This Monitor focuses on overall office sector performance, as well as the impact of coworking space on office demand.

**Office Fundamentals Improve:** 2018 was a strong year for the office sector in the 12th District. Driven by the booming tech industry, District office fundamentals outperformed the nation. Aggregate demand in the 12th District surged to 30.0M SQFT of net absorption, easily surpassing 2017’s relatively modest 22.7M SQFT. The robust demand pushed the District’s aggregate vacancy rate down 50 basis points (bps) year-over-year to 8.4%. Aggregate annual rent growth of 3.3% remained positive but continued to slow as it has every year since reaching a post financial crisis peak of 7.5% in 2015.

With employers increasingly using office space to attract talent, top quality assets once again captured the majority of demand for office space. The District aggregate 2018 absorption rate at four and five star properties was 3.4%, at three star properties was 0.7%, and at one and two star properties was only 0.5%. With this stronger demand high quality office spaces were able to command increasing rent premiums over older or lower quality properties. The rent premium was greatest in tech markets reaching $21 in Seattle, $19 in San Jose, and $18 in San Francisco. The smaller markets of Fresno and Pocatello also had significant rent premiums. Fresno added two new medical office buildings, while Pocatello’s small and stable inventory of four and five star buildings helped maintain a fairly constant rent premium.

Another trend from 2018 was the improved performance of suburban properties. Most of the new supply hitting the office sector was in central business districts (CBD), which are generally synonymous with downtown. As a result, suburban properties narrowed the vacancy gap with CBDs, and rent growth reached par with CBDs after lagging for most of the economic expansion.

CoStar forecasts that office employment growth, a key driver of office demand, will slow to 2.1% in 2019 from 3.3% in 2018, and aggregate net completions in the District will jump to 32.7M SQFT from 17.9M SQFT. This translates to smaller forecast declines in the vacancy rate, down 30bps to 8.1%, and even softer annual rent growth of 3.2%.

At the market level, 37 of 72 12th District markets covered by CoStar are forecasted to have higher vacancy rates at the end of 2019. While the average increase among the 37 markets is only 53bps, Santa Cruz, Provo, Honolulu, El Centro, and Ogden could see vacancies rise by more than 100bps. Part of the vacancy rate volatility in these markets could be attributed to their small size, but each of these markets (particularly Provo) is also adding inventory.

**Coworking Becomes A Demand Factor:** Over the last two years, space leased by coworking operators has been an important new source of office demand. According to a recent Colliers International report, leases to coworking operators accounted for one-third of office leases across 19 national markets during the last 18 months. These operators essentially offer sublease space marketed as coworking space.
Several factors are fueling the coworking trend. Short leases of small amounts of space are attractive to solo entrepreneurs in the gig economy. Companies hoping to attract talent with the kind of dynamic environments coworking space can provide are drawn to the concept as well. Startups (many in tech) find coworking space offers the flexibility they need for difficult-to-predict real estate needs. More established companies are using coworking as short-term surge space, incubator space for new projects, or a footprint in a new market. Finally, new lease accounting standards incenting leases of a year or less have the potential to draw any business to the short leases typically offered by coworking providers.

Subleasing coworking space makes business sense in high cost markets. In high cost markets, the upfront cost to build-out space relative to the monthly extra premium paid for leasing coworking space is significantly more than in lower cost markets. High cost tech markets, such as San Francisco and Seattle, are a focal point for the growth of coworking in the 12th District. WeWork, the coworking market share leader, has leased roughly the equivalent of a 40-story office tower in each of these markets over the past 24 months. Additionally, markets with softer net demand, such as Orange County, have seen outsized contributions to net absorption from WeWork leases.

In addition to the revenue generated from leases to coworking operators, office property owners benefit from the capital improvements operators often make to the property. However, there are risks office owners and lenders must consider. Foremost is the mismatch between the long-term obligations that operators enter into and the short-term subleases they offer. This mismatch is not stressed during the kind of real estate expansion taking place for the past nine years, and most coworking operators have not experienced a real estate contraction (Regus, another sublease space provider, filed for bankruptcy during the financial crisis, and is now trying it again as IWG). The operators are entering into leases at market high rents and subleasing space to many thinly capitalized startups that have also largely not experienced an economic downturn.

Other potential risk factors include overexposure to coworking operators, and incentives the owner may offer the coworking space provider, such as 12 months free rent or free rent in exchange for property improvements. In a worst case scenario, the owner may not receive any rent, and the improvements made by coworking operators may not be as transferable to more traditional tenants.

Coworking operators maintain that in a downturn the flexible short-term subleases they offer would fill a need for tenants that are downsizing. How substantial that need would be is uncertain. An economic downturn would likely see plentiful choices for sublease space, and downsizing companies may be less inclined to pay a premium for coworking subleases.

Finally, owners should understand that, although a source of immediate demand, coworking is ultimately a space optimization technique similar to other densification trends, such as hoteling. In the long run coworking reduces the overall demand for office space.