POLICY BRIEF

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The Hollowing Out of Downtown Pittsburgh

Pittsburgh's downtown office market has softened substantially in recent years as indicated by rising vacancy rates and falling prices for buildings. The Pittsburgh situation, until the last quarter or so, has mirrored the national office market trend. But, as of late, the national and local pictures have begun to diverge.

Nationally, office vacancy rates started rising in 2002 and only began to improve a little in late 2004. At the end of the third quarter of 2004, the national vacancy rate for suburban markets stood at 18.1 percent while vacancies in Central Business Districts had reached 15.3 percent. Pittsburgh's experience has somewhat paralleled the national trend. Specifically, Pittsburgh's suburban rate stood at 23.3 percent in the third quarter of 2004 while the rate in the Central Business District was 18.1 percent.

However, there has been one major difference between Pittsburgh and the national experience over the last few years. To wit; even with the weaker demand, new downtown office construction continued nationally, albeit at a slow pace, while there was no new construction in downtown Pittsburgh. Thus, the vacancy rate rise in Pittsburgh's downtown is due entirely to falling demand as compared to the national situation which is attributable in part to increased supply as well as weaker demand.

In Pittsburgh's Central Business District there are 20.8 million square feet of office space, nearly 50 percent of the region's total. The vacancy rate for all classes of buildings was 18.1 percent while the City's Class A buildings' vacancy rate was more than 20 percent in the third quarter of 2004—a rise of 37 percent since 2001.

High vacancy rates have created a "tenants' market" wherein landlords compete over the remaining tenants by lowering rents and customizing space. Rents have been falling since 2001 when the average rental rate for Class A buildings stood at $22.36 per square foot. By the third quarter of 2004 Class A rent had dropped to $20.47—a decrease of 8 percent. With the reduction in rental rates, tenants are reaping the rewards as many have moved from building to building—sometimes within the Central Business District or to the fringe markets of the North or Southside, and sometimes to the suburbs—to take advantage of the deals being offered.

A jump in vacancy rates and downward pressure on rents have caused two downtown buildings to be put up for Sheriff's sale and others to resell below earlier sales prices. Due to high vacancy rates, falling rents, and the uncertain future of its main tenant, the owners of Dominion Tower were forced to sell the building at Sheriff's sale. The sales price fell to $42.5 million—a decrease of 46 percent from its 2000 sales price of $80 million.

The second building, the Warner Center, was put up for Sheriff's sale in February 2005. Warner Center's vacancy rate has been about 60 percent. The building sold to its creditor for $2.7 million—well below its assessed value of $4.9 million. The lender decided that there were no acceptable bids—the minimum asking price was $3.7 million—and retained control of the building.

Typically, once a building's vacancy rate approaches 25 to 30 percent financial problems will arise as landlords fail to generate enough rent to make loan payments or earn an adequate return on investment. Another building in the Central Business District with a vacancy rate in this range is the Frick Building. It had a vacancy rate in the second quarter 2004 of 23 percent and was put up for sale. Thus far, it has failed to obtain an acceptable offer.

In Pittsburgh's case, it is important to note that, in addition to the soft office market, there is a substantial quantity of vacant retail space resulting from the closing of the Lord and Taylor and Lazarus department stores as well as the failed Fifth and Forbes Marketplace revitalization. With large amounts of new retail space opening in other parts of the City and County, downtown retail sales and demand for retail space has undoubtedly been negatively affected.

What's more, there are government-subsidized office buildings and office space under construction on the North Shore and on the Southside that will create even more competition for downtown space. Indeed, one of the new buildings will result in several hundred employees moving out of the Central Business District to the North Shore. All this portends a further general decline in total market value of downtown real estate and a drop in property tax collections for the City, County and school district.

Even though the national commercial real estate market is improving, there are some uncertainties surrounding the market in Pittsburgh's Central Business District—most notably the City's financially distressed situation. City expenditures have been rising rapidly and there has been no real effort to bring them in line with comparable cities. The City petitioned for and was granted tax increases for both workers and for-profit businesses.

Obviously, taxes and business climate can weigh heavily in a firm's decision of whether or not to operate in the City. Many will opt to move to locations with a more business friendly, low tax environment. If the City wants to see marked improvement in its commercial real estate market, it will be absolutely necessary to reduce government expenditures and tax rates to become more attractive to businesses. Unless and until that happens, vacancy rates will remain high and buildings will continue to decrease in value.

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