



# nerej

## **This is not your classic market change: This cycle has two humps, not just one**

May 27, 2008 - Spotlights

The classic 10 to 13 year contraction, recession, recovery, expansion cycle has received a severe jolt:

- \* 2001-03 were recession years.
- \* 2004-07 we started recovery
- \* But were hammered again in August 2007's credit and collapse which looks to last well into 2009. This is the second hump.

As stated by one of our firm's clients "the markets have been so volatile in the last six months that every two weeks can, in and of itself, be considered material change."

This article will have two parts:

- \* To outline Boston's real estate economics which suggest trends that are starting to develop in these uncertain times.
- \* Present my view of the valuation business going forward.

### **Boston's market economics**

As I have discussed on numerous occasions, employment growth is the key to the success of the commercial real estate market. When employment grows, positive absorption takes place, leases are signed and there is a pulse to the market.

While I await receipt of the NEEP May 2008 New England Economic Outlook, I see no indication that there will be a decline in employment.

One quarter in a year does not make a market. For Q1 2008, there was positive absorption in our office markets. Overall, we absorbed 552,885 s/f of office space, 41,974 s/f was in Boston. The largest absorption was in the suburbs with 852,377 s/f absorbed in 8 out of our 10 submarkets. Cambridge was a negative 342,466 s/f due to new construction.

Industrial markets were negative 1.289 million s/f. The problem is that our manufacturing sector continues to slip. For 2007 there was only 236,805 s/f in a 133.69 million s/f industrial market. In 2006 there was a positive 3.336 million s/f in absorption.

### **Boston's market economy going forward**

A cloud hangs over new downtown Boston construction. While our office market may have flatlined, and all signs are for continued regional growth, new office construction in downtown faces a real challenge.

Construction costs have skyrocketed. The last downtown high-rise tower constructed in Boston penciled out at a cost of \$370± per s/f. Steel alone these last 18 months has doubled in price. High-rise office buildings must be built of steel and the taller the building, the more need for extra steel and cross bracing.

The problem is that construction costs are up to \$600+ per s/f. Of that \$600 per s/f, close to \$100

per s/f is land. The market says that a developer should have a return of 9.5%. This means that if cost is \$600.00 per s/f, his returns should be \$57.00 per s/f. Since operating costs are \$20 per s/f and vacancy allowance another \$3 to \$4 per s/f, rents must be \$80 per s/f to justify new construction. They are at \$70.00 per s/f.

The only place where there is "give" is in the land. Clearly, land values of \$100 per s/f (of FAR) can not be sustained at costs of \$600 per s/f. The overall result is that high rise towers will become shorter, thus lowering price. The overall result is that construction costs will create a squeeze on amenities packages so important for a building's success.

Basic and fundamental in real estate development is that the last agent in production is land. This is why, all things being equal, land tends to increase farther in value in a rising market but is the first to fall in value when markets decline.

The problem is that all things are not now equal. Increases in construction costs are now forcing down values attributable to land.

Developers work on tight margins and look at every penny. There are far higher risks in development than any other component in the real estate field. This is proven by Sam Zell's buying of property only after developer's mistakes. Tenants take the risk out of real estate and since 1977, no new towers have broken ground with a lead tenant signed.

Overall, this time around interesting market conditions are developing:

- \* The basic Boston economy is sound.
- \* But strategically we face a fundamental problem.
- \* Construction costs increases may stunt our growth
- \* Real estate economies may force compromise with the last agent in production, land, being the component to suffer.

Valuation business going forward

The valuation business going forward will be a different business. There will be far more complex problems to solve. In the above example, if you develop to a 9.5% return, there is nothing left for land. Thus, the importance of this mini case study. Construction cost increases only add to the second hump problem.

Going forward the business will become broader. There will be far more problems to solve as caused by: "Every two weeks can, in and of itself, be considered material change."

Appraisals will have no shelf life. They can be fine one day but obsolete the next. The last time this occurred was in the 1991-92 downturns. With the slowdown in the appraisal business, this is the time to re-tool, re-think and adjust business plans going forward.

Webster Collins, MAI, CRE, FRICS is executive VP/partner of the valuations and advisors services group for CB Richard Ellis/New England, Boston.