A New Look at Rental Price-Adjustment in Office Markets: Do Vacancy Rates Really Matter?

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In much of the literature on office markets and in practice, it generally is assumed that vacancy rates are the principal determinants of rent levels and analysis proceeds on that basis. However, that assumption depends on the definition of rents utilized, how vacancies are measured, and on whether or not average or building-specific data are employed.

Vacancy rates and trends are regarded as the principal indicators of the general health of local office markets, ostensibly illustrating the degree of disequilibrium characterizing these markets. As such, vacancies crudely determine the expected discount (or premium) for excess supply or demand when rents are transacted. However, the reasons for price-adjustments and perceived disequilibrium in the office market are complex, stemming from 1) the unique nature of office space as a good (i.e., each time space is offered on the market, it functions as a new product which must compete against truly new space); 2) the ways in which demand appears to shift in response to perceptions of space offered in each period and its quality; and 3) the signals observed and acted on by suppliers of office space.

As a result, this paper explores that validity of the assumption that office rental prices adjust primarily in response to various vacancy measures, using building-specific data on asking rents for existing buildings in one metropolitan market from 1980 through 1993. The framework developed incorporates the assumption that asking rents respond to indications of market disequilibrium, as measured by observed vacancies and by the difference between observed and estimated natural vacancy rates. However, given the uncertainty of demand for office space, costly information and search for both space and tenants in the market, and the generally greater attraction of new space, suppliers set rent levels to account for these potential costs and to signal the competitiveness of their space with space in new buildings.

The results indicate that vacancy levels are not as important as is generally assumed in determining asking rents. This result holds using building-specific vacancies, average observed vacancies by market or submarket, and vacancy differentials calculated as the difference between an estimated natural vacancy rate and the observed rate.

In the case of existing buildings, asking rents are seen as functioning as signals of building quality and competitiveness, especially where market information is poor and search is costly. The ceiling for asking rents is set by the rents on new construction. Available space in existing buildings competes with available space in new buildings: each time space is offered, it competes like a new good and its price reflects its perceived substitutability with new space. The factors influencing the uncertain demand which landlords seek to capture --the amount of new space, expected absorption, and the ease of search in the current market-- largely determine the asking rents set per building for existing buildings. Submarket differences also are seen as significant, indicating that market analysis proceed at that level.