Survey of U. S., Europe Reveals Strong Office Market; Rates on Increase Almost Everywhere

by Ronald R. Pollina

The excess of office space which, in recent years, has characterized the office markets in almost every major city across the nation is rapidly being absorbed. As occupancy rates have risen in the nation's principal business centers, so also have rental rates. Important to the reversal of the previous trend has been the improved economy and the lack of office building construction. With the tightening market, developers across the country are gearing up for a new wave of construction.

As our national economy has indicators which help economists in evaluating economic trends, so does the office market. One of the best of these indicators is rental rates and the best sign of an improving office market is rapidly rising rental rates. *Figure 1* represents rental rate changes over the last year for Class A office space in ten of the United States' major office markets. This figure also provides comparative data for five major European markets.

The rental ranges depicted in *Figure 1* are based on a survey of the European market conducted by the International Division of Romanek-Golub and Company. The data gathered illustrate the relative differences between the cities listed and provide an indication of rate changes over a one-year period. In the U.S. and abroad, local practices vary as to the criteria on which rental rates are based. In Europe, for example, common area costs are not included in quoted rental rates. Appropriate adjustments were made to the data in *Figure 1* to make the European rates more comparable to those in the U.S., where common area costs are generally reflected in quoted rental rates.

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FIGURE 1

QUOTED RENTAL RATE RANGES FOR CLASS A OFFICE SPACE IN SELECTED CITIES IN THE UNITED STATES AND EUROPE

City	Range 1976*	1977*	Change 1976-1977
Atlanta, GA	$ 6.50-$ 9.00	$ 7.00-$ 9.00	$ .50-$ 0
Boston, MA	$10.00-$13.00	$10.00-$13.00	$ 0-$ 0
Chicago, IL	$ 8.00-$13.00	$ 8.50-$16.00	$ .50-$3.00
Dallas, TX	$ 7.00-$10.50	$ 7.50-$11.00	$ .50-$ .50
Denver, CO	$ 8.50-$10.00	$ 9.50-$12.50	$1.00-$2.50
Houston, TX	$ 7.25-$10.75	$ 9.00-$13.85	$1.75-$3.10
Minneapolis, MN	$ 7.00-$11.00	$ 8.00-$14.00	$1.00-$3.00
New York, NY	$ 8.00-$15.00	$ 9.00-$20.00	$1.00-$5.00
San Francisco, CA	$ 9.00-$15.00	$10.20-$16.00	$1.20-$1.00
Washington, DC	$ 9.50-$12.00	$10.50-$13.00	$1.00-$1.00
Amsterdam	$ 9.50-$11.25	$10.50-$11.75	$1.00-$ .50
Brussels	$10.00-$12.25	$12.00-$13.50	$2.00-$1.25
Frankfurt	$12.00-$16.00	$12.00-$16.00	$ 0-$ 0
London	$21.00-$25.50	$29.00-$33.75	$8.00-$8.25
Paris	$20.50-$25.50	$20.50-$24.00	$ 0-$ 0

*Fourth Quarter

Based on a survey conducted by Romanek-Golub and Company, fourth quarter, 1977

LONDON, PARIS SUBSTANTIALLY HIGHER THAN U.S.

In comparing the U.S. markets listed to those abroad, it can be seen that rental rates for Class A office space in London and Paris are substantially higher than those of U.S. cities. London, which has the highest rental rates ($29.00-$33.75) of the surveyed European cities experienced a substantial increase in its rental rates between year-end 1976 and 1977. Rental rates for Paris, while high ($20.50-$25.50), remained stable during 1977. With the exception of London, the other European cities listed have had little or no increases. The overall range for rental rates in the U.S. is $7.00 (Atlanta) to $20.00 (New York) while the rental rates for the European cities listed range from $10.50 (Amsterdam) to $33.75 (London). While London's and Paris' rental rates are much higher than those of most U.S. cities, Brussels, Amsterdam, and Frankfurt are more closely aligned to the U.S. rates.

While most major American cities are showing signs of improvement, some cities are progressing much more rapidly than others. New York, which had one of the most depressed office markets in the nation at the height of the office market slump (1975), is currently experiencing a strong recovery in mid-town Manhattan. An improved leasing pace has resulted in the removal of most large blocks of contiguous space in prime mid-town buildings. Rental rates for Class A buildings have firmed up in the $9.00-$20.00 per square foot range in the better locations and many local experts foresee an increase of 25% or more in the next one to two years.

Unlike New York's market, Atlanta's market is rebounding more slowly. Recent signs indicate that the rate of recovery is increasing; however, Atlanta's office absorption rate is still lagging far behind what it was during the pre-recessionary boom years. Rental rates for Class A buildings remain low, in the \$7.00-\$9.00 range, and concessions such as free rent and above-standard tenant improvements are still frequently offered.

DENVER MARKET CURRENTLY STRONG

Denver, on the other hand, a city which did not experience the massive building programs characteristic of most other major cities, maintained a relatively healthy market through the recession and currently has a very strong market. Because of the overall smaller market in Denver, the little overbuilding that did occur during the pre-recessionary period was readily absorbed by the recent rapid growth in demand. Helpful in holding the vacancy rate down has been the steady influx of engineers, scientists, and other specialists who are making Denver their home base in their efforts to unlock the energy stockpiles of the Rocky Mountains. Rental rates for Class A Denver office buildings increased from a year-end range of \$8.50-\$10.00 in 1976 to \$9.50-\$12.50 at year-end 1977, according to James F. Hurlbert, Jr., senior vice president of Romanek-Golub and Company. Unlike other major cities which are on the verge of renewed building activity, Denver is currently experiencing a boom in construction of new office buildings.

CHICAGO'S RECOVERY RANKS AMONG STRONGEST

While Chicago's office market was not as healthy as Denver's during the recession, Chicago's occupancy rate remained above average when compared to other major office markets across the nation. The recovery of Chicago's downtown office market certainly ranks among the strongest in the nation. The city's economic vitality as a business and financial center is in a large part responsible for its rapid recovery. In addition, the lack of new building openings and improved economic conditions have resulted in a downtown occupancy rate which began to inch upward during 1976 and continued upward at an increasing rate through 1977. The remainder of this report will examine the cycle of rental rate changes in Chicago. In many respects, the trends in Chicago's rental rates reflect those of most major urban office markets in the United States.

Figures 2 and *3* illustrate the trends for the most frequently quoted rental rates (mode) for Classes A, B, C, and D office buildings in Chicago's Central Business District (CBD). The data from which this chart was developed are taken from Romanek-Golub and Company's computerized office leasing survey. Every building in Chicago's CBD is surveyed three times per year by Romanek-Golub to determine the existence of available space and current rental rates. These data are used to assist corporate clients with their relocation plans. The classification of buildings into four groups is based on the concensus of opinions of leading office leasing experts. The classification was subjective, in that the experts were asked to group the buildings according to the way in which most office space users perceive them. Variables entering into and affecting the perception of a building commonly include such factors as location, interior and exterior condition, building prestige and name recognition, and rental rates.

FIGURE 2

RANGE AND MOST FREQUENTLY QUOTED RENTAL RATES FOR CLASSES A-D CHICAGO OFFICE BUILDINGS

	1976*		1977*	
	Range	Most Frequently Quoted Rental Rate	Range	Most Frequently Quoted Rental Rate
Class A	$13.00-$8.00	$10.00	$16.00-$8.50	$12.00
Class B	$10.00-$6.50	$ 8.50	$10.50-$7.75	$ 9.50
Class C	$ 9.00-$5.00	$ 6.00	$ 9.75-$2.50	$ 6.50
Class D	$ 6.50-$1.50	$ 5.00	$ 6.50-$1.50	$ 5.00

Change in Most Frequently Quoted Rental Rate, 1976-1977:
Class A-+$2.00; Class B-+$1.00; Class C-+$.50; Class D-$0
*Fourth Quarter

AGE NOT ONLY CRITERION FOR CLASSIFICATION

Classification of buildings has been done in the past, however, most of these classification schemes have depended quite heavily on age as the principal or only criterion. While there is certainly a high correlation between newer buildings and the buildings classified here as A and B there are many exceptions. For example, there are a number of buildings in Chicago's financial district that are quite old but are highly competitive with many newer buildings located throughout the CBD. These buildings are not only competing for the same types of tenants but they are also, in some cases, charging similar rental rates. A building's relative newness (post-1970) did not guarantee its classification as a Class A building, although all newer buildings did receive at least a Class B designation.

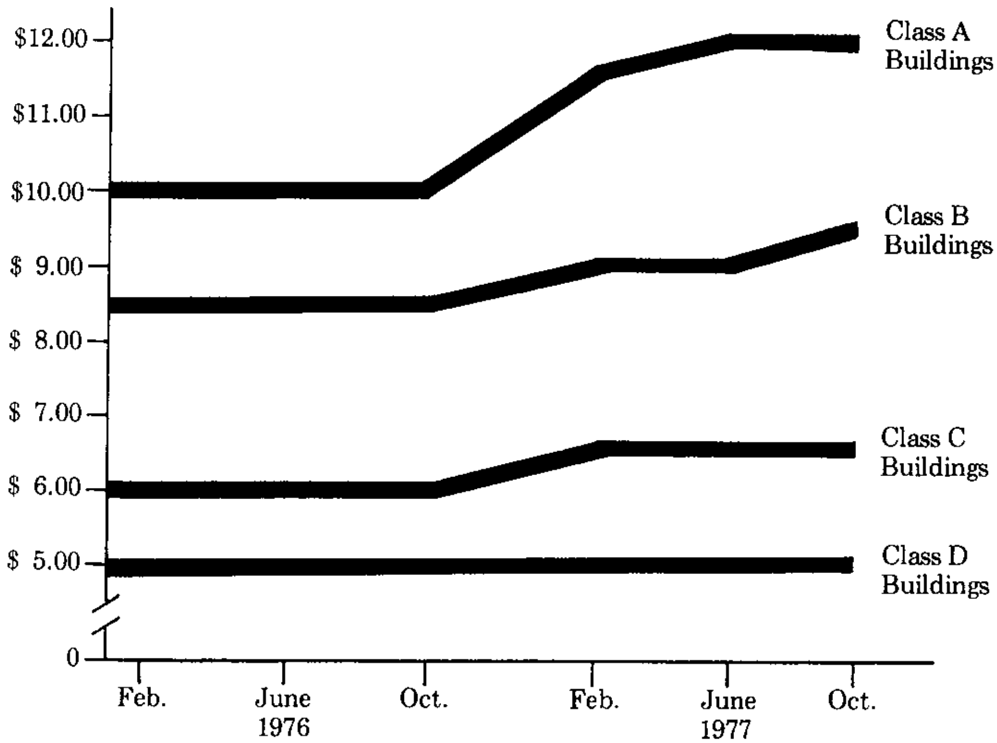
NINETEEN CBD BUILDINGS RATE CLASS A

Of the 179 CBD office buildings for which data were available, 19 were classified as A, 33 were classified as B, 78 as C, and 49 as D. Of all the Class A and B buildings, 14 were constructed prior to 1950. The oldest Class A building was constructed in 1933 and two Class B buildings were opened prior to 1900.

Rental rate changes for each class of buildings has an effect on the rental rates of the other classes. When occupancy rates are low, the differences between rental rates for each class of building tend to be closer. For example, as *Figure 2* illustrates, there was a difference of $1.50 per square foot between Classes A and B office buildings in October, 1976. Since then the market has improved, and the difference has risen to $2.50 per square foot. During periods of low occupancy, many firms find that they can afford space in higher quality buildings than they normally might during a tight office market. The result is that the total potential market for Class A buildings is greater as is true for the total market for Classes B and C buildings. The potential market for Class D buildings contracts as it loses many of its prospective tenants to Class C buildings. The increases in the potential markets for Classes A, B, and C buildings do not necessarily mean that more space will be leased; it simply means that many tenants who would normally be financially restricted to a lower class of space have the option of leasing higher class space during a tight market.

FIGURE 3

TREND IN MOST FREQUENTLY QUOTED RATES FOR CLASSES A-D OFFICE BUILDINGS—1976-1977



AS OCCUPANCY RISES, RATE SPREADS INCREASE

As a greater variation in rental rates develops, many users who would prefer a higher class of space are restricted by price to lower priced space. As occupancy rates rise, the spread of rental rates between the various classes of buildings tends to increase. Competition for as many tenants as possible tends to keep the spread in rental rates between classes at a minimum during periods of low occupancy rates.

When the market begins to improve, space in the higher class buildings is generally absorbed first. As this occurs each class of building tends to raise its rental rates at a different pace, with increases in Class A buildings occurring first and being the highest followed by Classes B, C, and D in that order. *Figures 2* and *3* illustrate this phenomenon. *Figure 2* shows that the most frequently quoted rental rates increased by $2.00 per square foot for Class A buildings, $1.00 per square foot for Class B, $.50 for Class C, and no increase for Class D for the period October, 1976 to October, 1977.

LAG PERIOD DEVELOPS IN RATE INCREASES

Figure 3 illustrates that a lag period develops. In the beginning, Class A demand is highest followed by Classes B and C. As a result of higher demand and decreasing space availability, the price of Class A space rises and the difference in price between Classes A and B space broadens. More prospective tenants then eliminate Class A space as an alternative and seek Class B space. Certainly there are some users who will pay whatever the cost to have better space, but many will take the lower priced space if the difference in cost is great enough. The wave that is created begins with Class A space and affects each successive class to a decreasing degree. As the cycle runs its course the rate of increases in rents for Class A space will slow. The rate of rental rate increases for Classes B, C, and D will also gradually decrease in turn as each class's rental rates come closer to approaching the rates of the next higher class.

For the developer this is a very important phenomenon; as rental rates for new Class A buildings rise, the size of his potential market diminishes. However, countering this decrease in the size of his potential market is often an increase in the number of tenants who actually relocate, provided the economy remains strong.

THREE FACTORS CAUSE RATE DECREASE

The three principal factors that will cause a decrease in the rate of rental rate growth are: 1) overbuilding of new Class A office buildings, 2) downturn in the economy which cuts back demand, and 3) Classes B, C, and D rates which lag far behind increasing Class A rates. For the tenant seeking space the best time to negotiate a lease is when the spread between rental rates for various classes of buildings is at a minimum. Chicago's office market has moved past that point and is now entering a period in which the spread will widen.

For the prospective tenant seeking office space, one of the most complicated tasks he has is to determine which office facility offers the most for his firm's rental dollar. Certainly, one of the most difficult problems in comparison shopping for office space is that there are no two buildings that are truly identical. All buildings vary in degree of prestige, location advantage, condition, services, and so forth. If we assume that two identical buildings could be found, it is highly unlikely that both buildings would quote rental rates calculated in the same manner. Comparison shopping would be greatly simplified if all rental rates were calculated based on a comparable list of lease terms including such items as utilities, maintenance, operations, and building standards.

DETERMINATION OF "RENTABLE" VERSUS "USABLE" IMPORTANT

One of the most important considerations in comparison shopping of rental rates is determining whether the rental rate per square foot per year is for "rentable area" or for "usable area" and how they are calculated in a particular building. "Rentable area" reflects a lower per square foot rate because it may include space such as washrooms, corridors, and other areas common to all building tenants. "Usable area" on the other hand often refers only to the space which is used solely by the tenants. Within Chicago a firm can be safe in assuming that most Class A and Class B buildings and many Class C buildings calculate their rental rates based on rentable area.

Even if a tenant knew that all of the buildings he was considering used rentable area as their criterion for quoting rental rates, the tenant would still find it necessary to compare many other costs that may or may not be included in the rate. Generally items such as utilities, maintenance, and security are included in the quoted rate while electricity costs are not. With rising energy costs, the energy efficiency of a building becomes a very important consideration when comparing the short and long-range costs of occupancy space in different buildings.

DIFFERENCES IN VALUE FOUND IN BUILDING STANDARDS

Differences in value for a firm's rental dollar can often be found in the area of building standards. Building standards refer to those items such as floor covering, partitions, painting, air conditioning, window coverings, telephone outlets, lighting fixtures, and other such items that may or may not be included in the rent. The tenant must determine which of these items are included, the quality of the items, and which he will have to install or pay extra to upgrade in order to meet his own needs. Some prospective tenants may find it essential to be represented by a professional in order to insure the greatest value for his rental dollar.