

U.S. Office Insight Q1 2009

Period of indecision weighing on leasing activity and rents

Massive job losses covering all industries and geographies are clearly impacting the demand for office space around the United States. Delayed decision-making by tenants and lack of new activity have depressed leasing volumes to new lows at the end of the first quarter. Meanwhile, increased sublease space continued to expand options for tenants. The resulting imbalance between supply and demand has driven effective rents down more than 10.0 percent over the past three months with further declines expected in the quarters ahead. Over the last six months, the capital markets and credit crunch impact on transactions and values have been the focus of real estate participants. However, we expect the shift in fundamentals to steal more of the headlines in the remainder of 2009. This transition will become an increasingly important factor in leasing dynamics and property values and will ultimately shape opportunities and challenges for occupiers and investors.

Office job losses spreading across all industries

The country has shed 5.1 million jobs since the beginning of 2008, including 3.3 million jobs since November alone. Losses, which at the start of the recession were focused in sectors at the root cause of the downturn including financial, manufacturing and housing-related industries, are now widespread affecting virtually all industries. While the pace may be peaking, job losses are expected to continue through the rest of 2009, and the cumulative loss projections are approaching 8.0 million jobs (3.7 percent of the peak employment base). Job losses in the office sector did not start to mount until October of 2008, and since then over 1.1 million jobs have been lost throughout the industries that largely occupy the office market. Markets with the most substantial losses to date included Los Angeles, New York, Chicago, Detroit, Phoenix and Atlanta.

March's unemployment rate of 8.5 percent skyrocketed up 3.4 percentage points from last March, representing a twenty five-year high.

In addition, one in six Americans were unemployed or underemployed at the end of March, up from one in every 11 Americans a year ago. Job losses will continue throughout 2009 with the hope that the rate of loss will subside in the second half of the year before employment levels bottom out in early- to mid-2010. Unemployment will approach if not surpass 10.0 percent in the first half of 2010.

Period of indecision weighing down leasing activity

Tenants' inability to project future business prospects has delayed real estate leasing decisions across the United States over the past two quarters. The indecision in the first quarter of 2009 led to one of the slowest quarterly leasing activity volumes in nearly a decade. In the first three months of 2009, leasing activity decreased 31.5 percent across the country relative to the fourth quarter of 2008 and remained more than 48.0 percent lower than levels achieved in the first quarter of 2008. Markets that exhibited the largest quarterly drop in leasing activity included St. Louis (84.0 percent decline), Fort Lauderdale (83.0 percent decline), Philadelphia (60.0 percent decline), Manhattan (42.0 percent decline), Boston (41.0 percent decline) and DC (41.0 percent decline). Markets that did see an uptick in activity, including Denver, Houston, Chicago and Silicon Valley, reported the vast majority of deals signed involved extensions and / or renewals. Tenants' unwillingness to make long-term capital decisions and landlords' desire to potentially re-negotiate at higher rental rates, 24 to 36 months down the road, has substantially increased the incidence of short-term extensions.

Space options for tenants expand through sublease and new developments

As companies continued to downsize their workforces, sublease space has grown dramatically. After remaining in check through September of 2008, sublease space has jumped more than 33.0 percent over the past six months. In the first quarter of 2009 alone, sublease space increased more than 11 million square feet. Twenty-two options of sublease space greater than 100,000 square feet were added to the market in the first quarter, while an additional 26 options between 50,000 square feet and 100,000 square feet also surfaced. Companies spanning all industries contributed to the overall gains, but those in the finance, technology, media, biotech, residential real

estate and retail industries accounted for the overwhelming majority of large blocks added during the quarter.

New office developments that were completed in the first quarter barely outpaced the level of new options coming to the market through the sublease space. In total, more than 15.2 million square feet of new office product was delivered to the market with preleasing levels below historical averages. Markets that accounted for the highest amount of new deliveries included the Chicago CBD, Midtown and Downtown Manhattan, the Houston suburbs, the Philadelphia suburbs, the San Diego suburbs and Seattle Eastside.

Dwindling demand, increasing sublease space leading to record occupancy declines

The lack of new leasing activity, coupled with the significant increase in sublease space, produced severe occupancy decreases in the first quarter across the country. Ninety-three percent of all markets tracked by Jones Lang LaSalle experienced occupancy losses. In total, nearly 1.0 percent of the total occupied office stock was shed during the first quarter. The significant rate of decline equates to nearly double the level posted in the fourth quarter of 2008 and the same annual level established in 2002. Losses were distributed equally across the CBD and Suburbs, but markets that experienced the largest percentage declines with respect to their current stock included Philadelphia, West Palm Beach, Jacksonville, San Diego, and Los Angeles. Dallas and Atlanta, two of the most diversified markets with respect to the office tenant base, were the only two markets to report an occupancy increase in the first quarter of 2009.

The steep drop in occupancy, combined with newly delivered vacant product, contributed to one of the largest jumps in quarterly vacancy in recent history. National vacancy levels closed the first quarter at 16.5 percent, up 110 basis points from the end of 2008. Vacancy was nearly 500 basis points above the first quarter 2008 level of 12.8 percent at the end of the first quarter. CBD markets displayed tighter vacancy levels than the suburbs at 13.4 percent and 18.7 percent, respectively, however both categories experienced significant quarterly increases.

Markets that closed the quarter with vacancy levels higher than the national rate included West Palm Beach, Dallas, Detroit, Jacksonville, New Jersey, Cleveland and Atlanta, among several other markets. Despite increased exposure to the financial industry, the tightest vacancy levels at quarter-end were achieved by Manhattan, Charlotte

and San Francisco. Other markets that remained tight included Washington, DC, Seattle, Baltimore and Miami.

Rents post most significant decline in several years

Overall, asking rents decreased 4.6 percent during the first quarter of 2009. The Class A segment of the market posted declines at 2.7 percent for the quarter. Both represent significant accelerations of the pace of decline. Asking rents over the past 12 months were down 4.1 percent overall and 3.4 percent in the Class A segment of the market due to gains in select markets in the first half of last year and slow translation of market pressures and effective rents into the statistical average face rates at the end of last year. While asking rents were cut nearly 5.0 percent during the first quarter, effective rents have been slashed anywhere between 10.0 percent and 30.0 percent across the vast majority of markets nationally. Major CBD's such as Manhattan, Boston, San Francisco, Los Angeles and Washington, DC have all posted effective rents declines in excess of 15.0 percent over the past 12 months. Increased tenant improvement allowances, coupled with increased rent abatement and lower taking rents, have left tenants with significant cost discounts from 12 months ago.

Over the past three months, we have seen evidence of another increasing trend. While tenant improvement allowances have escalated nearly 20.0 percent nationally over the past 24 months, we have seen anecdotal evidence that allowances have started to level off. One contributing factor is the inability by several distressed landlords to fund tenant improvement allowances and commissions. Another contributing factor is the fact that landlords are not willing to place substantial upfront capital to tenants they are not certain will exist in 12 to 36 months. While this is a trend we will continue to closely monitor, it's worth noting that rent abatement, which requires no level of financing, has continued to escalate across markets nationally. Since the middle of 2007, rent abatement has escalated more than 60.0 percent and we expect this trend to increase further as market conditions continue to soften.

Pockets of demand arise, but market will continue to waver through 2010

Job losses will continue to pile on throughout the better part of 2009 and likely into the first part of 2010. With the commercial real estate market a lagging indicator of employment markets, we can expect available space options to continue to mount well into 2010. Occupancy declines experienced in the first quarter will likely be a fraction of the declines we expect to see over the next 12 months. As options increase,

vacancy levels will exceed peaks established during the last downturn, possibly settling near 20.0 percent. Markets that will likely see vacancy rise quickly over the coming quarters include the CBD's of Charlotte, Miami, Seattle, Washington, DC and Atlanta, where construction activity represents more than 7.0 percent of the current stock in those markets.

The big question is how soon normalized demand will return to most markets. Congress passed the \$787 billion Economic Recovery and Reinvestment Act of 2009 that earmarked roughly two-thirds of the bill toward government spending and one-third toward tax cuts. In addition, the Treasury Department announced plans for the distribution of the second round of funds from the TARP legislation passed last October in the hopes of stemming fears in the banking sector.

Pockets of growth have surfaced over the past three months related to both of these government measures. Specifically, the federal government in Washington, DC (the Department of Treasury and the Federal Reserve) has expanded, as well as some other agencies related to homeland security and immigration around the country. Additionally, private sector demand related to clean technology, specifically solar power, has increased over the past several months in Silicon Valley and the East Bay markets. While we expect further demand to materialize related to infrastructure projects, healthcare and education, no significant demand had emerged through the first quarter that was noteworthy.

While these pockets of demand will create some activity, the vast majority of the office market nationally continues to be demand-constrained. The results of policies already enacted are still unclear, and further stimuli and aggressive policy moves are likely as the federal government and central bank continue to attack the underlying financial system issues and kick start real economic growth. As stated earlier, we believe that office market fundamentals have a long way to shift to adjust to economic damage already done. When could solid demand return? If the past recession was any indicator, a jobless recovery could be in the cards for this current downturn. The jobless recovery from the past recession lasted nearly three years. If the same situation unfolds during this eventual recovery, we could see slow growth across most segments of the market that extend beyond 2010. Conditions between now and then will present unprecedented leasing and buying opportunities.

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