VTS Green Shoots Report

Quarterly Report:
Q2 2022

Office Market Overview

Although Green Shoots focuses on emerging positive trends in the office market, we ended Q2 ‘22 with a different economic landscape that has emerged as the Fed raised rates by 50 bps on 5/4 and then another 75 bps on 6/15, the latter of which was the largest increase since 1994. The impetus was to slow the high inflation (9.1% YoY in June ‘22 and fastest CPI increase since 1981) hitting the US economy. Lastly, the stock market, a directional proxy for the economy (which CRE typically lags) was -16.6% QoQ. The TAMI and growth firm dominated Nasdaq 100 was down -29.4% in the first half of ‘22, and the finance sector (proxied by the XLF ETF) was down -19.5%, which directionally is consistent with VTS Data’s tenant touring activity, momentum, and total active demand comparison of TAMI vs. FIRE industries.

Key trends to consider:

Negative macro news jeopardizes 9 months of stable demand

The national VODI was 63 in June ‘22 and had remained in the 60’s range for eight of the past nine months. However, the stable demand for the past three quarters and slightly higher new tenant demand (+6%) YTD ‘22 over YTD ‘21 through May ‘22 was trumped in the last month of Q2 as VODI’s five-point drop from 68 in June put the change of new tenant requirements into the red (-3%) YTD over ‘21 YTD through June. Although still down significantly (-40%) from pre-Covid ‘18-’19 averages, this one-month 7.4% downtick in VODI demand puts the spotlight on the recent macro decline and calls into question the near-term direction of tenant demand. In June ‘22, Boston (-22.0%), New York (-15.9%) and Seattle (-11.3%) hit the brakes the hardest, whereas resistance to downard demand volume was displayed in San Francisco (+15.9%) yet that coincides with an eight market low VODI of 51 and Houston (+22.7%), at a VODI of 108, continues to benefit from high oil prices.

Demand higher with stronger NER growth in Low- vs. High-Remote Markets

Demand in June ‘22 vs. pre-Covid levels showed an increase in Low-Remote (back-to-office) work markets down only -24% and outperforming High-Remote (WFH) work markets, which continue to slip down -50% (since ‘18-’19 avg). Specifically, High-Remote VODI of 54 (DC, SF, SEA, BOS)[1] vs. Low-remote VODI of 79 (HOU, NYC, LA, CHI)[1]. This demand strain has similarly impacted NER growth rates. NERs in High-Remote work markets lagged by 145 basis points, growing just 0.75% on average when comparing ‘22 YTD executed lease and active proposals to executed leases in ‘20 and ‘21. NER’s for Low-Remote work markets were up 2.2% over the same period, a growth rate difference of approximately 66%.

Back to Office vs. Work from Home

Top 8 Markets - Avg. NER Growth Comparison | '22-YTD Leases + Active Proposals vs. '20+'21 Leases

Low-Remote Market		High-Remote Markets	
Los Angeles	1.3%	San Francisco	-3.9%
Chicago	1.8%	Washington D.C.	2.0%
Houston	2.6%	Boston	2.2%
New York	3.2%	Seattle	2.7%
Average	**2.2%**	**Average**	**0.75%**
NER Avg. Growth Rate Difference: 1.45% Relative % Difference: 66%			

Finance back-to-office; TAMI work from home (WFH) with creative sparks

The T3M count of tenants entering the market for Finance is down -30% vs. the pre-Covid level, whereas Tech and Creative new tenant counts are down by -44% and -52%, respectively. That said, the QoQ count of Tech (-4%) and Creative (-5%) tenants is only down slightly less than Finance (-10%) over the same period, but the June slowdown hit the TAMI sector harder. Regardless, this Finance over TAMI trend is consistent over the long term as TAMI's share of total square feet of New Reqs is down in 7 of Top 8 (not LA) while Finance tenants share of demand is down by more than 1% in only 2 (DC & SF) of Top 8 markets since '21 vs. pre-Covid.

Flight to quality is real: premiums up 12% on average in 6 of Top 8 markets since Covid

New York has the largest premium at 87% for its average of the top 10% of rents on spaces leased in '21 and '22 and currently active proposals relative to the other 90% of market activity. The top 10% of spaces continue to outperform the rest of the market, and upgrades by tenants to higher quality assets have been one primary factor in offsetting and preventing a decline in average starting rents since pre-Covid. The higher interest rate and softening economic environment will test the current rent premium differentials and create an uptick in distressed office asset opportunities. A further demand slowdown or continued uncertainty in the market more likely will likely maintain the trend of tenants upgrading to better assets with favorable concessions above pre-Covid norms. The two markets that did not see an increase in premiums since Covid were Washington DC and Boston.

Revisiting Green Shoots from Q1 ‘22 (Grow or Go)

Houston reward for risk?

Last quarter we predicted a near-term surge in demand based on Q1 ‘22 Green Shoots insights, weighing the impact of the Russia / Ukraine war and surging oil prices. Consistent with our prediction, demand spiked in Houston increasing 44.0% QoQ (vs. 3.3% for Top 7 Markets) to a VODI of 108, and is currently the only Top 8 market above its ‘18-19 VODI average. Similarly, active proposals are up 20.2% with slight increases in deal economics terms across the board.

Markets on the move

In Q1 ‘22 we praised the strong performance of the Seattle market, but suggested tracking the VODI following an 18 point index decline from Feb to March ‘22 to assess if it was an outlier. Unfortunately, changes in VODI and deal economics T6M over T6M dropped slightly, consistent with average percent changes of the national trend. Positive indicators include +6.9% proposal volume (-0.1% Mkt Avg) and modest +8.2% QoQ rebound to a VODI of 55, up from a decline to 51 in March ‘22. It’s worth monitoring if concessions continue to climb (6%+ T6M over prior T6M) as owners leverage them to defend starting rents.

More touring in Low-Remote markets

The new demand gap exists in Q2 ‘22 as VODI rebounds to signal demand is now down -24% (from -32% Q1 ‘22) in Low-Remote markets vs. pre-Covid, and hovers at -50% (from -52% Q1 ’22) in High-Remote markets.

FIRE is recovering the fastest

FIRE remains well ahead of TAMI in its recovery. However, the 114 average monthly Finance (-10%) tenants entering the market was slightly lower QoQ than that of Creative (-4%) and Tech (-5%).

Elevated concessions but rents hold

Starting rents remain up having increased 0.5% on average over the past 6 months, while TI’s increased +3.1% and free rent increased +2.4% over the same period.

Upsizing large requirements yet small tenants touring

Count of New Reqs by size since Jan/Feb ‘20 (pre-Covid) remained down at -30% -36% & -45%, (Q2 ‘22) vs. -27%, -40% & -39% (Q1’22) for <10k, 10-50K, & 50k+ sf tranches, respectively. New Reqs <10K, although down -10% QoQ on a count basis, still had the lowest drop of the three tranches since pre-Covid. 10-50K tenants increased by +6% QoQ. Total SF of New Reqs for 50K+ tenants continues to grow at +14% QoQ and +5% vs. pre-Covid averages for Top 8 markets.

Standout Statistics by Market

The below table summarizes recent trends around tenant demand and deal economics (volume, rent, concessions, term). Combined with the VODI (tracks unique requirements for tenants starting a space search), VTS proposal data is a reliable indicator of rates and leasing activity expected over the next ~2 quarters.

Market		VODI	Logged Lease Proposals (T6M Ended June '22) [2] [3]						
			Avg % Change T6M vs. Prior T6M						
	Trending	VODI June '22 / '21	Total Proposal Count [4]	Starting Gross Rent/sf/yr	NER/sf/yrt [5]	TI's/sf/yr	Free Rent (mos)	Lease Term (mos)	Active Demand June '22 [6]
Boston	▼	46 / 61 -15 pts	390 -0.3	$70 -2.3%	$63 -4.0%	$10.71 +12.3%	4.3 -2.1%	92 -1.1%	5.7M
	Despite Boston's 5.7M SF of active demand also has the highest ratio to available SF of the Top 8, VODI dropped 22% in June and 16% QoQ, the biggest declines for a market across both periods. NER (-4.3%) and Starting Rent (-2.3%) declined and TI's increased 12.3%.								
Chicago	▶	67 / 136 -69 pts	853 +14.3%	$46 -0.6%	$38 -2.4%	$9.90 +0.5%	8.2 +1.2%	93 -1.5%	14.2M
	Chicago proposal activity is up 14.3% over the T6M vs. prior T6M. Active Demand grew significantly to 14.2M in part due to the VODI increasing 15.5% QoQ, but NER's are down 2.4%.								
Houston	▲	108 / 102 +6 pts	553 +20.2%	$38 +1.3%	$32 +1.6%	$8.07 -1.9%	8.6 -1.4%	90 +0.4%	8.7M
	Houston is the Top market performer at least for a quarter as Q2 has been all green trending performance led by: 1) an uptick of 20.2% in proposal volume 2) NER (+1.6%) and Starting Rent (+1.3%) increases and 3) declining concessions. VODI was up 23% in a challenging June '22 and up 44% QoQ to a VODI of 108, above pre-Covid averages. It's still an uphill battle as 8.7M of total active demand is the lowest percent of available SF of the Top 8.								
Los Angeles	▲	73 / 100 -27 pts	594 +10.6%	$54 +2.0%	$47 +0.0%	$10.51 -4.5%	7.1 +4.2%	92 +2.6%	7.7M
	LA is a top market performer of late. VODI remained flat in June '22 at 73 and was only down -8.8% QoQ. Proposal volume was up 10.6%. TI's were down 4.5%, Starting Rents were up 2.0% and NER's remained flat over the T6M vs. prior 6M. Creative and Tech demand were only down slightly QoQ.								
New York City	▶	69 / 97 -28 pts	1,145 -3.8%	$76 +0.5%	$66 +0.7%	$12.19 -0.1%	8.4 -2.1%	104 +2.8%	27.6M
	Over the TTM, NY ranked 3rd highest in demand growth compared to both the prior TTM (+55%) and vs.18-'19 pre-Covid average (-24%). A 15.9% drop in June '22 VODI is a significant and negative reading to monitor despite positive rent growth and flat TIs. Active Demand (27.6M) is up slightly QoQ and has the 2nd strongest demand to direct available ratio. Lease term is up +2.8% on 1,145 proposals. 6.4M SF of active demand in Midtown South represents a favorable supply / demand balance on a relative basis.								
San Francisco	▶	51 / 60 -9 pts	430 -26.2%	$85 +4.1%	$80 +2.9%	$12.15 +12.7%	4.3 +5.8%	86 +4.7%	5.9M
	San Francisco's VODI was up 72% over the TTM vs. the prior TTM, but that growth was aided by a weak historical comparable. A June '22 VODI of 51 is the second lowest of any market and is still down 54% vs. pre-Covid, the most of any Top 8 when comparing the past 12 mos. to the pre-Covid demand average. Starting Rents (+4.1%) and NER's (+2.9%) were up but so were TI's (+12.7%) and Free Rent (+5.8%) wheC comparing the past two T6M periods.								
Seattle	▼	55 / 61 -6 pts	247 +6.9%	$51 -1.1%	$47 -1.4%	$8.59 +6.5%	3.8 +6.0%	89 +0.4%	3.6M
	NERs and starting rents are declining as TIs and Free Rent also climbed yet proposal volume is up slightly (+6.9%) and VODI is up (+7.8%) QoQ, however VODI was down 11.3% in June '22.								
Washington, D.C.	▼	62 / 71 -9 pts	521 -22.7%	$64 -0.1%	$55 -1.9%	$11.11 -0.9%	12.11 +7.5%	103 -3.4%	7.4M
	Another slow quarter for DC as VODI is down 7.5% QoQ on 7.4M of total active demand, which is the second lowest (least healthy) ratio of available SF for the Top 8. This is already on the heels of a recent and significant reduction (-22.7%) in the volume of paper trading with NER's down 1.9% and Free Rent up 7.5%.								
Averages		**66 / 86** **-20 pt**	**592** **-01%**	**$61** **+0.5%**	**$53** **-0.6%**	**$10.40** **+3.1**	**7.1** **+2.4%**	**94** **+0.6**	**10.1M**

*Figures in green are trending more favorably and in red less favorably for landlords. VODI Top 4 markets in green and markets ranked 5 to 8 in red.

LOS ANGELES

Markets on the Move

Los Angeles has performed relatively well in the past quarter and remains a top market performer of late. Specifically, VODI remained flat in June ‘22 at 73 and was only down -8.8% QoQ. Proposal volumes were up 10.6%. TI’s were down 4.5%, starting Rents were up 2.0% and NER’s remained flat over the T6M vs. prior 6M. Creative and Tech demand were only down slightly QoQ.

The next page is a side-by-side comparison of Los Angeles and San Francisco, featuring both near term and pre vs. post-Covid changes in demand momentum and velocity as well as changes in rental rates and related deal economics dynamics.

Market Health & Momentum Comparison

The below table spotlights key data points and the varying road to recovery between two specific markets tracked by VTS; Los Angeles, a recent out-performer had proposal volume and rents climb, and San Francisco, which has had the highest VODI decline since pre-pandemic.

Metric or Percent Change	Los Angeles	San Francisco	Mkt Avg	Analysis Time Frame
Demand / Supply				
% chg. # of Proposals	+10.6% (3)	-26.2% (8)	-0.1%	T6M (Jun '22) to Prior T6M
Avg. VODI % Change	-20% (1)	-54% (8)	-34.7%	TTM (Jun '22) to Pre-Covid
% chg. Count of Unique Tours	-1.2 (3)	+10.7% (1)	-2.5%	T3M (Jun '22) over Prior T3M
Rent Dynamics (Class A Trophy 36+ Mos) [2]				
NER Proposal Growth [8]	-6.8% (3)	-8.9% (4)	-8.3%	T6M (Jun '22) to Pre-Covid
NER Proposal Growth [8]	+1.8% (3)	+2.5% (2)	-0.2%	T6M (Jun '22) to Prior TTM
NER Proposal Growth	0.0% (4)	+2.9% (1)	-0.6%	T6M (Jun '22) to Prior T6M
% chg. Proposal Starting Gross Rent	+2.0% (4)	+4.1% (1)	0.5%	T6M (Jun '22) to Prior T6M
% chg. in Proposal Ti's	-4.5% (1)	+12.7% (8)	+3.1%	T6M (Jun '22) to Prior T6M
% chg. in Ti's [8]	+18.4% (5)	+17.7% (4)	+17.7%	T6M (Jun '22) to Pre-Covid
% chg. in Free Rent [8]	+30.3% (3)	+54.7% (7)	+38.5%	T6M (Jun '22) to Pre-Covid
% chg. Starting Gross Rent [9]	+4.0% (3)	-3.0% (6)	+0.8%	Active Proposals to Executed '19
% chg. Starting Gross Rent [9]	-2.0% (3.5)	-2.0% (3.5)	-3.9%	Proposals to Executed '22 YTD
% chg. Top 10% NER Premium [7]	+4.0% (5)	+11.0% (3)	+5.9%	21, '22 Executed + Active Proposals to Executed '18 & '19
Top 10% NER Premium [7]	70.4% (2)	41.7% (8)	55.2%	Top 10% vs 90% Avg Rent in '21, '22 YTD Executed + Active Proposals
Average of 8 Market Ranks	3.1	4.6		

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

Notes

[1] Market selection is based on a University of Chicago White paper titled “How Many Jobs Can be Done at Home?” published in June 2020.

[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 Jun ‘22.

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

[5] NER adds $15 to HOU and $18 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 5K+ sf and a term of 60+ months in Class A and Trophy buildings.

[9] Deal Economics are for executed leases with 5K+ sf (10K+ in CHI & NY) term of 60+ months for in 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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