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Office-Space Market Show Signs of Slowing

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The amount of sublease office space available to tenants increased nationally for the first time in five years, an indication that commercial leasing is slowing in many markets across the U.S.

The increase demonstrates that many businesses related to home-mortgage lending have returned space to the market. It also shows that many industries are nervous in light of the credit-market turmoil and want to keep costs down as much as possible until they see whether the economy will slump further in coming months.

Sublease space, in which tenants lease their rented space to other tenants, usually at below-market prices, increased to 77 million square feet in the third quarter from 73 million square feet nationwide in the second quarter, according to data provided by Grubb & Ellis Co., a real-estate services firm based in Chicago. That marked the first national increase since the third quarter of 2002, when the economy was in recession after the dot-com bust and the terrorist attacks of 2001. In the third quarter last year, available space was 76.5 million square feet.

The amount of sublease space in a market can affect the extent to which landlords can push up rents, because their "direct" space is competing with short-term sublease space that is often much cheaper, and tenants have more bargaining power.

A total of 77 million square feet is only about half the amount that was available in the so-called shadow market at the bottom of the cycle in the first quarter of 2002 and shouldn't be reason for office landlords to despair. Yet, the increase in sublease space, combined with a national vacancy rate that remained flat or barely budged downward over the quarter (depending whose data are used), indicates the market could be softening, says Bob Bach, senior vice president of research for Grubb & Ellis.

Even so, rents continue to climb. Average effective rents -- the amount tenants pay after concessions -- increased 2.4% nationwide over the third quarter, according to Reis Inc., a real-estate research firm.

Yet, soaring rents over the past few quarters could be one reason that sublease space is on the rise. As costs increase, businesses may look to downsize or even move out of a market to save money even as they must still pay on their previous lease. "Some of it is part and parcel of a market when rents have been rising rapidly, and suddenly there's more uncertainty and caution," Mr. Bach says.

Such uncertainty is related to the continuing fallout from the home-mortgage industry. Many troubled lenders are closing branch offices, and home builders have scaled back their operations. Indeed, Countrywide Financial Corp., the nation's biggest home-mortgage lender, is putting as much as 200,000 square feet of office space in the Dallas suburb of Richardson, Texas, on the shadow market and another 5,000 square feet in nearby Arlington, according to Tim Terrell of Stream Realty Partners LP, who represents Countrywide.

Sublease space increased over the third quarter in 29 of the 47 markets that Grubb & Ellis monitors. While shadow space continued to drop in the strongest office markets, such as New York, Boston and San Francisco, Mr. Bach predicts that even those markets will start to see an increase in coming quarters.

In South Florida, one of the areas hardest hit by the housing crisis, sublease space in Miami-Dade County increased 28% over the past four quarters and increased 36% in Fort Lauderdale-Broward County over that time. Moreover, rising rents in Florida have been compounded by escalating insurance premiums for storm coverage and higher real-estate taxes because of the run-up in property valuations, forcing some tenants to look for cheaper space.

San Diego, where sublease space has increased 43% over the past four quarters, also has been hit hard by the housing crisis as well as an increase in office supply. Developers have added four million square feet of office space in the past few years. Thus, in some case, tenants are getting good deals on new space and

subletting their older offices. "For the most part in San Diego County, there are a fair amount of opportunities in the marketplace today to leverage a transaction," says Brian Ffrench, a San Diego-based senior executive with Studley Inc., a tenant-representation firm.

Studley represented one law firm, Mintz Levin Cohn Ferris Glovsky & Popeo PC, in taking more than a floor of sublease space in the northern part of the county that was vacated by an investment firm that decided against maintaining so large an office in San Diego. That allowed Mintz Levin to get palatial offices at 20% below market rate.

In Orange County, Calif., where many of the mortgage brokers are based, the amount of sublease space on the market hasn't changed since this time last year, about 2.4 million square feet. That is because many of those lenders "threw in the keys," Mr. Bach says, and filed for bankruptcy. So the space is being marketed by landlords as direct space instead of sublease. The vacancy rate there ticked up 0.7 percentage point over the past quarter, Reis found.

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