$129.00	24.0% ↑	\$39.47	7.8% ↓
San Francisco	\$79.90	2.4% ↑	\$104.69	2.2% ↓	\$67.65	8.8% ↑
Washington, DC	\$70.70	6.0% ↑	\$201.88	21.7% ↑	\$44.33	1.5% ↓

Source: Savills Studley

Densification Prevents Demand From Overheating

Increased concession packages combined with reduced effective rents across the country give tenants the opportunity to modernize their workplaces with the amenities necessary to attract the right talent. Ever since the beginning of this decade, companies have been moving away from traditional, inefficient office layouts toward more flexible layouts. The status-conscious office design of the mid- to late-20th century meant there was a lot of excess space devoted to individual offices, and often a shortage of meeting spaces.

Modern office building floorplates enable better space utilization through open office design. This open concept is gaining popularity because it incorporates more natural light, more social space and more task-based work areas. These design innovations encourage more employee interaction and collaboration, and enhance employee productivity. And, because the design allows companies to fit more employees into less square footage, the trend has contributed to densification.

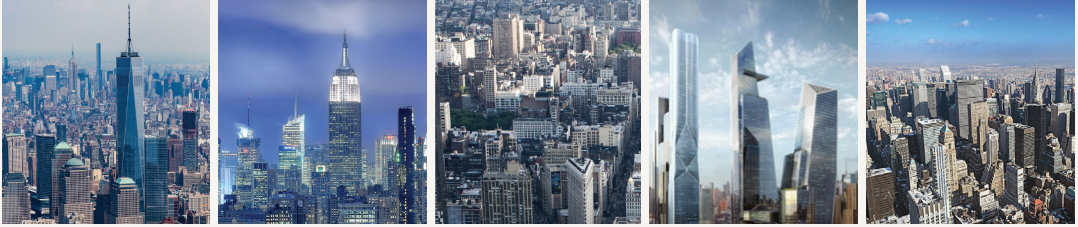
¹ Savills Studley's Effective Rent Index is based on actual lease terms that tenants pay for top tier, Class A office space. "Tenant Effective Rent" is gross rent less amortized concessions.

As many organizations have used better space optimization to reduce their footprint significantly, they have been able to upgrade to higher quality space. These space upgrades enhance a company's talent acquisition and retention efforts, while holding real estate costs in check.

In the current economic cycle, this space optimization trend has run counter to the normal expansion phase of the real estate cycle. As companies have continued to densify, landlords have more available space. This trend is particularly apparent in Manhattan.

From 2013 through Q1 2018, we analyzed all 44 office relocations from one submarket to another in Manhattan that involved 100,000 rentable square feet or more. In total, across the 44 moves, tenants were able to reduce their footprint by over 2,500,000 square feet, or 15 percent [see Chart 4].

Chart 4: Manhattan Relocations of 100,000+ SF, 2013–Q1 2018

2013 to Q1 2018					
Number of Tenants	Downtown	Midtown	Midtown South	Hudson Yards	Manhattan
 Moving From	6	27	8	3	44
 Moving To	15	9	2	18	44
Net Total	9	(18)	(6)	15	-
Total Square Footage					
 Moving From	2,887,589	12,389,659	1,485,659	678,500	17,441,407
 Moving To	4,446,590	2,317,883	687,996	7,416,949	14,869,418
Net Total	1,559,001	(10,071,776)	(797,663)	6,738,449	(2,571,989)

*Source: Savills Studley

Densification nationwide has had a significant impact on the amount of occupied office space in all markets. We have seen no sign of a slowdown in this densification trend, and we anticipate it will continue into the future. The chart below [see Chart 5] illustrates the degree of densification in five major U.S. markets over the past 8 years.

Chart 5: Occupancy/Employment 2010–2017

City	Change in Occupied Space %	Change in Employment %	Sq. Ft. Occupied by Employees %
Chicago	5.3% ↑	10.1% ↑	5.1% ↓
Los Angeles	4.5% ↑	10.6% ↑	5.6% ↓
New York City	1.7% ↑	15.2% ↑	11.7% ↓
San Francisco	12.1% ↑	26.9% ↑	11.7% ↓
Washington, DC	3.6% ↑	7.0% ↑	3.2% ↓

Source: Savills Studley/REIS

The amount of space not leased due to changes in space utilization is dramatic in all major markets. This significant change to the demand side of the equation, along with tighter credit requirements from lending institutions, has resulted in much less new speculative construction in most major markets than in previous real estate cycles [see Chart 6].

Chart 6: Space Not Occupied Due to Densification

City	Potential occupied space w/o densification (2017 msf)	Actual occupied space (2017 msf)	Shortfall due to densification (2017 msf)	% of Market	Current availability rate (June 2018)	Availability w/o densification
Chicago	429,781	408,041	21,740	5.1%	15.5%	10.4%
Los Angeles	431,373	407,388	23,985	5.6%	19.7%	14.1%
New York City	645,765	569,993	75,772	11.7%	11.7%	0%
San Francisco	178,782	157,947	20,835	11.6%	10.0%	0%
Washington, DC	461,818	447,184	14,634	3.2%	16.2%	13.0%

Source: Savills Studley

Conclusion

The significant impacts of both low interest rates and densification on the demand side of the equation will result in this real estate cycle lasting significantly longer than previous cycles. While effective rents have peaked in many major markets, we do not see any indication that the markets will enter a free fall as occurred in 2001 and 2009.



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