ALLEGHENY INSTITUTE
FOR PUBLIC POLICY

Space For Rent:
The State of the Commercial Real Estate Market in the Golden Triangle

Frank Gamrat, Ph.D., Senior Research Associate
Allegheny Institute for Public Policy

Allegheny Institute Report #05-01
January 2005

305 Mt. Lebanon Blvd.◆ Suite 208 ◆ Pittsburgh, PA 15234
Phone: 412-440-0079 Fax: 412-440-0085 www.alleghenyinstitute.org

Table of Contents

Executive Summary

The commercial real estate market around the country has been marred by high vacancy rates and falling rents. Vacancy rates began rising in 2002 and have only begun to decrease in 2004. The higher vacancy rates have caused building owners to offer lower rents to attract tenants. The combination of higher vacancy rates and lower rents has reduced the value of buildings as investments. The good news is that, on a national level, the commercial real estate market has been improving since mid 2004. However, even though the economy has been improving and vacancy rates have been slowly falling, it may be a few years before the market returns to normal.

Nationally, downtown vacancy rates have fared better than those in the suburbs, but both have followed similar trends. By the end of the third quarter of 2004, the national vacancy rate for suburban markets had fallen to 18.1 percent while Central Business Districts' had a vacancy rate of 15.3 percent. In the Pittsburgh region, the experience has been identical. The 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. The focus of this research is on the Central Business District in Pittsburgh where high vacancy rates and low rents have caused two buildings to be put up for Sheriff's sale and others to resell below either their initial sales price or market value.

In Pittsburgh's Central Business District there is 20.8 million square feet of office space, nearly 50 percent of the region's total office space. Even though the vacancy rate for all classes of buildings was 18.1 percent, looking more closely at the City's best or Class A buildings, the office vacancy rate was more than 20 percent in the third quarter of 2004. The vacancy rate increased from 14.6 percent during the third quarter of 2001—an increase of 37 percent in three years.

These high vacancy rates have caused rental rates to fall. For Class A buildings in Pittsburgh's Central Business District, the square footage rental rate was $22.36 in 2001. By the end of the third quarter of 2004 that rate had fallen to $20.47 per square foot—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 the fringe markets of the North or South Side, and sometimes to the suburbs.

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 declaration of financial distress. The City's expenditures have been rising and there has been a reluctance to bring them in line with comparable cities. Therefore the City petitioned and was granted tax increases to both workers and for-profit businesses. Taxes and the business climate can weigh heavily on a firm's decision to enter or leave the City. They may opt for a more business friendly, low tax environment in which to move. To assist the commercial real estate market, the City needs to reduce expenditures and subsequently taxes to become a more attractive place to locate. Until then, vacancy rates will continue to languish and buildings will continue to decrease in value and the recovery that is being experienced by the rest of the nation will pass us by.

Introduction

Moody's Investors Service recently rated Pittsburgh's commercial real estate sector as one of the ten worst in the country. This ranking was based on activity in 2004. While this may come as a surprise to some, demographic trends since 2000 suggest that this is not an aberration and may continue over the next few years. Even though this ranking is for the region as a whole, the driving force behind the region is the City itself. Therefore the crux of this paper will focus on conditions in the City and what these conditions mean for the City's commercial real estate market.

City population has been declining for decades. In 1950, the City's population stood at 676,000 and had declined to 423,000 in 1980. In 1990 the number of City residents fell to roughly 369,800 and by 2000 fell another 9.5 percent to 334,500. This trend shows no signs of subsiding as population has fallen another two percent from 2000 to 2002.

Once the hub of employment, the number of people working the City has also declined as evidenced by the collection of the City's occupation privilege tax. In 2000, roughly 324,000 people worked within the City; by 2004, that number had declined to 320,000. An even broader measure of the region's economic health is the total employment figure for the Pittsburgh Metropolitan Statistical Area (MSA).[1] Total employment in the Pittsburgh MSA was 1,055,300 in 1980. By 2003 that number had climbed to 1,119,100—an increase of 63,800 or 6 percent. This translates to less than 3,000 additional employees per year. More recently, the total number of employees reached a high of 1,148,500 in 2001 before declining 2.5 percent by 2003. The decrease in the number of total employees corresponds to the increase in the vacancy rates.

The reduction in the population and the workforce has caused a decline in the number of passengers on the region's mass transit system. The Port Authority has seen decreases in its ridership in the last few years. From 2003 to 2004, system wide ridership fell nearly 5 percent. From 2001 to 2004, total ridership has fallen by 12 percent. Despite expanding the system to include a new busway in the west suburbs, an extension of the busway in the eastern suburbs, an expansion of the light rail line through the southern neighborhoods, and even an increase in the City's parking tax, ridership still declined. Since most of the Port Authority's lines run into the City, specifically the central business district, any changes in population and the workforce will be reflected in ridership numbers.

Parking in Pittsburgh has always been a problem. Parking in the Central Business District (CBD) is limited. In a 2002 Allegheny Institute study "Parking in the Golden Triangle: How Pittsburgh Compares to Similar Cities", Pittsburgh only has 51,000 parking spaces in the CBD, fewer than Baltimore, Denver, and Indianapolis. The parking tax is also the highest in the nation at 50 percent (up from 31 percent in 2003). The expense and limited availability of parking in downtown has certainly impacted firms' willingness to locate in the CBD, thus contributing to the high vacancy rates. One

[1] Counties included in Pittsburgh's MSA are: Allegheny, Beaver, Butler, Fayette, Washington, and Westmoreland.

example was the decision of the InRange Technologies to put its office building up for sale as it looked to move out of the Central Business District.[2] According to representatives from InRange, the decision to move came at the request of its employees who cited parking as a major issue.

Vacancy Rates in Pittsburgh

Office vacancies are not a problem that is confined to Pittsburgh and its surrounding markets. National office vacancy rates had been increasing steadily from late 2001 until 2003. In 2004, the national market began to improve, albeit ever so slightly. Downtown vacancy rates have fared better than those in the suburbs, but both have followed similar trends. Although the national market is improving, it is believed that, given current absorption rates, it may be 3 to 4 more years before the national market is restored to its equilibrium rate.

Vacancy rates for the total office market in Pittsburgh were more than 19 percent in 2002 and by 2003 had climbed to more than 20 percent. Conditions improved in the latter half of 2003 and, by the third quarter of 2004, had fallen slightly to under 20 percent. The national rate has been somewhat better during this stretch, but follows a similar pattern. Overall vacancy rates nationally were approximately 17 percent in 2002 before increasing to nearly 18 percent in the first quarter of 2004 before falling to 17.24 percent in the third quarter of 2004.[3]

Central Business District

Although suburban vacancy rates are greater than those found in the Central Business District—23.3 percent and 18.1 percent respectively for the third quarter of 2004—the focus of this research will be on the CBD. Central Business Districts have a national vacancy rate at 15.3 percent for the third quarter of 2004 and appear to be improving. Analysts believe that the national equilibrium rate of vacancy to be approximately 10 to 12 percent.[4] In a healthy market, the vacancy rate falls by less than 2 percent per year. At this rate, with a less than fully healthy market, the national market will take nearly 3 years to return to equilibrium. If the Pittsburgh CBD follows the national trends, it could take 4 or more years until its vacancy rates reach 10 to 12 percent.

In Pittsburgh's Central Business District there is 20.8 million square feet of office space, nearly 50 percent of the region's total office space (45.4 million square feet). To illustrate the rapid increase in the vacancy rates, the rate in the second quarter of 2001 was 14.5 percent and had fallen to 13 percent in the fourth quarter. In 2002 the first quarter rate was only 14.3 percent. However, by the fourth quarter of 2002, that rate had climbed to 17.2 percent. Narrowing the focus even further, the vacancy rate for Class A office buildings was more than 20 percent for the third quarter of 2004—up from the 15.9

---

[2] Guzzo, Maria. "InRange Puts Headquarters Up For Sale." *Pittsburgh Business Times.* March 8, 2002
[3] "Office Market Trends: North America". Grubb & Ellis Research. Winter 2004.
[4] Ibid.. page 4.

percent during the third quarter of 2002 and 14.6 percent during the third quarter of 2001. Vacancy rates for Class A+ buildings in Pittsburgh were between 4 and 8 percent in the mid to late 1990s through most of 2001.[5]

New Construction

A contributing factor to high vacancy rates was the rate at which new office buildings were being brought online in the early 2000's. The dot-com boom and the low interest rates of the late 1990s and early 2000s spurred a wave of office building construction across the nation.

The per capita value of office and bank building construction in the Pittsburgh area showed a steady decline since 1999. From 1998 to 2003 the per capita value of office and bank construction declined by 49 percent. Nationally, the per capita value of office and bank construction increased from 1998 to 2000 before declining 40 percent from 2000 to 2003. From 2000 to 2003, the trend in the per capita value of office and bank building construction in this region very closely mirrored the national trend.

Office and bank building construction in Allegheny County was more than 8.3 million square feet built between 1998 and 2003. Eighty percent of this construction (6.7 million square feet) took place from 1998 to 2001. In 2002 and 2003 only 1.6 million square feet were built—an average of only 821,000 annually. Projections for 2004 and 2005 show an improvement in activity at 885,000 and 1.1 million square feet respectively.[6]

All new office construction has taken place in the fringe markets of the CBD. Two new office buildings are being constructed on the North Side, another is planned for the South Side, and another in Oakland, which is one of the region's hottest office markets. The last major office building to be constructed in Pittsburgh's CBD was the 32-floor former CNG tower (now Dominion Tower) that was built in the late 1980s. The CBD is facing increased competition from new and renovated office buildings on the fringe of its market in areas such as Oakland, the South Side, and the North Side, as well as in the suburbs in the west and south. These markets are providing fierce competition to the CBD.

Vacancy Rates and Rents

There is a negative correlation between vacancy rates and rent per square foot. As vacancy rates rise, rental rates tend to fall. This has been evidenced all over the country. From 2002 to 2003, rental rates in San Francisco declined by 30 percent, in Minneapolis they declined by 14 percent and even in Manhattan and Chicago the rates fell by 12 and

---

[5] DeParma, Ron and Sam Spatter. "High Vacancy Rates Plague Downtown Offices." *Pittsburgh Tribune-Review.* December 23, 2004.
[6] Gamrat, Frank, "Commercial Construction in Southwestern Pennsylvania: 1998-2003." *Allegheny Institute*. Report 04-02. March 2004.

10 percent respectively. As previously mentioned, the vacancy rate in Pittsburgh's CBD stood at 14.5 percent for the second quarter of 2001. The average rental rate during that time was $24.28 per square foot. One year later, during the second quarter of 2002, the vacancy rate had risen to 17.2 percent while the rental rates had fallen to $23.22 per square foot—a 4 percent decline.

For Class A buildings, the 2001 vacancy rate was 16 percent and the average square foot asking price was $22.36. By the fourth quarter of 2002, the vacancy rate climbed to 19.4 percent and the asking price fell to $21.54 square foot.[7] By the end of the third quarter 2004, the rental rate for Class A buildings was $20.47 and it's believed that the vacancy rate of these buildings has topped 20 percent.

As vacancy rates began to rise, building owners began lowering rental rates to attract tenants. This created a tenants' market that saw many firms change buildings. Firms are able to not only lower their square footage costs, they are able to acquire space that may be built out to their specifications. The moves may be minor such as within the CBD or major such as across the river to either the North Side or South Side or to the suburbs. With landlords aggressively chasing tenants, rental rates were quickly lowered. Even though the rent for Class A buildings fell to $20.47 per square foot, the rent for Class B buildings fell to $15.56.[8]

Building Investment

High vacancy rates and low rents tend to drive down the office investment market. Analysts seem to agree that, at the national level, there is a recovery underway as evidenced by a decrease in vacancy rates for all classes of office space. With interest rates low and the stock market tepid, the demand for commercial real estate across the country has been growing—2004 transaction volume was up by 55 percent over the 2003 level. Lower interest rates lower debt payments, which have allowed owners to reduce rents to attract tenants and lessen vacancy rates.

While this is helping the national office investment market, the trend has not caught up to the Pittsburgh market, where high vacancy rates have helped reduce the demand for office buildings as an investment. In addition to continued high vacancy rates, there are other factors at play, particularly in Pittsburgh's CBD. As stated by Grubb & Ellis researchers, "…the financial health of the City and the retention of US Airways at Pittsburgh International Airport have created political and economic uncertainties that will weigh heavily on decisions for long-term investments and commitments."[9]

This uncertainty was most evident in the recent Sheriff's sale of the Dominion Tower in January 2005. Dominion Office Tower was built in 1987 for approximately $79 million

---

[7] Elliott, Suzanne. "Commercial Real Estate Market Remains Victim of Weak Economy." *Pittsburgh Business Times*. April 25, 2003
[8] Supra. Note 2. Page 5.
[9] "Regional Overview: Great Lakes." *Grubb & Ellis*. Winter 2004. Page 26.

and then sold in 2000 for $80 million.[10] However, by late 2004, the building was plagued by high vacancy rates, which had increased from 6 percent in 2000 to nearly 34 percent. One reason for the increase in vacancy rates was the loss of major tenants such as Rockwell International. The status of the main tenant, Dominion Resources whose lease expires in 2007, had caused the building's value to fall.

The high vacancy rates resulted in falling rents, which once went from a high of $28 per square foot in the mid-1990s and fell to $24.50 in 2003 and then to $20 in late 2004. These two factors contributed to mounting debts for the building's owners. They were forced to let the building go into receivership and subsequently Sheriff's sale. Allegheny County assessed the property at $53 million, but at Sheriff's sale the building was sold for $42.5 million—a decrease of 46 percent in four years.[11]

Analysts believe that if a building's vacancy rate rises above 20 to 30 percent, then debt problems will arise as landlords fail to earn enough in rent to make payments. As mentioned above, Dominion Tower has a vacancy rate of 34 percent (209,922 of 615,942 square feet are available). Another building in the CBD with a vacancy rate of 60 percent is the Warner Center. It is also being sold at Sheriff's sale in February 2005.[12]

Another building with vacancy problems is the Frick Building. Its vacancy rate in the second quarter of 2004 was 23 percent—up from 10 percent in 2003. In mid-2004 it was up for sale, but the terms were not disclosed. Its value at that time was $25.65 million—an increase of only 3 percent from its purchase price of $24.8 million in 1998. That deal fell through and by early 2005, it was back on the market with an asking price of $32.5 million.[13] With a soft, tenant friendly market, the owners may have difficulty reaching their asking price. The reason that the Frick Building's vacancy rates had risen was the loss of two major tenants as they moved to other buildings in the CBD. As revealed in a survey of commercial real estate agents, the top two risk factors in purchasing an office building are a weak leasing market and slow job creation.[14]

Further evidence of the decline in commercial real estate as an investment opportunity in Pittsburgh's CBD is the Gateway Center Towers. The Gateway complex includes four office towers, two parking garages, and 10 acres of land that sit beneath the Hilton Hotel. In 1995 the complex was purchased for $57.35 million and then sold in late 2004 for $50 million—a decline of 13 percent in value.

---

[10] Built as part of a $114 million project, which included a $35 million renovation of the Stanley Theater (Benedum). Green, Elwin. "Dominion Tower Bought at Auction for $45.2 Million." *Pittsburgh-Post Gazette*. January 4, 2005.

[11] Spatter, Sam. "Dominion Building Buyer Found." *Pittsburgh Tribune-Review.* January 4, 2004.

[12] This is not the first time a major office building has been sold at Sheriff's sale. In 1998, One Oliver Plaza (now Freemarkets Center) was sold at Sheriff's sale for $30 million--$63 million less than its original purchase price of $93 million.

[13] Elliott, Suzanne. "Trammell Shows Interest in Frick Building." *Pittsburgh Business Times.* May 14, 2004.

[14] Bach, Robert, Nicholas Buss, Elizabeth Ptacek, and Robert White. "Bubble Re (W) rapped: Retesting the Theory of Rational Exuberance in the Office Market." Grubb & Ellis. March 2004.

The only entity that seems to not be concerned with vacancy rates in the CBD is the Urban Redevelopment Authority (URA). For their development efforts they purchased properties on Wood Street (434 and 438) and paid 50 percent more than the assessed values—purchased for $1.3 million or $315 per square foot. In the Fifth and Forbes corridor they have paid between $200-$250 per square foot.[15]

However, with the exception of purchase by government entities, the prices paid for buildings in the downtown corridor have been falling. One reason is the above mentioned rising vacancy rates and falling rents, but another reason has been the City's mass development strategy, in which the threat of eminent domain was often mentioned as the City's development arm, the URA, tried to assemble a number of properties for retail development. This threat has caused retailers to abandon many storefronts in the CBD and has limited any retail interest in this area. It is possible that the dearth of retailers and the blight that has been left behind is starting to cast a negative pall over the CBD as a place to do business.

Business Climate

Many national real estate experts believe that the national market is improving in response to a growing economy. Vacancy rates are falling as the construction boom subsides and net absorption is increasing as the economy begins to add more jobs. In Pittsburgh though, there is an additional issue that may be holding back the market—the City's financial situation.

Taxes can weigh very heavily in a firm's location decision. City officials insisted on blaming commuters working in the City and the exemptions in the business privilege and mercantile taxes for revenues that were unable to keep up with the City's expenditures. The City asked for and received Act 47 distressed status and was placed under the control of a fiscal oversight board by the state legislature. A result of this situation, the City received an increase in its Occupation Privilege Tax on workers—now called the Emergency Municipal Services Tax (EMS)—and a new payroll preparation tax on all for-profit employers.

Anyone working within the City of Pittsburgh owes $52 annually—up from $10. There are exemptions for those making less than $12,000 per year, but these workers still must pay the tax and then apply for a refund in the following year. For example, they will pay the $52 tax in January of 2005 and in January of 2006, when they can prove that they earned less than $12,000 in 2005, can apply for a $42 refund. Even though the EMS tax is available to all municipalities across the Commonwealth, not every one has taken advantage and increased the amount of the tax.

The payroll preparation tax is a 0.55 percent tax on the total value of a for-profit firm's payroll. The intent of this tax is to eliminate the exemptions of the business privilege and mercantile tax that had been granted to manufacturing and financial firms. Previous

[15] Schooley, Tim. "URA's Spending Under Scrutiny." *Pittsburgh Business Times*. May 10, 2002.

Allegheny Institute research (Policy Brief, Volume 4, Number 46) estimated that manufacturers would owe the City $5.5 million annually and those in the financial sector would be responsible for another $9.6 million.[16] Those firms—wholesalers and retailers—who were paying the business privilege and mercantile tax may or may not be better off under the new system as the mercantile tax was eliminated and the business privilege tax was reduced and will be ultimately phased out. All in all, the City will collect an additional $5 million from its businesses with the new payroll tax.

As leases expire in the City, firms may look at the business climate in the City and listen to concerns from their employees before deciding on whether or not to renew. They may opt for a more business friendly environment and relocate to the suburbs or even to another county. Developments in Butler County (Cranberry Township) and Washington County (Southpointe) remain popular and continue to expand offering firms a close alternative to the City and the CBD.

Conclusion

The real estate market in Pittsburgh, especially in the Central Business District, has suffered in the last few years. A weak economy, new construction coming online, and a City in distress has caused high vacancy rates which, in turn, has caused low rents which, in turn, has caused a drop in the value of buildings as investments. There seems to be some optimism that the market has hit bottom and has begun to rebound. Vacancy rates for the last few quarters of 2003 and 2004 have shown a small decline, but it may take a few years for them to reach the national equilibrium of 10 to 12 percent.

However, for the market to recover fully, a few uncertainties must be resolved. Chief among those is the financial situation of the City. The City needs to reduce its expenditure levels, particularly on public safety, so that it can begin to roll back taxes on businesses. Once the City becomes more business friendly, employment within the CBD will increase and vacancy rates will fall and rental rates will again increase. Secondly, the City needs to let the private sector rebuild the retail corridor without the threat of eminent domain. The top-down government directed development efforts did not succeed and should be abandoned. When the private sector is allowed to function without government intervention, the Central Business District will return to vitality.

[16] Haulk, Jake and Frank Gamrat. "Pittsburgh's New Business Tax Structure: Who Pays?" Allegheny Institute. December 8, 2004. http://www.alleghenyinstitute.org/briefs/vol4no46.pdf.

References

Bach, Robert, Nicholas Buss, Elizabeth Ptacek, and Robert White. "Bubble Re(W)rapped: Retesting the Theory of Rational Exuberance in the Office Market" *Grubb & Ellis.* March 2004.

DeParma, Ron and Sam Spatter. "High Vacancy Rates Plague Downtown Offices." *Pittsburgh Tribune-Review.* December 23, 2004.

Elliott, Suzanne. "Commercial Real Estate Market Remains Victim of Weak Economy." *Pittsburgh Business Times*. April 25, 2003.

---"Trammell Shows Interest in Frick Building". *Pittsburgh Business Times*. May 14, 2004.

Gamrat, Frank. "Commercial Construction in Southwestern Pennsylvania: 1998-2003." *Allegheny Institute.* Report 04-04. March 2004. http://www.alleghenyinstitute.org/reports/04_02.pdf

Green, Elwin. "Dominion Tower Bought At Auction for $45.2 Million." *Pittsburgh Post-Gazette.* January 4, 2005.

Guzzo, Maria. "InRange Puts Headquarters Up for Sale." *Pittsburgh Business Times.* March 8, 2002.

Haulk, Jake and Frank Gamrat. "Pittsburgh's New Business Tax Structure: Who Pays?" *Allegheny Institute.* December 8, 2004. http://www.alleghenyinstitute.org/briefs/vol4no46.pdf.

"Office Market Trends: North America". *Grubb & Ellis Research.* Winter 2004.

"Regional Overview: Great Lakes". *Grubb & Ellis.* Winter 2004.

Schooley, Tim. "URA's Spending Under Scrutiny." *Pittsburgh Business Times*. May 10, 2002.

Spatter, Sam. "Dominion Building Buyer Found." *Pittsburgh Tribune-Review.* January 4, 2005.