Diamonds in the Rough: Some Office "Star Submarkets" Have Outperformed Amid Disruption

By Lisa DeNight

The National Trend: "Star Submarkets" Feature Common Denominators

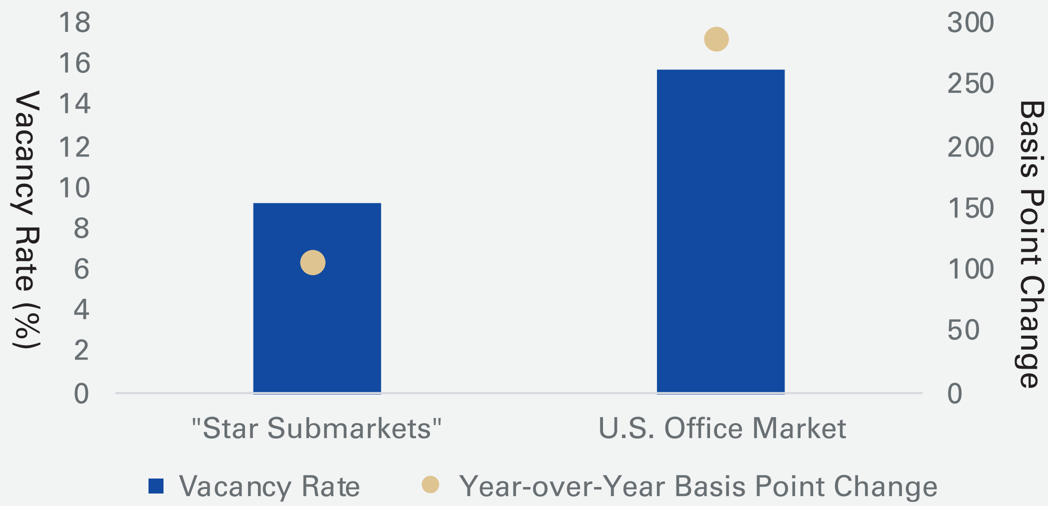
The first quarter of 2021 marked a year since the office sector was upended due to COVID-19, a year in which each of the 56 U.S. office markets tracked by Newmark Research realized an increase in vacancy on the heels of economic turbulence and persistent remote-work strategies. Most of these metro areas endured a deterioration in fundamentals throughout the region, but not all: 12 metro area markets reported "star submarkets" that typically exhibited more favorable vacancy trends, lower increases in sublease space, and stronger rent performance as compared to their peer submarkets. In some cases, those star submarkets did not just remain stable but flourished despite the considerable headwinds generated by the pandemic. Analysis of these disparate pockets of office properties revealed certain commonalities that, while not panaceas for all of the risks and challenges facing the office sector as a whole, nonetheless emerged as key stabilizers. Those core commonalities of "star submarkets" include:

- Growing demand from life sciences firms.
- Being anchored by educational and health institutions, or mature tech firms such as Facebook, Apple, Amazon, Netflix and Google (FAANG).
- Boasting a long-demonstrated appeal due to their confluence of quality space, prime location, and accessibility. Such appeal is generally reflected in average asking rents higher than the overall market average and lower vacancy rates. The first figure shows the 650-basis-point gap between the lower vacancy rate of these outperforming submarkets and the higher average rate of the broader U.S. office market.

The fight against COVID-19 shined a global spotlight on the life sciences industry, but prior to the health crisis, the overall narrative of a dynamic, growing industry was already catalyzing record investment into the sector and consequently driving increased demand for specialized commercial space. In many established and emerging life sciences clusters around the country, life sciences leasing has not lost momentum since the pandemic began, and in some leasing has accelerated. Seven of the 12 "star submarkets" shown in the second figure are experiencing growing demand from this industry. The distinction between submarkets with growing life sciences demand and the most mature epicenters is also telling—Boston's most resilient office submarket right now is not Cambridge, its premier life sciences submarket, but rather Seaport, where increased demand for lab space has helped stabilize office fundamentals. Demand has increased, and vacant, competitive office space is being removed from the inventory and converted to lab space to accommodate tenant demand.

Portions of an office market with a vibrant concentration of education and health institutions ("eds & meds") or the Big Five tech firms were also more likely to outperform surrounding submarkets. Eds & meds have struggled with the financial toll and disruption wreaked by the pandemic but remain among the most recession-resistant industries. Furthermore, eds & meds institutions tend to think of a commercial footprint in terms of a master development plan that may span decades; compared to the uncertain life cycle of companies in more volatile industries, an eds & meds concentration anchoring a submarket can more reliably yield stability. Eds & meds is driving demand in some "star submarkets" and helping to buttress others. For example, San Diego's UTC submarket has experienced strong demand from healthcare due to its proximity to UC San Diego's campus and its

Q1 2021 OFFICE VACANCY RATES AND YEAR-OVER-YEAR CHANGE



Source: Newmark Research; April 2021.

associated medical and research facilities; in Chicago, the most resilient submarket, North Michigan Avenue, is home to two of Chicago's main hospital groups and several Northwestern University campuses.

The tech industry has been a significant driver of weakening fundamentals across the office landscape—a software coder does not require a specialized built-environment in which to work—yet the largest companies in tech, FAANG firms, have all continued to lease space throughout the pandemic, bolstering demand in office markets across the country. Submarkets anchored by FAANG, such as Silicon Valley's Moffett Park or Puget Sound's Lake Union, have seen barely any budge in single-digit vacancy rates during the past year. All 12 of the select "star submarkets" reported a concentration of resilient occupiers in the eds & meds or FAANG categories, or they are bolstered by government occupancy. Boasting a resilient industry is perhaps the most critical factor in a submarket outperforming during the pandemic-induced downturn.

The final core commonality among the "star submarkets" is more general, but exceptionally fundamental. In every market, there are the haves and the have-nots: submarkets that are prized by tenants seeking quality space with an amenity-rich, easily-accessible location, and submarkets that offer more cost-conscious options, often at the expense of these benefits. As such, desirable submarkets tend to carry with them a higher cost of entry than the overall average market rate. There is a fine line to this, as tenant migration away from the highest-end rent districts has been occurring for some markets during the pandemic. Yet across the board, higher-quality space in a prime submarket remains more attractive to tenants than lesser-quality space. Eight of the 12 "star submarkets" posted above-average rents in the first quarter of 2021.

Featured Submarket: Philadelphia's University City

University City, located in Philadelphia's Central Business District, has emerged as a "star submarket" in the past year. Already a popular office and lab destination in the Philadelphia region, it has experienced strong demand and rent growth, negligible increases in sublease availabilities, and an increase in preleased development during the past 12 months. Its world-class concentration of eds & meds has not just stabilized the submarket during this period of economic turmoil but is at the heart of the submarket's expanding life sciences demand, especially in the cutting-edge fields of gene and cell therapy. Of the 341 identified gene therapy trials active in the U.S. in 2019, more than 280 were sponsored by hospitals, universities and the National Institutes of Health. This signals a deepening of a trend that University City has pioneered: cell and

“STAR SUBMARKETS” COMPARISON AND CORE COMMONALITIES SCORECARD

Market	Submarket	1Q21 Submarket Vacancy (%)	1Q21 Overall Market Vacancy (%)	Core Commonalities		
				Growing Life Sciences Demand	Anchored by Resilient Occupiers	Above Market-Average Rent
Silicon Valley	Moffett Park	0.6	12.2		X	X
Salt Lake City	Research Park	2.3	12.4	X	X	
Puget Sound	Lake Union	3.0	10.1	X	X	X
Washington, DC	NoMa	6.1	15.7		X	
Sacramento	Roseville Douglas	7.4	11.1		X	X
San Diego	UTC	8.0	15.3	X	X	X
Philadelphia	University City	10.2	15.6	X	X	X
Chicago	North Michigan Ave	12.0	17.1		X	
Phoenix	Sun City	12.1	16.4	X	X	X
Boston	Seaport	14.2	14.7	X	X	X
Suburban Maryland	North Bethesda	14.4	15.4	X	X	
Atlanta	Midtown	21.0	21.1		X	X

Source: Newmark Research; April 2021.

gene therapy startups spinning out of the academic and medical institutions that foster them, and taking commercial space in a growing, proximate cluster. Due to a dearth of competitive space, plus sustained and elevated demand, the average asking rent in University City grew 4.3% over the past year to $42.05/SF, which is the second-highest average asking rent in the Philadelphia market.

What Are the Implications for Our Clients?

Investment in office assets is slowly but steadily rebounding as the pandemic lessens its grip on the country. For cautious investors, taking into consideration the core commonalities of submarkets that have withstood the economic storm, and using such considerations to guide investment decisions, may mitigate risk to future asset values.

Many office occupiers located in “star submarkets,” whether those identified in this report or otherwise perennially popular office destinations in a given market, will be reassessing workplace strategy and company budgets in 2021. Those considering a reduction in office space may wish to consider the cost of underestimating space needs in the short term, only to experience a potentially higher-cost landscape when re-engaging with the market in the future.

Sources: Newmark Research, JAMA Network Open, Real Capital Analytics

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