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The Coming Storm in Office Development

BY LAWRENCE DICKSTEIN
PRESIDENT, ITRA/DICKSTEIN REAL ESTATE SERVICES

ONCE UPON A TIME, DEVELOPING A NEW OFFICE BUILDING SEEMED SUCH A SURE-FIRE BET THAT IN SOME MARKETS, THE TAX BREAKS HELPED PUT A NEW BUILDING ON EVERY CORNER OF A CBD. OR SO IT SEEMED

Once upon a time, developing a new office building seemed such a sure-fire bet that in some markets, the tax breaks at the time helped put a new building on every corner of a CBD. Or so it seemed.

A lot can happen in 20 years: today, new office buildings are an endangered species.

While new office building construction costs are "scraping" the sky, many new construction projects may never touch the ground, as developers, fearful that businesses will balk at the resulting increase in rents, shelve their building plans.

Last year steel prices rose more than 48%, according to the Wall Street Journal. This is due in part to strong demand from China. During 2005, the prices of concrete and gypsum products rose 10% and 13%, respectively. These increases were prior to the impact of a troubling hurricane season led by Hurricane Katrina, where thousands of homes were severely damaged or destroyed. Developers are stampeding to construct new homes and repair existing ones throughout the South, diverting materials away from the

other regions of the country and driving their costs through the roof.
In addition, operating costs are reaching the penthouse thanks largely to spiking energy costs. While the gas pump is the leading indicator for painfully expensive petrol, this winter we have been experiencing higher prices for heating oil, natural gas and electricity. The first businesses to feel the effects of rising energy prices are the Industrial sector, whose pain is immediate, as their net leases pass the rising costs directly along. Tenants in the Office sector are now feeling this pain as their annual energy escalation clauses kick in. We are experiencing the largest spike in energy costs in more than two decades.

Thanks to the effects of more than a dozen recent rate hikes by the Federal Reserve Bank, rising mortgage rates have made commercial property owners weary of the potential for the return of a tight credit market and double-digit mortgages.

The potential is for a triple threat or "perfect storm" that will put a thundering halt to new office development. There will be a resulting shortage of available office space that increases rents due to the effects of supply and demand. The factors are already in place: rising prices of construction materials, energy price increases and rising mortgage interest rates.

There is no doubt that the rising cost of building materials has already placed some major projects on hold, particularly in already overbuilt office markets. For example, Prudential Real Estate Investors has postponed the 250,000 square foot second phase of its Quiet Waters

Business Park in Deerfield, Florida. Kelly Real Estate Inc.'s plans for two new office towers at 270 Office Center also are on hold.

Office development conditions vary greatly from region to region. At one end of the spectrum are master planned communities found predominately in the Sun Belt. In these communities, future roads and infrastructure are already mapped out. At each intersection there are retail malls, schools and religious institutions. In the middle of the block are the housing developments. In these areas of the country, municipal approvals for new Office Buildings can take as little as 90 days and rarely more than six months. These markets have a tendency to overheat when conditions (such as low costs and interest rates) are right for development.

At the other end of the spectrum are the Northeast rust belt communities where *home rule* means that each town determines its own building codes. In these communities, approvals typically take a year or two, but can take many more if there are sensitive issues to be resolved. This elaborate approval process dampens new development, preventing an overheated condition due to the difficulties of market entry.

One rule of thumb quoted in The Wall Street Journal is "for every $10 increase in construction costs, the developer needs to get an additional [square] foot in rent." Developers are very sensitive to market rents and will tend to halt new development when they sense their project is reaching the price ceiling for a quick rental.

The market may soon experience a metamorphosis from the *Tenants'* market to the dreaded *Landlords'* market, where a Tenant's favorite Landlord transforms from the *nice guy* Landlord who wants to keep his tenants happy to the *take it or leave it* Landlord, whose attitude radiates "there is always another Tenant who wants the space, if you don't!"

The three conditions necessary for a "perfect storm" in office development-- rising prices of construction materials, energy price increases and rising mortgage interest rates--have become a reality. The effects of supply and demand will result in a shortage of available office space as rents increase.

Already, the solid economy we have experienced the last four years is starting to impact the national real estate market. The average vacancy rate in major markets has dropped to 2.5% and the average rent has increased to $22.26 per square foot--a sure sign that the demand for existing space is now rising. If the development pipeline for new office space shuts down, as it now appears possible, then in the next few years, tenants in many markets will experience office rent sticker shock, with very limited options.

Don't let dark clouds form over your horizon--plan well ahead for your real estate needs. Your ITRA Real Estate Advisor can help you develop effective strategies to minimize the potential impact on your bottom line.

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For more information regarding the subject of this article, please contact Beth Wade, ITRA at bwade@itraglobal.com or 1.706.654.3201