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Strong absorption rates based on new tenant occupancy in greater Boston hide market slowdown

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The greater Boston office market surged forward in the first quarter with 972,000 s/f of absorption based on new tenant occupancy, although the volume of leasing deals signed has perceptibly lagged at the start of the year. The economic slowdown gripping the country and region has heretofore had little observable impact on the greater Boston office market. Throughout the last six quarters, vacancy has consistently been driven downward through new absorption, while asking rents spiked upwards. Even as area housing prices drop, consumer confidence dwindles and trouble on Wall St. threatens the financial services sector, the expansionary trajectory of the cycle has continued. Tellingly, the office property bearing the lowest vacancy rates is the premier, most expensive space on the market. In CBD tower properties, class A office in East Cambridge and signature properties along the MassPike in Waltham, Needham and Newton vacancy rates are significantly below the average. This establishes that tenants have not been put off by the run up in asking rates and have avoided trading quality for price.

While the preceding information paints a picture of good health for Boston office tenants, one trend becomes apparent that signifies the wider economic situation is in fact starting to perceptibly drag on the office market. The amount of sublease space made available by tenants in the entire market rose for the first time in the past six quarters. During that stretch, sublease availability had diminished from 5.5 million to 3.7 million s/f throughout the market, but in the first quarter it rose again to 3.8 million s/f. The turnaround in the trend line implies that the number of tenants seeking to recoup some of their occupancy expenses is increasing, whether because of layoffs, increasing operating costs, diminishing revenues, or a variety of other reasons.

Another notable trend is that regional employment growth seems to have peaked and may be starting to decline. According to the Bureau of Labor Statistics, employment in the financial services sector in February was down forty basis points from a year ago, and down almost 4,000 jobs from the peak in July, 2007. This level of job reduction extrapolates into 1-1.2 million s/f of expected future tenancy loss. Although overall employment in the region remains strong, financial services are a major driver of absorption in the CBD and a weakening in that sector would lessen the demand for top quality space in the future.

The CBD remained upbeat with an active first quarter that produced 600,000 s/f of net absorption. Vacancy dropped to 8%, representing the lowest level since the first quarter of 2002. For the CBD class A product market, vacancy is a much tighter 6.7%, and for class A space above the 20th floor, vacancy shrinks again to a scant 3.3%. Ever increasing asking rents, now averaging $60.84 per s/f for class A space and upper floors in tower properties asking $70.00 to more than $100.00 per s/f, have clearly not dissuaded tenants from seeking top occupancy accommodations at this point in time.

Since the completion of 33 Arch St. in 2004, no new office tower has been constructed in the CBD. However, in addition to the work already under construction at Two Financial Center, work is soon expected to start at Russia Wharf, 888 Boylston St., Fan Pier and 1 Franklin St. among others. All together, the pipeline of proposed and under construction properties in the CBD totals more than 6.5 million s/f. If tower demand remains robust in the near term, expect several of these new projects to break ground before the end of the year.

The CBD will see asking rents flatten out as the year progresses. The effects of the Blackstone takeover of the former Equity Office portfolio have now had some time to work through the system, and the market has readjusted to the new dynamics. Asking rents are expected to be higher by the end of the year, but quarterly raises will no longer be in the same magnitude of the jumps that occurred at the end of 2006 and throughout 2007.

The overall suburban market finished the first quarter up 372,000 s/f of new tenancy. While the majority of submarkets experienced a tenancy gain, Cambridge lost 118,000 s/f and Rte. 495 tenancy contracted for a second consecutive quarter. The Rte. 128/95 markets contributed 214,000 s/f of absorption to the mix, with the South Rte. 128/95 market leading the way with 81,000 s/f of gain. No new construction projects broke ground, but a small, 65,000-s/f class A facility at 1560 Trapelo Rd. in Waltham delivered in the first quarter.

Suburban asking rate appreciation is still going strong, rising across the board in all suburban markets. Rather than a slowdown in rental appreciation, the suburbs have seen a moderate decrease in overall absorption in the past several quarters. Certain submarkets seem to have reached equilibrium with vacancy, such as the MassPike Rte. 128 market hovering around 11% vacancy. Positive absorption in some of these markets should be offset by negative absorption elsewhere in the suburbs.

Ryan McCullough is the general manager at Grubb & Ellis, Boston, Mass.