Due diligence: Three common sense ways as to how to look at the office market

October 25, 2012 - Spotlights

The term due diligence is a defined real estate term. In one sentence it is "making a reasonable effort to provide accurate, complete information."

As a reader of various market publications, I find market conflicts as relates to office space everywhere I turn. One minute such statements are made as a market with "steady performance," then the next quarter "the office market recovery remains on tract" and then when market statistics cross my desk I see just the opposite from what I read.

The intended purpose of this article is to set aside what I read and provide three simple common sense ways as to how to look at the office market:

* When will true recovery take place in the office market?
* How to work in between short term bubbles that inevitably occur
* What history tells us on the shape of the Boston market going forward

When will true
recovery take place?

The sky fell Q4 2008. Initial studies prepared January 2009 indicated a "V" shaped recovery. The market began its decline one year prior but over the next four years was expected to pop back to where it had been in 2007. I interviewed several pundits who I know well and respect and found consistency as to job growth and recovery. The problem is that level of job growth never materialized to a point where it could provide support for a true market recovery. In the Boston area, positive job growth has been anemic. The truth of the matter is that it is GDP growth that really matters. When our markets were really humming we had 4%Â± per year in GDP growth. We are less than half of that today. So, the first bench mark is "track GDP growth." If you see it at 4% or better, that is the time to act.

Working in between the bubbles

There are hot bubbles in real estate. In Boston, the hottest part of our office market has been the Back Bay section of the city which is a bubble about to burst.

Just look at what is going on. Where is negative absorption taking place? It is Boston's Back Bay. Q3 negative absorption was (362,112) s/f and for the first 9 months of 2012, the number is (460,128) s/f. The reason is that with vacancy rates at only 5.6%, asking rents for class A product are off the charts at $59.17/s/f and tenants can buy for less in other locations.

The second bench mark is do not get trapped chasing the hot market. Hot bubbles burst. Office users in the second decade of the 21st century are price and space sensitive and will move to the least costly option, all other factors being equal. This is the world we live in today.

What history tells us

Between 2000 and 2010, we had two cycles built into one. The market crashed (1/01) then started to recover (1/04), peaked (12/07), then crashed (12/08) and rose again with an upward move (1/11). We had "saw toothed" cycles in the 2000s, what is coming next?

One thing in real estate is to look the opposite way and give weight to what you see. As all as one has to do is look back at what Tom Flatley said, think of his "blood on the street" statements and remember that he made the prediction in March 2007 as the market was rising.

Conclusion

Going forward, I am convinced that we are through the "saw toothed" period of the last decade. For the next decade, my "reasonable effort" leads me to believe that we have a long, slow period to the 2019-2020 time frame before the unsettling economic forces impacting the office sector can be put behind us. I see a very slow growing market. The major risk will be loss of ultra-low interest rates serving as a brake to economic recovery when rates rise.

My due diligence leads me to believe that there are many good office buildings that are going to be left behind. I wrote this article on October 3, 2012 just after inspecting a "left behind" building. It was great in design with atrium lobby. Half the building was owner occupied with the remaining half totally obsolete. There are 100's of similar office buildings in Boston.

My crystal ball tells me that the communication changes that we are going through are going to override the traditional office products developed in the last several decades and leave this product in the scrap heap just as occurred with mill buildings at the beginning of the 20th century.

Finally, my due diligence tells me that increases in cap rates will shift recovery toward the next decade and add years to recovery. For recovery to occur, good, meaningful, long term job growth is required which can only be funded by a solid GDP growth level supported by good jobs. Stimulus is not the answer.

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