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Investors favor the Class B market in an uncertain time: Is it justified?

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Summer has returned to Boston, but the frigid credit climate has yet to thaw. A limited number of downtown office building have traded in the past half year as investors have bypassed large Class A assets and bid on smaller Class B buildings. Transactions that occurred in the second quarter are Synergy's purchase of 100 North Washington and 100 Franklin St.; two separate purchases, but with a combined price-tag of over $50 million. In addition to the sale of the above assets, six other Class B product buildings have hit the market. All of which are under 250,000 rentable s/f.

There is good reason for such concentration on Class B product. Year-to-date, Class B buildings have contributed to over two-thirds of all positive absorption (97,461 s/f), compared to Class A's one-third (52,142 s/f). The statistic is even more impressive when you consider that total downtown Class B product is only half of Class A's total.

Direct vacancy also continued to decline for second tier space. At the close of 2007, Class B space stood at 9.6% vacant, that number has since decreased to 8.2% at the close of 2008s second quarter. With increased competition for space and constant demand, rents have climbed incrementally. In a survey of over 60 Class B financial district lease transactions that occurred between Q4 2007 and Q2 2008, rents have increased as tenant improvement (TI) dollars have decreased. In the fourth quarter of 2007, TI dollars averaged at $20 per s/f and average rents were $36.31 per s/f. At the close of the second quarter of 2008, TI dollars plummeted to $5.33 per s/f and average rents achieved a rate of $38.90 per s/f.

For Class B landlords, the atmosphere appears conducive to getting deals done; and in many ways it is. TI dollars have fallen because tenants are opting to renew in order to avoid expensive transition costs. But, tenants will not go without a fight. Many tenants have negotiated down their average rents with the sacrifice of fewer TI dollars. The last time landlords held such power was before the technology crash, when vacancy hit even lower than the current 8.2% rate. At that time rents quickly soared above the $40 mark. Unfortunately, not all could afford the high rents and as the economy fell, so did rents, due to an increase in vacancy as sublease space quickly popped-up. Therefore, although Class B rents have not achieved pre-2001 status, they are certainly healthy for an unhealthy economy. A history both tenants and landlords are all too familiar with.

Available contiguous blocks of space of 25,000 s/f or more for Class B buildings has slipped to 11 current options for a total of 852,454 s/f. Of these options, only two are located in the Financial District and Back Bay: 40 Broad St. and 25 Stuart St. The Seaport District offers the most, with five opportunities for a total of 426,000 s/f: Channel Center; 1 Harbor St.; Seaport Center; 263 Summer St.; and 343 Congress St. Traditionally, Class B tenants' size requirements average below the 25,000 s/f mark. Therefore, such a limited number of available contiguous blocks of space is not as worrisome. But, with asking rents for Class A tower space averaging at $65 per s/f, an inexpensive

Class B option could become extremely appealing. JP Morgan is one such example. In May, the financial institution opted to leave its downtown space for the lower rent alternative of Seaport Center, committing to 103,000 s/f with options to expand. If general economic turbulence continues, decisions such as JP Morgan's, may become more common.

In order to determine future success, current leasing velocity can offer a potential perspective. Class B product leasing velocity is currently in-line with that of the last two-years. Traditionally, in the first two quarters of the year, velocity for Class B product weighs in at approximately 650,000 s/f. Although the second quarter registered slightly lower at approximately 600,000 s/f, it mirrored that of 2006s 590,000 s/f. Last year 750,000 s/f of Class B leasing velocity hit the office market, thus fueling the positive absorption experienced at end of 2007 until today. Although, the future currently foresees less absorption for Class B in 2009, leasing could be strengthened by those tenants holding out for an improved economy.

Contributions to this article were made by Lincoln Property's downtown Boston brokerage team.

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