

Suburban Office Values - What's Next?



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Owning an office property has been a good investment for the last few years. **In fact, NCREIF reports an office return of 18.1% for 1998, with a three-year average of 15.8%.**

While we intuitively understand that rents drive value, we often fail to grasp that values can rise faster than rents. The following summarizes a hypothetical Suburban Class A building. While rent grows at a strong 6.8% annual rate, value grows almost three times as fast.

Office Value - A Brief History

Description	1994	1999	5-yr Change	Annual
Gross Market Rent	\$ 18.00	\$ 25.00	38.9%	6.8%
Vacancy & Collection Loss				
<i>Percent</i>	15.0%	5.0%		
<i>Dollars</i>	\$ 2.70	\$ 1.25		
Effective Gross Income	\$ 15.30	\$ 23.75	55.2%	9.2%
Operating Expenses	\$ 8.63	\$ 10.00	15.9%	3.0%
Net Operating Income	\$ 6.67	\$ 13.75	106.0%	15.6%
Overall Capitalization Rate	9.0%	8.5%	-5.6%	-1.1%
Market Value	\$ 74.15	\$ 161.76	118.1%	16.9%

Of course, this simple model is, well, simple. Astute investors know that distressed properties were bought for \$30 PSF in the depths of the recession. In contrast, a few properties with long-term leases sell each year at or near replacement cost.

Where are we today? In broad terms, the market is relative balance. **CB Richard Ellis** quotes the Chicago suburban vacancy rate at 8.6%, below the national suburban rate of 8.9%. **Insignia/ESG**, **Cushman & Wakefield** and **Marcus & Millichap** all report average Class A rents in excess of \$25.00 PSF. The following table summarizes major office transactions.

Suburban Office Sales

100,000 SF and Up Over \$10,000,000
64 Selected Transactions Totaling \$ 2,667,721,402

Description	1996	Change	1997	Change	1998
Transactions	21	14.3%	24	(20.8%)	19
Sales Volume	\$ 661,888,896	54.0%	\$ 1,019,317,644	(3.2%)	\$ 986,514,862
Median Price	\$ 24,000,000	7.8%	\$ 25,877,125	9.9%	\$ 28,438,000
Average Price	\$ 31,518,519	34.8%	\$ 42,471,569	22.3%	\$ 51,921,835
Total SF	5,642,312	25.3%	7,069,061	(8.2%)	6,487,864
Median SF	225,318	(6.1%)	211,674	3.0%	218,000
Average SF	268,682	9.6%	294,544	15.9%	341,467
25th Percentile	\$ 97.35	14.5%	\$ 111.44	7.2%	\$ 119.50
Median	\$ 113.14	13.9%	\$ 128.87	4.0%	\$ 134.05
75th Percentile	\$ 131.91	16.1%	\$ 153.20	3.7%	\$ 158.91
Average	\$ 116.88	15.3%	\$ 134.71	4.6%	\$ 140.92
Weighted Average	\$ 117.31	22.9%	\$ 144.19	5.5%	\$ 152.06

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Existing Class A prices are approaching new construction costs of \$175 to \$200 PSF.

Where are we going? Several firms forecast that the peak has been reached, projecting a 1999 rent increase of less than one percent. The theory is that the market will slow and then stop when it reaches stability. Some of the best empirical research concludes otherwise. **Torto Wheaton Research** forecasts a rising vacancy rate - about one percentage point per year. Rents will continue to outpace inflation for the near term. In essence, market demand is driving new construction at new construction rents.

Existing buildings will then require competitive upgrades, further increasing average market rents. **As the best product can always find a buyer, it is a safe bet that at least a few sale transactions will occur at record prices.** This will provide further comfort to builders and lenders; some overbuilding will inevitably occur and the cycle will continue.

We should take pride in the fact that Chicago has low inherent real estate investment risk. Prices and rents did not fall as fast or far as coastal areas. **For investors who require a true hedge, Chicago offers opportunity.** A recent study makes this point. A best case market model developed by **Torto Wheaton** was contrasted with a recession scenario. The recession discount for a Class A office building in Chicago is nominal - 4.3%. In Boston, the model indicates a 38.3% value loss and in Los Angeles a 26.8% decrease. A suburban office building in Chicago looks better all the time!

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