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Downtowns Get a Fresh Lease

Suburbs Lose Office Workers To Business Districts, Reversing A Post-War Trend

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As the market for office space shows signs of recovery, the suburbs are getting left behind.



A succession of mayors have revitalized downtown Houston, above, persuading companies like BG Group to relocate there from the suburbs.

For decades, the suburbs benefited from companies seeking lower rent, less crime and a shorter commute for many workers. But now, office buildings in many city downtowns have stopped losing tenants or are filling up again even as the office space in the surrounding suburbs continues to empty, a challenge to the post-war trend in the American workplace and a sign of the economic recovery's uneven geography.

Even some forlorn cities are showing signs of revival. In Detroit, Health insurer Blue Cross Blue Shield of Michigan next spring will start moving thousands of suburban employees into the downtown.

Like many cities, Detroit offered an incentive package, including giving Blue Cross employees free annual passes to a public-transit system that connects its downtown buildings. Another motivation: to have more people in one place as the insurer adjusts to the health-care overhaul.

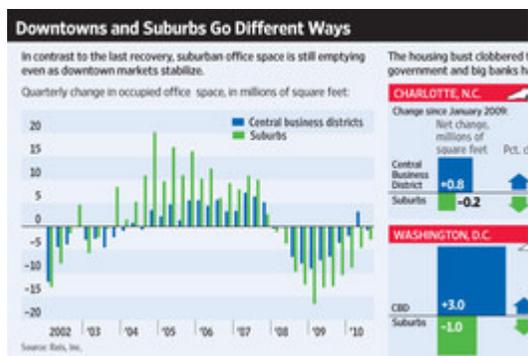
Vacant office space in many downtown areas is filling up while their suburban counterparts continue to lose tenants. Kelsey Hubbard discusses the new trend with WSJ's Anton Troianovski.

"We believed having everyone together would very much benefit us when we had to make quick changes as a result of national reform," Blue Cross vice president Tricia Keith said.

Statistics show that suburban office markets were hit harder by the recession than their downtown counterparts and are recovering more slowly. The national office vacancy rate in downtowns was 14.9% at the end of the third quarter, the same level as in early 2005—while the suburban vacancy rate hit 19%, 2.3 percentage points higher than in 2005, according to data firm Reis Inc.

In the first three quarters of this year, businesses in the suburbs vacated a net 16 million square feet of occupied office space—nearly 280 football fields—while downtowns have stabilized, losing just 119,000 square feet.

Downtowns and Suburbs Go Different Ways



Things were different after prior recessions. As commercial real estate recovered in 2003 and 2004, office space in the suburbs filled up faster than in downtowns, Reis's data shows. For much of the 1990s, as businesses abandoned downtowns to be closer to their suburban work forces, suburban office buildings tended to be more occupied.

But since early 2009, the opposite has happened in major metropolitan areas including Houston, Las Vegas, Miami, Pittsburgh and Phoenix—occupied office space increased downtown but dropped in the suburbs.

Suburbs have been clobbered harder by a recession that hit businesses that are often based there, including mortgage lenders and home builders. Downtowns, on the other hand, have benefited from being home to less hard-hit sectors of the economy, such as government, and companies that have recovered more quickly, such as big banks.

To be sure, most American office workers continue to work in the suburbs—home to nearly twice as much office space as in central business districts, Reis says. And many real-estate developers largely expect suburban office markets to recover when job growth strengthens.

But some scholars, urban advocates, and developers believe a secular shift is under way in the American workplace.

"Young people don't want to be out on the fringe...and as people are beginning to figure that out, it's beginning to get factored into office relocations," said Christopher Leinberger, a real-estate developer and a visiting fellow at the Brookings Institution. "It's a major structural trend that we in real estate are going to have to adjust to."



Tale of Two Markets



As the economy recovers, the suburbs, in many cases, are getting left behind. The metropolitan areas below have lost occupied office space in the suburbs since early 2009 while gaining occupancy downtown.

In suburban Los Angeles and Orange County, Calif., the amount of occupied office space has dropped by a combined 12.4 million square feet from January 2009 to the end of September 2010, or more than 5% of the entire inventory. The pain was much less severe in downtown Los Angeles, which lost 659,000 square

feet over the same time period, or 1.8% of the total inventory, Reis data shows.

Detroit's suburbs have lost more than two million square feet of occupied space since early 2009, 3.4% of its inventory, while the hard-hit downtown has lost just 42,000 square feet, just 0.3% of its total.

Progress made by cities from Denver to Pittsburgh in revitalizing their downtowns in the last decade also has played a role. New retail, nightlife and condominium projects have helped attract some tenants who had long been based in the suburbs.

In Chicago, UAL Corp.'s United Airlines is leaving its one-million-square-foot, 1960s-era office park near O'Hare International Airport for the tallest downtown office building, the Willis Tower.

In Houston, British energy company BG Group PLC is moving its U.S. headquarters from the suburbs to 164,000 square feet in a new skyscraper downtown. The company

surveyed its employees and found downtown was a more convenient commuting destination, policy and corporate-affairs vice president David Keane said. BG also saw a recruitment edge thanks in part to the downtown-revitalization efforts of a succession of Houston mayors.

"When you're looking at new graduates coming into Houston, I think they want to be located downtown," Mr. Keane said.

Just this year, the country's biggest office market, Manhattan, had gained 1.8 million square feet of occupied space as of September. Meanwhile, New York's suburbs, from northern New Jersey to Westchester County, Long Island and Connecticut's Fairfield County, continued to lose occupancy—to the tune of a combined 1.4 million square feet, Reis data shows.

That difference has been felt by big landlords such as SL Green Realty Corp., a major Manhattan skyscraper owner that also owns dozens of office buildings in New York's suburbs.

"Whereas New York is recovering, I'm not sure most of suburban America is recovering," SL Green Chief Executive Marc Holliday said at the company's annual investor meeting last week.

In Denver, a light-rail system has contributed to a more vibrant downtown. Colliers International broker Brad Calbert, who helped arrange moves by energy companies SunCor Energy Inc. and Black Hills Corp. from the Denver suburbs to downtown, said, "There is a cultural transition going on."

For real-estate investors, the difference between suburban and downtown markets is stark. Downtown office buildings are sparking bidding wars especially in major cities like New York and Washington D.C. Meantime, many suburban office parks continue to languish on bank balance sheets, attracting few buyers.

"We're gravitating toward the well located, well leased sites mostly in the traditional urban areas," said a spokesman for one of the country's biggest real-estate investors, the California State Teachers Retirement System.