Will Office Real Estate in Texas Ever Recover?

Growing employment, tax breaks for real estate investors and abundant credit caused a flurry of investment in office development in Texas during the early 1980s. Skylines dotted with new office towers and busy construction projects symbolized a booming real estate market. Investors, encouraged by new tax laws that favored office development over housing, poured money into new buildings.

In 1986, however, the boom in building activity came to a grinding halt. Since 1986, real estate investors have endured falling rents and declining building values. Office demand, once projected to keep growing at the furious pace of the 1980s, instead has dissipated. Today, office vacancy rates in most major Texas cities exceed 20 percent, a level that is well above the national average. What happened to Texas' office real estate sector, and when, if ever, will it recover?

The Rise of the Texas Office Market

The Texas real estate boom came on the heels of the state's oil boom. The oil boom had accelerated the rate of Texas' economic growth and spurred creation of new jobs in most sectors of the Texas economy in the late 1970s and early 1980s. Despite a national downturn and a decline in oil prices in 1982, the Texas real estate sector continued to grow steadily, mainly because real estate tax incentives had increased and a vast supply of money was available for lending.[1]

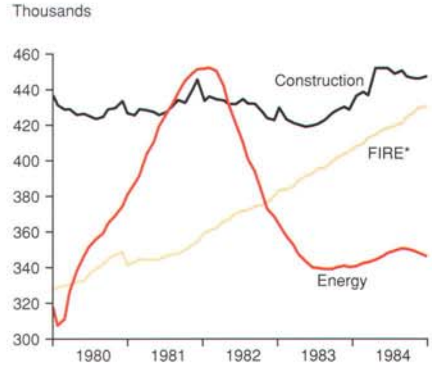
Interest in real estate development heightened after the passage of the Economic Recovery Tax Act of 1981, which gave significant tax advantages to commercial real estate investors, including investors in office space.[2] The most noteworthy element in the 1981 tax law was a major change in business depreciation allowances. The new law significantly reduced tax lifetimes of certain depreciable assets, such as industrial plant and equipment and real estate properties other than owner-occupied housing. The effects of shortening the period over which an asset can be depreciated are a reduction in the effective tax rate on the lifetime income generated by the asset and accelerated recovery of investments.[3]

The 1981 tax law was especially attractive to high-income investors, who could buy into real estate through limited partnerships and deduct depreciation costs from personal or other business income. The law resulted in a surge of investment in commercial real estate, including office buildings. At the same time, a sharp drop in interest rates motivated many investors to shift out of the bond market and into commercial real estate.

While more people were willing to put money into office real estate, financial institutions were acquiring a larger pool of available funds to lend to real estate investors. The Depository Institutions Deregulation and Monetary Control Act of 1980 accelerated the deregulation of deposit interest rates by providing an eventual phaseout of interest rate ceilings on time and savings deposits. In addition, the Garn–St Germain Depository Institution Act of 1982 created a new account, the money market deposit account, or MMDA, which was competitive with unregulated money market funds.[4] As these new accounts became available, a flood of money poured into banks and thrifts. Meanwhile, the same monetary easing that initiated a decline in interest rates in 1982 added to banks' liquidity. Together, these factors created a large source of funds from which banks and savings and loan associations could lend. Texas lending institutions, which had prospered greatly from energy loans in the late 1970s, were searching for new, profitable investments, and real estate lending was the outlet they chose.

At the same time that real estate became an attractive investment, many observers viewed Texas as having one of the strongest economies in the nation. The state gained more than half a million jobs from 1980 through 1981, and Texas was expected to be a growth leader throughout the decade. Meanwhile, the rest of the country was in the midst of an economic dowturn, which increased the large inflow of investment capital to finance

Chart 1
Texas Construction, FIRE and Energy Employment



* Finance, Insurance and Real Estate.
SOURCE: Federal Reserve Bank of Dallas.

Texas property developments. Tax breaks and an increased flow of investment funds raised the demand for high-quality existing properties. This higher demand, in turn, put upward pressure on property prices and encouraged developers to increase the supply of office buildings in Texas.

Despite an economic downturn in Texas in 1982, office building activity remained at high levels through the early 1980s. A fall in oil prices spurred a decline in energy jobs in early 1982, and total nonfarm employment in Texas began to fall. Remarkably, however, construction employment remained relatively healthy, and employment in the finance, insurance and real estate (FIRE) sector continued to rise (*Chart 1*).

Typically, after economic activity turns downward, some sustained level of construction activity continues for a while because of the substantial lag time between the start and finish of an office building. Yet in Texas, high levels of building activity continued well into the 1980s, even as vacancies skyrocketed. Because of the 1981 tax depreciation incentives, yields on office real estate were higher than the yields of alternative investments. Consequently, builders continued to build, and financial institutions continued to lend despite the faltering economy. Office building permit values remained at elevated levels, even as office vacancy rates began to increase (*Chart 2*). In Dallas, for example, office vacancy rates grew from 8 percent in 1980 to 24.3 percent in 1985.[5]

The Long, Hard Fall of the Texas Office Market

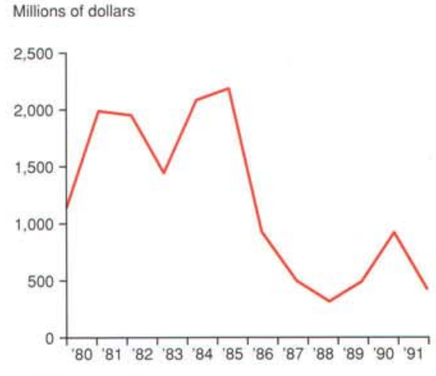
In 1986, a steep decline in oil prices and changes in tax laws initiated the Texas real estate market collapse. The 1986 Tax Reform Act removed the tax depreciation advantages given to real estate investors five years earlier. The act also disallowed income-tax deductions from active income for net losses of passive income, such as limited-partnership investment in office property. At the same time, oil prices plummeted, and the Texas economy fell into a deep recession. The rest of the nation, however, was doing reasonably well. Texas employment fell by approximately 250,000 jobs during the year, and as jobs disappeared, people began leaving the state. Together, these factors left Texas with an abundant supply of office space and little demand for it.

Given the amount of office space built during the Texas real estate boom, the 1986 bust was devastating. As office demand fell in 1986, vacancy rates continued rising, and the large supply of office space relative to demand exerted downward pressure on property values. As Table 1 shows, in 1987 vacancy rates were near 30 percent in most major Texas cities. A substantial decline in building activity since 1986 has lowered vacancy rates in Texas, but not enough to bring them below the national average.

Texas in Comparison with the Rest of the Nation

Elsewhere in the United States, office real estate did not decline as early as it did in Texas. The nation enjoyed economic growth in 1986, while Texas was mired in recession. As U.S. economic growth became sluggish in the late 1980s, however, the demand for office space diminished, and office vacancies across the nation began to rise. The recent national downturn pushed vacancy rates even higher as firms across the country tried to lower overhead costs by using space more sparingly. Vacancy rates in Boston increased from 13.7 percent in 1988 to 18.2 percent in 1991. Rates in Los Angeles increased from 15.4 percent to 19.7 percent during the same period (*Table 1*). Nationally, vacancy rates continued to rise in the first quarter of 1992. The 1990–91 recession had less of an impact on Texas office markets,

Chart 2
Texas Office Building Permit Values



SOURCE: M/PF Research, Inc.

however, and vacancy rates remained relatively stable.

Is a Recovery of the Texas Office Market in Sight?

Office markets in Texas cities have come a long way toward recovery. Low levels of office construction have helped reduce some excess space, and vacancy rates have fallen from the extreme highs of the mid-1980s. However, demand for office space has not risen enough to bring vacancy rates back down below the national level. Nevertheless, Texas possesses certain geographic and demographic characteristics that are likely to stimulate office demand. In all likelihood, the office market in Texas will recover by the end of the decade.

In Texas, a slowdown in office construction has already occurred, and the construction of office space has become more sensitive to demand. There are few, if any, speculative projects under way. Most office construction is build-to-suit. As Chart 2 shows, office construction in Texas has fallen significantly from the pre-1986 highs and remains at very low levels.

Despite restrained construction activity, the Texas economy has not improved enough to trigger a significant increase in the demand for office space, as the high vacancy rates suggest. Office demand is the primary factor influencing vacancy

Table 1
Metropolitan Area Vacancy Rates

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992*
Dallas	23.2	20.7	24.3	27.7	27.7	28.0	25.5	25.7	25.4	26.5
Houston	29.1	27.6	28.2	29.9	31.8	28.7	27.0	24.1	22.9	22.5
Austin	n/a	n/a	n/a	35.2	39.5	36.5	31.1	25.0	20.3	22.0
Fort Worth	n/a	n/a	n/a	28.5	25.7	25.8	24.6	23.0	20.7	21.2
San Antonio	n/a	22.9	24.2	29.7	29.1	28.4	30.7	28.5	n/a	n/a
Boston	7.7	13.1	14.1	13.8	14.0	13.7	15.0	18.2	18.2	17.4
Los Angeles	15.9	16.7	16.9	17.3	16.8	15.4	15.9	17.9	19.7	19.7
U.S. Average	**16.2**	**17.2**	**20.1**	**21.5**	**20.7**	**19.7**	**20.0**	**19.5**	**19.4**	**19.6**

*Through March.
n/a = not available.
SOURCE: Coldwell Banker Commercial Real Estate Group.

rates, rents, prices and an eventual need for office construction. An increase in office demand depends on population and job growth. As more goods and services are demanded by more people and businesses, more office demand is generated. Today, office prices remain well below construction costs, which suggests that demand for space in Texas still must increase significantly to spur construction activity.

The outlook for growth in office demand is positive, however. Texas' central location, mild climate and relatively low cost of living make the state attractive to businesses planning to relocate, and these unique factors are likely to contribute to higher office demand during this decade. Texas also has a relatively young labor force, which will help attract business to the state. Nationwide, as the baby boom generation ages, the supply of workers in the most productive age groups is expected to diminish. The relatively young Texas labor force, however, means that the growth rate of the most productive age groups are expected to exceed the national average.[6] As businesses move to the state to take advantage of the young labor force, the demand for office space is likely to rise.

Although Texas office markets eventually will recover, the turnaround may not come for several years. Because of the large amount of space built during the boom years of the early 1980s, office markets have fallen harder in Texas than in many other areas of the country. Office construction has diminished, but office demand has not risen enough to absorb the vacant space. A recent survey[7] of real estate appraisers forecasts some Texas office markets, like Dallas, to rebound in about six years, while office markets in other cities, like San Antonio, may take longer to recover.[8] While this forecast may not bode well for the short run, the long-term outlook appears more positive. Construction activity in 1992 is in line with demand, and future office demand will be driven by the fundamental strengths of Texas and its economy.

—D'Ann M. Petersen

[1] For an interesting and amusing look at what happened to the Texas economy during the 1970s and 1980s, see Perryman, Ray M. (1990), *Survive and Conquer* (Dallas: Taylor Publishing Company).

[2] Downs, Anthony (1985), *The Revolution in Real Estate Finance* (Washington D.C.: The Brookings Institution), 93.

[3] For an explanation of how accelerated depreciation reduces the effective tax rate, see Musgrave, Richard A., and Peggy B. Musgrave (1989), *Public Finance in Theory and Practice*, 5th ed. (McGraw-Hill Book Company), 380–84.

[4] Spong, Kenneth (1990), *Banking Regulation: Its Purposes, Implementation, and Effects* (Kansas City, Mo.: Federal Reserve Bank of Kansas City), 140.

[5] Data provided by CB Commercial/Torto Wheaton Research.

[6] For a more detailed discussion of what makes a state attractive to business, see Brown, Stephen P.A., and Lea Anderson (1988), "The Future of the Southwest Economy," Federal Reserve Bank of Dallas, *Southwest Economy*, November.

[7] *Viewpoint 1992: Real Estate Value Trends*, (Minneapolis, Minn.: Valuation Network, Inc., Real Estate Appraisers and Counselors), 11.

[8] The same survey predicted that the recovery of the U.S. office market would take another 5.5 years, and even longer in some cities. Boston and New York, for example, experienced a contraction in office real estate later than most Texas cities and are not expected to recover for eight and 10 years, respectively.

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