Flash note

Examination of sublet office space in Orlando | **Q4** 2016

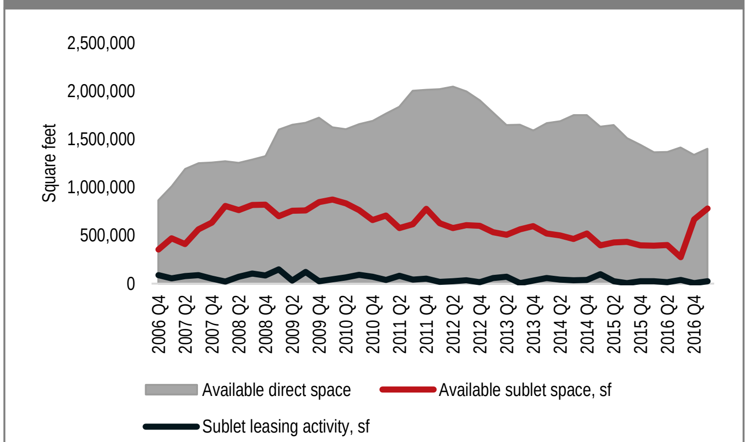
Does a swift increase in Orlando office sublet space give cause for concern?

A popular measure of a market's trajectory and economic position is the sublease market. For the Orlando office market, a sharp increase in sublet space in the fourth quarter caught our attention. With a 67.6 percent increase in sublet space compared with one year ago and the anticipation of tenants subletting additional space in the quarters to come, this development warrants further examination to determine the severity and scope of this new real estate dynamic.

Sublet availabilities have been trending downward since 2010, but a reversal of that may be underway

Although available sublet space peaked in 2010, the plateau of available sublet space originated in 2007/2008 just prior to the onset of the Great Recession. This plateau also represents a period of muted sublet leasing activity, indicating a time when spaces lingered on the market through their expiration date. Whereas, during the period of decline starting in 2010, sublet leasing activity was the key factor in the compressed availability trend.

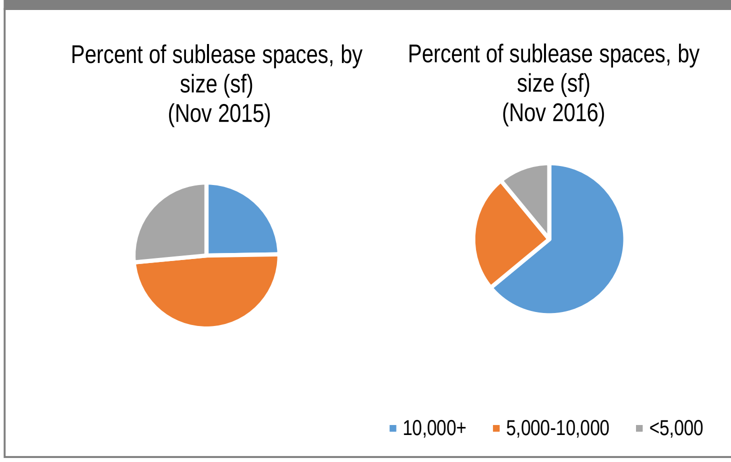
Sublet space has been trending downward, but a reversal is underway



Sublet availabilities declined; however, given the low volume in sublet leasing activity, it appears this was mainly a result of sublet space lapsing into direct availabilities rather than true sublet absorption. Interestingly though, the market also saw a reduction of direct availabilities during the period of declining sublet space, indicating an overall healthy market. From 2010 to present, direct available space declined over 17.0 percent, far outpacing the decline in sublet space during that time. In contrast, as sublet space has increased this year, direct available space has not seen rapid declines toward the back half of 2016, which may be a sign of a market slowdown—at least over the short-term.

There are currently 77 subleases being marketed, totaling 665,370 square feet in the Orlando market. In one year's time, there has been a noticeable shift in the size of the spaces offered for sublet. This time last year, only 24.7 percent of sublet square footage being marketed was in spaces greater than 10,000 square feet; however, total marketed sublet space in that size range currently accounts for nearly 60.0 percent of the for-lease sublet inventory.

Larger sublet spaces coming onto the market than in the past



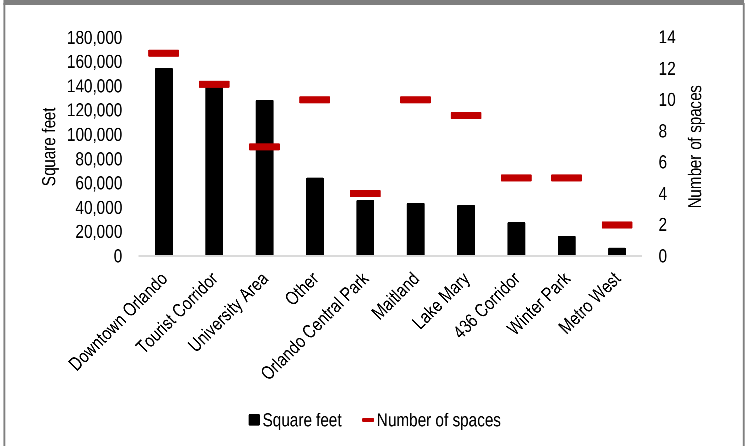
Many of these larger sublet spaces have come on-line in recent months, including an 89,000-square-foot space marketed by the culinary school Le Cordon Bleu in Southwest Orlando's Tourist Corridor. The increase in out-sized subleases on the market warrants close consideration as these subleases tend to have longer terms. The potential for these spaces to linger in the market is much greater than those sized 10,000 square feet or less. This is particularly true when looking into the downtown market.

The rise in sublet space is across an array of industries and submarkets, but is effecting some core aspects of the market

Three of Orlando's busiest office submarkets are home to the majority of sublet spaces on the market, led by the Orlando CBD with 154,158 square feet of sublet availabilities* (14.5 percent of all available space in the submarket) across 13 spaces. Most notably, HD Supply is marketing

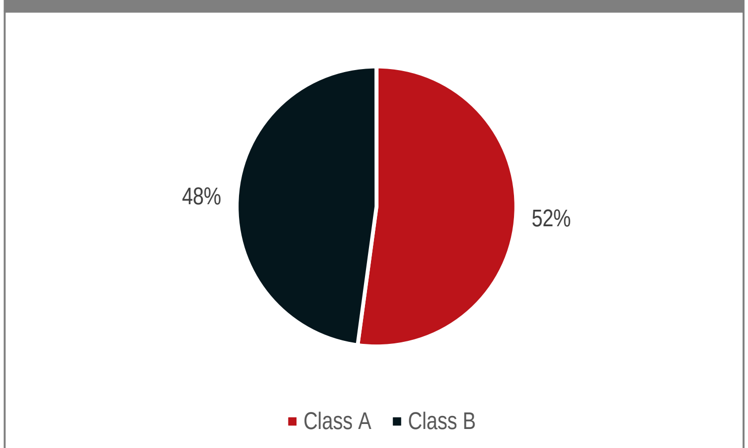
36,750 square feet of space for sublease in the Class A HD Supply building. The other submarkets with the most sublet space on the market are the Tourist Corridor (Southwest Orlando) and the University area, which account for 268,262 square feet of marketed sublet space and also offer the largest sublet spaces on the market. When excluding spaces under 5,000 square feet, the average size space on the market is 14,103 square feet—far larger than the all-inclusive market average of 8,754 square feet.

Orlando's prime submarkets comprise 76.5 percent of available subleases



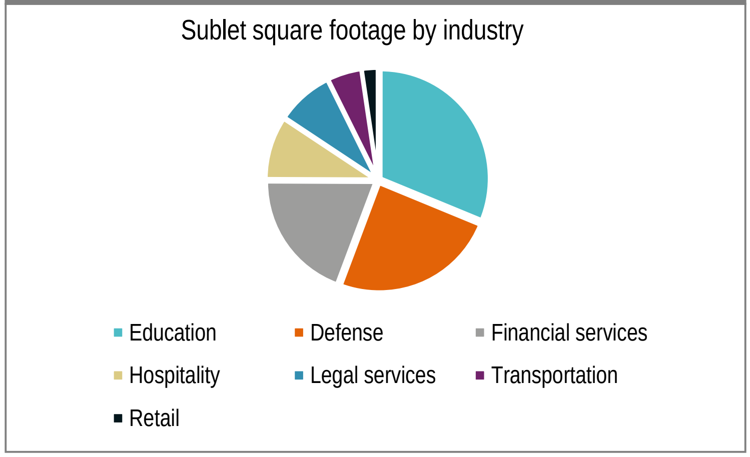
Although the availabilities skew toward the market's traditionally more active submarkets (as would naturally be the case), proportionally in terms of total stock for each market, the figure hovers around 2.2 percent of the submarket's inventory (with little variation among submarkets). This suggests that the prevalence of sublet space is fairly evenly distributed throughout the market, similar to when examining these availabilities across market's Class segments.

Sublease availabilities split fairly evenly between asset classes



Although the Class B market overall comprises only 38.0 percent of Orlando's total inventory, that segment accounts for 48.0 percent of all marketed sublet space. And while a small majority of sublet space on the market is Class A, the broader tenant roster of these assets can help explain the discrepancy between market share and available sublet space. Additionally, 83.6 percent of the Class A sublet space is accounted for by 21 tenants, making the availability of Class A subleases much more concentrated. Further, the majority of Class B sublet spaces are within outlying submarkets where that asset class is far more competitive than traditional Class A office product. Still, across the board the availability of sublet space proves more widespread across the office inventory, but a look at an industry breakdown of sublet space helps explain why Class B product is capturing more than its fair share of availabilities.

Top three sectors comprise 75.1% of sublets, but industries still diverse



Overall, tenants marketing sublet space are diverse; however, the larger spaces on the market fall within three primary sectors. The first of those are within the education sector, particularly for-profit education. Three large operators (ITT, Corinthian Colleges, and Career Education Corporation) have recently shuttered facilities due to federal regulatory changes and put a combined 135,176 square feet on the market for sublease in the greater Orlando area. Another sector tied heavily to federal decision making is defense and defense contractors. This segment comprises 24.5 percent of all sublet space on the market due to contract elapses and other factors. The other prime industries, particularly downtown, is the financial sector and legal services. There are currently three national banks listing sublet space.

Given the composition of the available sublet inventory, is Orlando's office market at a call for concern?

Overall, sublet availabilities have increased 243.3 percent since reaching a 10-year low earlier this year. This sharp increase is similar to what the market saw in 2007 when sublet availabilities jumped 171.7 percent from the first quarter of 2007 to the first quarter of 2008, later proving to be a harbinger of a greater economic crisis. However, this does not appear to be the case today.

Economic fundamentals for Orlando remain strong, and a large quantity of space for sublet are highly customized, functionality specific spaces, not suitable for traditional office use. While the situation presents itself for these spaces to linger on the market even after they elapse into direct availabilities, their impact on traditional demand sectors should remain minimal. The trend does require attention though as the sharp spike in availabilities is relatively recent. With a limited development pipeline and overall vacancy trending downward, there is possibility for these sublet spaces to become more enticing—particularly if the market experiences accelerated rent growth among competing product. We will continue monitoring the influx of sublet space on the market. Until the market sees traditional economic backbones such as retail, hospitality and legal services placing space on the market, reaction to the glut in sublet space will likely be tempered.

*Analysis focuses on spaces of at least 5,000 square feet.

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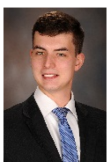

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