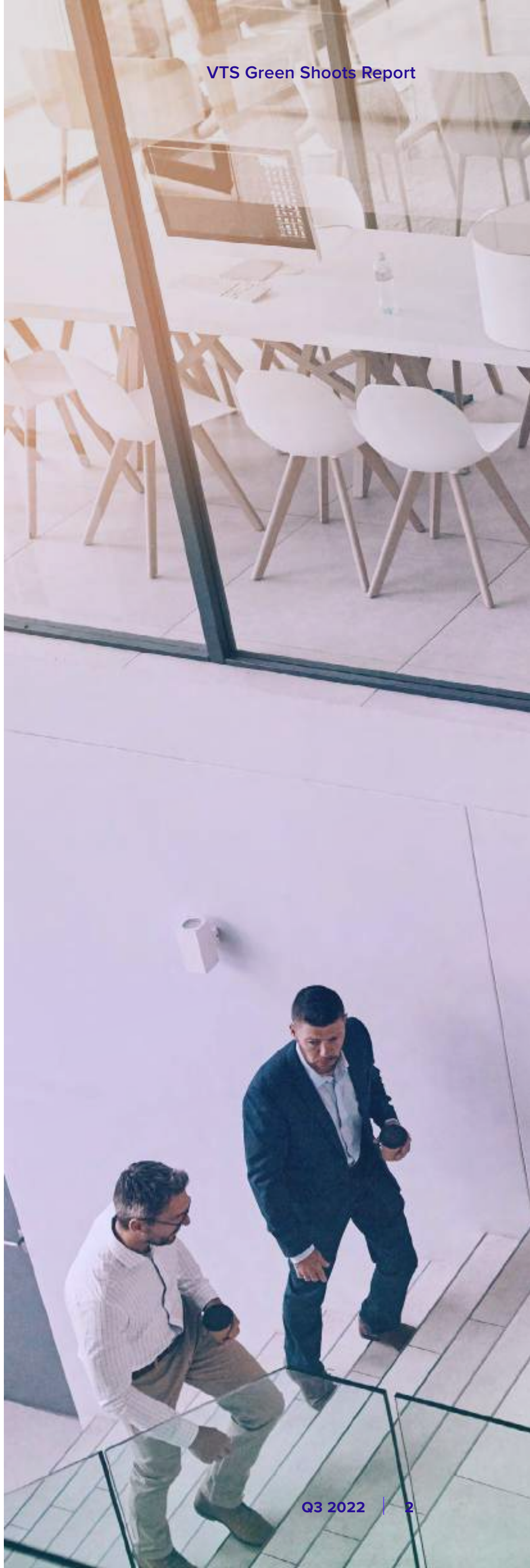
VTS Green Shoots Report

Quarterly Report:

Q3 2022



Office Market Overview

Financial market indicators continued to disappoint in Q3 ‘22 as the Fed increased interest rates twice again during the quarter, +75 bps on 7/27 and another +75 bps on 9/21. The Federal Funds Rate (now at 3.25%) was nearly zero as recently as nine months ago. As a result of the higher cost of capital, the S&P 500 ended Q3 ‘22 down 5.3% QoQ and down 24.8% YTD, whereas the NASDAQ is down 32.4% YTD and down 4.1% QoQ.[1] These leading indicators of the office sector’s performance are consistent with the drop in new tenants entering the market in Q3 ‘22.

Similarly, the VTS Office Demand Index (VODI) recently declined by 15 index points (-24%) to 48 in Sep. ‘22 from 63 in Jun. ‘22 across the top 7 markets and is also down 25 index points YoY (-34%) from a VODI of 73 in Sep. '21.

Although it was hard in Q3 ‘22 to identify green shoots, Washington, DC, another underperformer since before the pandemic, also deserves recognition for its stability in Q3 ‘22, cutting through the national headwinds this summer. Houston was the only market with a QoQ gain, albeit modest (+1pt), due to oil industry dynamics that continue to be favorable.

Total Active Demand within the top 8 markets totaled over 71M sf at the end of Q3 '22 with an average requirement size of 17.2k sf. Despite a decline (-12%) in Active Demand QoQ, the Sep. ‘22 national VODI halted the slide of the last four consecutive months, albeit upticking by only 1 index point from the recent low of 47 in Aug. ‘22. This pause in the VODI, coupled with an 11.7% uptick in the volume of new lease proposals reported in the top 8 markets, offers optimism of a potential reversal of the recent declining momentum in this otherwise volatile US office market.

Based on nearly 6k lease proposals in Trophy & Class A assets (1k+ sf and 36 mo+ terms) across 8 markets over the trailing 6 months (T6M), starting rents (-1.7%) and NERs (-2.2%) both declined slightly vs the prior T6M ending Q1 ‘22.

The incremental rate decline (-0.55%) in NERs vs starting rents over the two six-month periods was mostly attributable to a marginal increase (+1.1%) in the average Tenant Improvements (TIs) to $10.67/sf/yr, while there was a decline (-1.8%) to 7.7 months in Free Rent. The average lease term tracked over the T6M was 7.8 years, a slight increase (+0.45%) over the prior T6M.

Trends

Small Tenants More Resilient

The count of the new large tenant (50k+ sf) requirements declined 20% across the top 8 markets for the T3M over the prior period and is down 58% vs pre-Covid levels. The count of smaller tenants (<10k sf) has remained relatively liquid, down 7% for the T3M vs the prior period and down 32% since pre-Covid. Large tenant demand over the T3M from the TAMI (Technology, Advertising, Media, and Information) and FIRE (Finance, Insurance, and Real Estate) sectors was down 76% and 71%, respectively, vs pre-Covid levels.

Public companies represent a larger portion of large tenant demand. They are more sensitive to short-term earnings than private companies, often reacting quicker to market declines to manage operating costs, including rent and overhead. This is consistent with the Q3 trend in the frequency of 50k+ tenants hitting the brakes harder than smaller tenants.

New Industries Making Headlines

Corporate RTO plans have not been as swift or aggressive as many anticipated as the pandemic focus fades. Decisions like Uber's recent announcement, requiring only two days in the office per week, will shape future demand. In Q3 '22, we have seen an uptick in new demand activity from Professional Services, particularly Legal in Chicago and Seattle, and from Government and Non-Professional Associations in NY and DC, and Healthcare across the board. Despite material declines in overall new demand, Healthcare demand only declined by 6% in Q3 vs Q2. Finance, Creative, and Tech were down 15%, 18%, and 25%, respectively, over the same period. Additionally, Healthcare was the only of these four sectors that directionally had a positive momentum (+2%) change in Q3 (vs Q2 over Q1). In contrast, Finance, Creative, and Tech decelerated momentum, declining 5%, 13%, and 17%, respectively, over the same periods.

Flight to Quality (FtQ)

FtQ is consistent and remains strong in 6 of the top 8 markets. Executed leases and active proposals (Class A&B) for the top 10% of rents in '21-'22 YTD compared to pre-Covid levels are up 1.2%, whereas the bottom 10% of rents are down 6.3%. As of Q3 '22, there is an average premium of 56% across the top 8 markets. NY has the highest premium at 93% (87% through Q2 '22) on the average NER of the top 10% of deals (over the average rent of the other 90%) for executed leases and active proposals during '21-'22 YTD. This 93% premium in NY now reflects a +35% change (25% through Q2 '22) over the 69% premium that existed in NY during the '18-'19 pre-Covid era.

Standout Statistics by Market

Market	Trending	VODI	Logged Lease Proposals [2] [3]						
		Sep. '22 / '21	T6M Ended Sep. '22 Totals & Avgs & % Change vs Prior T6M						As of Sep.'22
	Trending	VTS Office Demand Index	Total Proposal Count [4]	Starting Gross Rent/sf/yr	NER/sf/yrt [5]	TI's/sf/yr	Free Rent (mos)	Lease Term (mos)	SF of Active Demand [6]
Boston	▼	31 / 59 -28 pts	428 14.7%	$71 -1.5%	$63 -2.6%	$11.36 11.9%	4.3 -1.0%	93 .07%	4.7M
Chicago	▲	43 / 88 -45 pts	1,275 28.8%	$48 1.7%	$41 3.0%	$10.42 4.5%	7.9 -4.0%	93 5.0%	11.7M
Houston	▲	105 / 69 36 pts	768 31.5%	$38 -0.9%	$32 -0.4%	$8.12 -0.8%	8.2 -8.9%	84 -4.8%	8.3M
Los Angeles	▼	52 / 88 -36 pts	705 2.8%	$53 -2.4%	$47 -4.4%	$10.63 1.4%	6.8 -5.0%	84 -6.5%	6.8M
New York City	▶	54 / 79 -25 pts	1,339 19.8%	$76 0.3%	$66 1.6%	$11.57 -9.6%	8.3 -5.4%	103 0.0%	24.0M
San Francisco	▶	39 / 49 -11 pts	483 -17.0%	$82 -0.9%	$77 -2.4%	$12.20 7.2%	4.3 -1.4%	82 2.4%	4.5M
Seattle	▼	44 / 77 -33 pts	247 -26.9%	$52 0.5%	$47 -0.3%	$9.07 7.9%	4.1 9.6%	89 1.7%	4.0M
Washington, DC	▲	62 / 54 8 pts	737 7.9%	$64 1.1%	$55 0.9%	$11.33 3.0%	12.0 0.0%	105 1.0%	7.1M
Total / Market Avg:		48 / 73 *	5,982	$60	$53	$10.67	7.7	93	8.9M
Change vs Prior:		-25pts	11.7%	-1.7%	-2.2%	1.1%	-1.8%	0.5%	(Avg / Mkt)

*Figures in green are trending more favorably and in red less favorably for landlords. Top 4 markets shown in green and bottom 4 markets shown in red for only VODI (based on change in index points YoY) and sf of Active Demand (based on % change from market's total sf reported in prior quarterly report). *Total / Market Avg. for VODI represents the National VODI (ie top 7 markets excl. Houston).

Standout Statistics by Market

New York

After being hit hard over the summer, the VODI jumped in Sep. ‘22 9 points MoM or 20% to a VODI of 54, as one of two top 8 markets to regain lost velocity. This is offset by the fact that NY’s VODI just a month earlier was down 34 points or -43% vs a local VODI of 79 in Sep. ‘21 and had the highest market VODI at 84 as recently as May ‘22. Sep. ‘22 alone had a MoM increase of +44% on its 204 new tenant requirement count and +72% for its 2.8M monthly sf total. Quarter over quarter, the total sf of new demand is down 37% from Finance, 30% from Tech, and 58% from Legal. However, Association/ Non-Profit and Government tenants continued to see total sf of demand growth, up 260% and 95% QoQ, respectively. NY is moving in the right direction as average NERs are up 1.6% over the prior T6M fueled by declining Free Rent (-5.4%) to 8.3 months and TIs (-9.6%). At $11.57/sf/yr, NYC has the second lowest TI’s as a percent of starting rents (15.3%).

Los Angeles

Last quarter's top market performer, LA, has cooled off as its VODI at 52 is down 21 points, or 29% QoQ, and treaded water Sep. '22, down only 4 points. The monthly average count of new tenant requirements is down 30% QoQ, and YTD '22 is down (-24%) since pre-Covid (Jan./Feb. '20) levels. Starting rents (-2.4%) and NERs (-4.4%) had the steepest T6M declines vs prior T6M of the top 8 markets. The average lease term of proposals was shortened to 7.0 years (-6.5%).

Boston

With a VODI of only 31 in Sep. ‘22, Boston has the lowest VODI of the top 8 for three months after climbing out of the VODI cellar from Feb. '22. A VODI of 31 is a top 8 low for the past 19 months since Feb. '21. The number of tenants in the 10-50k sf range in Boston over the T3M had the steepest decline (-78%) since pre-Covid (Jan./Feb. ‘20) of any top 8 market area. As TIs have jumped (+11.9%) to $11.36/sf/yr, it’s no surprise NERs at $63/sf are down (-2.6%) as are starting rents at $71/sf (-1.5%). On the positive side, proposal volume is up (+14.7%).

Washington, DC

As the only top 8 market area to realize a VODI increase in both MoM and YoY, DC reported a 1-point MoM (+1.6%) increase in the Sep. '22 VODI to 62 in a month, where the national VODI declined QoQ by 15 points. Similarly, YoY, DC VODI increased (+14.8%). During Q3 '22, 23 Government/Contractor tenants totaling 373.5K sf and 30 Lobbying/Professional Services firms totaling 238.8k sf of new demand entered the market, logging a 141% and 60% YoY sf increase from these sectors, respectively, giving promise of an uptick in leasing activity entering Q4 and 2023.

Houston

The only market with a VODI above its ‘18-’19 average at 105, Houston has been a top momentum performer (granted, off a low base) since Mar. '22 when VTS’ Investor Research team first identified green shoots despite softness in the overall market’s health. That said, it could be a good time for companies to pick their spots as the VODI increased 36 points YoY to 105, setting a record for the best Sep. of the last 5 years and the only top 8 market area with a positive QoQ VODI point gain (+1). The <10k sf (-1%) and 50k sf (-8%) tenants supported demand, whereas the mid-size tenants (10-50k sf) were down (-26%) since pre-Covid, the latter of which is more consistent with declines in other markets. Proposal volume was also favorable, up 31.5% T6M over the prior T6M. Rent declines were modest, but months of Free Rent dropped significantly (-8.9%) in the landlords' favor. The flight to quality theme prevails as the volume of tenants touring Class B assets QoQ ballooned to nearly a 16% deficit, a good sign for projected leasing activity and new occupancy moves in 2023. However, the VODI 1-mo drop (-5.4%) from Aug. ‘22, albeit consistent with the average VODI percent change for the Top 8 markets (-2.3%), is a short-term trend worth noting. An assessment of the stage of tenants in the Active Demand pool in Houston indicated a very low percent of tenants have placed their requirement "on hold," while a high relative percent of active tenants currently have “leases out.”

Seattle

The last month of the quarter brought only 17 new office requirements totaling just 149k sf and leaving little to no room for any silver linings. These figures are down 47% and 61% MoM, respectively, and are the lowest totals since Dec. ‘20. Seattle had the largest Q3 '22 percent decline in new requirements from small (<10k sf) tenants compared to pre-Covid (Jan./Feb. '20) levels, down 64%. Seattle has the largest average size requirement at 13.5K sf, edging out both San Francisco (12.9K sf) and New York (12.4K sf) and performing relatively well in the 10-50k and 50k+ sf tenant size tranches. The slight uptick in starting rents to $52/sf helped offset a large increase (+7.9%) in TIs at $9.07/sf/yr and Free Rent (+9.6%) to 4.1 months vs the prior T6M.

San Francisco

The volume of lease proposals in San Francisco was one of only two markets in the top 8 down (-17.0%) during the T6M over the prior period. Average NERs at $77/sf also dropped -2.4%, mainly as a function of higher TIs (+7.2%) at $12.20/sf/yr over the T6M. San Francisco's count of new requirements was down 24.6% QoQ, consistent with a sluggish summer for many markets. However, on the flip side and albeit on a low base, San Francisco continues to increase its count of new requirements TTM over prior TTM (+10.2%) and second smallest YTD '22 decline (-22.6%) to pre-Covid levels.

Chicago

The Chicago VODI continued its summer decline, dropping 4 more points in Sep. '22 to 43, marking the biggest YoY decline for any market tracked by VTS (--51.1%). However, Chicago had positive Q3 '22 momentum as T6M proposal activity was up 28.8% over the prior T6M, partially attributable to smaller and mid-size tenants dominating the market. Starting rents rose 1.7%, but NER's (+3.0%) outperformed partially due to Free Rent declining (-4.0%). Flight to quality is the primary reason why demand in Chicago is slowing while rents are being maintained or even increased on an effective basis.

Markets on the Move

In this quarterly report, the two markets that have outperformed the benchmark in Q3 '22 compared to the national averages of the other metro markets tracked by VTS are Houston and Washington, DC.

Houston has been gaining momentum for the past 7 months now, around the time energy prices spiked. Washington, DC, has only more recently risen the relative ranks, emphasizing DC's downside protection for the right assets.

The next page is a side-by-side comparison of Houston and Washington, DC, featuring both recent and pre-pandemic changes in demand momentum and velocity, as well as changes in rental rates and related deal economics dynamics.

Market Health and Momentum Comparison

The below table spotlights key data points and the varying road to recovery between two of the specific markets tracked by VTS that were more challenged pre-pandemic. First is Houston, a market in which demand levels are currently higher than pre-Covid levels as momentum has been positive for a few quarters. Second is Washington, DC, which has had the most stable new demand velocity and rate parity based on its rent-sensitive government economy.

Market Health and Momentum Comparison				
Metric or % Change	**Houston**	**Washington DC**	**Mkt Avg**	**Analysis Time Frame**
Demand, Supply				
% Change # of Proposals	31.5% (1)	7.9% (5)	11.7%	T6M (Sep. '22) to Prior T6M
% Change New Req sf	-9% (1)	-51% (7)	-43.2%	YTD (Sep. '22) to Pre-Covid
% Change Count of New Requirements	1% (1)	-1% (2)	-10.0%	T3M (Sep. '22) over Prior T3M
% Change Active Demand sf	-5% (3)	-3.4% (2)	-12.1%	Last Q (3Q '22) to Prior Q
Rent Dynamics (Class A Trophy 36+ Mos) [2]				
NER Growth[8]	-4.1% (6)	-4.4% (7)	-5.5%	T6M (Sep. '22) to Pre-Covid
NER Growth [8]	-0.2% (4)	0.6% (3)	-2.8%	T6M (Sep. '22) to Prior TTM
NER Growth [8]	-0.4% (5)	0.9% (3)	-2.2%	T6M (Sep. '22) to Prior T6M
% Change Starting Gross Rent	-3.6% (8)	0.5% (6)	-1.5%	T6M (Sep. '22) to Pre-Covid
% Change Starting Gross Rent	-0.9% (5)	1.1% (2)	-1.7%	T6M (Sep. '22) to Prior T6M
% Change in TIs	-0.8% (2)	3% (4)	1.1%	T6M (Sep. '22) to Prior T6M
% Change in TIs [8]	7.4% (1)	19.1% (6)	14.7%	T6M (Sep. '22) to Pre-Covid
% Change in Free Rent [8]	10.9% (2)	37.5% (6)	28.6%	T6M (Sep. '22) to Pre-Covid
% Change top 10% NER Premium [7]	4% (6)	-2% (7)	7.1%	'21, '22 Executed + Active Proposals to Executed '18 & '19
Top 10% NER Premium [7]	43% (7)	52% (4)	55.8%	Top 10% vs 90% Avg NER in '21, '22 YTD Executed + Active Proposals
Average rank of top 8 markets	**3.7**	**4.6**		

*Figures in green ranked in top 4 and in red for rank 5-8 for a given category.

Notes

[1] S&P 500 and NASDAQ pricing data from Yahoo Finance.

[2] Proposal data is limited to Class A (+Trophy in NY) buildings and a min. of 36 months with a min. of 1,000 sf proposed lease unless otherwise noted.

[3] Unless noted the period is T6M ending Sep '22.

[4] Count is the number of proposals logged in VTS Lease.

[5] NER adds $15 to HOU and $20 to CHI of avg. expense reimb. for gross rent comparisons.

[6] Active Demand (AD) quantifies the total sf and count of reqs. touring/pursuing space in the market and is similar to Tenants In The Market.

[7] NER for proposals and executed leases 1k+ sf, 12+ mo term over specified time period.

[8] Concessions are for executed leases and active proposals with 1K+ sf and a term of 36+ months in Class A and Trophy buildings.

[9] Deal Economics are for executed leases with 1K+ sf and a term of 36+ months for Class A (+Trophy in NY) buildings.

Appendix available upon request for charts and tables supporting the green shoots and other emerging trends and themes referenced in this report.

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