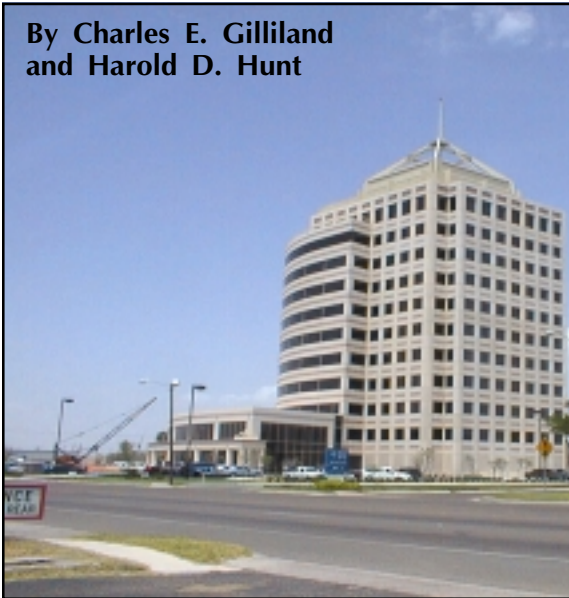


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REALITY CHECK FOR OFFICE CONSTRUCTION



By Charles E. Gilliland and Harold D. Hunt

Flocks of construction cranes hatched in the 1990s by booming economies in Austin, Dallas-Fort Worth, Houston and San Antonio are busy building office space for expanding businesses. However, this drive to develop new investment-grade office space has not occurred in smaller metropolitan areas. So when are Beaumont, Corpus Christi, El Paso, Lubbock and McAllen likely to see new, top-quality office buildings appear on their skylines?

Analysis of building and land costs suggests that office rents must rise significantly in these markets before new development is feasible. Current rental rates for new office space in these cities range from \$12 to \$18 per square foot. New investment-grade development

NEW OFFICE SPACE like these investment-grade buildings in Beaumont (top) and McAllen (bottom) is not likely to appear in the near future.

Table 1. Rental Market Conditions in Selected Texas Cities

	City				
	Beaumont	Corpus Christi	El Paso	Lubbock	McAllen
Land and building costs (in dollars)					
Land cost per square foot	6-8	10-20	6-8	5.50-7.50	8-10
Building cost per square foot	100-110	100-120	90-100	60-80	80-100
Rental rates and expenses (in dollars)					
Gross rental rates per square foot	12-14	16-18	14-16	12-14	14-16
Landlord expenses per square foot	4.25-5.25	6-7	6-7	5.20-5.50	5-5.50
Operating expense ratio (percent)*					
Range	37.5-39.6	37.5-38.9	42.9-43.8	43.3-39.3	35.7-34.4
Average	38.5	38.2	43.3	41.3	34
Overall capitalization rate (percent)	10.5	10.5	10.5	10.5	10.5

*Ratio of operating expenses to gross potential income
Source: Real Estate Center at Texas A&M University

would require rents greater than \$23 per square foot, even if land can be acquired at a minimal \$6 per square foot. While some land may be available at that price in Beaumont, El Paso and Lubbock (see Table 1), land costs are higher in Corpus Christi and McAllen, and that translates into required rents in the \$25- to \$26-per-square-foot range.

Investors develop office space to earn a return on their invested capital. When local demand does not provide a sufficient return, new development ceases until rents rise high enough to entice that new investment. The capitalization rate is a traditional measure of investors' expected return in any given market. When the market provides a return exceeding the capitalization rate, new construction is likely.

Determining the point at which rising demand signals a need for new space to be developed requires analysis of current building and land costs in the local market. Table 2 shows assumptions made for this analysis of proposed office construction in Beaumont, Corpus Christi, El Paso, Lubbock and McAllen.

Applying the market parameters in Table 2 to actual land and building costs in each local market yields the rent needed to justify new construction (see Table 3). For example, in Corpus Christi, with land selling for \$10 per square foot and building costs at \$110 per square foot, new office space must rent for at least \$25.51 per square foot. Using the land and building costs shown in Table 1, the rental rates needed to justify new office construction in other smaller Texas markets can be determined.

Prime office space in Corpus Christi currently rents for between \$16 and \$18 per square foot, substantially less than the \$25.51 required to encourage new construction. To build new office space in this rental range, with land costs at \$6 per square foot, construction costs could be no higher than \$60-\$80 per square foot. Projects with land costs of \$14 per square foot would be restricted to building costs of \$60 per square foot to keep rental costs within the current range.

Investment-grade office buildings are described by the Marshall Valuation Service as being constructed with reinforced concrete frames in which the columns and beams are either formed or precast concrete. These structures are fire-resistant, with floors and roofs made of precast or formed concrete slabs. Exterior walls are typically built of masonry or reinforced concrete and may be partially load-bearing. However, non-bearing panels of concrete, metal, glass or stone are often used



RENTS WILL HAVE TO RISE before Lubbock will see new prime office space development.

Table 2. Market Parameters for Office Space Analysis

Efficiency ratio	0.90
Occupancy rate	95 percent
Vacancy rate	5 percent
Operating expense ratio (OER)	0.35
Capitalization rate	10.5 percent

Source: Real Estate Center at Texas A&M University

as well. Interior partitions are generally made of masonry, reinforced concrete or gypsum block, but lightweight, movable partitions may be used where structural walls are not a necessity.

Cost per square foot for a 30,000-square-foot, three-story building of this quality in Corpus Christi approaches \$114 per square foot, according to the Marshall Valuation Service cost estimator. Assuming that actual costs may vary, building costs for investment-grade properties in Corpus Christi are likely between \$100 and \$120 per square foot. Given current land costs of \$10 to \$20 per square foot, Table 3 shows that new construction would be feasible only after rents exceed \$23.62 per square foot.

That leaves a sizable gap between the current rent of \$18 per square foot and the minimum \$23.62 per square foot needed to support new investment-grade office structures. Only unsatisfied demand for better quality space or an influx of highly profitable business is likely to boost rents to those levels. The current outlook for business growth in Corpus Christi does not indicate that either of these circumstances will occur in the near future, so it is doubtful the city will see new investment-grade office construction any time soon.

However, some office development projects may be possible under current market conditions. Rather than investment-grade construction, Corpus Christi should anticipate construction of less expensive structures, in the \$60- to \$70-per-square-foot range, developed by local investors. The same is true for the other four markets discussed here.

This office building market analysis reflects the perspective of a no-nonsense investor dedicated to achieving a return commensurate with current opportunities in other markets. To attract such an investor, rents in a community must provide returns that compensate for the capital used to buy the land and construct the building.

To specify your own parameters or to see results under different market conditions, get a worksheet from the Center's website at <http://recenter.tamu.edu>.

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Table 3. Rental Rate Required to Justify New Office Construction*

		Building cost per square foot						
		\$60	\$70	\$80	\$90	\$100	\$110	\$120
Land cost per square foot	\$6	14.18	16.06	17.95	19.84	21.73	23.62	25.51
	\$8	15.11	17.00	18.89	20.78	22.67	24.56	26.45
	\$10	16.06	17.95	19.84	21.73	23.62	25.51	27.40
	\$12	17.00	18.89	20.78	22.67	24.56	26.45	28.34
	\$14	17.95	19.84	21.73	23.62	25.51	27.40	29.29
	\$16	18.89	20.78	22.67	24.56	26.45	28.34	30.23
	\$18	19.84	21.73	23.62	25.51	27.40	29.29	31.17
	\$20	20.78	22.67	24.56	26.45	28.34	30.23	32.12

*Assumes 10.5 percent capitalization rate, 95 percent occupancy and 90 percent efficiency ratio
Source: Real Estate Center at Texas A&M University

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