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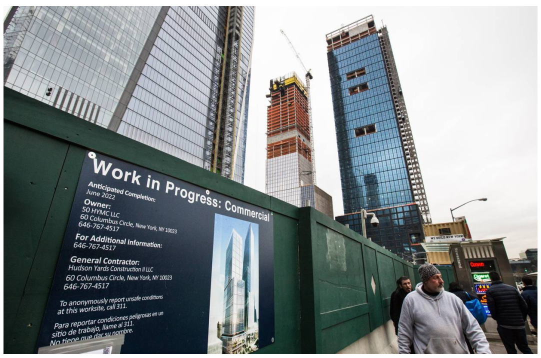
PROPERTY REPORT

Moody's Amps Up Worries About Office Space Glut

Report expects higher vacancies as demand for office space weakens while supply continues to grow



Construction continues at the Hudson Yards redevelopment site in New York City. **PHOTO:** MICHAEL BUCHER/THE WALL STREET JOURNAL

By Emily Nonko

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Moody's Investors Service has joined the growing chorus of voices raising concern about a possible glut of new office space that could hurt some market participants.

In a new report, Moody's notes that new office construction increased markedly about three years ago, averaging around a 1% increase in inventory per year. And through 2018, the credit rating agency expects the annual growth rate of U.S. office space to roughly double that of the past three years.

At the same time, Moody's expects the growth in demand for office space to weaken. In 2018, the annual growth rate of office-using employment will be about half of what it was this year, Moody's predicts.

The upshot: higher office vacancy. "As supply exceeds demand, the overall office vacancy rate will likely climb more than 1.5 percentage points over the next three years from the current cyclical low of about 13%," the report stated.

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Of course, higher vacancy can be good news for tenants looking for space or renewing leases. It often means lower rents and increased landlord concessions like interior work and months of free occupancy.

But Moody's tends to look at commercial real estate through the lens of creditors, particularly investors who purchase commercial mortgages that are packaged into rated debt securities.

Like other rating agencies, Moody’s analyzes these securities to assess their chances of defaulting, a risk that increases as vacancy rises in the property backing the mortgages.

Moody’s, a unit of Moody’s Corp. MCO 0.52% ▲ , lately also has been concerned that underwriter standards have been softening, particularly when it comes to putting a value on the commercial property backing the commercial mortgage-backed securities. Lenders in the commercial mortgage-backed securities market currently are underwriting many office buildings at values that surpass those of the pre-financial crisis peak.

“We’re looking at a cyclical shift in how underwriting is being done on the loans we see coming through,” said Kevin Fagan, a vice president with Moody’s. “Typical of the late stage of a cycle, we see some pretty aggressive underwriting with high expectations of future rent growth, and very low vacancy assumptions.”

Banks and other lenders sold a record $250 billion of commercial mortgage backed securities in 2007, according to a report by Morningstar Credit Ratings. Following the 2008 crash, the default rate soared, partly because of lax lending standards in the years just before the crash.

Lenders have been more restrained in the current economic recovery. They’re expected to issue less than $100 billion in new commercial mortgage-backed securities this year partly because of restrictions imposed one year ago by the Dodd-Frank regulatory overhaul.

The market has learned “major lessons” since the crash, according to Scott Singer, president of real-estate finance firm Singer & Bassuk Organization LLC. “It’s a very aggressive lending market now for senior debt, but the competition that’s occurring has been more focused around providing lower rates, creative structures and flexibility for borrowers than it has by increasing the leverage amount and lending more,” Mr. Singer said.

Up until recently, vacancy growth was kept in check because developers and lenders were showing more restraint about delivering new supply than in the years leading up to the crash. In the third quarter of this year, Cushman & Wakefield reported a 9% vacancy rate in Manhattan, slightly down from 9.1% a year ago. The commercial real-estate firm also tracked 7.5% vacancy in Seattle, 8.5% in San Francisco, 10.4% in Boston and 10.5% in Austin.

In some markets, brokers are dismissing alarms about new supply. “We consider our vacancy rate very stable ... and we’re continuing to see rising rents,” said Tom Pehl, senior vice president CBRE Group Inc.’s Seattle office.

But other analysts agree supply is surging. Cushman & Wakefield is tracking 106 million square feet of new office space under construction in 87 U.S. markets. “These completions are higher than what we’ve historically seen,” said Revathi Greenwood, head of Americas research for Cushman.

Also, new supply is hitting some markets harder than others. In a December report on the office sector entitled “More Naughty than Nice,” Green Street Advisors, of Newport Beach, Calif., said that “Sun Belt pipelines seem okay” but supply growth in a concern in New York City and Washington, D.C.

“Office fundamentals continue to slowly decelerate as supply growth waxes and job/demand growth wanes,” the report said.

Moody’s analysts pointed out that vacancy also is being boosted because in the current cycle tenants are using space more efficiently, giving employees less individual work space and eliminating places like libraries in law firms. “One additional square foot being added to the market is much more impactful to the overall supply and demand fundamentals than it was just five years ago,” said Robb Paltz, an associate managing director for Moody’s.

Mr. Paltz predicted that markets where a lot of new space is being delivered will “ultimately be able to absorb its inventory over a 10-year basis.” But he asked: “Can a building achieve an all-time rent, underwritten before a massive amount of new supply comes to the market? The answer is no.”