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Demand for office space per worker is growing

INSIDER VIEW

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In the early 1990s, a recession and a crisis in our banking systems, paired with a dramatically overbuilt office market, sowed the seeds for a fundamental change in the way new projects would be done in the future. Vacancy rates rose to the mid-20 percent range and rents fell to the high $20s for Class A space. Demand was anemic, and for the first time in memory office buildings were viewed not as assets but as liabilities. During this time, virtually every major office building in Boston went back to its lender to restructure its debt.

The mid-'90s saw vacancy rates falling to the low teens with rents rising to the high $30s and no new supply in the pipeline. Part of the reason for the lack of new supply was the prediction of the effective demise of the traditional office model. As the theory went, technological advances, downsizing and improved space-management techniques would permanently reduce the demand for office space nationwide. Employees who formerly occupied offices would be so precisely organized that they would share an office with several others — this, of course, when they were not working remotely from home.

The predictors of doom and gloom for office space demand were wrong, and it is our experience that the amount of office space per worker has grown since the early '90s.

Fueled by the tech boom in the late '90s, the market swung into full recovery, marked by low single-digit vacancy rates and rents spiking to stratospheric levels, reaching nearly $100 per square foot in some buildings. Companies talked of "defensive leasing" — leasing space now in anticipation of future growth — and some landlords were able to hold auctions for space. Few developers anticipated the pace and strength of this recovery, so virtually no new supply was delivered to this now-overheated market.

The recession caused by the bursting of the tech bubble in 2000, followed by the national shock of 9/11 and the corporate malfeasance scandals, saw companies contract. That sent vacancy rates into the mid-teens and rents falling to the high $30s. The acquisitions of major Boston companies by out-of-state corporations chilled prospects for recovery and added significant amounts of space to the market.

As we approach the end of 2006, the tide has clearly turned. Over the past two years, steadily increasing absorption from the legal and accounting, private equity, private wealth management, venture capital and mutual fund and investment sectors has caused vacancy to again sink into the sub-10 percent range — this despite the ongoing corporate consolidations.

High-rise "view" space is virtually unavailable, with vacancy rates under 5 percent and peak rents now exceeding $60 per square foot.

These market fundamentals are not lost on buyers. Office building values have soared to unprecedented levels not only in anticipation of rent spikes but also due to the coupling of an increased inflow of capital into the real estate market and lower institutional yield expectations.

A significant number of major office buildings have been sold to investors who underwrite, on average, rent increases in excess of 40 percent through 2011, thereby increasing the upward pressure on market rents.

This begs the question: Are developers and tenants ready to take the leap? We have been hearing about new construction at Russia Wharf, South Station and in the Seaport for years, but to date no one has broken ground on a speculative project even though these buildings would not be delivered to the market until 2010 at the earliest. The market indicators would seem to assure success for the first one or two well-conceived projects to be delivered.

But the dramatic and continuous increases in construction costs have dictated rents — rapidly approaching $70 per square foot for a project started today, making it difficult for developers to pin down rents several years in advance.

The fact that replacement-cost rent still exceeds current market rents by more $10 per square foot, as well as a demand that is outpacing supply, ensures further rent increases.

Finally, a sobering bit of perspective on the cyclical nature of real estate: The net rents paid by the two lead tenants at International Place in 1986 were around $38 per square foot — still less than the top net rents today, 20 years later. But well-conceived, well-executed and well-located trophy office space is still the king of real estate and always will be.

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