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Office Market Close-up: Miami MSA

Overview and Economy. The Miami MSA office market has 115.2 million square feet in 19 submarkets and a population of about 6.1 million residents. The MSA's top employment sectors are trade, transportation, and utilities (22.8%); professional and business services (18.3%); education and health services (15.3%); leisure and hospitality (11.6%); and government (10.2%). Major employers in Miami include University of Miami, Baptist Health South Florida, American Airlines, Carnival Cruise Lines, Miami Children's Hospital, Mount Sinai Medical Center, Florida Power & Light Company, Royal Caribbean Group, Wells Fargo, and Bank of America Merril Lynch.

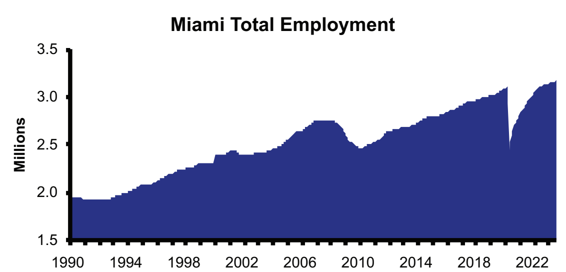


figure 1

Prior to the pandemic, Miami's first-quarter 2020 office market vacancy rate was 8.3%, with an average asking rent of $42.30 per square foot. Buoyed by relocating firms, the vacancy rate has since risen by a comparatively modest 140 bps, to 9.7%, in the second quarter of 2023. The average metro area real asking rent rose to $44.60 per square foot in the same period. In comparison, the U.S. office market saw an average second-quarter 2023 vacancy rate and asking rent of 13.1% and $33.86 per square foot, respectively. Market conditions are modestly improving, as demand for office space increases despite slow return-to-office rates.

In previous issues, we have discussed a covariance analysis that was originally published in the *Spring 2007 Wharton Real Estate Review* and is updated regularly in this publication. This analysis examines how various economic indicators behave in individual metropolitan areas based on national economic changes. Specifically, for each MSA, we estimate a statistical equation, which summarizes how a 100-bp change in national employment affects local employment. The equation consists of a constant ("alpha") for each market and a "beta," which is a multiplier applied to the national percent change in employment. The alpha indicates MSA growth that is independent of national growth. If there is no national job growth, then the alpha is the expected annual change in MSA employment. The beta for the U.S. is defined as 1.0. An MSA with a beta of 1.0 registers (on average) an increase of 100 bps in employment growth (plus its alpha) when national employment rises by 100 bps. A beta that is less than 1.0 indicates that the MSA does not boom (or bust) to as great an extent as the national economy, while a beta of greater than 1.0 indicates that such an MSA experiences swings of greater magnitude (around its trend) than percentage changes at the national level.

With a high employment beta of 1.24, changes in the MSA's employment base have a 24% greater magnitude around its trend than the national employment growth rate. Miami's alpha of 0.25 indicates that when U.S. employment growth is zero, the MSA experiences job gains of 0.25% per year. The interaction between the alpha and beta results in Miami's breakeven point for U.S. job growth of -0.20. This means that U.S. job growth can be as low as -0.20% per year, and Miami's expected job growth will still be positive. Miami's R-squared statistic of 0.89 indicates that the forecasting model for Miami explains future job growth with an 89% "fit."

Our model projected that Miami's employment would decline by 7.3% during the Financial Crisis, given the 6.3% national job loss, but the MSA performed worse than expected and lost 296,000 jobs (10.8%) from its 2008 peak. During the Financial Crisis recovery, U.S. employment grew by 17.5% from the bottom through February 2020, while employment in Miami increased by 25.9% from the bottom, almost exactly in line with our prediction of 25.0%. From the shutdown low in April 2020, through July 2023 (latest available for MSAs), the nation's job base increased by 23.6%, implying an expected Miami rise of 25.0%. In actuality, Miami outperformed expectations and gained 740,000 jobs (30.5%) from its shutdown low through July 2023.

The Miami unemployment rate bottomed at 2.6% in February 2020, rising to 14.4% by May 2020 due to the pandemic shutdown. This far surpassed the area's 11.0% Financial Crisis unemployment rate. The MSA's labor market is exhibiting a strong recovery, registering

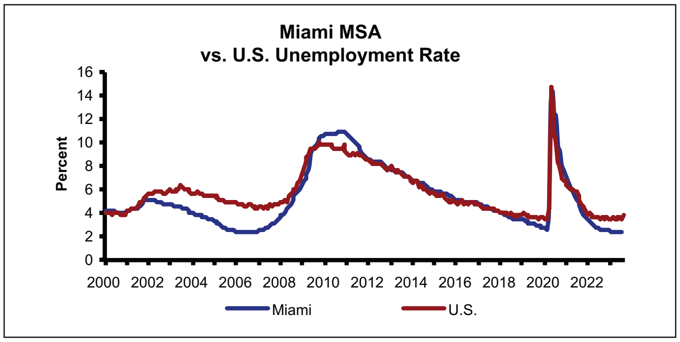


figure 2

an official unemployment rate of 2.4 % in July 2023. In comparison, the U.S. unemployment rate was 3.5% in February 2020 and officially peaked at 14.7% in April 2020 but stood at 3.8% in August 2023.

Absorption and Vacancy. The Miami office market has a total inventory of 115.2 million square feet, the largest submarkets of which are Miami Airport (22.2 million square feet), Kendall (13.5 million square feet), and Downtown Miami (12.7 million square feet). This past year, the Wynwoos-Design District and Northeast Dade submarkets saw 318,000 square feet and -113,000 square feet of net office absorption, respectively.

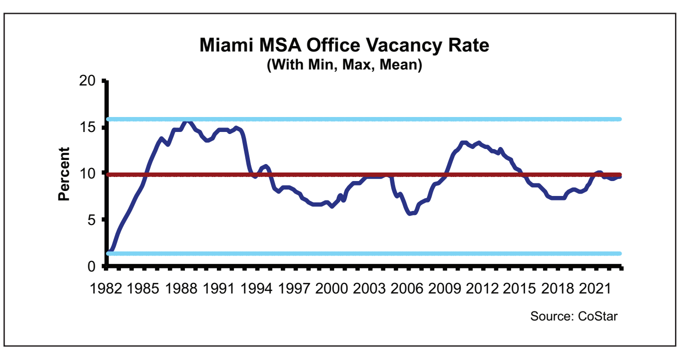
According to CoStar, the MSA's vacancy rate of 9.7% in the second quarter of 2023 was just 10 bps below the long-term average (since 1982) of 9.8%, though 830 bps above the 1982 low of 1.2%. Throughout the pandemic, the Miami office vacancy rate rose modestly but has now leveled off despite solid employment growth. Return-to-office has been slow in Miami, with many workers adopting the work from home model and pushing back against employers wanting them back in the office.

The local vacancy rate increased by 10 bps over the last year through the second quarter of 2023, and 20 bps over the last quarter. In comparison, the second-quarter 2023 U.S. office vacancy rate was 13.1%, up 20 bps year-over-year and 60 bps during the quarter. Expect office vacancy rates to generally decline over the next several years as the COVID-19 situation stabilizes and reality brings workers back to the office.

Rental Rates. CoStar reported real average office asking rents of $44.55 per square foot in the metro area in the second quarter of 2023, 46.4% above the 2003 low of $30.43 and 23.7% above the long-term average of $36.02, respectively. The current real rent is up 2.9% from a year earlier and is on par with the 2021 peak of $44.58 per square foot. In comparison, the real average U.S. office asking rent was about $33.86 per square foot in the second quarter, reflecting a 3.3% decrease year-over-year.

There were few major second-quarter leases in the MSA. According to CoStar, they include Greenberg Traurig LLP's 128,000-square foot lease in Downtown Miami and Blanca Commercial Real Estate's 38,000-square foot lease in the Wynwood-Design District, both signed in August 2023. Despite improving fundamentals, the MSA is witnessing a downsizing trend in the office market, with employers seeking newer, higher quality space with less square footage.

Development/Construction Pipeline. There were 4.6 million square feet under construction in the MSA in the second quarter of 2023 (4.0% of inventory). This pace of increase is higher than the 1.4% U.S. office market construction pipeline (121 million square feet under construction on 8.4 billion square feet of inventory). The market has a historical average of 2.6 million square feet under construction. One major project in the MSA is The Pomp, a dynamic mixed-use destination comprised of 1.3 million square feet of retail and entertainment space,



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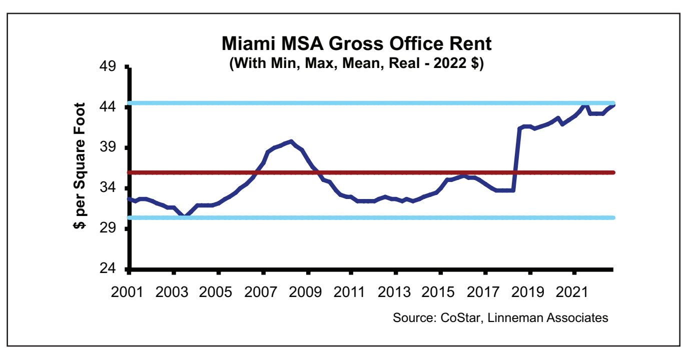


figure 4

4,000 luxury residential units, two hotels and 1.35 million square feet of Class A office. The Pomp, built on the site of the old Pompano Park racetrack, is slated to "spur community revitalization," according to Pompano Beach Mayor Rex Hardin. Hardin expects the project to bring millions of visitors annually and provide thousands of jobs for Pompano Beach and South Florida.

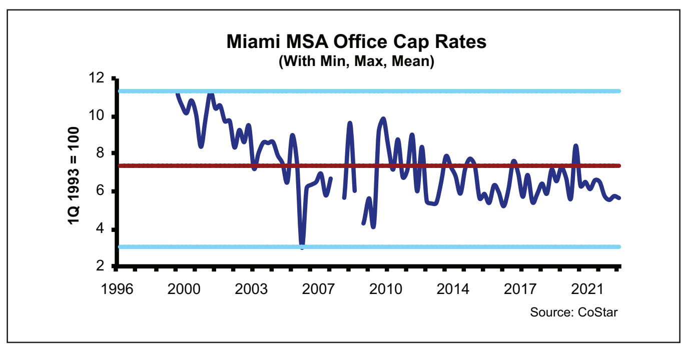
Michael Shvo, a relative newcomer to Miami real estate, recently announced plans to develop a $200 million, six-story building with 170,000 square feet of office space, 17,000 square feet of retail, parking, and condos. Shvo has also announced plans to redevelop a 13-story office building located at 407 Lincoln Road. Furthermore, he has plans for a six-story office building at 1665-1667 Washington Avenue. Shvo, in line with goals of city commissioners, has declared the South Beach office market to be bullish and initiated many projects.

Submarkets

- ***Downtown Miami.*** With 12.6 million square feet of inventory, the submarket had a vacancy rate of 14.2%, real rent of $51.30 per square foot, and 2.2 million square feet under construction in the second quarter of 2023. The submarket saw a 12-month net absorption of 198,000 square feet.
- ***Outlying Miami-Dade County.*** With 355,000 square feet of inventory, the submarket had a vacancy rate of 49.6%, real rent of $42.80 per square foot, and nothing under construction in the second quarter of 2023. The submarket saw a 12-month net absorption of 16,500 square feet.
- ***Northeast Dade.*** With 7.1 million square feet of inventory, the submarket had a vacancy rate of 5.4%, real rent of $39.10 per square foot, and 2,700 square feet under construction in the second quarter of 2023. The submarket saw a 12-month net absorption of about -118,500 square feet.
- ***Miami Beach.*** With 5.1 million square feet of inventory, the submarket had a 10.6% vacancy rate, real rent of $54.20 per square foot, and 741,500 square feet under construction in the second quarter of 2023. The submarket saw a 12-month net absorption of 41,000 square feet.
- ***Kendall.*** With 13.6 million square feet of inventory, the submarket had a vacancy rate of 5.4%, real rent of $42.20 per square foot, and 80,000 square feet under construction in the second quarter of 2023. The submarket saw a 12-month net absorption of about 157,000 square feet.
- ***Coral Gables.*** With 12.1 million square feet of inventory, the submarket had a vacancy rate of 10.2%, real rent of $48.60 per square foot, and nothing under construction in the second quarter of 2023. The submarket saw a 12-month net absorption of about 223,500 square feet.
- ***Aventura.*** With 2.6 million square feet of inventory, the submarket had a vacancy rate of 4.5%, real rent of $61 per square foot, and 587,000 square feet under construction in the second quarter of 2023. The submarket saw a 12-month net absorption of about 23,000 square feet.

Investment and Sales. In the second quarter of 2023, the average CoStar cap rate in the Miami office market was 6.4%, up 70 bps over both the quarter and year. The average second-quarter cap rate was 340 bps above the all-time low and 490 bps below the historical high. However, there are few meaningful transactions.

In the second quarter of 2023, the real four-quarter moving average price of office space in the Miami MSA was $347 per square foot, compared to $290 for the



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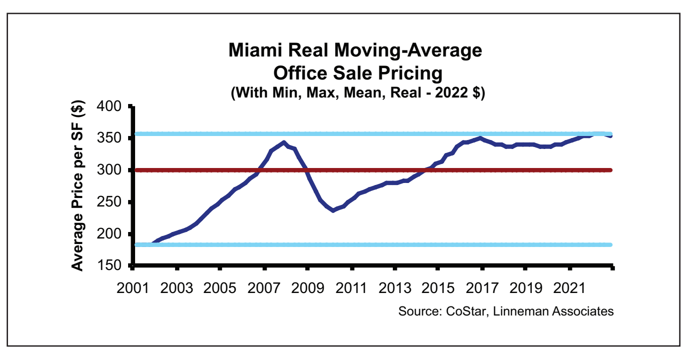


figure 6

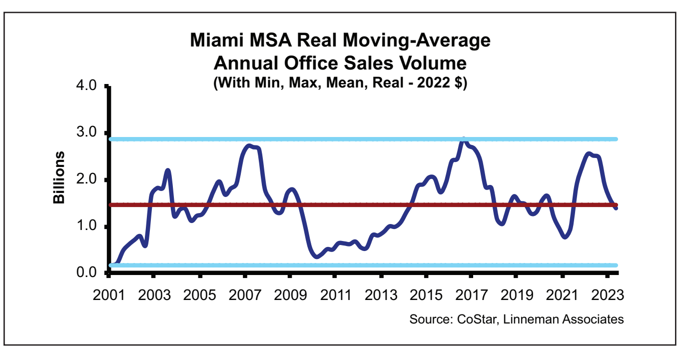
nation, according to CoStar. Current real MSA pricing is 2.6% below the historical high though it is still 16.2% above the long-term average. The current level is 91.8% higher than the 2001 low. By comparison, current real U.S. office sale pricing is 11.2% above the long-term average of $291 per square foot and 56.7% above the historical low of $206 per square foot. Real U.S. office values peaked at $358 per square foot in 2020.

Real four-quarter sales volume in the MSA was a mere $1.4 billion through the second quarter of 2023, down 44.9% from the previous year and 4.9% below the long-term average of $1.46 billion. The current level is 11.8% below the previous quarter and 51.7% lower than the long-term high of $2.9 billion seen in the third quarter of 2016.

The largest sales transactions in the second quarter included: a thirteen-story office building in Coral Gables, which was acquired by Torose Equities for $55.4 million ($246 per square foot); and a three-star suburban office building at 6600 Cowpen Road in Miami Lakes, which was sold by The Osheroff Group, LLC for $8.7 million ($236 per square foot) to Inpatient Healthcare Group.

Opportunities and Challenges. Miami's key industries include tourism (year-round), financial services, international trade, and media. True to its high beta, the MSA has regained a robust 109.7% of the jobs lost during the pandemic through July 2023 compared to 140.5% for the nation.

Florida is to receive about $13.3 billion in funding from the bipartisan infrastructure bill, over five years. The funding will go towards roads and highways, bridges, safe and sustainable public transportation, electrical vehicle chargers, high-speed internet, clean water systems, climate change preparations, and improving airports.



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As discussed, our research indicates that the MSA's employment breakeven statistic is -0.20, indicating that U.S. employment can be as low as -0.20% per year and still have positive expected employment growth in Miami. This market is at a relatively low risk of being disproportionately negatively impacted if the economy weakens, given its 0.25 employment alpha. While both the national and MSA economies will slow modestly, we do not predict a recession.

The Miami office market saw losses in occupancy due to the pandemic and has generally experienced modest net absorption during the recovery. Due to factors such as the widespread adoption of the hybrid work-from-home model throughout the MSA, recovery to pre-pandemic office occupancies is challenging.

With a resurgence of international travel, low unemployment, solid job growth, and even Inter Miami's signing of Lionel Messi, the Miami MSA's economy seems to be booming. Miami Mayor Francis Suarez has said that Miami has become "the most dynamic city in the world." Behind this boom there are challenges. One is that many of greater Miami's largest landfills are reaching capacity, with some estimated to run out of space by 2026. Miami-Dade County's solid waste director, Michael Fernandez, quit in July, citing the fact that "the County will have to issue a moratorium to stop all development" if it does not find enough space for trash soon.

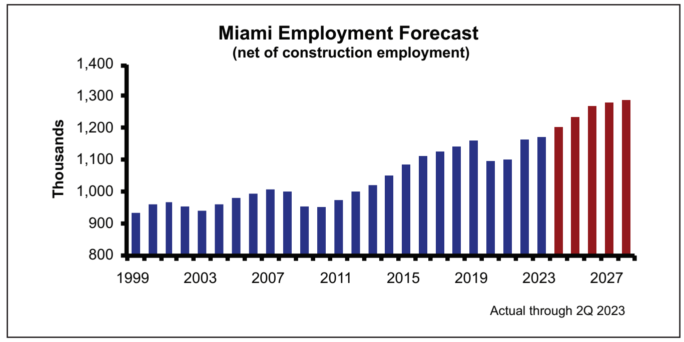
Seemingly more pressing, each time it rains in Miami, many sewage and septic tanks that serve Miami's 2.7 million residents overflow, releasing bacteria and contaminants. However, switching from septic tanks to water and sewer, a system much more typical of such urban areas, would cost at least $4 billion, according to government estimates. Homeowners would also be required to pay $20,000 each to connect their homes to sewer lines. In turn, higher taxes and fees needed to fund such projects, as well as dysfunctional infrastructure, could challenge development in the MSA.

Governor DeSantis signed several insurance reform bills into law during the 2022 an 2023 legislative sessions. These regulations seek to stabilize the struggling home insurance market in Florida. Because of rampant fraudulent lawsuits and the high claim risk in Florida, many insurance companies have net losses over $1 billion over the last two years, resulting in

30 providers pulling out of the state altogether. The bills seek to address policies being denied based on roof age, granting Florida homeowners grants to strengthen their homes against damage, and restricting the rates lawyers can charge for property insurance claims cases, hopefully discouraging fraudulent lawsuits.

For now, development projects abound. Construction on Inter Miami CF's Miami Freedom Park began in August and has a scheduled completion in 2025. On 113 acres, the park includes 58 acres of open green spaces, a "Tech Hub" that will provide office space, various entertainment facilities, a 750-room hotel, and, of course, a 25,000 seat soccer stadium. Once the stadium and initial retail and entertainment facilities are completed, Miami Freedom Park has announced plans to construct additional retail, hotel, and commercial facilities through 2030. Driven by the arrival of Lionel Messi, the excitement around the future of Inter Miami CF and Miami Freedom Park is palpable.

Outlook. We forecast that the Miami MSA will gain about 38,000 jobs per year in 2023-2028 (about 191,000 in aggregate). Sustained job growth is the ultimate driver of office demand. Given the limited pipeline, we expect that the current vacancy rate of 9.7% will fall consistently to 4.6% by year-end 2028.



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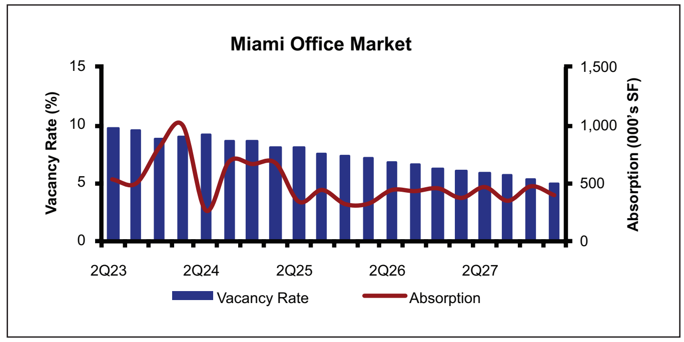

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