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Midway through the 2001-2014 market cycle: Sound judgment will start to come into play

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After the 2001-2003 real estate recession, we are now six years beyond its start, through the recovery phase, and into an expanding market.

If we studied Boston's last three real estate cycles, we know that they run typically 10 to 13 years in terms of time frame. A 10 to 13 year time frame means that we should again peak somewhere between 2011 and 2014. A cycle starts with recession, then moves to recovery and expansion before falling back into recession. A real estate cycle has 4 phases.

The purpose of this article is to look at where we are now and project where we will be some 5 to 7 years hence.

Employment Projections - 2011

The Economic Outlook published by the New England Economic Project (NEEP) shows growth and employment through 2011. Our principal market in Boston is the office market. When we allocate office oriented jobs, the NEEP study shows 65,650 new jobs between now and 2011. In turn, at 250 s/f per employee, this would support some 16.41 million s/f in terms of absorption.

If there were no new construction, with 16.41 million s/f of absorption, vacancy rates would fall from their present 11.9% level to the 7% level.

The strongest market in Boston is presently downtown Boston with a 6.1% office vacancy. This is followed by Cambridge at 9.4%. The suburbs still have a lot of space at 16.4%.

The wild card is the amount of new construction.

New Construction

Downtown Boston has 1.2 million s/f which has recently broken ground. This includes Russia Wharf (in redesign), the Fan Pier, and 2 Financial Center. Waiting in the wings is 3 million s/f which includes One Franklin St. (Filene's), One South Station, and 115 Federal St. The average Class A rent is \$66.53 per s/f. Rents at this level can support new construction.

The suburbs are a different story. There is still 16.4% vacancy and average rents of \$22.25 per s/f. New construction requires rent upwards of \$40 per s/f which we just do not see, but for small blocks in and around the city of Waltham. The suburbs will be the feeding ground for tenants looking to escape from Boston's high downtown rent.

Not all tenants can afford to pay present rent levels in downtown Boston. In the study of recent leases at the \$60-70 per s/f level, the tenants are predominately financial service companies with high cash flows able to pay current asking prices.

In contrast, one of our most prominent law firms has recently moved out of the high-rise section of a high-rise tower to low-rise Class B space as a fallback. The same is occurring in older buildings in

rehab in the Seaport area. Not all tenants can afford rent levels commanded in the market. When increases in new construction and in our markets, there will be a stabilization of rental rates. Likely timing is in the 2010 to 2011 time frame. The time to start construction is when markets are at their bottom. Those that started construction in the 2005 time frame when the market was in recovery captured huge increases in value when expansion began in 2006.

Historic Perspective

My acorns are old company records that I have squirreled away. We are in the year 2007. I have saved statistics from the year 1997. It is interesting to look back and compare Class A and Class B office markets in Boston and ponder where rents might be ten years hence.

Class A office rents in 1997 averaged \$46.54 per s/f as of year end. As of Q3 2007, Class B office rents average \$39.35 per s/f. Thus, Class B rents today are at 85% of where the market stood ten years ago.

If Boston follows an historical pattern, in ten years we could be looking at Class B rents in the high \$50 per s/f to low \$60.00 per s/f range. This is 85% of current Class A rents. In studying cycles, one item that I have noticed is that in each succeeding cycle, rent peaks exceed that of the prior cycle and rent troughs never go below that of the prior cycle.

Summary

Boston has had its ups and downs in terms of cycles. Cycles have been relatively short at, recent times of ten to 13 years each. In contrast, 50 minutes from Boston is Providence which has had a far longer cycle. Its market has been in recovery/expansion for the last 15 years with no sign of peaking.

If we can continue to create jobs and can avoid another high-tech/dot com melt down, what I see is a bright future for our markets. The recent capital market crash, I believe, will become memory in 2009. I see the crash as a benefit to our market as with stricter underwriting guidelines, the huge speculative forces that have been in place in Boston, as shown by the innumerable "flips" which have occurred, just will not continue.

Speculative forces have driven total sales of property into the double digit billions and I believe future years will slip back to a more normal pace. There is an old fashion real estate principle known as the "principle of balance". What has happened is that over the past three years our markets have slipped out of balance. What I see happening is that sound judgment will start to come into play as property owners and those in the real estate service business recognize that most important creed - they must properly service their tenants and clients at all times. In the past three years, with record low financing rates and an oversupply of funds chasing deals, basic fundamentals in my view have been forgotten.

Webster Collins, MAI, CRE, FRICS, is executive vice president/partner of CB Richard Ellis/New England Partners, LP, Boston, Mass.