

COMMERCIAL CONNECTION

Office space seesaw keeps swinging

An evenly balanced office market carries a vacancy factor between 8 percent and 10 percent. Evenly balanced means neither tenants nor office building owners have a distinct advantage over the other. Just think of two kids playing on a seesaw who each weigh 80 pounds. If neither kid takes advantage of the other by pushing off like he's going to the moon, these two kids could easily be suspended in air on their respective sides of the fulcrum. They would be "evenly balanced."

The reality of office markets is they are rarely evenly balanced for any length of time. Normally this "even balance state" is achieved only briefly while the office market vacancy is swinging one way or the other ... just like the kids on the seesaw.

But unlike the fun-loving kids playing on the seesaw, would office owners and office tenants really want to take advantage of each other? Oh yeah. Every office owner wants the highest rent he can get away with and every office tenant wants the lowest rent he can get away with. So who decides who will get the advantage? Hint: It's not the leasing agent. Answer: The market vacancy factor decides who will get the good deal.

For example, Southwest Florida had an office vacancy factor of around 6 percent in 2005, which was the lowest office vacancy in the past 20 or more years. Office owners live for a year like 2005 when double-digit growth in office rental rates was common. So office owners took advantage of office tenants and raised rents across the board with any new or renewing leases. Since higher rents equals higher sales prices (using the cap rate formula for income property valuation), office developers took gleeful note of these festivities and promptly started new office building developments in our area to fill this clear need for more office space. They couldn't wait to get some of these high rents themselves. Even though interest rates were at historic low levels,

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post-Hurricane Charley high construction costs were no laughing matter and these forecast high rental rates were absolutely needed to be able to make their numbers look respectable. But when you have a need (due to low vacancy) for more office space, you just can't turn on a faucet and get new office space ready the next day. It normally takes 18 to 24 months to design/construct an office building in today's eco-friendly environment. So lots of new office buildings are under construction right now and will be opening for business soon on a street near you.

The office market seesaw is starting to swing. Office tenants look pleasantly anxious as they sit ramrod straight on their end of the seesaw that is heading for the sky. The office owners do not look particularly pleased as they slouch on their end of the seesaw that is heading for the sand. The office leasing agents are standing in the middle at the fulcrum ... and we always smile.

A company called Co-Star tracks office data and sets up analysis grids for markets across the United States. Co-Star is one of the best, unbiased sources for office market statistics in the U.S. According to Co-Star, the Southwest Florida office market, comprising Lee, Charlotte and Collier counties, in August showed a total office supply of 13.2 million square feet, of which 1,042,000 square feet is currently vacant for a 7.7 percent vacancy factor. This would normally indicate a pleasantly balanced market. But hold on to your seats for the swing.

Of this 1,042,000 square feet that is presently vacant, 488,000 square feet of it was newly constructed that opened in the first half of 2007. But here's the real kicker. There is currently under construction an additional 1.2 million square feet of new office space that is due to open for business over the next 12 months. Of this 1.2 million square feet of new space, 36 percent, or 432,000 square feet of it,

is supposed to be pre-leased, according to Co-Star. Typically, 95 percent of space rented each year in a market on average comes from tenants in the same market who simply relocated from other buildings.

It's called "reshuffling the deck." So I suspect that of this pre-leased 432,000 square feet of new construction, at least 95 percent of this space is being rented to tenants from within our own market so they will vacate their current space here in Southwest Florida in order to move to this new space ... which does not dramatically change the current vacancy factor. Typically 5 percent of the space rented annually in our market comes from outside our market area and is known as "absorption." Co-Star showed negative absorption of 100,000-plus square feet of office space in the first half of 2007 in Southwest Florida.

This means that even if we did have new companies move to Southwest Florida in the first half of 2007 to rent new office space, the same amount left (or closed) plus another 100,000-plus square feet of office space was vacated. This negative absorption number may seem big and bad but it is not. It represents less than 1 percent (or 0.007 to be exact) of our total office market in Southwest Florida. It merely shows that demand for office has softened, I suspect caused by our local slowing economy due to the major correction in our residential real estate market.

But what happens to our office vacancy when this 1.2 million square feet of new office space (that is presently under construction) hits our market over the next 12 months? Well, that would bring our total office supply to 14.4 million square feet with total vacant office space of 2,242,000 square feet or a 15.6 percent vacancy. This makes the bold assumption that no positive absorption occurs for the next 12 months (i.e. square feet of new businesses moving here are offset by square feet of businesses moving out or closing). If we are lucky and get, say,

300,000 square feet of positive absorption over the next 12 months, then our vacancy will be down to 1,942,000 square feet or 13.5 percent vacancy.

That means over the next 12 months, regardless of absorption, advantage shifts back to the office tenants. There should be no growth in rents and a slight weakening may occur. Concessions by owners to sign tenants to long-term leases should increase. Co-Star also shows that our office market is divided into three quality categories. Class A space (best quality, highest rent) represents 8 percent of our total office market, Class B space represents 55 percent of the market and Class C space represents 37 percent. Co-Star further states that our Class A office space currently has an 18 percent vacancy and combined class B and C space ranges from 6 percent to 9 percent vacancy.

I have witnessed during slow economic times in years past that more affordable space (i.e. Class B and C) is usually more desirable and some tenants moving down a class (of space) is not uncommon. Conversely, during previous strong economic cycles, tenants moving up a class of space are common.

But don't worry, you office owners. It will shift back again. It always does. The one constant is change. The seesaw will keep swinging. I was the speaker on the subject of the Lee County office market at the Southwest Florida CCIM Annual Outlook Conference in March of 2002 when the office vacancy factor was 16 percent. Then it took only three years to swing back to our all-time low of 6 percent vacancy in 2005. Just be thankful that our calendar doesn't read 1991 right now. If it did, we would have 21 percent office vacancy and the office tenants would be dancing in the streets. As it is, 2008 will see Southwest Florida office tenants merely as a cheerful bunch.

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