

COSTAR INSIGHT

Effective rents weighed down by growing office concession packages

Despite high office rents, elevated free rent and construction costs impair landlord cash flows



CoStar's Market Effective Rent tool can reveal the true price of office space in a transformed occupancy market. (CoStar)

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There are a lot of ways to analyze a lease transaction, and points of view vary depending on which region of the country and on which side of the negotiating table you're sitting.

One useful way to track the relative balance of power between the parties to a lease negotiation is through market effective rent, a measure of the true occupancy cost for tenants.

Even here, there are multiple options to approach this concept. Some prefer to amortize the average of free and paid rent over the lease term. Among those who take that approach, some use a straight-line method; others apply a discount rate. Some include tenant improvement costs on a per-transaction basis, while others prefer to segregate them out over multiple leases. Some even include additional categories, such as leasing commissions and parking income.

CoStar's new Market Effective Rent index takes a standardized approach that reflects the net present value of all lease payments, minus the free rent and tenant improvement allowance, which are amortized over the lease term. This yields a single effective rent number that encapsulates the quality of the space and the concession package a tenant receives in relation to the rent they pay.

Take Boston, for example, with a market average asking rate of \$43.20 per square foot as of the beginning of the fourth quarter. The market starting rent, or contract rate, is about 2% lower at \$42.33 per square foot.

Breaking down effective rents in Boston

RENTS	MARKET	NATIONAL INDEX
Market Asking Rent/SF	\$43.20	\$35.57
Market Starting Rent/SF	\$42.33	\$33.17
Annual Escalations	2.8%	2.7%
Free Rent in Months	3.2	4.8
Tenant Improvement Allowance/SF [Ⓢ]	\$34.93	\$37.77
Term in Months	58.1	64.7
Market Effective Rent/SF [Ⓢ]	\$39.76	\$29.86

Source: CoStar, October 2024



Given the softness in the office occupancy market, such a discount to asking rates is perhaps not as large as might be expected. This is because landlords are holding tighter to their asking rates due to the extensive cost of tenant improvements, requiring a reasonable payback period on their investment.

The next component in the effective rent calculation is annual escalations, or contractual rent increases. In Boston, these stand at an annual average of 2.8%, just above the national index of 2.7%.

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What follows in the calculation are the two major components of a typical concession offering, beginning with the period of free rent, also known as rent abatement. Direct, new leases in Boston currently have an average rent abatement period of 3.2 months. Given that office lease terms in Boston average 58.1 months, this relationship is about two months of free rent for every three years of lease term.

Tenant improvement allowances are the last piece of the effective rent puzzle. These reflect the cost of constructing new or additional improvements inside the space to suit the tenant's needs. They do not include common area amenities or exterior renovations.

For brand-new office spaces in 4 and 5-star-rated office buildings, this expense could push well above \$100 per square foot in primary markets such as Boston. However, once the latest generation of tenant improvements has been constructed, future investments into the space over the next decade tend to be dramatically reduced. Thus, the market average is usually much lower than what is spent upfront to build out space in new buildings.

The \$34.93 per square foot tenant improvement allowance represents the typical landlord contribution to improving the average office space in the Boston market.

Finally, the Market Effective Rent summarizes all these considerations into a single number: in this case, the cost for an office tenant in Boston to occupy space is \$39.76 per square foot. This value will fluctuate over time as the balance of power between tenants and landlords ebbs and flows through each real estate cycle.

These rent summary tables are now conveniently located on each market's summary page. CoStar subscribers can take advantage of this and other resources to help stay abreast of decision-influencing trends.