

BOSTON MARKET HIGHLIGHT

Each month, *Northeast Real Estate Business* asks local experts to contribute to a Market Highlight focusing on a region in the Northeast.

BOSTON INVESTMENT MARKET

Coming off a strong year in 2005, the office market in Greater Boston has gained considerable momentum during the year, absorbing over 5 million square feet of space and dropping vacancies down to the 18% level, it's lowest in 5 years. The Class-A market represented 80% of the absorption and with a tightening in vacancies, many submarkets are finally seeing evidence of rent growth. With delivery of new developments, typically 18-24 months out for suburban office and 12-months further for CBD office and with a structural vacancy benchmark of 10%, we may see projects jump off the drawing boards into reality in the next 12 months assuming absorption continues its recent pace. With current Class-A average market rents of \$40 per square foot in the CBD and \$30 per square foot in the Route 128/Mass Pike suburban market, we would still need to see rent growth of 30-40% in order to justify new construction in those markets. New starts however, are unlikely to move forward without a significant pre-lease requirement. With fewer available large contiguous blocks of space, many large space users are accelerating their space planning needs in order to take advantage of the tenant favored market conditions rather than waiting until later. This activity has manifested in increased sales transactions.

The CBD has historically been attractive to investors/lenders and has seen consistent low cap rates on purchases. Partially to completely

vacant assets were also in high demand due to the conversion potential to condo or hotel. The re-zoning for residential on CBD assets has generally been received well by the City and the BRA due to its desire to create more housing (market rate and affordable) and strengthen the Downtown's 24/7 appeal. In the suburbs, sellers are now realizing value not only for leases/income in place, but are receiving credit for vacancy which in the recent past did not factor too much in a buyer's price. Pension funds, foreign investors (especially Australian), and operators with opportunity fund capital have dominated the acquisition market.

A few recent transactions worth noting: Transwestern's purchase of 40 Broad Street, a 300,000 sf Class B office building in the Financial District for \$50MM from Prudential (formerly TMW). The asset was 35% leased at the time of purchase. Transwestern's business plan is to retain the property's office use and lease-up the vacant space drafting off the strength in the Class-A market. The purchase at \$166 per square foot and projected all-in basis at stabilization, even if it costs \$50 per square foot or more to re-tenant the building, will be well below replacement cost. If the asset were sold a year ago in the same condition, it would more than likely have been a residential conversion play. The buyer's plan highlights the current softness in the condo market, as well as, the rising office market conditions. The other point worth noting about the transaction

is the seller, Prudential's TMW, a fund made up of German insurance, private banks and individual investors has been seeking increased liquidity in many of their real estate holdings, like other German investors, since the Mills Corporation earnings re-statements.

Another noteworthy transaction was Broadway Partners' \$63MM purchase of the 100-300 Fifth Avenue from TA Realty Associates, a 475,000 sf office portfolio of three buildings located in the prime suburban Route 128/Mass Pike office submarket. At \$132 per square foot, without even considering the excess land which could support an additional 100,000 square foot building, the buyer is at 60% of replacement cost on the asset which was 76% leased at the time of sale. Owners who have been sitting on assets for the past 3-5 years waiting for a market recovery are now inclined to sell assets as the prospect for growth haven't looked this good in a while.

The only caution signal might be the pace of absorption, which overall has outstripped job growth, hence tenants are growing faster than they are hiring. This shadow/expansion space currently represents about 8 million sf of vacant space in the market or 5% of the entire supply. Overly aggressive business plans and tenant expansion was the primary reason we got hurt in the last downturn. Hopefully we have all learned a few lessons.

- Dennis Walsh is a senior director
in the Boston office of
Tremont Realty Capital