

THOUGHT LEADERSHIP SERIES



STATE OF U.S. OFFICE LEASING CONCESSIONS AND THE OUTLOOK FOR 12 MAJOR CITIES

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KEY FINDINGS

- ◆ U.S. office market fundamentals have strengthened steadily over the past five years with vacancy declining 320 basis points and asking rents rising approximately 17%. As of 2016, U.S. market conditions are substantively similar to those of 2006, with the exception of a significant reduction in net absorption.
- ◆ Despite market fundamentals shifting in favor of owners over the past several years, average concessions for Class A space in major U.S. cities have risen significantly during this time period. Since 2008, average tenant improvement allowances per square foot and average months of free rent per year of term have risen 66% and 73%, respectively. Meanwhile, average starting rents have also risen, albeit at a much slower rate of 21% over the same time period.
- ◆ The demand patterns for office space in the U.S. have shifted significantly over the past several years as changes in space utilization and trends toward densification, consolidation, and space efficiency have all impacted how much office space tenants require. The result has been robust competition for large tenants as a slowdown in demand for office space has yielded muted net absorption and rising concessions in most markets. These conditions have occurred despite other market metrics performing well.
- ◆ While concessions are rising on average, that is certainly not the case for every building in every market. There are many submarkets among the major metro areas that are outperforming in terms of demand and which offer much less than the national average in concessions.
- ◆ We examined 12 major metro areas and prepared a market-level qualitative analysis and an assessment of whether each market is currently landlord-favored, tenant-favored, or somewhere in between. Below is a summary of where each market is positioned as of late 2016, as well as the outlook for 2017 – 2018.

For details on concessions please see the individual market profiles.

2016 MARKET CONDITIONS SUMMARY

STRONGLY TENANT-FAVORED MARKET	MODERATELY TENANT-FAVORED MARKET	BALANCED MARKET	MODERATELY LANDLORD-FAVORED MARKET	STRONGLY LANDLORD-FAVORED MARKET
HOUSTON	NEW YORK	CHICAGO	ATLANTA	DALLAS
WASHINGTON, DC		PHOENIX	BOSTON	
			LOS ANGELES	
			MIAMI	
			PHILADELPHIA	
			SAN FRANCISCO	

2017 – 2018 MARKET OUTLOOK SUMMARY

STRONGLY TENANT-FAVORED MARKET	MODERATELY TENANT-FAVORED MARKET	BALANCED MARKET	MODERATELY LANDLORD-FAVORED MARKET	STRONGLY LANDLORD-FAVORED MARKET
HOUSTON	CHICAGO	ATLANTA	DALLAS	
	NEW YORK	BOSTON	MIAMI	
	WASHINGTON, DC	LOS ANGELES	PHILADELPHIA	
		SAN FRANCISCO	PHOENIX	

STATE OF THE U.S. OFFICE LEASING MARKET AND CONCESSIONS

The U.S. office market has been strong over the past several years, with market fundamentals tightening steadily. The overall vacancy rate has experienced a methodical decline from nearly 16.6% five years ago to 13.4% as of the third quarter of 2016. Meanwhile, average asking rents have risen 17.1% over that same time period to \$29.64/SF as of the third quarter of 2016. The U.S. office market has largely recovered from the economic downturn that started in 2008. As illustrated in the adjacent chart, **market conditions in 2016 are materially similar to those experienced at the prior market peak ten years ago**, with vacancy, rent growth and the construction pipeline the same or similar to the levels seen in 2006. **One metric that has changed significantly is net absorption, which is down compared with 2006 and which has in turn affected leasing concessions.**

While asking rents and vacancy are important measures of the market, leasing concessions are another consideration for tenants and landlords alike. Leasing concessions are the discounts, rebates or abatements offered by a landlord to incentivize a tenant to lease a particular space and are a commonly used tool in lease negotiations. (See the glossary on page 19 for definitions of other terms used in this study.) In most U.S. office markets, the most common

concessions offered are tenant improvement allowances and rental abatement, commonly given as months of free rent. As a general rule, softer leasing markets tend to see higher leasing concessions as competition for tenants increases. **Despite falling vacancy and rising rents, concessions in U.S. Class A downtown office properties have trended upwards since the Great Recession.** The adjacent chart shows leasing concessions and starting rents over the past 15 years, with all data weighted by the number of square feet leased. The average months of free rent per year of lease term has increased from 0.43 months in 2008 to 0.75 months in 2016, a 73% increase. For a ten-year deal, that equates to 7.5 months of free rent. At the same time, the average tenant improvement allowance has risen from \$41.28 per square foot in 2008 to \$68.67 per square foot as of the end of 2016, a 66% increase. Meanwhile, the average starting rent has increased at a much slower rate, rising 21% over the same time period to \$62.56 per square foot in 2016.

One possible reason concessions have risen at a much faster rate than starting rents is that landlords may be cautious about significant fluctuations in rental rates but are able to be more flexible on the concessions they offer. **Even in tighter markets, concessions are**

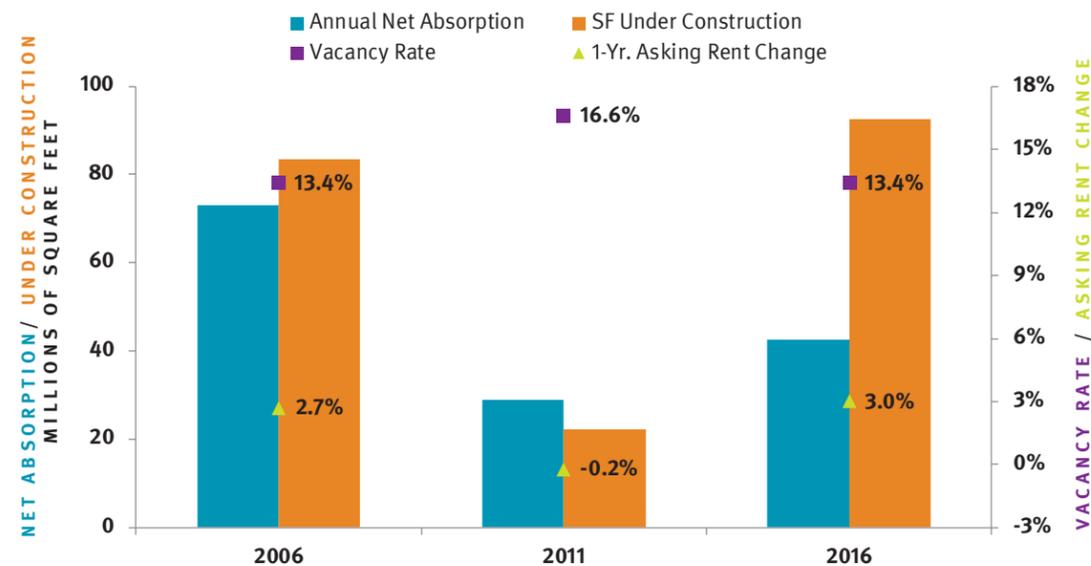
often an assumed part of a transaction, particularly for larger deals. Because of the intense competition for larger tenants that is a common theme in most major markets, especially at present, concessions have continued to increase. In softer markets, starting rents often remain flat while concessions increase, as decreasing rental rates could negatively affect a landlord's leverage in future negotiations, so additional incentives are instead offered in the form of higher concessions.

So what is driving the increase in concessions despite strong leasing fundamentals supported by steady office-using job creation? As illustrated in the chart on page 4, market conditions are very similar to those experienced at the last market peak in 2006 prior to the economic downturn. The one metric that has declined materially since that time is net absorption. **The demand patterns for office space in the U.S. have shifted significantly over the past several years as changes in space utilization and trends toward densification, consolidation, and space efficiency have all impacted how much office space tenants require.** The result has been robust competition for large tenants as a slowdown in demand for office space has yielded muted net absorption and rising concessions. These conditions have occurred

despite other market metrics performing well. **While concessions are rising on average, that is certainly not the case for every building in every market. There are many submarkets among the major metro areas that are outperforming in terms of demand and which offer much less than the national average in concessions.**

The following section examines overall market conditions and the state of concessions in 12 major U.S. cities. Important note: We have elected to aggregate the concession data from these cities to show the trends on a national level. Because concessions are so nuanced and every deal is structured differently, examining concessions at the local level could misrepresent the relative health of these markets. That is, a single large deal with a unique structure could overweight the market average and distort our findings, particularly for the moderately-sized markets. Instead, as a companion to the national concessions data with its robust sample size, we offer a market-level qualitative analysis and an assessment of whether each market is currently landlord-favored, tenant-favored, or somewhere in between. We also offer an outlook for overall market conditions in 2017-2018, including our thoughts on how concessions may change during the next two years.

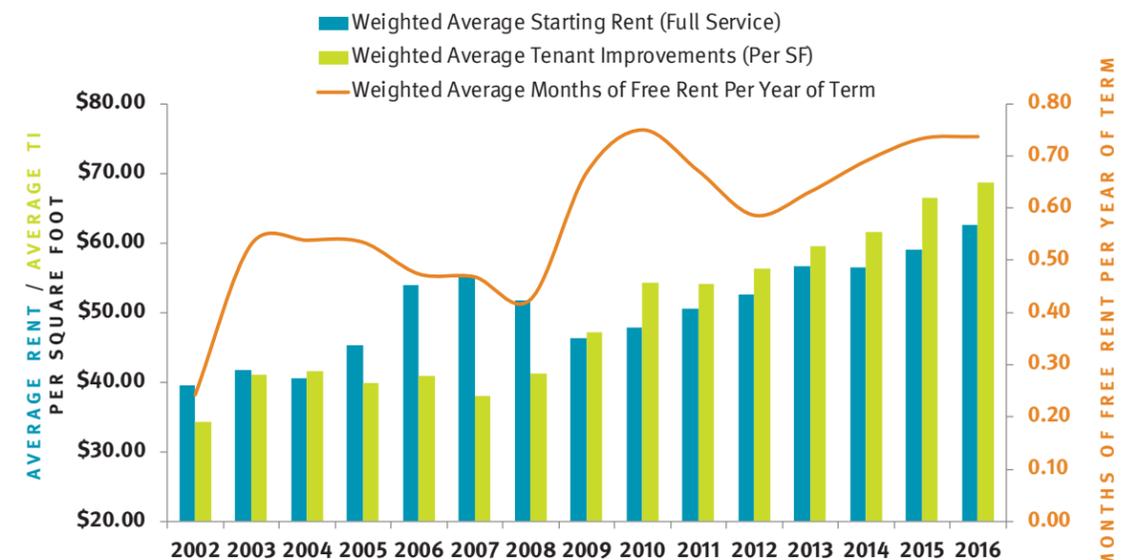
U.S. OFFICE MARKET CONDITIONS 2006 VS. 2011 VS. 2016



Note: SF under construction and vacancy rate are as of the third quarter of each year; net absorption and asking rent change are for the 12 months ending in the third quarter of each year.
Source: NGKF Research; December 2016

CLASS A CONCESSIONS IN U.S. CENTRAL BUSINESS DISTRICTS 12 LARGEST U.S. METRO AREAS

WEIGHTED AVERAGE CONCESSIONS: 2002 - 2016



Note: Among lease transactions that contained concessions. Data based on sample of the downtown or CBD areas of the 12 largest U.S. metro areas by employment. Data includes only Class A properties and direct lease transactions with a minimum term of 5 years.
Source: NGKF Research; December 2016

STATE OF LEASING CONCESSIONS AND OUTLOOK FOR 12 MAJOR U.S. CITIES



ATLANTA, GA



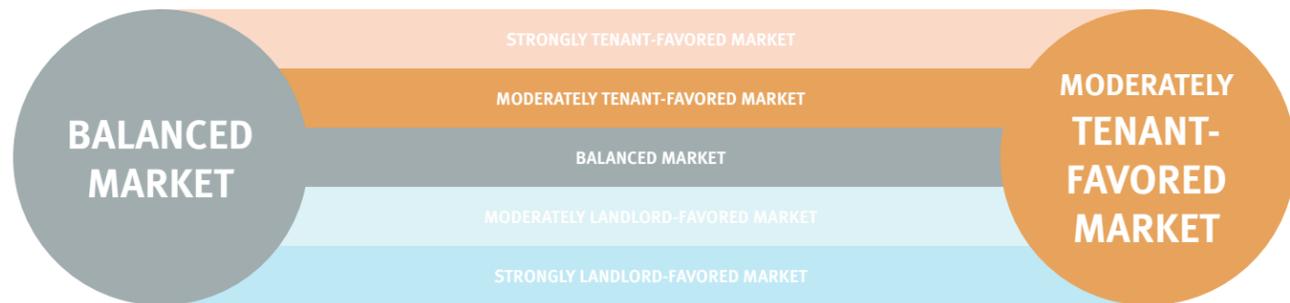
BOSTON, MA



- ◆ Concession packages in the Atlanta office market have declined gradually over the past five years as market conditions have tightened.
- ◆ Concessions have changed only gradually as landlords prefer to raise rents rather than decrease concession packages in a tightening market.
- ◆ Tenants 50,000 SF or larger seeking lease terms of seven years or more are generally able to obtain favorable concession packages across most submarkets. The Downtown and Northeast Atlanta submarkets tend to have the highest concessions as of 2016.
- ◆ Although demand has tightened over the past several years, the rate of absorption has slowed in the second half of 2016, signaling the Atlanta market is likely to become more balanced into 2017 and 2018.



- ◆ Average starting rents in Boston have continued to climb over the past five years, to the tune of 24.3%, with tenant improvement allowances also having steadily increased over the same period. The amount of free rent extended to tenants has fluctuated from 0.35 to 0.42 months per year of term since 2009.
- ◆ In 2016, both free rent and tenant improvement allowances experienced a slight decline, directly attributed to the decline in the average lease size and term. The market has seen fewer large leases this year as vacancies started to hit post-recession lows in mid-2015.
- ◆ Limited availability, high relocation costs, and the push for densification and efficiency among tenants have also been critical factors behind less robust leasing activity in 2016.
- ◆ Boston CBD will likely be a more balanced market between landlords and tenants as the supply pipeline materializes from 2017 onwards. The increase in asking rents slowed noticeably in 2016 amidst the slowdown in activity, potentially indicating that as new construction delivers, the market could see starting rents for tower and premium Class A space decline modestly along with a slight uptick in free rent.



OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

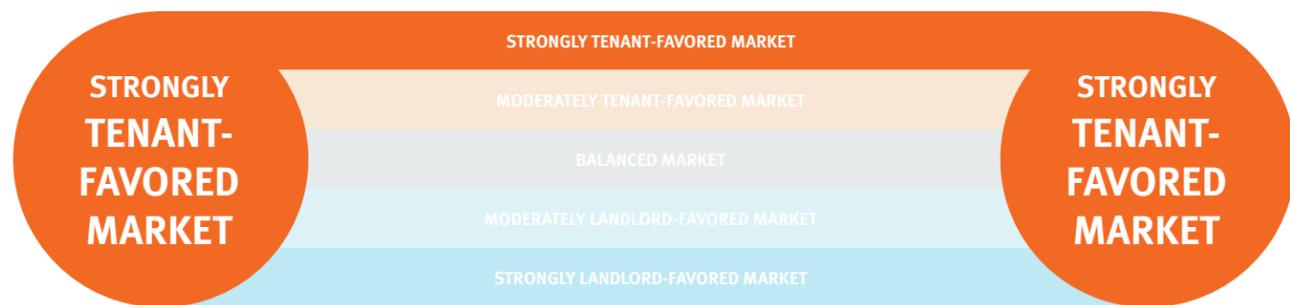
- ◆ Tenant improvement allowances spiked in the early years of the economic recovery, then leveled off during 2015, then spiked again in the past 12 months. Landlords are motivated to lease space before new supply and backfill space reach the market in 2017 and leverage shifts toward tenants. Tenant improvement allowances have become a more popular form of concession in recent years as the demand for spec suite space has increased. Landlords are now devoting more of their concession offerings to the buildout of these plug-and-play offices.
- ◆ Rents experienced a slow recovery through 2014 but that growth has accelerated in the past two years. This is occurring across all property types but particularly in the market's Class A and trophy assets where vacancy is at a historical low of 10.9%.
- ◆ After increasing sharply in the early years of the recovery, the amount of free rent offered has declined in the past two years. This decline can be attributed to the increase in tenant improvement concessions. As tenants have demanded more tenant improvement dollars for spec space buildout landlords have given fewer concessions in the form of free rent.
- ◆ After seven years of little new construction, 3.8 million square feet will deliver in the next two years. As a result of this new supply and the addition of 2.2 million square feet of vacant backfill space, the Chicago office market likely will become more tenant-favored in the next six months. With that, we will likely see rent growth slow and continued increases in landlord concessions, particularly for tenant improvement costs.



OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

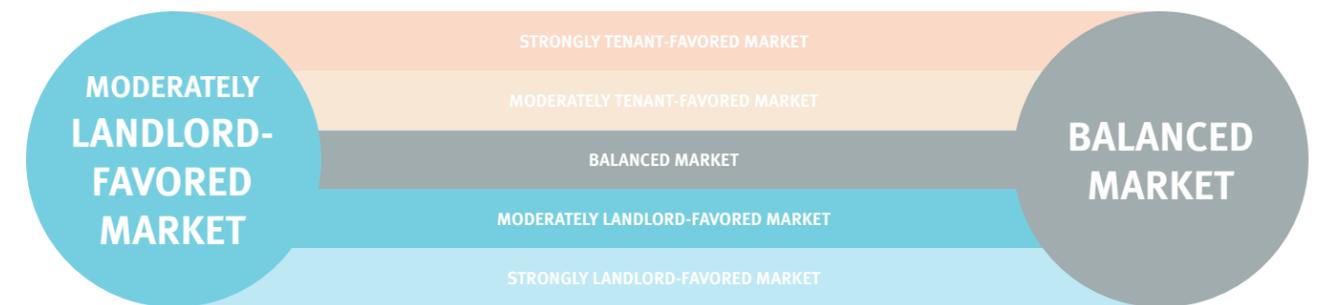
- ◆ Average concessions in Dallas have trended modestly lower since the employment recovery began to take shape in 2011. Meanwhile, average face rents have been on a steady climb since 2012, illustrating the strength and duration of the recovery.
- ◆ One exception could be seen in downtown Dallas where vacancy is running above the five-year average. This area is home to 22 blocks of contiguous space with 100,000-plus rentable square feet at the end of third-quarter 2016.
- ◆ With more than 7.0 million rentable square feet underway, first-generation users should benefit from healthy concession packages as landlords work through the lease-up stage.
- ◆ The pace of employment growth has accelerated for five consecutive years and the local economy is on track to create more than 100,000 new jobs in 2016. This suggests metro-wide concession levels will remain relatively stable in 2017.



OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

- Average concessions in Houston have trended higher since the decline in the energy industry’s demand for space that began in 2014. While average face rents have declined modestly over the past two years, both tenant improvement allowances and months of free rent have continued to climb.
- Concession usage has become more prevalent in response to rising office vacancy rates and an increasing number of big blocks of available space.
- In the Class A segment alone, the City of Houston has 75 blocks of available space in excess of 100,000 rentable square feet and 25 blocks of available space in excess of 200,000 rentable square feet as of the end of third-quarter 2016.
- Concession usage is expected to remain widespread in 2017 due to continued softness in the market.



OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

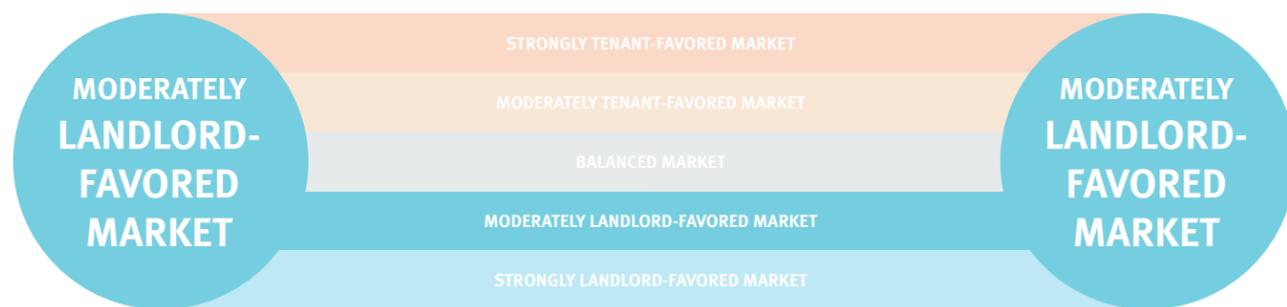
- Average starting rents remained generally consistent from 2007 to 2015. However, starting rents are up notably based on partial-year data for 2016; this is largely due to the leasing of creative office space, which often commands a rent premium compared to traditional Class A space.
- Concessions vary depending on the transaction size and length of lease term. For new deals larger than 30,000 SF with ten or more years of term, it is not unusual to see concessions of \$60/SF or more in tenant improvement allowance and 10 months of free rent.
- Partial-year data for 2016 suggests average tenant improvement allowances have increased while months of free rent per year of term have plateaued. It remains to be seen whether this trend will hold up when the full year of data is available.
- Tenant demand remains healthy and is diverse across industry segments. Yet ground-up and redevelopment projects are increasing after minimal construction deliveries this cycle, while U.S. corporate profits have been wobbly in recent quarters. It is likely market conditions will shift from landlord-favored to balanced in the second half of 2017 as new supply delivers.



MIAMI, FL



NEW YORK, NY



**MODERATELY
LANDLORD-
FAVORED
MARKET**

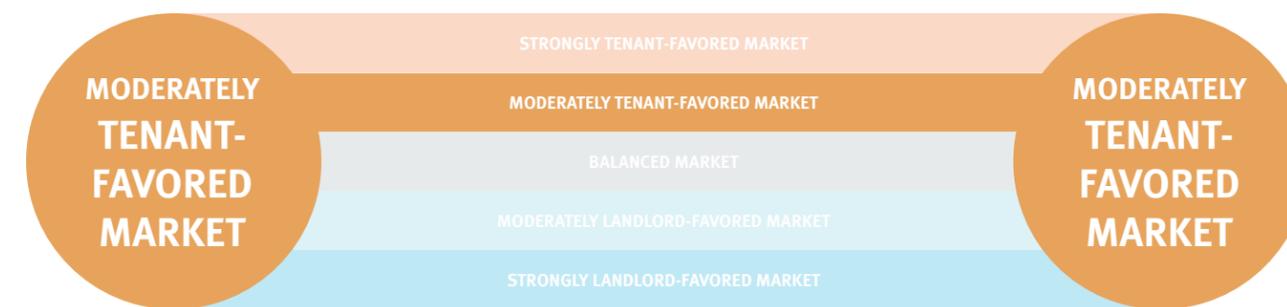
STRONGLY TENANT-FAVORED MARKET
MODERATELY TENANT-FAVORED MARKET
BALANCED MARKET
MODERATELY LANDLORD-FAVORED MARKET
STRONGLY LANDLORD-FAVORED MARKET

**MODERATELY
LANDLORD-
FAVORED
MARKET**

OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

- ◆ Miami's office market has experienced strong demand and is currently a landlord's market.
- ◆ Demand is projected to remain steady through 2017 and into the beginning of 2018 with possible slowing in the second half of 2018.
- ◆ Two buildings totaling just over 300,000 square feet are under construction with projected completion in 2017. 100,000 square feet of that space is already leased.
- ◆ Free rent and tenant improvement concessions have diminished significantly since recovery from the Great Recession began. Free rent tends to be one month for every year of term on mid-size to larger lease deals with five or more years of term.
- ◆ The forecast for 2017 is for a continuing decline in vacancy and an increase in asking rents. Barring any major geopolitical or economic event, South Florida is well positioned for the next economic cycle.



**MODERATELY
TENANT-
FAVORED
MARKET**

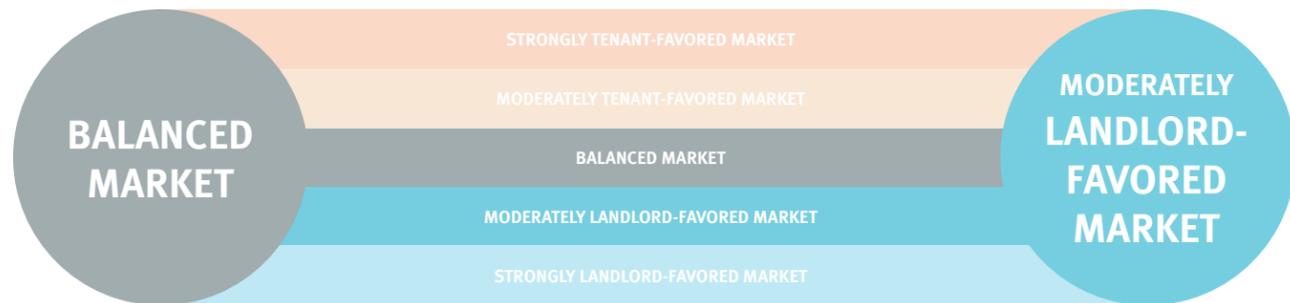
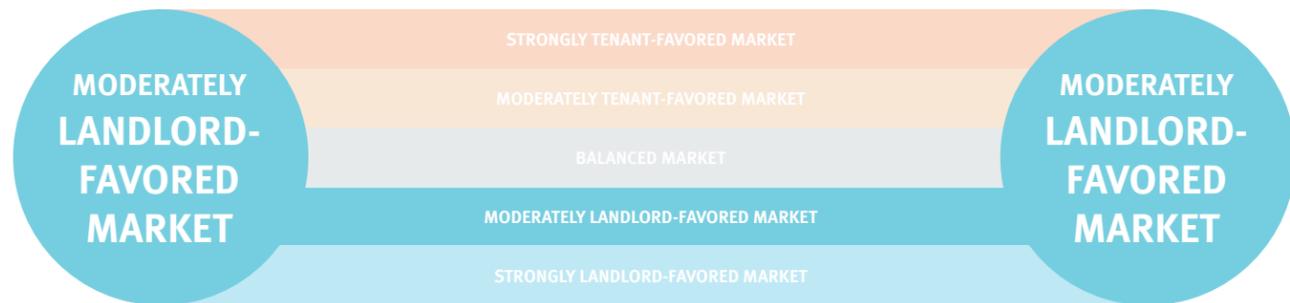
STRONGLY TENANT-FAVORED MARKET
MODERATELY TENANT-FAVORED MARKET
BALANCED MARKET
MODERATELY LANDLORD-FAVORED MARKET
STRONGLY LANDLORD-FAVORED MARKET

**MODERATELY
TENANT-
FAVORED
MARKET**

OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

- ◆ As market conditions improved following the recession and starting rents increased, Midtown Manhattan property owners pulled back on concessions. Beginning in 2014, with large-block availabilities expected in Midtown, owners again increased concessions.
- ◆ Downtown property owners boosted concessions for several years after the 2008 - 2009 recession to land large tenants relocating from other markets.
- ◆ In Midtown South, concession packages rose at a slower, steadier rate than in Midtown and Downtown from 2010 through 2016.
- ◆ Manhattan-wide, asking rents increased at a slower rate in 2016 than in recent years. The slowdown was generally more pronounced in starting rents. However, net effective rents have flattened as landlords are giving more substantial concession packages including an increased amount of tenant improvement allowance.
- ◆ With large-block availabilities projected to continue in 2017, and new construction deliveries on the horizon, landlords are expected to continue to use concession packages as part of their effort to remain competitive.



OFFICE LEASING MARKET AS OF 2016

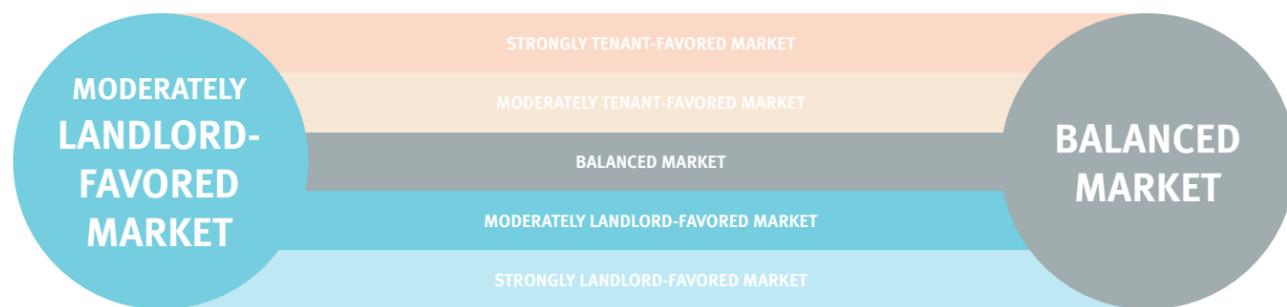
OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

- ♦ Class A starting rents in Downtown Philadelphia increased over the past year as a result of fewer options for large requirements, many buildings with a new cost-basis due to recent acquisition, and strong absorption in 2015. Comcast’s explosive growth is also beginning to drive space demand as Comcast vendor firms concentrate in the City.
- ♦ The average tenant improvement allowance spiked in 2015 but then declined to recent average levels in 2016. Meanwhile, average months of free rent have risen slightly in 2016.
- ♦ Tenants who sign leases with a minimum term of 11 years are usually offered a tenant improvement allowance over \$50/SF and one year’s free gross rent.
- ♦ Free rent will begin to ratchet downward on higher-elevation space, which is in high demand but short supply. It is not unusual to find two tenants competing for the same high-elevation space.
- ♦ We do not expect the decline in allowances to continue, as new work layouts are denser but more expensive to construct, and construction prices have been rising quickly over the past 12 months.

- ♦ The overall Phoenix office market has been strengthening since 2011, with vacancy at 20.0% as of the third quarter of 2016, the lowest rate since 2008.
- ♦ Over the past several years, average concessions have ranged from a half-month to one month free rent for each year of contract while tenant improvement allowances have averaged around \$25 per square foot.
- ♦ Rents have increased in the suburban markets of Tempe and Scottsdale and concessions continue to decline in those submarkets.
- ♦ Landlords have begun offering increased tenant improvement allowances to attract high-end tenants.
- ♦ Construction activity remains strong, with 1.9 million square feet expected to deliver in 2016, the highest annual completions total since 2008.
- ♦ As demand remains strong, Phoenix is expected to shift toward a landlord’s market in 2017-2018.



OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

- ◆ Several San Francisco landlords took advantage of the market-wide lack of creative space by building out single floors or suites of creative spec space, causing an increase in overall tenant improvement allowances over the last 4-5 years.
- ◆ As demand for space in San Francisco grew following the recession, landlords offered less free rent. Partial-year data for 2016 suggests months of free rent have increased slightly. It is likely that as supply increases, landlords will continue to offer more free rent to stabilize asking rents.
- ◆ Concessions in San Francisco differ significantly depending on the transaction size, length of term, and age and type of space. For new construction deals, it has become fairly commonplace to see concessions of \$90/SF or more in tenant improvement allowance and 6 months or more of free rent.
- ◆ There is some sentiment in the market that concessions are increasing and will continue to do so as new construction hits the market between 2017 and 2020. At current demand levels, it is likely that the San Francisco office market will become more balanced over the next two years.



OFFICE LEASING MARKET AS OF 2016

OFFICE LEASING MARKET OUTLOOK FOR 2017-2018

- ◆ Average concessions in the District of Columbia have risen continually since the Great Recession in 2008. While average face rents have remained fairly consistent over the past eight years, both tenant improvement allowances and months of free rent have continued to climb.
- ◆ Concessions in the District of Columbia differ significantly depending on the transaction size and length of lease term. For new deals larger than 50,000 SF with ten or more years of term, it has become typical to see concessions of \$100/SF or more in tenant improvement allowance and 12 months or more of free rent.
- ◆ Partial-year data for 2016 suggests average tenant improvement allowances have declined slightly while months of free rent per year of term have plateaued. It remains to be seen whether this trend will continue into 2017, as demand remains limited.
- ◆ There is some sentiment in the market that concessions have peaked, but with demand for office space still curbed by densification in the private sector and consolidation and austerity in the public sector, it is likely concessions will continue at or near the current level in the near term.
- ◆ With demand still limited and a significant pipeline of properties set to deliver through 2018, expect the District of Columbia to remain a tenant's market over the next two years.

SUMMARY

While we have provided an overall summary of the state of leasing concessions in major U.S. cities, market fundamentals vary greatly by city and by submarket. Beyond evaluating the unique situation in your market and submarket, consider these potential action steps for tenants and owners of office space.

ACTION STEPS FOR OWNERS

- ◆ Keep in mind not all market segments and locations are the same and be prepared to offer higher concession packages in submarkets with less demand.
- ◆ Configure concession packages to the specific needs of each potential tenant, with varying balances of tenant improvement allowances vs. free rent.
- ◆ Target tenant types with requirements that fit a certain type of space. If there is a particular industry sector that is attuned to your type of project, offering niche space can decrease competition and potentially lower the required concession package.
- ◆ It is the consensus of economists that there will be a national recession in 2018 or 2019. A recession would likely reduce tenant demand in the short term and may lead to a further increase in the value of concessions that is required in order to remain competitive.

ACTION STEPS FOR TENANTS

- ◆ Target up-and-coming submarkets where demand has not yet accelerated. Getting in before demand picks up will likely lead to larger concession packages being offered.
- ◆ Focus on submarkets with greater oncoming supply. The increase in owners' competition for tenants will likely lead to higher concession packages both in the existing space as well as the new space while it is still in the lease-up stage.
- ◆ Determine which types of concessions are most important to your company. If a premium build-out is important to your organization, target a higher tenant improvement allowance. If you want to save cash up front, target free rent.



GLOSSARY

Glossary

- ◆ **Asking Rent:** The listed rental rate at which a particular space is marketed. The asking rent is often the initial rent requested in a lease proposal, but is not necessarily the final rent that is agreed upon.
- ◆ **Concessions:** The discounts, rebates or abatement offered by a landlord to incentivize a tenant to lease a particular space.
- ◆ **Consolidation:** When a tenant who leases space in multiple locations or on multiple floors of the same building combines offices into one location, often to offload excess or underutilized space.
- ◆ **Densification:** The trend toward reducing the amount of square feet leased per worker through space efficiency, denser layouts, reduction or elimination of common areas and/or reduced office and cubicle sizes.
- ◆ **Free Rent/Rental Abatement:** Discount offered to reduce total amount of rent paid by a tenant, often offered as a number of months of free rent.
- ◆ **Landlord-Favored Market:** Leasing market where demand is greater than available supply, shifting leverage in negotiations toward landlords' favor.
- ◆ **Starting Rent:** The negotiated rental rate paid during the first year of the lease term, often subject to annual increases.
- ◆ **Tenant-Favored Market:** Leasing market where available supply is greater than demand, shifting leverage in negotiations toward tenants' favor.
- ◆ **Tenant Improvement Allowance:** Sum offered by a landlord to a tenant to be used for build-out and customization of the interior of a leased space. The tenant improvement allowance is most often offered as a dollar amount per square foot of space leased.

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