Opportunities arise in a downturn for North Carolina tenants and beyond

Avison Young | Occupier Solutions Team (Raleigh-Durham)

What a difference a quarter makes. Just a few months ago, Avison Young's 4Q19 Raleigh-Durham office report portrayed sustained landlord-favorable market conditions supported by strong local and national economic tailwinds. Eleven years into an expansionary market that has been marked – unlike previous cycles – by disciplined construction activity, tenants found themselves in the most competitive leasing market in 20 years. Limited availability, particularly for Class A space, combined with sharply higher construction costs led to steep increases in occupancy costs. While an aging economic cycle and looming presidential election gave reason to anticipate a modest softening in market conditions in 2020, overall fundamentals were largely expected to mirror those witnessed in 2019.

Enter COVID-19 – an unprecedented turn of events. 1Q20 ended with the U.S. and many other countries across the globe shutting down large segments of their economies. While the media is largely fixated on the economic fallout of the virus and subsequent shutdowns, Avison Young's tenant representation specialists are preparing to assist clients with both the challenges and the opportunities presented by today's rapidly changing landscape.

Currently, and as noted in Avison Young's latest briefing on the matter, economists and real estate experts hold widely varying predictions for the economic fallout, both in terms of depth and duration, but there will almost certainly be downside impacts to all property markets. While the hospitality and retail sectors face the strongest headwinds, office is likely to be impacted as many businesses pause in their spending and decision making.

As a lagging indicator of economic trends, commercial real estate fundamentals are likely to begin showing the effects of the COVID-19 disruption in 2Q19 and through the second half of the year in the Raleigh-Durham region and

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beyond. A potential slowdown in leasing activity, combined with the anticipated delivery of more than 2 msf of new construction in 2020 in the Raleigh-Durham region, offers favorable opportunities for tenants in the market. Companies looking to expand their footprint or upscale their office space in terms of building quality, location, or both, may find more options for consideration than would otherwise be available. The sublease market is likely to expand, not only offering plug-and-play options at a reduced rate, but also increasing competition with direct space by adding pressure on landlords to concede more favorable lease terms and occupancy costs.

Given the high cost of new construction and the Raleigh-Durham office market's strong position prior to the COVID-19 pandemic, asking rental rates are likely to flatten rather than fall precipitously in the near term in response to softening demand. While local construction activity is at a 12-year high in terms of square footage underway, it remains modest by historical standards at 5% of inventory. In previous expansions, construction in the local market has typically peaked at 10% of inventory or higher. With Class A vacancy hovering near a 20-year low at year-end 2019, tenants have increasingly turned to new construction for their space needs. Of the 2.6 msf currently underway in the Raleigh-Durham region, 36% has already been preleased, which will soften the impact of new supply on vacancy. At the same time, the high material costs and shortage of skilled labor that have contributed to sharply higher rental rates will remain a factor in the near term. Landlords are likely, however, to become more aggressive with concessions as they fight to keep and attract tenants. Flexibility will be back in play as a changed landscape leads some landlords to consider shorter terms, termination options and other concessions that will mitigate tenant risk. Tenants with a few years remaining on their lease may consider downsizing and subleasing part or all their space. Another consideration would be a blend-and-extend model, by which the tenant would receive concessions, such as reduction of space or rent abatement now in exchange for a longer lease term.

Opportunities arise with every challenge. Whether looking to bring savings to the bottom line or upgrading space to attract and retain talent, shifting market conditions are likely to give tenants increased leverage in managing and obtaining their space needs.

Pictured left to right: Ginny Hager, Baxter Walker, Thomas Kenna and Kathy Gigac.

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