Marcus & Millichap

Office Research Market Report

Second Half 2016

Orlando Metro Area

Construction Amplifies as Intense Demand Tightens Vacancy in Orlando

Office-using employment strengthens; vacancy further declines. Orlando's rising millennial population and healthy economic base have driven hiring in the professional and business services sector, fostering the need for office space. The growing demand for office facilities has pushed vacancy down to a near 10-year low in the second quarter of this year as net absorption outpaces the previous five-year average. Additionally, these tightening conditions have aided in a steady rent recovery after asking rent reached a cycle low in 2013. Construction activity has begun to pick up as builders work to keep pace with demand, and it is on track to rise significantly above last year's number of completions. Facilities over 200,000 square feet are also working through the planning process with delivery dates scheduled throughout the next two years. Development will be widespread, with several larger projects located within the Lake Mary and Tourist Corridor submarkets. Despite a rise in construction, vacancy will further tighten as net absorption reaches nearly 1.5 million square feet of office space, supporting a fourth consecutive year-over-year increase in the average asking rent.

Strong demographics pique buyers' interest in Orlando's office facilities. Improving market fundamentals and steady hiring motivate investors to deploy capital into the metro's office properties. During the previous four quarters, transaction velocity has risen considerably year over year as buyers target the area's assets. Class A facilities in particular are in high demand; however, few listings push many investors into well-located Class B/C properties. Office assets located within the northern suburbs and near central Orlando have garnered significant buyer attention. The average first-year return in these areas typically starts in the low-6 percent range and trades upward into the mid-7 percent span. Additionally, the metro's medical office buildings are highly targeted, with investors snatching up what few listings are available. These facilities change hands with first-year yields in the mid-7 to low-8 percent range on average. Overall, the high demand for the metro's office properties compressed the average cap rate down during the last 12 months to the low-7 percent span in June. The high number of sales also placed upward pressure on property values.

2016 Annual Office Forecast

5.0% increase in total employment

Employment:

Orlando employers will increase payrolls by 5.0 percent this year with 59,000 workers. Office-using employment will rise 2.8 percent during this time. In the previous year, hiring registered a 4.4 percent advance.

500,000 sq. ft. will be completed

Construction:

After constructing 258,000 square feet in 2015, builders are on track to complete more than 500,000 square feet of office space this year. The majority of deliveries will be located within the Lake Mary and South Outlier submarkets.

140 basis point decrease in vacancy

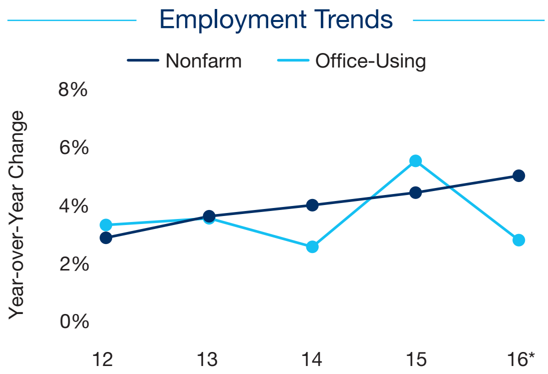
Vacancy:

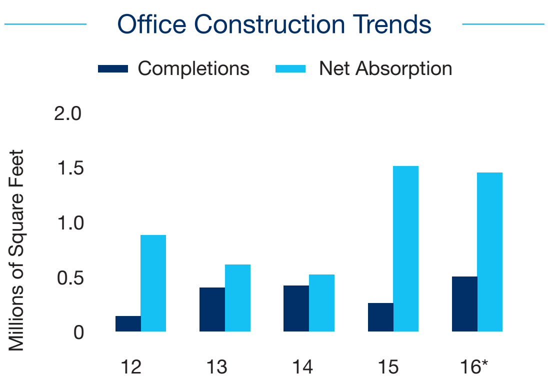
Strong demand for office space will push vacancy down 140 basis points this year to 13.6 percent as net absorption nears 1.5 million square feet. In the prior annual period, the vacancy rate fell 180 basis points.

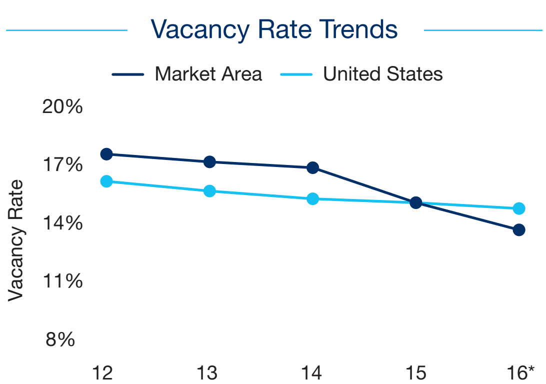
3.6% increase in asking rents

Rents:

Tightening vacancy will help drive the average asking rent up 3.6 percent this year to $20.59 per square foot. Last year, asking rent climbed 3.8 percent.







* Forecast

Economy

- During the previous 12 months ending in June, employers created 51,200 positions. Hiring was led by the leisure and hospitality sector with nearly 14,000 jobs. In the prior year, payrolls increased by 46,800 workers.
- Office-using employment during the last four quarters rose 2.0 percent with 5,700 positions. Professional and business services' gain of 6,500 jobs offset slight declines in both the financial activities and information sectors. Last second quarter, 4.7 percent office-using jobs were created year over year.
- The hiring boost pushed the unemployment rate down 60 basis points during the year to 4.3 percent in the second quarter, a cycle low. In the previous year, the rate fell 100 basis points.

Outlook: After a 4.4 percent increase in 2015, the employment base will grow 5.0 percent this year with 59,000 positions added to payrolls. Office-using employment will advance 2.8 percent in 2016.

Construction

- During the last four quarters, builders constructed nearly 205,200 square feet of office space in Orlando. More than half of the deliveries were located in Orange County. In the prior yearlong period, more than 182,000 square feet of space was delivered.
- Approximately 487,000 square feet of office space is under construction with completion dates scheduled through 2018. The Tourist Corridor and Lake Mary will receive the majority of deliveries. An additional 4 million square feet is working its way through the planning process.
- The largest project being developed is Kirkman Point II in the Tourist Corridor submarket. The 136,000-square-foot speculative center is forecast for completion in the summer of 2017. The Class A facility will have a food court and will be located near major transportation routes.

Outlook: Construction activity will increase from the 258,000 square feet delivered in 2015 as builders are on track to deliver more than 500,000 square feet of office space this year.

Vacancy

- Strong net absorption of 2.2 million square feet during the last four quarters dropped average vacancy 280 basis points to 13.2 percent at midyear. In the prior year, the vacancy rate fell 90 basis points on net absorption of 806,000 square feet of office space.
- Limited completions and healthy absorption in Seminole County during the previous 12-month period led to a 470-basis-point plummet in vacancy to 14.9 percent. During this same time, average asking rent in the county registered a 1.7 percent gain to $18.34 per square foot.
- The growing demand for office space during the year ending in June led to sharp declines in vacancy across each asset class. Vacancy in Class A facilities dropped 390 basis points to 13.6 percent as net absorption exceeded 1 million square feet. The rate in Class B/C properties plunged 220 basis points to 13.0 percent as 1.1 million square feet of space was absorbed.

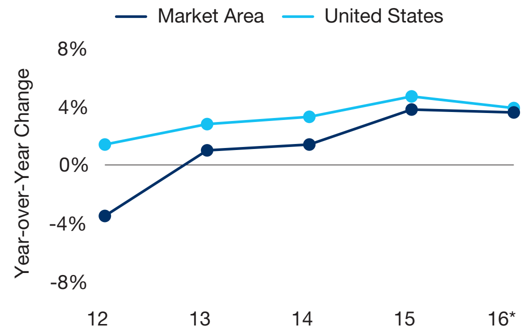
Outlook: Vacancy will fall 140 basis points this year to 13.6 percent as demand for office space in Orlando grows. Last year, vacancy declined 180 basis points.

Rents

- Tightening vacancy and healthy demand placed upward pressure on asking rents during the last four quarters, rising 2.2 percent to $20.15 per square foot. During the previous annual period, the average rent climbed 4.3 percent to $19.71 per square foot.
- The largest rental gain during the previous 12 months was registered in Osceola County with a 9.8 percent increase to $25.65 per square foot, the highest asking rent marketwide. The county also posted the lowest vacancy in the second quarter of 10.6 percent after a 100-basis-point year-over-year decline.
- During the year ending in June, the average asking rent for Class A facilities rose 3.3 percent to $23.39 per square foot. Rent for Class B/C office space inched up 1.5 percent during this time to $18.43 per square foot.

Outlook: After rising 3.8 percent in 2015, the average asking rent will move up 3.6 percent to $20.59 per square foot this year, reaching a cycle high.

Rent Trends

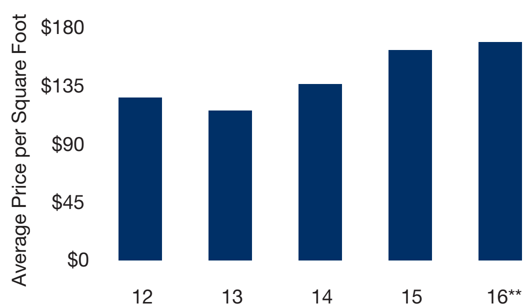


Sales Trends**

- Investor interest is heating up in Orlando as transaction velocity jumped 32 percent over the last four quarters with buyers primarily targeting Class B facilities. In the prior annual period, sales rose 17 percent year over year.
- The average price during the previous 12 months rose 10 percent to nearly $170 per square foot. Relatively newer, well-located assets priced near $200 per square foot or higher. Properties with a lower entry cost could be found within the Lake County and Maitland Center submarkets for $30 to $50 per square foot less than the average.
- The heightened demand for office space compressed the average first-year return 10 basis points during the year ending in June to the low-7 percent range. Newer Class A assets traded up to 100 basis points less on average.

Outlook: Investors will target assets near the CBD and suburban office properties north of central Orlando. Class B assets built during the 2000s will be highly sought after.

Sales Trends

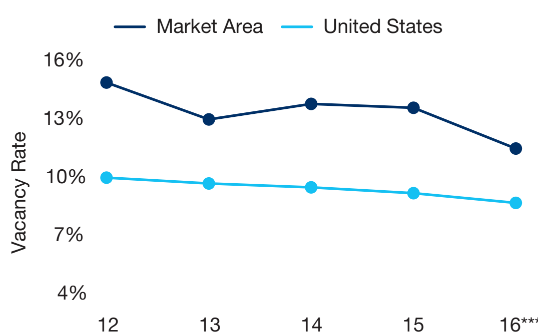


Medical Office***

- Despite no new office space coming online during the last four quarters, 70,000 square feet of space is under construction and forecast for completion by year-end. An additional 810,000 square feet of space is under proposal with planned delivery dates through 2018.
- During the year ending in June, the average vacancy rate plummeted 250 basis points to 11.4 percent on net absorption of 134,000 square feet of space. During this same time, asking rent for medical office space ticked down 1.8 percent to $20.85 per square foot.
- Based on a handful of transactions during the previous 12 months, investor interest in medical office buildings is picking up in Orlando with buyers focusing on Class B properties. Office facilities changed hands with average prices near $125 per square foot.

Outlook: Medical office buildings will remain in high demand as vacancy tightens to a cycle low. However, limited listings may push several investors to traditional office facilities.

Medical Office Vacancy



* Forecast
** Trailing 12-month period through 2Q16
*** 2Q16
Sources: CoStar Group, Inc.; Real Capital Analytics

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The 10-year U.S. Treasury has been trading lower, closing below 1.7 percent, since the Federal Reserve decided to leave the federal funds rate unchanged in September. Policymakers left the door open for a rate increase before the end of December and proposed how interest rates could rise over the coming years. The S&P 500 Index and other U.S. equity indexes continue to hover around all-time highs.
- The Federal Open Market Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities and rolling over maturing Treasury securities at auction. It anticipates doing this until normalization of the level of the federal funds rate is well underway. The committee anticipates holding longer-term securities at sizable levels should help maintain accommodative financial conditions.
- Interest rate volatility has moved over to the commercial loan markets and 10-year fixed-rate loans are now pricing between 3.9 and 4.4 percent. Loan to values range from 60 to 75 percent for commercial properties depending on location, as underwriters remain competitive in an effort to do business. Floating-rate bridge loans for stabilized assets will require LTVs of 70 percent and price with a spread between 275 and 425 basis points over Libor, while repositioning will be underwritten at 80 percent LTV with a 375- to 475-basis-point spread.
- A Federal Reserve survey of lenders indicates that commercial real estate loan standards tightened in the second quarter. Debt providers are likely seeking to balance risk exposure to commercial real estate and take a more conservative lending approach while the current cycle matures, rather than expressing a bearish outlook on commercial property. Some of the greatest tightening occurred for construction loans, a trend that may potentially prevent some early-stage developments from advancing and ultimately minimize the upward pressure of new supply on vacancy rates.

Local Highlights

- As many companies continue to relocate and bring jobs to Lake Mary, a large mixed-use development is under proposal to bring additional office space to the area. The complex, named New Century Town Center, would be located on 153 acres near the I-4 corridor. The development would include 1.2 million square feet of office space, 100,000 square feet of retail space, 340 hotel rooms and 350 apartments.
- A 10-story office tower is working its way through the planning process in downtown Orlando. The 250,000-square-foot center named CNL Tower III will be built on Orange Avenue where the former “Round Building” was located. The building will be energy efficient and is forecast for completion in 2017.
- A new Major League Soccer stadium is being constructed in downtown Orlando, with completion expected in time for the 2017 season. The project has created nearly 900 temporary construction jobs. The stadium will be able to hold 25,000 fans and will be one of the largest in the league. This project is expected to have a significant impact on the local economy and should serve as a catalyst for additional development in the area.