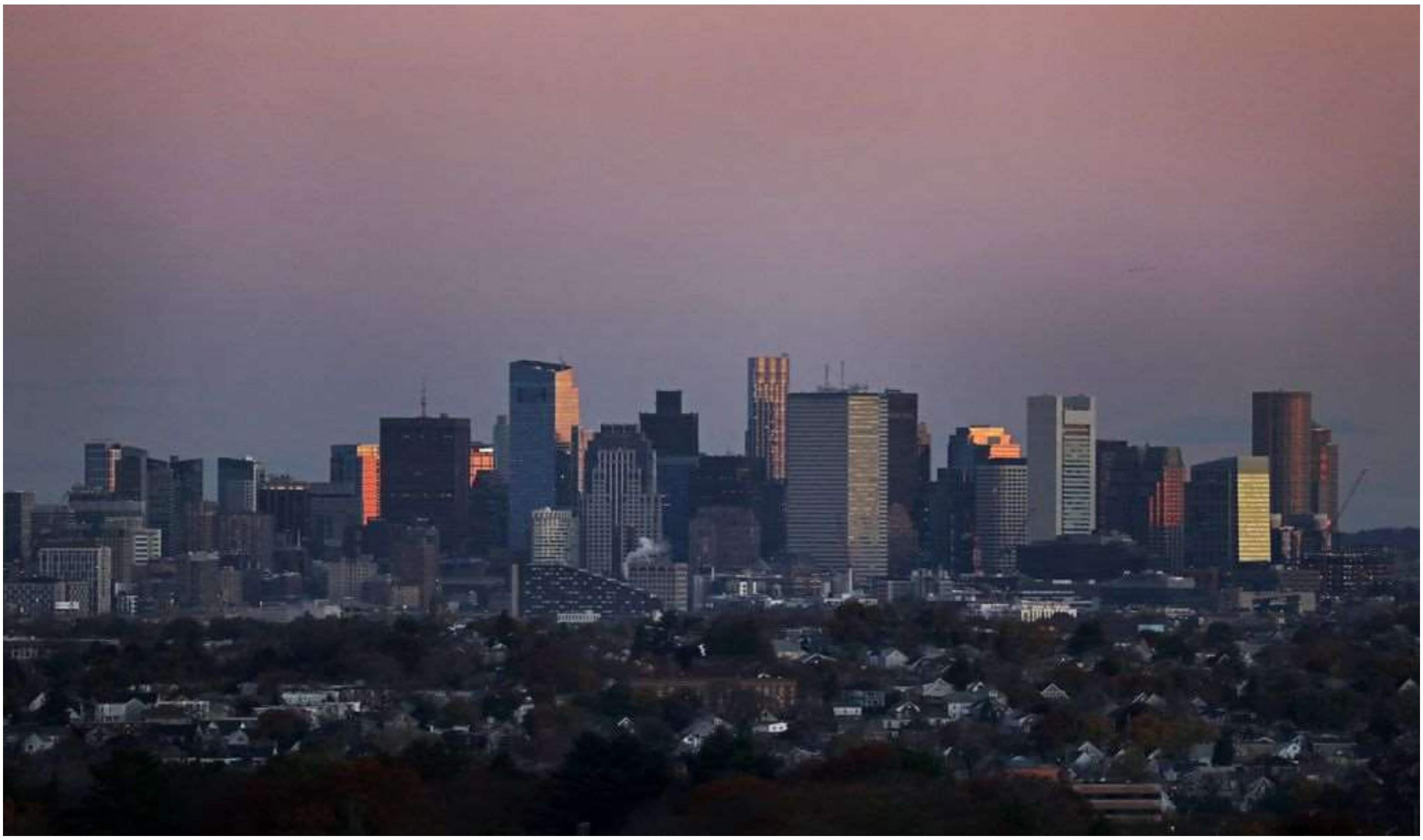
As Boston office market stagnates, worry grows about the value of big buildings

Few have sold this year, and the ones that have are going for a discount

By **Catherine Carlock** Globe Staff, Updated July 25, 2023, 5:40 a.m.



The value of office towers in downtown Boston is an open question right now amid the highest office vacancy rate the region has seen in more than two decades. PAT GREENHOUSE/GLOBE STAFF

In early 2020, some of the region's heavyweight real estate investors were engaged in a bidding war for a premier property: three fully occupied office buildings — more than half a million square feet in all — brimming with paying tenants, just across from the Riverside MBTA station in Newton. Alexandria Real Estate Equities, one of the biggest life-science developers in Greater Boston, eventually won out, paying $235 million for Riverside Center with plans to convert it to lab space.

Last month, Alexandria sold the complex for exactly half of what it had paid just three years earlier: $117.5 million. The new owners — Greatland Realty Partners and a subsidiary of MassMutual — may keep it as office space, or may move forward with labs.

One reason the price fell was because one of the buildings had been emptied to make way for the lab conversion, bringing occupancy from 100 percent to 70 percent. But there's a bigger reason: Boston's office market has changed dramatically since early 2020. And now the bill is coming due.

The sale to Greatland is one of just a smattering of building deals that have closed in Greater Boston since the start of this year, a slow pace that makes it hard to tell just how wobbly the region's commercial real estate market has become. The 36 million square feet of office space that's currently available — either vacant or up for sublease — is an all-time high for the region. Landlords are spending big bucks to compete for tenants. Experts estimate many buildings have lost 20 to 40 percent of their value. And those wobbles are starting to reverberate.

Jack Creedon, co-head of the real estate investment and transaction group at law firm Ropes & Gray in Boston, has seen lenders, borrowers, and other stakeholders pursue a "very granular . . . asset-by-asset evaluation" of their office properties to consider which ones to keep, and which ones to shed. That's a different approach than many took following the Great Recession of 2008 and 2009, when owners sold off entire office portfolios at once. Now, with so much unclear in the market — and with more complicated deal structures — those decisions are tricky.

"No one wants to catch the falling knife," he said. But it's easier to make a case for newer, premier office towers, classified as "Class A," compared to an older property with dated systems and few amenities, a "Class B" office.

"Those are going to be much more difficult to find a solution for," Creedon said.

Indeed, those sorts of buildings are bearing the brunt. Across the board, office vacancy rates in Greater Boston office buildings hit 19.7 percent in the second quarter, according to real estate data firm Colliers. That's up from 16.1 percent a year prior and is the highest in more than 20 years. In the city of Boston, availability is at an all-time high of 21.1 percent, Colliers data show.

The Boston skyline and construction as seen from 321 Harrison Ave. PAT GREENHOUSE/GLOBE STAFF

Tenants looking for new digs are diverting to fancier buildings; of the 1.2 million square feet of space leased downtown so far this year, nearly 900,000 of it has been in Class A buildings, according to Cushman & Wakefield.

And leasing is slow as companies continue to settle into the new normal of hybrid work environments, which is changing how they view their office needs.

“They still want space. They just don’t want as much,” said Riley McMullan, Cushman & Wakefield’s senior manager of Boston research. Even her firm is an example; the real estate brokerage is moving across the street soon, and shedding 6,500 square feet in the process. Another example: Toast, the restaurant technology company, recently paid Alexandria $16 million to break the lease on most of its 133,000-square-foot headquarters at Fenway’s Landmark Center. The company is now searching for 40 percent less space, JLL research shows.

The availability of both new office space and sublease space — along with landlords' increasing willingness to shell out generous tenant improvement packages or free rent — is making downtown Boston and the surrounding region something of a tenant's market.

Typically when buildings finish construction or renovations, they're ready as what's called a core and shell — an operable building core with elevators and other systems, and a blank space surrounding it. That leaves tenants to fit out their spaces with paint, fixtures, and furniture, often largely at their own expense. But these days, landlords are sweetening the deal. The average tenant improvement allowance — the amount the building owner kicks in to fit out the space — shot up by 47 percent for Class A deals larger than 10,000 square feet at the end of last year, compared to the year prior, said Sam Crossan, an executive vice president with brokerage JLL. And it's still growing.

"The past six to 12 months, the amount of free rent or improvement allowances you can get is a lot larger than we had seen" before, said Jeff Myers, research director at brokerage Colliers. As more leases expire and tenants negotiate new deals, they're "probably going to be in a decent negotiating position."

But that will likely further erode building owners' bottom line, and the values of the buildings themselves.

500 Boylston and other Boston buildings are reflected in the John Hancock Tower. SUZANNE KREITER/GLOBE STAFF

Office valuations contribute to the "urban doom loop," whereby emptier offices result in less income for building owners, who then seek a break on property taxes, which in turn results in less property-tax revenue for cities, and smaller budgets for city services. It's not clear yet how many owners in Boston are requesting abatements: The deadline for applying is Feb. 1, 2024. During last year's application period, the city received 1,799 abatement requests. That's down from 2,040 the year prior but higher than in any year from 2018 through 2020, city data show.

Property taxes generate nearly three-fourths of the city's $4.3 billion budget, with commercial property taxes producing a major slice of the pie. Ashley Groffenberger, the city's chief financial officer, told the Globe earlier this year that the city's property-tax structure "is stable in such a way that we do not anticipate that we will see revenues fall off a cliff in any dramatic fashion." Still, the city's keeping an eye out.

“While the Boston real estate market has demonstrated considerable resilience in the face of the pandemic, the city continues to monitor the lingering effects on property values,” the city web page outlining this year’s property taxes states.

And the city hopes to stabilize and right-size its office market for the new climate in part by converting some obsolete buildings into housing, recently announcing a short-term pilot program offering steep tax breaks to landlords to do so.

Myers pointed to some glimmers of hope: The national inflation rate is now 3 percent, down from 9.1 percent a year ago. The Federal Reserve did not increase interest rates at its June meeting after 10 straight increases. Many of the employment sectors that drive office use, such as professional and business services, have recovered to their pre-COVID levels. The amount of time workers spend in offices — as opposed to working from home — is gradually creeping up as some companies have started requiring them to come into the office four days a week.

“There are green shoots out there, and they’re legitimate,” Myers said. “Something’s going to give one way or the other. Either we’re going to have the recession or not. And that’s what everybody’s trying to figure out.”