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Finance

The state of office financing in the Denver market

Lease rates continue to go higher, the speculative office development increases and overall office vacancy continued to decrease in the first half of 2019. Record unemployment below the national average, along with steady job growth, has put metro Denver in the upper tier of targeted U.S. markets for investors, lenders and developers.

Political and economic factors have led to a rising interest rate environment over the past couple of years, but a trade war has led to a freefall in Treasurys and other indexes, bringing the cost of borrowing significantly down. Interest rates have helped spur investment and transaction activity, aided by continued headquarters relocations and expansion of the technology sector.

While the massive rent growth we'd seen over the past seven years appeared to be stabilizing at the end of 2018, asking lease rates for office ticked up by 2.8% at the end of the second quarter. Rent concessions and tenant improvements had increased late last year, but positive absorption and decreased vacancy in the first half of the year have leveled them off.

Of the over 450,000 office square feet absorbed in Q2, over 185,000 sf of that was in the central business district. RiNo, the northwest submarket and the southeast submarket also saw strong gains in Q2. This trend shows no sign of slowing for the remainder of the year. The improved rents, absorption and vacancy factors in the suburban office submarkets have made lending there more attractive than in the years following the recession, and factors like near-term rollover are not as troubling as they have been historically.

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With the immense growth and diversification of the Denver economy this cycle, the metro area has become much more of a primary market for national and global sources of capital investment.

Interest rates had steadily risen through the end of 2018, creating concern around rising cap rates as well as slowed investment and transaction activity. Then, as very few people expected, U.S. Treasurys and other indexes plummeted through midyear. This, in particular, has brought long-term interest rates to near record lows.

Strong economic conditions, rising rents and improved occupancy factors combined with low costs of debt have spurred office investment activity in Denver and across the country. Investor demand and transaction volume seemed to dip in the first half of 2018, but ramped back up later in the year. One reason for this may be tax reform, the newly created opportunity zones and the new 20% deduction on pass-through entities.

In addition to a more favorable tax environment, interest rates falling through the floor have made for a very favorable environment for investors. What appeared to be a rising interest rate environment at the end of 2018 has turned into an outlook of stable, low rates for the foreseeable future. Caps on floating rate debt are significantly less expensive than they were in 2018, and with the Fed deciding to cut rates, it seems like we'll be in this environment for at least the time being.

> The strong fundamentals of the market, combined with projected office demand, are enough going into 2020 to keep lenders optimistic for Denver.

Leasing activity in the tech/software industry has been among the biggest drivers in the Denver office market in the first half of the year. Occupancy costs and cost-of-living advantages over the West Coast are likely to remain drivers for tech relocation to Denver. SwitchFly, Strava, Xero, Opentable and Marketo are among tech companies that have leased space in the Denver market recently.

The trend of oil and gas, health care and tech headquarters relocation activity in Denver during this expansion period looks to continue for the foreseeable future as well. VF Corp., the parent company of The North Face, Dickies and Lee jeans, is bringing over 800 new jobs to Denver.

In recent years, many have expressed doubts about the future of the office market because of the rise in coworking space and more employees working remotely. As the attractiveness the Denver market has to out-of-state and international companies continues, this does not appear to be an issue in Denver nearly as much as it does for other cities.

Another concern is the 2.3 million sf of speculative office space under construction in metro Denver. The strong fundamentals of the market, combined with projected office demand, are enough going into 2020 to keep lenders optimistic for Denver.

Denver's office market will continue to be attractive to capital sources for the remainder of 2019 due to the low cost of borrowing, a strong local economy, job growth and office market factors.

Cap rates, which seemed to be on the rise last year, have leveled off and will see some compression with interest rates falling like they have. Interest rates look as if they will stay in this near-record low territory for the foreseeable future. Headquarters relocations and the expansion of the tech sector look to be only increasing and help to balance the strong levels of office space delivery continuing in Denver.▲