

# To Build or Not Build in the Southeast?

## Office Renovations Take Off

Many U.S. cities have seen the return of construction cranes in recent years. However, unlike in previous building booms, residential towers have dominated new construction. So far, new office construction has not yet reached its prerecession level. On the other hand, cities across the nation are bustling with office renovations.

Could widespread renovation be dampening demand for new construction, as firms fix up rather than build anew? And if office space continues to grow scarcer, could increased demand soon outstrip what renovations can provide? Could we see new construction out of the sheer need for more workspace?

Trends in the Federal Reserve Bank of Atlanta's six-state district generally mirror those in the nation. Let's move down a floor to start looking at the Southeast.

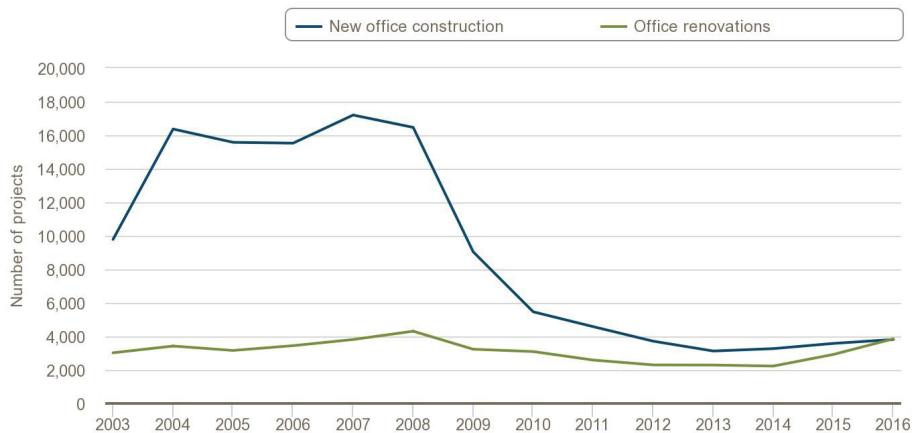
For a closer look at the national trends, read the *Real Estate Research* post "Investigating the Trend in Office Renovations" ([realestateresearch.frbatlanta.org/rer/2017/02/investigating-the-trend-in-office-renovations.html](http://realestateresearch.frbatlanta.org/rer/2017/02/investigating-the-trend-in-office-renovations.html)).

## Renovation versus New Construction in the Southeast

Data on regional office renovations and new office construction projects in recent years show some regional parallels in construction and renovation trends. Across the Southeast, the number of renovations jumped nearly 75 percent in 2016 compared to just two years earlier, according to data from CBRE-EA/SupplyTrack. The bulk of those upgrades were in Florida and Georgia, where the number of renovations more than doubled in both states from 2014 to 2016 (see the charts).

### Office Construction and Renovations

Sixth District



Source: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations



### Office Construction and Renovations

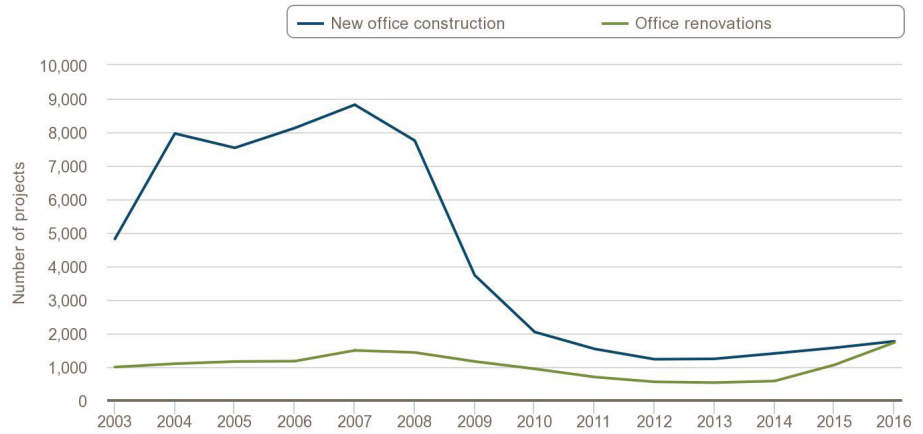
Alabama



Source: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations

### Office Construction and Renovations

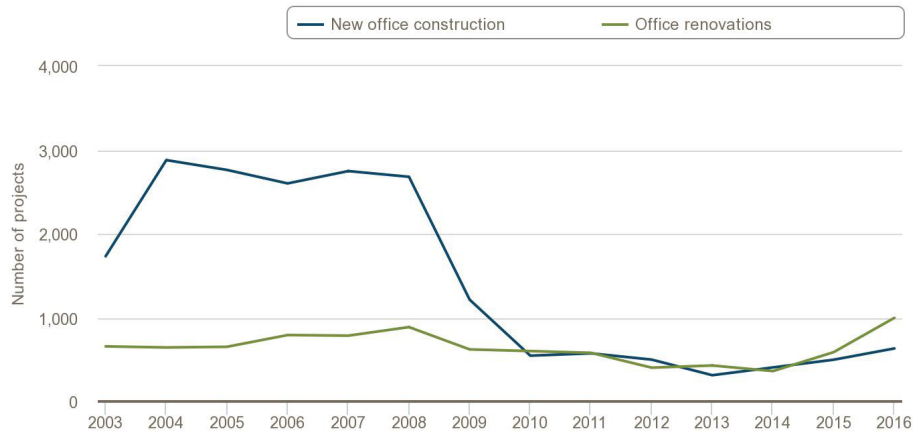
Florida



Source: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations

### Office Construction and Renovations

Georgia



Source: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations



### Office Construction and Renovations

Louisiana



Source: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations

### Office Construction and Renovations

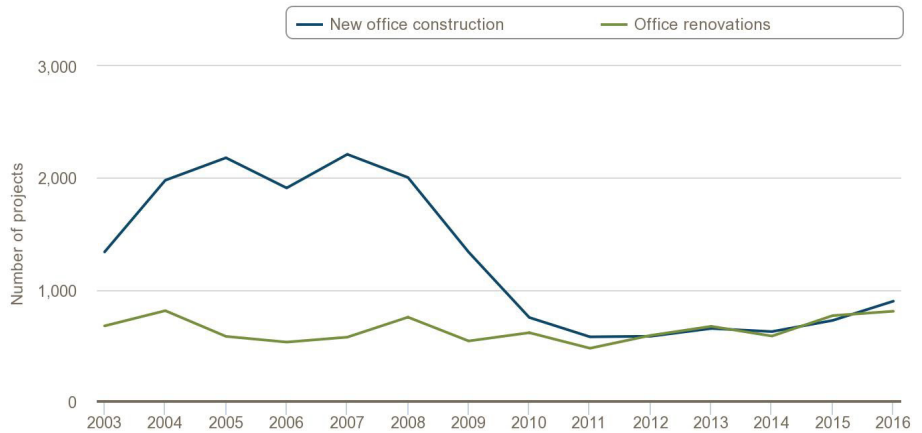
Mississippi



Source: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations

### Office Construction and Renovations

Tennessee



Source: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations

Notably, in Florida and Georgia, the number of office renovations matches or even exceeds new office construction projects—quite a change from past trends. This upswing in renovation activity appears to have begun in the past two years, so it does not appear to be an obvious consequence of the recession, which ended in June 2009. Had the renovation boom been caused by the recession, it would presumably have shown up sooner than six years after the downturn ended.

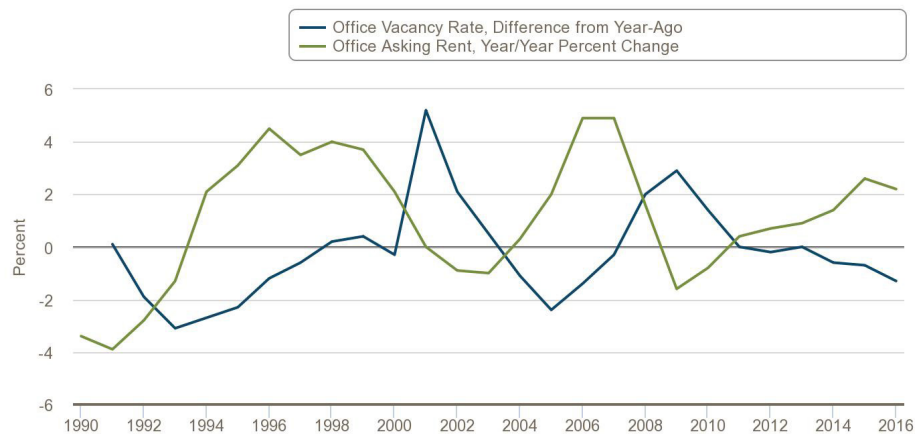
### Construction Costs, Market Fundamentals

Basic forces generally stimulate office building. Respondents to an Atlanta Fed survey of construction industry contacts cited market fundamentals such as rents, vacancy rates, and changes in construction costs for their ability—or inability—to justify new office construction ([frbatlanta.org/real-estate-analytics/surveys/realestate.aspx](http://frbatlanta.org/real-estate-analytics/surveys/realestate.aspx)).

Vacancy rates and rents help size up the landscape of existing space. Both show promising signs for builders. Asking rents for office properties in southeastern urban areas have risen on a year-over-year basis for several years. At the same time, vacancy rates have fallen steadily in southeastern metropolitan areas (see the chart).

#### Change in Vacancy Rate and Asking Rents

Weighted Average of Sixth District Metropolitan Statistical Areas



Sources: CBRE-EA / SupplyTrack (fka Dodge Pipeline), authors' calculations

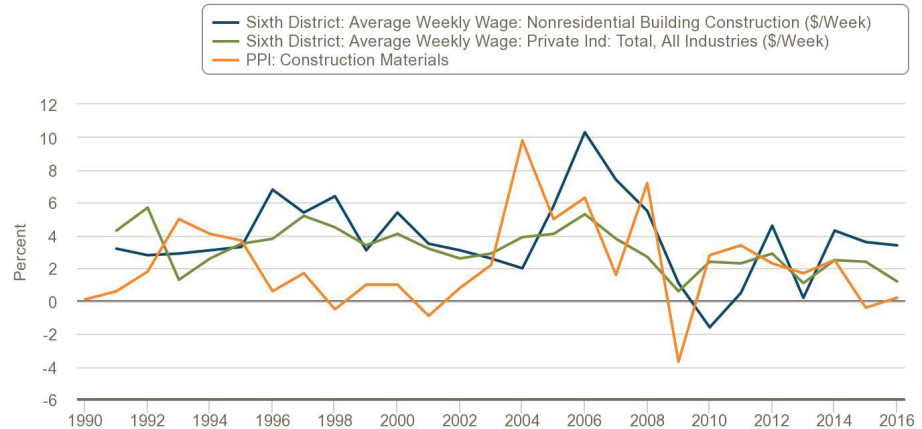
These hopeful fundamentals do not tell the whole story, however. The Atlanta Fed's business contacts are quick to point out that construction costs have increased significantly, while rents often haven't risen enough to make new construction economically practical. Although reliable data about overall construction costs aren't readily available, the prices of labor and materials, the two biggest drivers of construction costs, act as a proxy.

Pay is up. Average weekly wages for southeastern nonresidential construction workers have increased on a year-over-year basis since 2011 and have outpaced wage growth for all workers in most years since 2012.

The price of construction materials, on the other hand, has softened a bit over the past few years after rising significantly since 2003, according to the U.S. Bureau of Labor Statistics (see the chart).

## Tracking Changes in Inputs to Construction Costs

Year-over-year change



Sources: Bureau of Labor Statistics, Haver Analytics, authors' calculations

Taken together, the data appear to support business contacts' claims that conditions may not yet be right for a robust rebound in new office construction. This conclusion raises the question of whether the trend of slowly rising rents and rapidly increasing construction costs was behind the rising number of office renovation projects.

### The Workplace's Changing Nature

The industry contacts that the Atlanta Fed's Regional Economic Information Network spoke with generally said they are renovating office space to create more communal space and less solitary space. (See [frbatlanta.org/rein.aspx](http://frbatlanta.org/rein.aspx).) They seek to attract and retain workers, reduce the office's footprint, better use their existing capacity, and offer better amenities.

- **Creating more communal/shared space.** Business contacts attributed much of the renovation activity to shifting preferences toward more open and collaborative workspaces—or “we space versus me space,” as one contact put it. The goal is to encourage creativity, teamwork, and productivity. They noted the twin drivers of these changing preferences: the age of workers and enhancements that allow employees to work at their desk, in a shared space, or elsewhere in the office.

Regional construction contacts agreed, noting that most customers prefer a combination of quiet and open spaces when refurbishing office space.

- **Attracting and retaining workers.** For a couple of years, business contacts have described a tightening labor market. Attracting and retaining workers has been extremely competitive. As a result, many firms have designed state-of-the-art environments with ample amenities.

Demographics also play a role. Contacts said attracting millennials was an important factor in the decision to update space. Business contacts pointed out that the generation that grew up with technology, social media, and the sharing economy has different expectations and demands than its predecessors. In fact,





results from a CBRE survey of millennials found that a high-quality physical work environment weighs heavily when selecting an employer.

- **Reducing space and improving capacity utilization.** Some businesses have chosen to renovate space to reduce their overall footprint and improve capacity utilization. One method has been to allocate less space to each employee. In the United States, occupied office space per employee has trended down over the long term. The average office footprint shrank by 24 percent from 2003 to 2013.

Although some businesses have reduced per-employee space, many others have enlarged communal spaces to create a more open and collaborative atmosphere. Consequently, though the overall footprint may not have shrunk, space per worker has. Another method southeastern firms have employed is having some staff work from home.

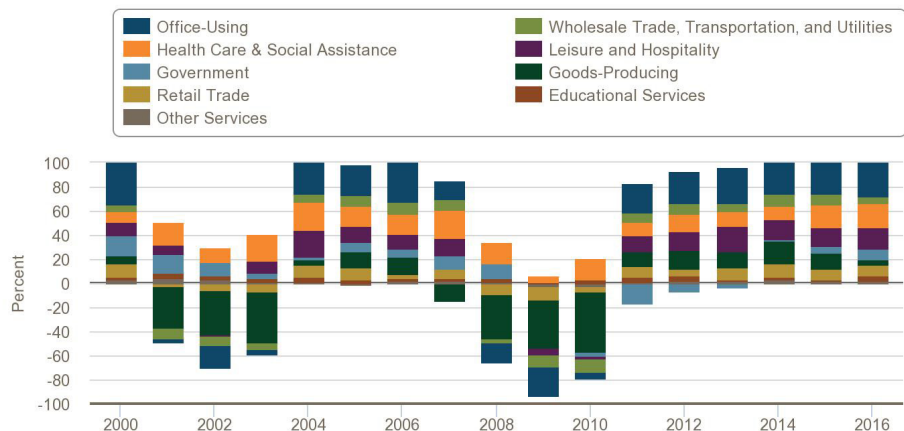
- **Improving amenities.** Many firms across the Southeast have climbed aboard the amenities bandwagon, renovating office space to add health and wellness features like standing and treadmill desks, fitness centers, and adjustable spaces that allow more daylight into the office (not to mention cafeterias, coffee bars, game rooms, and technology centers). CBRE research foresees U.S. firms continuing to increase health and wellness initiatives and making corresponding upgrades to physical space. (See [cbre.com/about/Live-Work-Play-2016](http://cbre.com/about/Live-Work-Play-2016).)

### Office-Using Employment and Its Role

Office-using employment, which includes the professional and business services, financial activities, and information sectors, is a helpful category to examine because it can suggest future demand for office space. Historically in the United States, industries with office workers have contributed more to overall employment than have other industries (see the chart).

#### U.S. Share of Employment Contributions to Nonfarm Payrolls

Annual net contributions, percent of total, seasonally adjusted

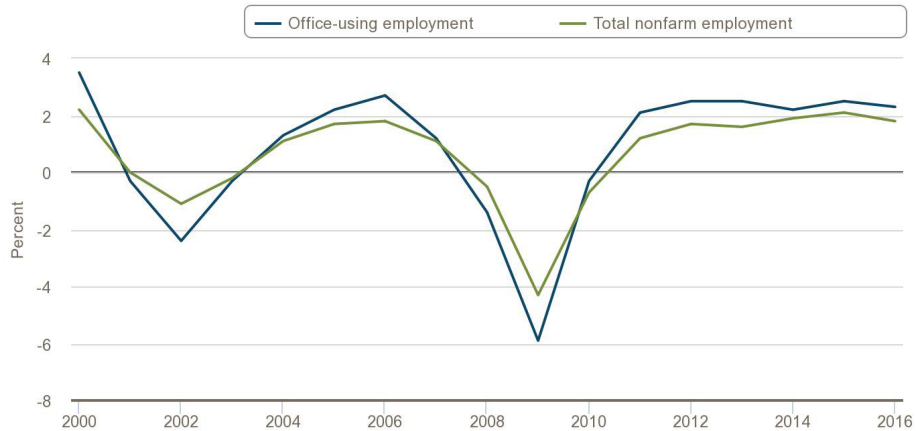


Sources: Bureau of Labor Statistics, Haver Analytics, authors' calculations

Since 2010, office-using employment has risen more than 2 percent on a year-over-year basis, outgrowing total nonfarm employment. In 2016, office-using employment was up 2.3 percent from the year before, compared with 1.8 percent growth in overall nonfarm employment (see the chart).

### U.S. Office-Using Employment Growth

Annual growth rate, seasonally adjusted

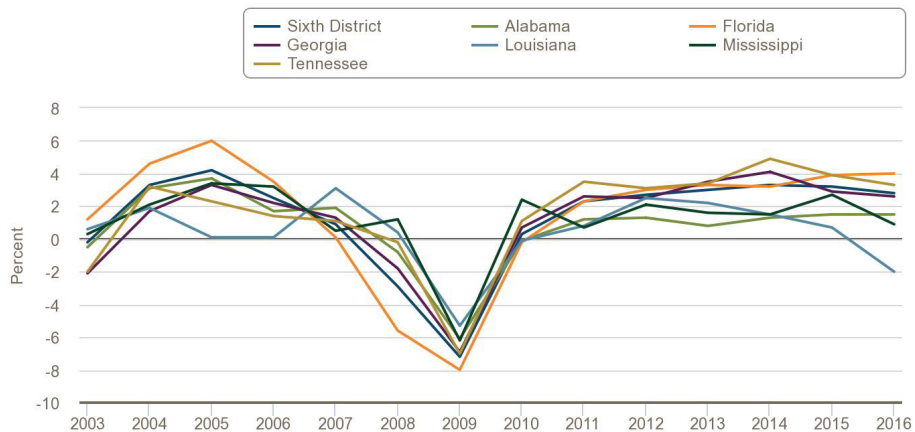


Sources: Bureau of Labor Statistics, Haver Analytics, authors' calculations

Generally, office-using employment growth parallels the number of office renovation and construction projects. Southeastern states with the biggest uptick in office renovation or construction projects in recent years—Florida, Georgia, and Tennessee—also had the highest growth rate in office jobs. In Louisiana and Mississippi, office-using employment growth has slowed during the last few years, which correlates with declines in office construction and renovation projects there (see the chart).

### Office-Using Employment

Annual growth rate, seasonally adjusted



Sources: Bureau of Labor Statistics, Haver Analytics, authors' calculations

On the other hand, Alabama's office-using employment growth rate has trended slightly up during the past few years, but the number of projects has steadily declined. Perhaps firms are using office space more efficiently and renovating existing space to accommodate additional employees. But this observation could also be the result of a



data limitation in CBRE's threshold values, as the CBRE-EA/SupplyTrack data include projects only with a value of at least \$500,000.

### **The New Normal or a Shorter-Term Trend?**

New office construction activity has risen steadily throughout the economic recovery, though not to the previous peak. Renovation activity has also increased. When office market fundamentals are ripe and the economics make sense, new office space will go up. However, tepid rent growth in some markets coupled with increasing construction costs have made it difficult to make new construction the go-to option.

There are still a handful of unanswered questions. Will office renovation activity accelerate or persist at an elevated level for a prolonged period? Does increasing renovation activity have more to do with the business cycle, or with shifting preferences?

Based on insights from business contacts, the recent jump in office renovation appears to be preference-driven. Eventually, though, firms may reach the limits of renovations they can make to accommodate more workers in existing space and may ultimately have to resort to new office construction.

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