

OFFICE  
MARKET  
ANALYSIS

Studley

Beyond Fundamentals:  
Pushing Rents to  
Pro forma Projections

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Office property sales reached record levels in 2006, totaling \$133.6 billion nationwide, 32% higher than the prior peak set in 2005. Approximately one third of the markets tracked by Real Capital Analytics posted dollar volume increases of 30% or more in 2006. Equity Office Properties' \$23 billion sale of 543 buildings to Blackstone, which closed in February 2007, and Blackstone's subsequent flipping of most of the assets will likely mark the high point in the current commercial real estate cycle in terms of sales volume and prices paid for office properties.

Well before Torto Wheaton economist Jim Costello coined the phrase "the EOP effect" commercial real estate brokers specializing in tenant representation warned the market that the spike in sales prices would financially impact tenants in two ways: initially, new owners would attempt to charge higher rents to meet their aggressive pro formas, and subsequently, landlords would pass through a portion of tax increases resulting from building re-assessments to tenants. Some landlords have already raised rents in anticipation of these tax hikes.

### Rental Rate Increases - Market vs. Sold Properties



Studley recently conducted a study that quantifies the initial impact of this frenetic sales market on rental rate increases. Using building sales data from Real Capital Analytics and asking rent data from CoStar's and Studley's proprietary databases for eight major U.S. markets, Studley charted the average asking rental rate growth in buildings that were recently sold and compared them with the average asking rental rate growth in their respective markets. On average, Studley found that buildings sold between July 2005 and July 2007 showed a 21.2% increase in asking rental rates, as compared to an average market increase of 12.6%.

Rents increased at a higher rate in sold properties in markets with both solid and weakening fundamentals. In Manhattan and Washington, DC, for example, where overall availability rates have fallen by 2.7 percentage points and 1.0 percentage point respectively, over the last two years, recently sold buildings registered asking rental rate increases of 33.1% and 7.5%, while these markets posted rental rate increases of 22.4% and 4.6% for the same time period. The same phenomenon was even observed in deteriorating markets where one would expect to see a decrease in asking rents. Availability has increased by 2.9 percentage points in Orange County and 0.9 percentage points in San Diego, but again, asking rent rate growth for space in sold office properties has outpaced market averages. Orange County, for example, now at the center of the sub prime fallout, experienced a 12.3% increase in rents in buildings sold – well above the 8.1% increase for the market.

The findings indicate that many landlords are setting asking rents based on optimistic pro forma projections rather than by what supply and demand dictate. As supply increases, market fundamentals will eventually prevail as tenants choose from an increasing number of options. Even in Manhattan and Washington, DC, the ability of new owners to hit pro forma targets depends upon the capacity and willingness of large tenants to bear these costs.

Recent hiccups in the economy are starting to have an impact on commercial real estate as job growth slows and the demand for office space in most markets has peaked. Similar to the investment sales market, rents might soon top out, particularly in those areas where ample supply will undercut rate growth. Even if rents do crest, tenants in many markets will continue to face occupancy costs that are 50% to 100% higher than when they signed their leases seven to ten years ago.

#### **Methodology:**

Studley researched office property sales data from Real Capital Analytics for Manhattan; San Francisco; Washington, DC; Atlanta; Chicago; Los Angeles; San Diego and Orange County. More than 500 sales over the last two years were evaluated. Asking rent data for properties sold in the respective markets was derived from CoStar's and Studley's proprietary databases. Any buildings sold without adequate rental rate information or under any unusual conditions such as partial interest sales were excluded.

**The asking rental rate change in a sold property equals** the current asking rent less the asking rent during the quarter prior to the sale of the property, divided by the asking rent during the quarter prior to the sale of the property. For every market, rental rate changes in sold buildings in the respective markets were averaged, resulting in the percentage change for all sold properties in the market.

**The asking rental rate change in a market equals** the current average asking rent in the market less the average asking rent in that market during the quarter prior to the sale, divided by the average asking rent in the market during the quarter prior to the sale. For every market, rental rate changes in all buildings were averaged, resulting in the percentage change for properties in the market as a whole.