



Economic Development Analysis

Executive Summary – Office Market Assessment – Part II

Completed for the Downtown Dayton Partnership
12/14/2009



EXECUTIVE SUMMARY – OFFICE MARKET ASSESSMENT

As a complement to the downtown SWOT and target industry analyses for the Downtown Dayton Partnership (DDP), Janus Economics was asked to perform an assessment of the downtown office market, including recommendations on how much, if any, of the existing office space should be deemed surplus due to reduced demand. To complete this market assessment, Janus performed a peer city comparison, conducted a field inspection of the downtown area, sorted and assessed the downtown building inventory by class, vacancy rate, etc., interviewed commercial brokers, and conducted research on national trends in downtown – real estate markets.

Several data sources were used, but the two main ones were CoStar (for peer city and national comparisons) and the database of over 70 downtown buildings maintained by DDP. CoStar covers a larger geographic area (referred to in their lingo as the CBD – Central Business District) and tracks more buildings than the DDP downtown data base. The main difference between the CoStar and DDP data is that CoStar includes owner-occupied buildings, which do not report any vacancy unless some space is being sublet. Due to this major difference and geographic and other differences in coverage and scope, CoStar data shows a much lower vacancy rate than the DDP data.

KEY FINDINGS AND RECOMMENDATIONS

- Various vacancy rate and downtown building stock “targets” were considered and the option that Janus recommends is 16.2%, which is equal to the Dayton suburban and national average suburban office market vacancy rate. We believe this goal can be reached through concentrated, cooperative efforts in leasing and adaptive re-use (and selective demolition) in the downtown area.
- Using a combination of **filling vacant space (425,000 sq. ft.)** with tenants and **removing an equal amount of vacant space (425,000 sq. ft.)** from the market, the suggested core downtown vacancy rate of 16.2% (down from the current 32% for all building classes) can be achieved.
- This would reduce the total amount of leasable office space in the core downtown area from 4,971,848 sq. ft. to 4,546,848 sq. ft., of which 736,590 sq. ft. would be vacant.

RECENT TRENDS

Over the past decade, several negative demographic and economic trends including declines in employment and establishments at state and local levels have contributed to a significant increase in the vacancy rate in the downtown office market: from 14.5% in 2002 to 31.3% in 2008, according to DDP data. Over the past two years, the Dayton CBD office market has experienced a cumulative net absorption of negative 200,000 square feet according to CoStar. For the first half of 2009, the Dayton CBD’s negative office space absorption of just over 125,000 square feet far exceeded the negative or small positive absorption in the CBD areas for the peer cities (Buffalo NY, Des Moines IA, Lexington KY, and Springfield MO and Syracuse NY). Current (through second quarter 2009) vacancy rates are higher for all classes of buildings (A, B and C) in the Dayton CBD than all other peer city CBDs (except for Class C

in Des Moines). Reflecting this soft market, the average rental rate for all classes of buildings in the Dayton CBD of \$13.32 per square foot is lower than the rate in all other peer city CBD areas. On a positive note, CareSource chose to remain in Downtown and consolidated its employees from three downtown buildings into its new 300,000 sq. ft. headquarters facility on North Main in early 2009.

REAL ESTATE STOCK IN DAYTON CBD VS. PEER CITIES

While vacancy and rental rates can change quickly due to fluctuating demand, real estate supply or stock (office buildings) is fixed and does not change significantly in the short run. A comparison of the real estate stock in the Dayton CBD compared to peer city CBDs reveals the following:

- The Dayton CBD has more square feet of office space (all classes) and buildings than the peer city CBD average.
- The Dayton CBD has less Class A and B space and buildings than the peer city average, both in absolute and percentage terms (Class A and B share of all space). However, the Dayton CBD has considerably more Class C space compared to the peer cities, again both in absolute and percentage terms.
- Calculations of real estate stock per capita (city and metro areas) also show that Class A and B office space and buildings are overrepresented in the Dayton CBD compared to peer city CBDs, and Class C office space and buildings are overrepresented in the CBD.

REAL ESTATE STOCK IN DOWNTOWN DAYTON: DDP DATA

According to DDP's database of over 70 buildings in the downtown area (the smaller "core" downtown area contained within the larger CBD area tracked by CoStar):

- There are 10 Class A office buildings and 39 Class B/C office buildings in the core downtown area (many buildings were eliminated from the analysis because they were primarily retail or residential in nature, or were not currently leasing space).
- Class A space totals 2,275,334 square feet with an average floor plate size of 17,439 and a vacancy rate of 27.57%.
- Class B/C space totals 2,696,514 square feet with an average floor plate size of 13,152 and a vacancy rate of 35.67%.
- Total space (A and B/C) totals 4,971,848 with an average floor plate size of 13,887 and a vacancy rate of 31.97%.

As part of the project scope, Janus was asked to examine floorplate sizes in downtown Dayton to determine if they were smaller than newer buildings, and if so, what the impact on demand for downtown office space is. According to CoStar data, the average floorplate size for Class A buildings in the Dayton CBD is slightly larger for Class A buildings than for new Class A buildings in the peer cities (all buildings completed in 2009 through second quarter or under construction in CBD and suburban markets). For Class B buildings, the average floorplate size in the Dayton CBD is significantly smaller than

the average size in the peer cities. Office realtors in the Dayton area interviewed by Janus did not report that floorplate size was a significant issue when their clients consider downtown as a possible office location. However, they stated that most of their clients considering a downtown location were smaller companies that would not occupy multiple floors. They did opine that smaller floorplates in many downtown buildings might be an issue for larger clients considering a central Dayton location.

ADDRESSING SURPLUS OFFICE SPACE IN DOWNTOWN

To ascertain the amount of office space in downtown Dayton that could be considered surplus, the first question that must be addressed is “what is the appropriate office vacancy rate for downtown?” While the answer to this question is up to the appropriate stakeholders in Dayton, Janus considered three target vacancy rate possibilities to help frame the question:

1. The national average downtown office vacancy rate of 13.7% (as of end June 2009);
2. The highest vacancy rates among major metro areas range from 20 to 25 percent.
3. The suburban Dayton office vacancy rate of 16.2% (Colliers Turley Martin Tucker mid-year 2009 rate) which also happens to be the national suburban vacancy rate (Colliers International).

For purposes of analysis, number 3 was selected as a reasonable target vacancy rate for downtown Dayton. There are two ways to reduce the vacancy rate: fill up vacant space (demand side approach) or reduce the amount of vacant space on the market (supply side approach). Given that the amount of vacant space in downtown Dayton is currently around 1.6 million square feet and current absorption is negative or only slightly positive, it is highly unlikely that a pure demand side approach would suffice. Therefore, it is apparent that some of the existing supply of office space must come off the market to reduce the vacancy rate to anywhere close to 16.2%. There are two realistic ways to remove office space from the market: adaptive re-use (converting office space to residential, retail or other uses) and re-use of land by demolition of buildings. For the former to be effective, there must be a demand for the alternative uses. For the latter to be effective, there must be significant funding and a mechanism in place to purchase and demolish buildings owned by private (or possibly public) entities.

Five scenarios were analyzed as a way to reduce the downtown office vacancy rate to 16.2%:

1. Remove buildings and vacant space from the downtown office market (re-use or demolition) until the target vacancy rate of 16.2% is reached;
2. Leave all buildings in place and fill up vacant space with new tenants until target vacancy rate of 16.2% is reached;
3. Remove and rent equal amounts of vacant space to achieve the target vacancy rate of 16.2%.
4. Remove buildings with vacancy rates greater than 60% (common definition of distressed building);
and
5. Remove all Class C buildings from the market.

Scenario 2 is a pure demand side solution, while scenarios 1, 4 and 5 are supply side solutions. Scenario 3 is a mixed demand side and supply side scenario. Using the DDP data base, Janus sorted and analyzed the downtown building inventory and performed the simulations and calculations to assess how to reach the target vacancy rate of 16.2% under each of these five scenarios. The conclusions were (numbers correspond to numbered scenarios above):

1. 935,000 square feet of vacant office space would have to be removed from the market, equivalent to 18.8 percent of total downtown office building stock and 58.8 percent of downtown vacant space.
2. 783,905 square feet of vacant space would have to be leased, equivalent to a 50.7 percent reduction in the current amount of vacant space in downtown.
3. If 425,000 square feet of vacant space were first leased and then 425,000 square feet of vacant space were removed from the market, the vacancy rate would equal 16.2%. This would amount to an 8.55% reduction in total downtown office space, and a 26.74% reduction in vacant space through removal.
4. Removing the twelve Class B buildings and one Class A building in downtown with a vacancy rate greater than 60% would reduce total space by 891,623 square feet (17.9% reduction) and reduce vacant space by 674,817 square feet (a 42.5% reduction). This would reduce the overall downtown office vacancy rate to 22.4%.
5. Removing all 11 Class C buildings would reduce total space by 364,184 square feet (7.32% reduction in total space) and reduce vacant space by 199,634 square feet (12.6% reduction). The overall downtown vacancy rate would only decline to 30.2%.

The following conclusions can be drawn from these scenarios to reduce the downtown vacancy rate to that of the Dayton suburban market (16.2%):

- A total demand side solution to the high vacancy rate (leaving all buildings in place and renting half of the currently vacancy space) is not realistic given negative or low absorption rates and the older, less desirable state of some downtown office buildings.
- A total supply side solution to the high vacancy rate is also not realistic, as it would require the removal of 935,000 sq. ft., or almost half of the existing office market space.
- A 50/50 combined demand side/supply side solution is more realistic than either extreme approach.
- Removing buildings with the highest vacancy rates (over 60%) would not achieve the target vacancy rate of 16.2%. One Class A building accounts for over half of the space in the 13 buildings with vacancy rates over 60%; as discussed below, it is difficult to remove buildings from the market, and it would be particularly questionable to remove a Class A building.
- Simply removing the less desirable Class C buildings from the core downtown area would not make a significant difference in the vacancy rate.

FINAL RECOMMENDATION AND PREFERRED SOLUTION:

Scenario 3 above is a combination demand and supply side solution and, in the opinion of Janus Economics, represents a *reasonable, preferred plan*. **Removing 425,000 square feet of space** (in addition to **renting an equal amount of vacant space**) could be accomplished by removing one-half of the of the available Class C space ($1/2$ of 199,634 = 99,817), with the remaining space reduction of 325,183 square feet of space coming from the removal of Class B buildings. Vacant B space could be downsized by this amount by removing several Class B buildings (Table 8 shows the amount of vacant space for the Class B/C buildings). **Removal of 425,000 sq. ft. of office space from the market would reduce total space (all classes) from 4,971,848 to 4,546,848, which would be the new “right size” for downtown Dayton.**

Therefore, it is the recommendation of Janus Economics that the City and stakeholder organizations representing downtown Dayton adopt the goal of removing the 425,000 square feet from the downtown office space inventory through adaptive re-use and demolition, and leasing an equal amount of space to new tenants. Janus Economics believes that this preferred solution is reasonable in light of the peer city CBD vacancy rate data and discussions in this report. Furthermore, we believe this goal can be reached through concentrated, cooperative efforts in leasing and adaptive re-use (and selective demolition) in the downtown area.

ADDITIONAL RELATED RECOMMENDATIONS

Based on the analysis above, Janus makes the following observations and recommendations:

- On the demand side, economic development efforts (including recruitment, business retention and expansion and new business start-up) should be given top priority.
- Steps should be taken to ensure that the other two legs of the economic development “stool” – business retention and expansion (BRE) and new business start-ups – also have adequate resources and are operating at top efficiency.
- Building on the downtown target industry study completed by Janus, a marketing program and brand image should be created for downtown Dayton. The marketing program should address the role of various stakeholder organizations in recruiting new firms into downtown and how branding and marketing can help with business retention and expansion and new business start-ups. The marketing program should identify specific companies in each target industry sector, and include a detailed program of action steps to attract those firms to downtown.
- On the supply side, the solution will not be short term, but a program should be developed to help get the supply of office space more in line with the current demand. While priority should be taking older buildings off the market, it will also be necessary to encourage adaptive re-use of newer buildings.
- Much can be learned from actions other cities facing this same problem have taken. Public/private solutions must be developed to decrease the amount of office space downtown. An authority or

agency must be empowered and knowledgeable on structuring deals to get properties into adaptive re-use, and proactively pursue these deals.

- Many cities have used public bonds to finance adaptive re-use by purchasing buildings and land from private owners. Careful study should be given to how to spend limited public funds for adaptive re-use projects. Some cities seek to funnel re-use resources into concentrated areas in order to show more tangible results.
- An alternative to “remove the least desirable properties” approach is to use public bond money to help stabilize and restore the most promising buildings to profitability and competitiveness. Building owners could submit proposals to participate in such as program.
- Since the combined supply/demand solution to downtown Dayton’s vacancy rate will be a long-term effort, steps could be taken in the short run to ameliorate the negative impact of large blocks of vacant space. Perhaps building owners with lots of vacant space could be persuaded to offer free or greatly reduced rent to start-up companies. The City might consider granting some incentives such as property tax abatements to buildings that participate in such as program.