SEPTEMBER 2001

Urban Land

Tech Trends

DANA C. ROWAN

# Confronting the Tech Wreck

## The real estate industry today recognizes that the market probably needs a breather before economic expansion can resume.

After a peak year in 2000, the office and research and development/flex space markets across the United States softened noticeably in the first half of 2001. The slowdown was particularly noteworthy in the technology-dominated metropolitan areas, where absorption shifted from positive to negative, due largely to the end of demand from technology companies and their decisions to sublet or abandon space. By the beginning of the second quarter, real estate executives in professional meetings frequently referred to the tech wreck in characterizing the market impact of the collapse of dot.com, telecom, and related technology industries.

©WILL CROCKER/THE IMAGE BANK

Though economic storm clouds clearly were gathering last year, the speed and intensity of the 2001 decline in space demand caught many analysts off guard. Torto Wheaton Research reported that, from the fourth quarter of 2000 to the first quarter of 2001, there was a swing in office net absorption nationally from a positive volume of 19.9 million square feet to a negative 16.9 million square feet. This dramatic, single-quarter shift of 36.8 million square feet also marked the first time on record that net absorption across 53 U.S. markets in aggregate was negative.

The reversal of market momentum had its origins in spring 2000. Federal Reserve chairman Alan Greenspan's repeated warnings of "irrational exuberance" in the stock markets and Goldman Sachs economist Abbie Cohen's warning of an impending technical correction finally gave way to a precipitous decline in the NASDAQ. By the end of the year, 151 of 281 recent initial public offerings (IPOs) had shed more than 80 percent of their market capitalization. The collapse of the public markets signaled an end to cheap, easy money for the tech sector and reduced the volume of new IPOs to a trickle. With the public market window essentially shut, venture capitalists lacked a viable exit strategy and started to resist making further investments across the United States. As the correction widened, the larger technology manufacturers and service providers such as Intel, Cisco, Compaq, Lucent, Oracle, EMC, and Sun Microsystems also found themselves broadsided by the downturn.

Heady economic growth during 1999 and 2000, propelled by large infusions of private and public capital in the technology industry, accelerated space demand and, consequently, intensified the fallout from the tech wreck. In supply-constrained markets such as Boston and San Francisco, technology CEOs frequently grabbed twice the space they realistically needed so that real estate would not constrain their ability to grow. Not only did this preemptive takedown further deplete limited inventory and drive up rents, but it later magnified the volume of sublease space dumped back on the market once the industry collapsed.

Given their easy access to cheap capital, dot.com and telecom companies exhibited modest sensitivity to space costs. In Cambridge, near the Massachusetts Institute of Technology (MIT), rents soared from $25 per square foot gross to a peak of $60 per square foot, while San Francisco market rents rose faster than $1 a month and ultimately broke the $100-per-square-foot barrier.

Downtown Boston rents went from $40 per square foot to $80 per square foot gross in less than 24 months. In metropolitan areas such as Austin, Raleigh/Durham, and northern Virginia, where markets were less supply constrained, building owners still enjoyed substantial rental appreciation, while new construction expanded at unprecedented rates. Telecom switching facilities, which commanded rents in excess of $20 to $30 per square foot, became one of the more lucrative opportunities for nimble developers.

The year 2000 had been such a banner year for the real estate community that it took a month or two into 2001 for the reality of the economic chill to sink in. This was the first time in decades that the real estate industry found itself healthy, with supply and demand in balance, while entering a national recession. At first, concerns among bro-

DANA C. ROWAN *is senior vice president of New Boston Fund, a Boston-based private real estate investment firm.*

kers and owners were purely anecdotal, but soon a growing stream of negative articles in the *Wall Street Journal*, major business magazines, and local newspapers confirmed fears of a slowdown. Numerous business failures and impending bankruptcies, combined with growing anxieties among the CEOs and CFOs of the larger technology firms, put the brakes on almost all business expansion. It seemed that, overnight, space demand simply evaporated.

By the second quarter of this year, the big issue confronting the real estate industry was a surging volume of sublease space. Yet-to-be-profitable companies that were burning through their capital reserves suddenly were barred from the capital markets and forced to vacate their space abruptly or ultimately to reject their leases in bankruptcy. Meanwhile, collapsing sales forced larger, better-capitalized tech companies to acknowledge the diminished potential of new or rapidly fading business lines and quickly jettison surplus space through negotiated lease buyouts.

In metropolitan Boston, the impact of the tech wreck among the technology-dominated submarkets has been notable. For example, Cambridge saw its office vacancy (including sublease space) rise from 4.4 to 16.1 percent in the first six months of 2001. During 2000, it had been as low as 0.5 percent. Waltham, the heart of the tech community along Route 128, saw its vacancy rate jump from 6.3 to 22.3 percent over the same period. Downtown Boston saw vacancies rise from 4.7 to 10 percent by mid-2001.

Currently, landlords are finding it challenging to compete against sublease space that is refurbished for tenants and ready to use. Not only do tenant representatives offer sublease prospects attractively refurbished, flexible space, but also workstations, computers, and phone systems on literally a turnkey basis. The typically shorter terms of sublease tenancies also tend to work better for companies reluctant to make long-term commitments in a turbulent business environment. The space that is harder to sublease is the raw expansion space that aggressive tech tenants took down but never refurbished. Brokers admit that backfilling sublease space will be an important part of returning stability to the direct lease market.

Fortunately for the market, several of the larger national technology companies around Boston now have abandoned or postponed ambitious plans to build out or expand their suburban corporate campuses. For example, Cisco halted its plans to construct more than 1.8 million square feet of space on 580 acres. Sun Microsystems and EMC also have scaled back their space plans. Competitive building owners are hoping that corporate restraint on the supply side will help them avoid the fiasco of the early 1990s, when large tech companies such as Digital and Wang found themselves grossly overbuilt and dumped large volumes of space back on the market.

As 2002 approaches, real estate professionals and economists alike acknowledge that the tech recession will be more protracted than originally hoped. The good news for Boston is that sublease vacancies appear to be leveling off. Also, healthier real estate markets and a stronger, more disciplined banking system have helped considerably to temper fears of an impending real estate crisis in the midst of an economic slowdown. In sharp contrast to a decade ago, the real estate industry today views its more recent performance as a fortunate windfall and recognizes that the market probably needs a breather before economic expansion can resume. ■