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Boston's suburban office market will show noticeable improvement in 2011

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As the Boston suburban office market bumps along the bottom showing early signs of a recovery, are the fundamentals in place for 2011 to be the turnaround year? We are experiencing an uptick in tenant activity for the first time in seven quarters and registered positive net absorption of just over 250,000 s/f in Q3. The Boston suburban office market totals 85.6 million s/f with a combined availability rate of 23.4% which decreased slightly from 23.5% after Q2.

Some of the more pronounced trends in our industry are:

- * Flight to quality
- * Rent gap magnified between Class A and B property
- * Special servicers
- * Lenders are back

During an economic downturn, we typically experience a flight to quality with tenants trading up to Class A space. For the past two years, the vast majority of companies opted to renew their current leases on a short term basis, citing intrepidation with the economy. It was not until the middle of this year that we started to detect the emergence of the "flight to quality."

The flight to quality will start to impact the rent differential between Class A and B buildings. Although the suburban office market has an availability rate of 23.4%, the Class A properties in most submarkets has a vacancy rate below 12%. A number of the Class B buildings do not have the cash reserves to invest in the necessary capital improvements to remain competitive. In 2011, rates for the Class B buildings will remain flat while Class A buildings (especially in or near central Rte. 128) will experience rent appreciation. Thus, the rent gap between Class A and B buildings will be much more pronounced, and in some submarkets, will exceed \$10 per s/f.

More than ever, tenants in the market are scrutinizing the landlord's financial stability. As landlords default, a number of properties have been turned over to special servicers. With a large number of CMBS loans maturing over the next 18 months, special servicers are going to be extremely busy. Prospective tenants are really drilling down. They want to know how much debt the landlord carries, name of the lender, cash reserves, etc. Non-disturbance agreements used to be on a tenant's wish list, now they are mandatory in the majority of lease transactions.

While we have seen some evidence of startup companies beginning to reemerge, this does not appear to be having a meaningful impact on the suburban office market as a whole. Unlike the early 2000s where a fledgling company would base their s/f needs on three to five years of anticipated growth, the start-ups today appear to be far more conservative when leasing space. Whether this stems from the lessons learned from the tech bust or not, it is clear these companies are cautious not to take down more space than they can fill today, and gravitating more toward the short term flexibility and pricing of sublease space.

As for sales transactions, the most encouraging news is that lenders are back competing for loans. At the start of 2010, we predicted the volume of sales transactions would be quite moderate. This prediction has held true. However, very few people in the industry expected to see 5-6 lenders competing to place debt at spreads almost 200 basis points lower than in 2009. Investors have a voracious appetite for core properties with credit tenants. According to Mike Kirby, Green Street Advisor's director of research, "Pricing on transactions that have recently closed or that are in the works continues to enjoy positive momentum. The rebound in pricing that began in earnest about a year ago has been impressive in terms of both its vigor and durability. Sellers are feeling less pressure to act, the outlook for fundamentals has improved, well-capitalized buyers are plentiful, and financing markets are recovering." With the limited quantity of investment grade assets on the market, now is an opportune time to consider selling.

According to the Dow Jones Venture Source, "For the third quarter ending mergers & acquisitions of venture backed companies rose 5% compared to last year and initial public offerings rose more than fivefold." In addition, the personal income of Americans rose 0.5% in August while consumption inched up 0.4%, according to the Bureau of Economic Analysis, "Consumer spending rose 0.4%, or \$41.3 billion." These signs continue to show the economic recovery is underway and 2011 will be the turnaround year for the commercial real estate industry.

We expect the Boston suburban office market will post modest positive absorption for Q4 2010 and this trend will continue into 2011. Downward pressure on rental rates will subside, as leasing activity increases in 2011. Tenants will start to make longer term commitments whether renewing their lease or relocating. Overall, we will start to experience much stronger market fundamentals.

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