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2008 office market to exhibit same trends as 2007: Rental rates will appreciate across the board

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The greater Boston office market ended 2007 with a fourth quarter absorption tally of 837,000 s/f and a majority of submarkets increasing their asking rents. While these numbers are comparable with figures from previous quarters in the current growth phase, there is mounting evidence that the market may not be able to sustain much further growth. Demographic and economic issues have hampered the expansionary forces that have fueled the market for the past several years and will limit the extent of its recovery. It is a matter of speculation as to when the top of the market will be reached, but it is probable that the bulk of the growth in the current cycle has already occurred.

The recovery from the technology crash in 2000 has been the definitive direction of the greater Boston office market for the past several years. Overall market vacancy has dropped from 19.3% in the fourth quarter of 2003 to 12.2% today, and average class A asking rents have risen from $28.55 per s/f on a gross basis to the current rate of $40.38. The popularity of new investment vehicles and debt structuring have ushered in a change to the makeup of traditional landlords and fueled rapid turnover in ownership. The market forces that have been responsible for these recent gains are now being challenged by forces working to pull the market in the opposite direction. These forces are strengthening to the point where market expansion will soon halt, bringing an end to the current growth phase in Boston, and, depending on how issues in the larger economy play out in the next several quarters, may commence a market correction for the local office real estate market.

On the expansion side, the demand for office space is evident by the 20 consecutive quarters of positive absorption, even as rents have continued to rise. The education, health, technology and legal sectors of the economy are growing, providing a boon to the local job market. The weak dollar has encouraged foreign investment in New England businesses as well as cross-border expansion by Canadian firms.

These expansionary drivers are offset by struggles in the finance sector. Investors are anticipating an end to rising rental rates, as pricing for vacant space no longer commands a premium in transaction discussions. While Massachusetts maintains a leadership position in the biotech industry, the news that the large Novartis space requirement, codenamed "Project Magellan" by the Massachusetts Biotechnology Council, has eliminated the state from consideration and the ongoing struggle to lock up Shire Pharmaceuticals to a deal in Lexington is a cause for concern. These factors, as well as issues in the broader economy involving the subprime collapse and credit crunch, threaten to pull the rug out from under the local commercial real estate market gains.

Expansion in the office leasing market will start out 2008 at a rate of a half million s/f of new tenancy per quarter. The market should exhibit the same trends of 2007, in which rental rates appreciated across the board, but year-on-year increases varied widely by submarket, ranging from eight to 10% in the Rte. 495 suburbs up to 25% in and around the city. Availabilities in the CBD and prime suburban submarkets will remain competitive, though the rate of expansion in these areas will decline as a subset of tenants defect to peripheral markets and low-cost alternatives.

Average asking rents are expected to approach $70 in the CBD in 2008, reaching the benchmarks set in 2000 at the height of the technology boom. Market fundamentals are quite different in the current expansion cycle from the environment that existed eight years prior. At that time, vacancy was below 4%, and top availabilities were subject to a competitive bidding process by tenants. In today's market, with vacancy in the CBD at about 9%, tenants still have alternative options, including committing to new space in a proposed development site.

Rental increases in the current market can be attributed to a changing ownership profile in key properties rather than supply and demand. A market once dominated by REITs has given way to private equity investors. While some tenants have chosen to take top of the market rates, others are unwilling to concede that the market can sustain these high rents.

Activity is growing in the peripheral CBD submarkets of North Station, South Station and Fort Point Channel as certain cost-sensitive downtown tenant groups seek to limit their occupancy expenses.

Rental appreciation in the suburbs is impacting tenants up for renewal in properties owned by private equity landlords. Like the CBD, suburban tenants in submarkets around the MassPike are facing occupancy cost increases of 25 to 50% in some instances. The cost-sensitive component of this group will shake out and move up Rte. 128 to Burlington and Woburn, or out the MassPike to Framingham and Natick.

Increasing rents are also spurring new construction. In the CBD, work started on Lincoln Property's Two Financial Center and the first office tower at The Fallon Company's Fan Pier. Tenant interest in Russia Wharf may soon add a third to the list. Boston Properties' CityPoint development in Waltham was 90% pre-leased by the end of 2007 on a major space commitment from Phase Forward.

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