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## Trusting your gut: New Realities in office rental rates

For 15 years, rental rates in Class A downtown office towers have been a relative bargain. Compared with broad-based inflation indices and more specifically to the growth in total employee compensation over the same time period, space costs — rents — have not kept pace with inflation and, more importantly, have risen far slower than the employment cost index, which has increased nearly 60 percent more than office rents since 1989.

Several forces are now combining to push up office rents. First, construction costs have risen dramatically, far faster than general inflation and far faster than rents, and thus, new buildings coming online in the near future need significant rents to justify their investments. Secondly, the recent record-setting selling prices of many towers have been justified by this “replacement cost” metric, and as a result, we are seeing the beginnings of an extremely strong rental market, with rents in new and existing Class-A buildings carried on an upward wave.

In the first quarter of 2007 alone, there has been a rise in rents of approximately 13 percent. Given all of these factors, landlords will be able to bring their rents closer to where they would have been if rental rates had kept up with inflation over this period of time.

Tenants will naturally try to manage their lease expense through tough negotiation, but they may also consider space cost-reduction strategies such as increasing density, reducing build-out expense, or mov-



### INSIDER VIEW

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ing to lower-quality space. These tactics can produce apparent lease-expense savings but may actually drive up other costs, specifically payroll costs, and ultimately wipe out any lease savings. Payroll cost is a much more substantial and sensitive part of the overall budget for a Class A tower tenant than rent. Any lease decision that saves rent but hampers recruitment, retention or productivity can be a mistake.

Lease decisions rely on two sets of inputs: those that may be readily quantified — rents, relocation costs, tenant improvements — and those “gut” factors that are considered non-measurable, including location, style, feel, accessibility and convenience. Tenants wanting Class-A tower space start out by acknowledging that “gut” factors are of primary importance. They have well-considered business reasons for wanting that kind of prestige space, as it makes a strong statement to both clients and employees about the company’s style, vision and strength.

It is not easy to quantify “gut” factors, but when the costs of people are roughly

10 times the cost of space, it logically pays to tend to the needs and wants of employees. Given this 10-to-1 people-to-space cost ratio, one would think that space decisions should be made with those “gut” issues clearly in mind. A small increase in employee turnover, or a small reduction in productivity, or a lost prospective client can reverse intended savings many times over and for a long period of time.

In our region, the age of the bargain lease relative to employee costs in Class A space is passing. No one wants to waste money; it is important to get the best value for one’s lease dollars. But there is no wisdom in a savings that backfires, even in a hot rental market.

Companies must determine what they value most in their work space: offices that support talented, hard-to-replace employees, a feeling of importance and substance, a location that shines, offices that say, “You’ve chosen the right company” — or savings in the lease contract, a savings that may walk out with demoralized employees, hard-to-fix inefficiencies or uneasy clients.

It is enormously important that firms pay close attention to the human consequences of their lease decisions before committing to a building and a space-expense strategy.

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