Running in cycles

Ups and downs in the market for downtown office space. By Jane Katz

LAST SPRING, more than two years after the end of the recession, downtown Boston still had lots of empty offices. The vacancy rate for prime office space hovered above 10 percent, in the neighborhood of its recent peak, with suburban rates substantially higher. And asking rents for downtown Class A space at $30 to $40 per square foot were still declining. The story was similar in Hartford (vacancy rate 20+ percent) and in other parts of the country such as Chicago, San Francisco, and San Jose (15+ percent). Nationally, the downtown vacancy rate averaged almost 14 percent with rents falling about 4 percent year over year.

Yet only a few years earlier in 2000, the U.S. vacancy rate in downtown office markets had been about half that level. In Boston, prime space was even tighter, with vacancies running below a minuscule 2 percent and asking rents topping $60 per square foot. But then the stock market declined, which was followed by a national recession. In the aftermath, many small companies failed and many large technology, telecom, and financial services firms cut back hiring, resulting in the soft rents and empty space that persisted into autumn 2004.

THE MARKET FOR CORNER SUITES AND SMALL CUBICLES HAS LONG SHOWN A PATTERN OF BOOM AND BUST. WHAT ACCOUNTS FOR THESE CYCLES?

This was not the first time that the market for corner office suites and Dilbert-style cubicles had displayed a boom-and-bust pattern. But compared to the last big bust in the early 1990s, most downtown office towers held their value, and most large developers managed to avoid bankruptcy even as vacancy rates rose to comparable levels. "I'm back from the dead," the developer of Boston's 33 Arch Street told *The Boston Globe* in April. "Everyone was burying me six months ago."

Why are office markets prone to cycles? Why was the recent cycle less bloody than the one that ended in the early 1990s? And does this mean smoother sailing in the future?

PAST HISTORY

Cycles of over- and under-supply in real estate have long been more the rule than the exception. As far back as the 1930s, Homer Hoyt identified real estate cycles in his classic study of the Chicago real estate market from 1830 to 1933.

But by all accounts, the boom in the 1980s and the subsequent bust in 1989-92 was especially severe. Following relatively low levels of construction in the 1970s, the 1980s featured a period of massive building. Nationwide, metro-area office space increased by more than 1 billion square feet, or 95 percent, from 1980 to 1992, while office employment rose only about 40 percent, according to data from Torto Wheaton

OFFICE (S)PACE

It can take five to ten years before a new downtown office tower is ready to be occupied. By that time, market conditions can change quite drastically. | BY MARC ROSENTHAL

Research. About half the nation's office space in existence in 1992 was built during the 12-year period after 1980.

When the bust came, vacancy rates reached 15 percent and higher in many areas of the country. Rents fell sharply (as much as 25 to 50 percent) and property values dropped, too—"in some cases, precipitously," note Lynn Browne and Karl Case in their analysis in the Boston Fed volume, *Real Estate and the Credit Crunch*. In a separate study for Brookings, Case cites the example of the 1.4 million square foot Wang Towers in Lowell, Massachusetts, which sold in 1994 for $525,000, or a mere 38 cents a square foot.

DOWNTOWNS ARE OCCUPIED BY BIG COMPANIES, AND THE LAW FIRMS, BANKS, ADVERTISING AGENCIES, AND OTHER BUSINESSES THAT SUPPLY THEM

The consequences were more than just empty offices. Cash flows fell, sometimes below the debt service of the construction loans that developers had received from banks. In other instances, the decline in a building's market value put the developer in violation of the terms of its loan, forcing the bank to consider the loans "nonperforming" even if no interest payments were immediately due. Meanwhile, longer-term lenders (such as insurance companies), who had been expected to assume finance of the finished buildings, dried up as the market deteriorated. Banks (sometimes under supervisory pressure) went after whatever developers' assets they could in a high-stakes game of musical chairs. In the end, hundreds of developers failed, as did many banks. The cycle was particularly pronounced in the Northeast and in New England, where the Bank of New England, one the region's largest with $32 billion of assets, was closed by the Federal Deposit Insurance Corporation in January 1991, imposing net losses on that agency of $733 million. Many remaining banks responded by tightening their credit standards, contributing to the depth of the recession and subsequent slow recovery. Economists Patric Hendershott and Edward Kane estimated that economic losses from oversupply reached $130 billion.

The extra space wasn't fully absorbed until years later, when demand finally recovered enough to make new projects look feasible. In Boston's central business district, there wasn't a single new major office project completed between the opening of Two International Place (in 1993) and the World Trade Center East (in 2000).

FORCES OF BOOM AND BUST

Most downtown office space houses top managers and other corporate staff for large industrial and financial services companies and the business services that supply them: law firms, banks, insurance companies, accounting firms, business consultants, and advertising agencies.

Thus, the main driver of the demand for office space is economic growth, and especially an increase in office employment. And the proximate cause of a bust is usually an economic shock that results in a drop in demand for office workers and the offices that house them. Recessions, however, don't always produce a real estate bust; the recession of 1980-82, which was not preceded by a major building boom, saw relatively low vacancy rates and rent declines.

In addition, each cycle has its own unique circumstances. It is widely believed, for example, that changes in the tax laws were a contributing factor during the 1980s. Case notes that in the Tax Reform Act of 1986 (in conjunction with the Economic Recovery Tax Act of 1981) "drastically altered the tax landscape for real estate" by reducing marginal tax rates, repealing the capital gains exclusion, altering passive loss rules, and lengthening the depreciable lives of assets. This time around, the bust was probably exacerbated by the attacks on September 11, 2001, which not only further slowed the economy, but also made space at the top of a high-rise office building in a major downtown city look a little less attractive.

But beyond particular events, office markets also appear to exhibit cycling that is partly independent of national macroeconomic conditions (see chart on page 28). What might account for the particular pattern in office markets?

Timing is everything. Office buildings take a long time from when a project is conceived to when the offices are ready to be occupied. Buying the land, obtaining permits, designing the building, and putting together financing all take time—and that's before ground is even broken. In densely populated downtowns, where traffic patterns and infrastructure are already in place, construction can take several years. By the time the building is built, as many as ten years down the road, demand may have dried up. International Place Two, with 750,000 square feet of office space, was first conceived in 1981, announced in 1983, approved by the city in 1985, broke ground in 1988, and didn't open until 1993, by which time the vacancy rate in downtown

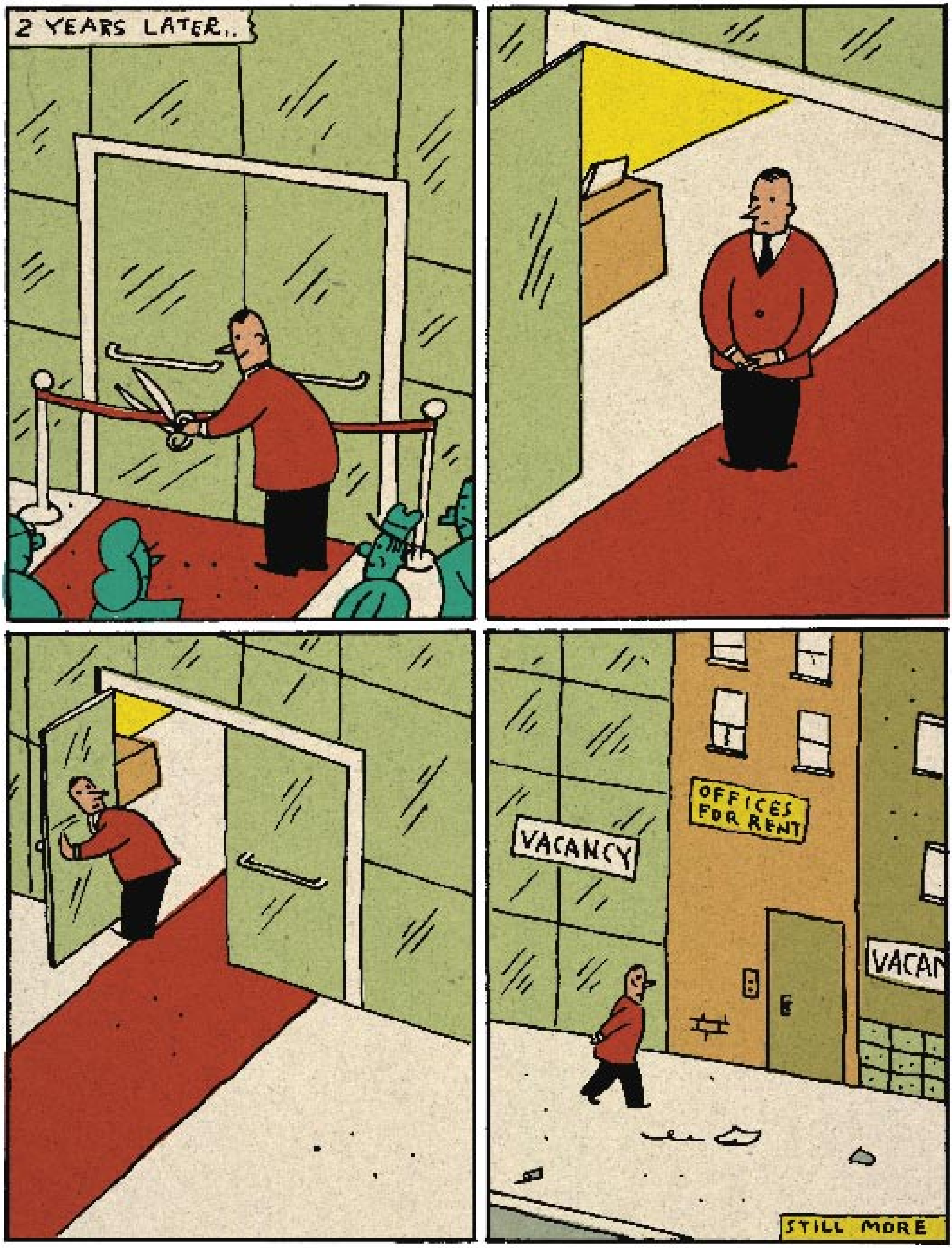
Recently opened in downtown Boston

Boston has seen 11 major office buildings built or renovated since 1999. Most are a relatively modest 500,000 to 600,000 square feet, far smaller than the Prudential Tower (1965) at 52 stories high and 1.2 million square feet or the John Hancock Tower (1976) at 60 floors and 1.6 million square feet. Of the 11, two were developed by publicly traded companies, and five are now at least partially owned by publicly traded companies.

Building	Floors	Square feet (1,000's)	Year opened/renovated
10 Post Office Square	14	450	Renovated in 1999; built in 1929
World Trade Center East	16	504	2000
10 St. James Avenue	20	585	2001
111 Huntington Avenue*	36	867	2001
Independence Wharf*	14	330	Renovated in 2001; built in 1926
World Trade Center West	17	532	2002
131 Dartmouth Street*	11	369	2002
One Lincoln Street*	36	1,020	2003
601 Congress Street*	16	400	2004
33 Arch Street	33	608	2004
100 Cambridge Street	22	565	Renovated in 2004; built in 1965

NOTES: Includes buildings zoned primarily as office space, with at least 10 floors and 100,000 square feet of usable space. * Indicates building was developed or is now at least partially owned by a publicly traded company.
SOURCE: *Spaulding & Slye Office Report*, Summer 2004


SOON
FANCY & SHMANCY ARCHITECTS
SHORTLY
CONTINUED


2 YEARS LATER..
OFFICES FOR RENT
VACANCY
VACAN
STILL MORE

Boston was 14 percent.

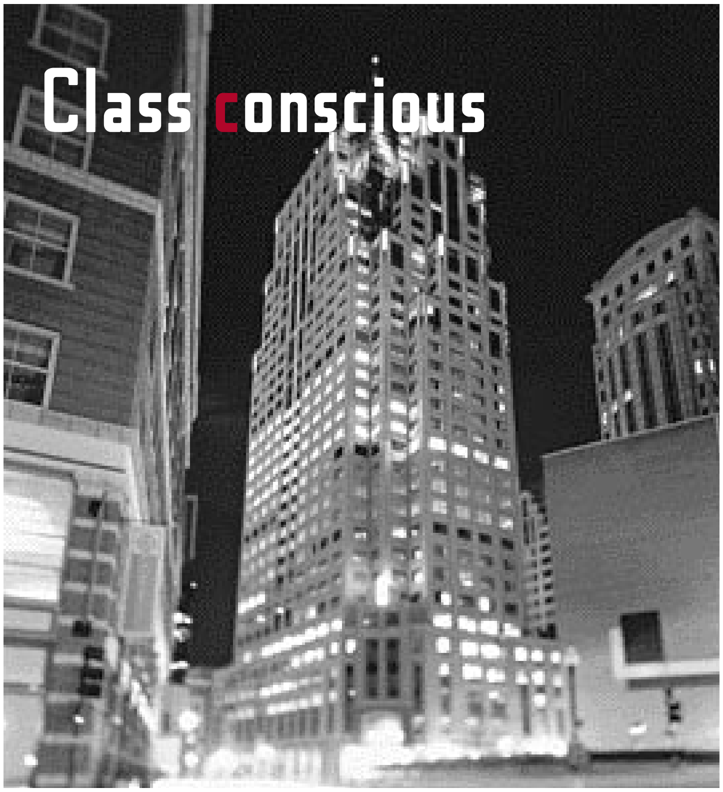
Even though developers know there will be lags, accurately predicting demand that far in advance is extremely tricky. And the difficulties can be compounded when accurate information is hard to obtain and interpret. To begin with, in downtown markets such as Boston, each building has unique attributes and location, and contracts are complicated, confounding the task of making accurate forecasts. In a slack market, concessions such as free rent and improvements are common, and can mask rent declines. And sometimes building owners hold space vacant as inventory for future demand or hesitate to adjust rents down when occupancy levels fall, as they wait for higher rental rates before leasing space.

An additional factor in periodic overbuilding: In major cities, new supply office space typically comes in big chunks. This suggests an incentive for the developers to try and get there first and snap up prospective tenants and financing. This can lead to overbuilding, as a number of firms jump in early thinking they can push out or discourage others from entering the market as well.

Financing and capital flows. There are a number of factors in the ownership and flow of financing that have also been implicated in historic patterns of boom and bust. Commercial development in the United States has historically been dominated by highly leveraged entrepreneurs. Often, they were men with outsized ambitions and reputations who were attempting to build vast personal fortunes and were willing to take on huge risks. They typically borrowed heavily from banks to finance their buildings, and their various projects were often linked—with one project providing backing for another; prior to the early 1990s, individual properties could carry mortgages representing as much as 90 percent or more of the building's construction cost or market value. As for the banks, the properties themselves and personal wealth and reputation of the developer seemed sufficient security for the loan, while rental income from tenants was presumed to be enough to cover the interest payments. Such "enthusiastic financial markets both nationally and locally" were part of the fuel in the 1980s building boom.

These forces for expansion could also be exacerbated by the incentives created by fees paid only upon doing the deal. Land assembly profits, consulting fees, project management fees, and bonuses at lending institutions can all be reasons why certain parties might push a deal once it's started—even though the deal might not make economic sense by completion.

So long as the economy was strong, building values were rising, and capital was flowing into the sector, everything worked out fine. But when values fell, as they did in the late 1980s and early 1990s, the net worth of many projects—which could actually be small relative to the size of their assets (and liabilities)—fell to zero quite quickly. And the revenue streams produced by tenants in many of the buildings shrank below the level necessary to cover interest payments. In the boom and bust of the late 1980s and early 1990s, this led to a cascading series of bankruptcies among developers and failures among banks who lent to them.



Class conscious

The United States currently has approximately 11 billion square feet of office space. About half is located in the central business districts of major metro areas, and half of that sits in only four downtowns: New York (29 percent); Chicago (10 percent); Washington, D.C. (7 percent); and Boston (5 percent).

SPACE ON TOP FLOORS tends to be the most desirable and the most expensive. Vacancy rates are often below those on lower floors; in April 2004, the vacancy rate for space above the 20th floor in Boston was 6.7 percent compared to 12.8 percent on lower floors.

SUBURBAN office buildings also tend to have lower rents and higher vacancy rates than downtown.

SUBLEASED SPACE is space rented from a tenant, and is generally less desirable and therefore cheaper than space leased directly from an owner. The sublease length is limited to the number of years left on the original lease, and the tenant may be less willing than an owner to make improvements. Still, subleased space is a close enough substitute that the release of a significant amount will affect rents on the direct lease market.

Office space is typically divided into three classes. Designations are subjective and made by local brokers based on geography, amenities, aesthetics, and maintenance—and different data sources may use different methods of classification.

CLASS A is premium space in good locations with unique tenant layouts and high-quality materials and workmanship. The buildings are generally new or recently renovated with modern mechanical systems and above-average maintenance and management. Class A space generally includes all major downtown office towers and accounts for about two-thirds of all downtown office space (square feet) and about one-third of all downtown office buildings.

CLASS B is utilitarian space without special attractions, and with average layouts and maintenance.

CLASS C is utilitarian space with below-average layouts and maintenance.

PHOTOGRAPH BY BOB O'CONNOR

CHANGES IN THE 1990S

Although vacancy rates were almost as high as in the last bust, this most recent cycle has seen relatively few bankruptcies. In January 2004, the *Wall Street Journal* even called real estate "an island of creditworthiness." Real estate companies hadn't had a corporate debt default in 10 years, and commercial mortgage delinquencies were 0.4 percent—compared to 7.5 percent in 1992.

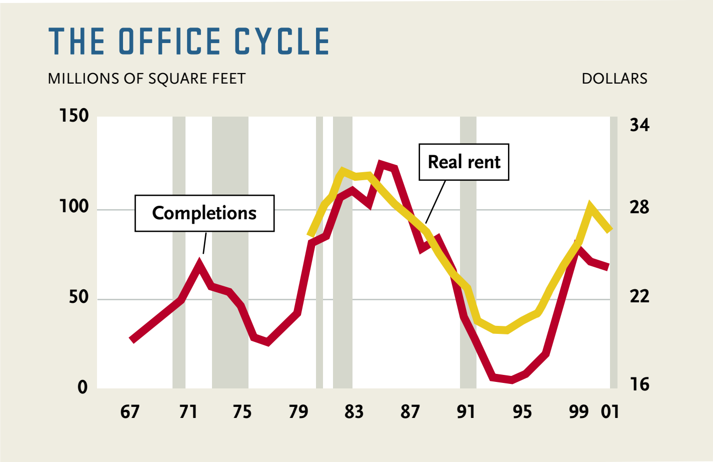
IN THE PAST, COMMERCIAL DEVELOPMENT WAS DOMINATED BY HIGHLY LEVERAGED ENTREPRENEURS WILLING TO TAKE ON BIG RISKS TO GET RICH

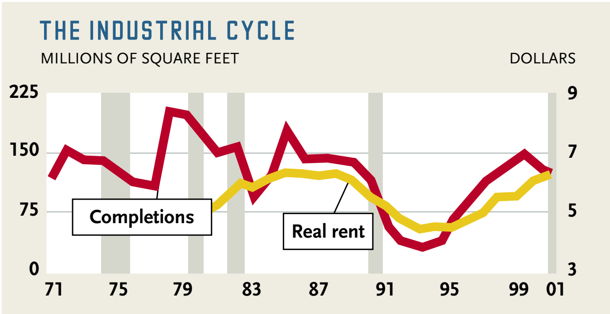
Part of the explanation was a more modest expansion in total space as compared to the earlier period. Nationwide metro-area office space grew only 17 percent from 1992 to 2003, while office employment grew 30 percent. In metro Boston, commercial office space grew by 18 percent, slightly less than the increase in office employment, which was about 25 percent over the period. Moreover, while more than 10 new towers went up in downtown Boston, on average they were relatively modest in size compared to the 1980s when One International Place, 125 High Street, One Financial Center, and Exchange Place all opened, each with approximately one million square feet of office space.

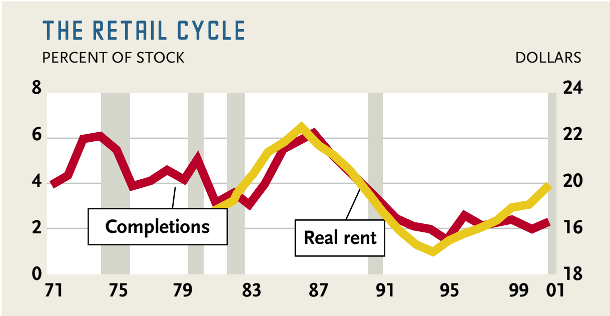
Many observers attributed at least some of the moderation to changes in ownership structure and an increased role of public capital markets in providing finance. On the equity side, real estate investment trusts (REITs) became more prominent during the 1990s. REITs were originally developed in the 1960s to overcome the difficulties faced by small investors in commercial real properties, which tend to be large, expensive, and concentrate too much of a small investor's portfolio in one place. The trusts were made free of income tax at the enterprise level and were required to distribute 90 percent of their net taxable income to shareholders annually—the idea was to create a passive instrument for managing previously acquired wealth.

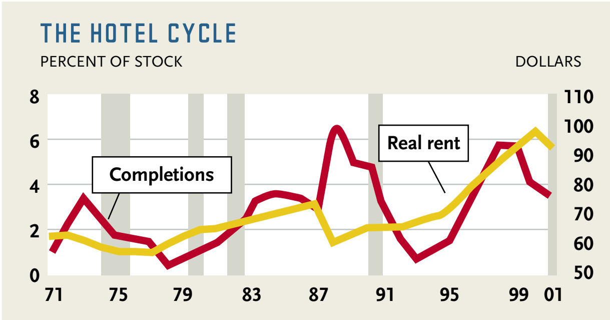
By the end of the 1990s, many REITs had grown into large, vertically integrated firms doing everything from acquiring land to developing and owning buildings to even managing large properties for other companies.

Starting in the 1990s, many also went public. Prudential Real Estate Investors estimates that about 8 percent of the nation's office space (in square feet) is owned by public companies. Public ownership is generally higher in bigger buildings and in large urban areas; SNL Financial estimates that more than one-third of Boston's downtown office space is currently held by REITs. Beacon Properties, a Boston real estate company owned by the Leventhal family, went public in 1997 and then merged with Equity Office Properties, the nation's largest REIT, which also went public in 1997. Originally founded by Sam Zell in





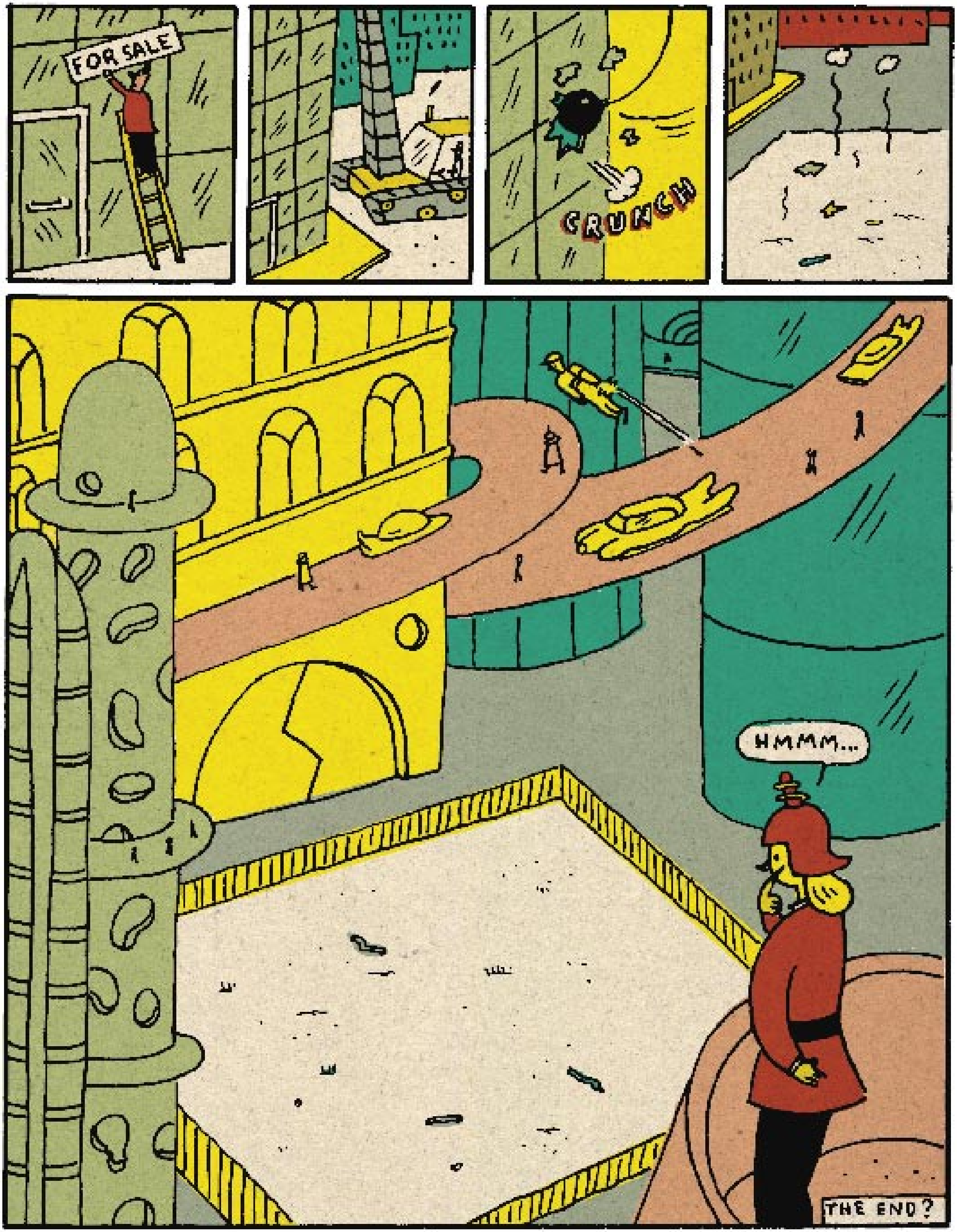




Commercial patterns

Over the last 30 years, the office market has experienced two major supply booms while the United States has seen five cycles of recession and recovery. Thus, the tendency to overbuild may be more than a reflection of the business cycle. Note that in all four commercial property markets, rent changes seem to follow supply flows.

NOTE: Dollars are indexed to 2000 for office and industrial markets; 1999 for retail and hotel markets. Shaded areas are recession periods defined by the National Bureau of Economic Research.
SOURCE: *Real Estate Cycles and Outlook*, 2002, Torto Wheaton Research


FOR SALE
CRUNCH
HMMM...
THE END?

1976, Equity Office Properties has quadrupled the space in its portfolio since 1997 (currently about 124 million square feet of office space) and has a capitalization of $25 billion. Its portfolio includes many downtown Boston properties, including 100 Summer Street, 225 Franklin Street, and 60 State Street. Another large REIT, Boston Properties, went public in 1997; its portfolio includes the Prudential Tower, 101 Huntington Avenue, and 111 Huntington Avenue. Both Equity Office Partners and Boston Properties are traded on the New York Stock Exchange.

With public companies come public scrutiny by boards and shareholders, including pension funds and other sophisticated institutional investors, all of which impose market discipline. Notes Chief Investment Strategist Doug Poutasse of AEW Capital Management, "Every day there is a stock price." There is also a raft of professional analysts following the stocks and the industry, none of whom existed in the early 1990s.

In contrast to many of the high-profile developers in the 1980s, a typical REIT has about half debt and half equity and thus is only about 40 to 50 percent leveraged. If property values fall, this means a larger equity cushion helping to prevent bankruptcy. And even if the REITs go under, the losers are private investors, not the banks or the public agencies that insure them.

On the lending side, there has been an increase in the market for securities backed by commercial mortgages. Similar to the market for home mortgages, commercial mortgages can now be sliced and diced according to risk, property type, and geographic area, and the resulting pieces are repackaged and sold in public bond markets. Some of these bonds are designed to have extremely low risk, while others are quite risky. The riskiest, says Poutasse, are bought by about five relatively small companies that are experienced at assessing and taking such risks. And even if they fail, they are not large enough to cause a collapse of the entire market.

PUBLIC CAPITAL MARKETS MAKE SOME DIFFERENCE, SINCE CAPITAL FLOWS TEND TO RESPOND FAIRLY QUICKLY TO NEW INFORMATION

Bank lending for construction loans also seems to have become more conservative. William Wheaton, professor and Research Director of the MIT Center for Real Estate observes that in the 1990s development construction lending became syndicated, with several banks taking part. This may have introduced more discipline and oversight into the process of making construction loans.

All these factors may have contributed not only to the relatively modest expansion in new downtown towers, but also to fewer buildings being financed without at least some tenants lined up in advance. For example, 111 Huntington broke ground with a major law firm as an anchor tenant. World Trade Center East had several tenants, including Fidelity, when it began construction. The "back-from-the-dead" developer of 33 Arch Street, who had built on spec—that is, without tenants—was more unusual in the 1990s than in the 1980s. So even with high vacancy rates, in many cases tenants were holding a large chunk of the space—vacant or subleased—and landlords were still receiving rent. Also, developers had more latitude to cut deals with tenants in trouble without first having to get the bank's approval.

Finally, in contrast to the severe liquidity crisis that developed in the early 1990s, this time around the stock market decline sent capital flooding into the real estate market, notes Poutasse, as people looked to invest in buildings. According to Prudential Real Estate Investors, "Public companies' equity capital-raising rose for the third consecutive year (in 2003). REITs raised a total of $13.3 billion in new equity capital, the most since 1998." This is yet another reason why the value of many buildings has held up to the decline in market rents and relatively soft rental market.

SMOOTHER SAILING OR BETTER LUCK THIS TIME?

Almost all observers note these changes and think they were important factors in the relatively bloodless downturn during this cycle. In his Brookings paper, Karl Case concludes, "Although commercial real estate markets remain inherently volatile, many of the destabilizing factors of the 1980s are gone. New construction has been fairly modest. Given the experience of the early 1990s, financial institutions, pension funds, and insurance companies have become significantly more cautious in their real estate lending practices. The basic tax treatment of real estate has not changed dramatically since 1986."

David Geltner, professor and Director of the MIT Center for Real Estate, agrees that public markets make a positive difference, since capital flows respond fairly quickly to any positive or negative news. He points to a suggestive anecdote. In early 1998, the REIT market had been booming and real estate development really started to take off. Then, the Russian debt crisis followed by the Long Term Capital Management implosion put some clouds on the horizon. All of a sudden, the REIT market dried up, as did the market for commercial mortgage-backed securities. This curtailed some projects that would otherwise have eventually been completed.

Nonetheless, Geltner points out that it is hard to say for sure why things were better this time around. Much of the evidence is anecdotal—there is little data on construction loans and lending and monitoring practices. Moreover, despite the rise in public ownership, much office property is still held in private companies. And while public markets tend to be relatively efficient, experience with the stock market suggests that public capital markets are no guarantee against periods of irrational exuberance. It is even harder to know what will happen next time around. Some of the restraint of the 1990s might have simply come from memories of having been burned in the 1980s—memories that will inevitably fade.

Doug Poutasse is not overly optimistic. "I do not believe bank lenders have learned the underlying lesson. They just know that real estate is riskier than they thought it was, so they are lending less." Real estate was undervalued in the 1990s, he argues, when investors were busy investing in tech stocks. Today, he believes the situation has reversed, with capital flooding into real estate. "Office towers are easy to invest in and easy to underwrite compared to malls, since there are only about 10 to 20 leases versus 300 in a mall. Also, people underestimate how much capital it takes for maintenance and tenant improvements. They look at the price appreciation and don't realize how much it costs to maintain the building." He views history and sees chronic overinvestment in office towers. "People fall in love with them." ✳