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## **Office Sublease Levels Peak, while Rents in Key Markets Approach Bottom According to Jones Lang LaSalle's First Quarter North America Office Outlook**

*Shadow space to limit occupancy growth across U.S. markets through mid 2011*

**CHICAGO, April 14 , 2010**— While U.S. office market fundamentals still have a long way to course correct from the massive job loss effects on the economy, in the first quarter of 2010 more recovery signs emerged as the primary U.S. commercial office property markets bottomed and the level of rental decrease slowed. The office market is moving toward stabilization in the second-half of 2010, according to Jones Lang LaSalle's First Quarter 2010 North America Office Outlook. Jones Lang LaSalle's quarter report provides an overview of supply and demand conditions and statistical analyses of the major markets in U.S. and Canada.

### **Office Outlook highlights**

- Rise in national office vacancy rates slow, but continue to rise as corporations will right size space through 2010 with the flight to efficiency
- Sublease space has peaked and will continue to decline in the coming quarters
- Rent and occupancy growth through the beginning of 2011 will be limited due to shadow space
- Rental rates stabilize in primary markets; declines will continue in secondary and tertiary markets through beginning of 2011
- Tenant improvement allowances pull back as lenders favor free rent

The economic recovery shifted into a new gear during the first few months of 2010 as the expansion broadened from the manufacturing sector to include a wider segment of service industries. However, the fledging recovery in the services sector is dependent on positive leading indicators in the labor market translating into real job growth during the second quarter. For two consecutive quarters economic output was fueled by unsustainable sources related to the massive stimulus package. Economic growth will continue to remain below trend-like growth in 2010, but will remain positive before a more vigorous recovery takes hold in 2011.

"Consumers continue to remain hesitant to fully embrace the recovery underway and for good reason. Job growth, continued improvements in equity and housing markets, and an increased flow of credit are all imperative to prevent consumers from derailing the recovery," said Ben Breslau, Jones Lang LaSalle Americas Research Director.

***Stabilization: Second half 2010***

“Since the end of 2009 signs have continued to emerge, indicating that the office sector has reached an inflection point and begun to stabilize across numerous segments of the market,” said John Sikaitis, Director of Americas Office Research, Jones Lang LaSalle.

Two signs of stabilization that continued to surface in the beginning of the year included sublease levels decreasing for the second consecutive quarter and asking rents settling near bottom in the primary gateway office markets.

***Vacancy up, sublease down, shadow lingering***

While the national office vacancy rate rose in first quarter 2010 by 20 basis points to 18.3 percent, the rate of increase was substantially below increases experienced in 2009. The national vacancy rate, which surpassed a record high in the fourth quarter of 2009, will likely approach the 19.0 percent market in late 2010 and top out near 19.3 percent in 2011.

The stabilization of the national vacancy rate is a sign that tenants have become much more comfortable making leasing decisions. It is also a sign that the addition of new sublease space has slowed and new deliveries through the construction pipeline have virtually dried up withstanding a few markets. The sublease space market deduced by 8.5 percent in the first quarter 2010, marking the second consecutive quarter sublease space has declined.

“At this point last year, there were 25 large blocks of sublease space in excess of 100,000 square feet added to the leasing market nationwide, compared with just 6 large blocks in the first quarter of this year,” said Sikaitis. “That’s an encouraging decline as a number of tenants who previously put sublease space on the market have now pulled it off with the anticipation of using it. We’re not seeing organic growth yet from tenants, but the reclamation of sublease space is another sign corporations are becoming more confident in the health of their businesses.”

Despite projected employment gains though through the remainder of 2010 and into 2011, Jones Lang LaSalle's Outlook cautions on occupancy and rent growth in 2010 and even into the beginning of 2011. Many corporates are warehousing space that they are not currently occupying, nor marketing for lease. This phenomenon of shadow space signifies that corporates know they will need space in the near term to grow into for new hires and the first tranche of hires in many given companies will likely not lead to additional office occupancy gains and thus inhibit growth in the office sector in the near term.

“Most firms have roughly an extra 9.0 percent of office space they can grow into, so tenants who are adding new employees over the short-term will backfill what they’re currently occupying before growing. We’re still 10 to 15 months from a continued stabilization in vacancy and steady increase in occupancy gains,” added Sikaitis.

***Rental rates decline at slower rates, while concessions hold steady***

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Landlords in the first quarter adjusted asking rental rates downward, but at a slower pace than 2009 reductions. Asking rent declined 1.4 percent, compared with a reduction by 10.0 percent in 2009. Rental rates in primary U.S. markets like New York, Washington, DC and San Francisco displayed minor rent adjustments, compared with drops between 10.0 and 20.0 percent last year depending on the market. Rents will continue to stabilize and could possibly grow in certain market segments in gateway cities like Boston, NYC, San Francisco, Washington DC, among others. Rental declines are expected to continue, however, in secondary and tertiary markets in 2010, as those markets did not experience a similar rental rate super-drop like the primary markets in 2009.

Concessions also stabilized in the first quarter. Tenant improvement (TI) packages have topped out as lenders today are far less willing to approve borrowers or issue cash-in-hand to secure a new tenant. TI allowances grew by 40.0 percent from the middle of 2007 to the middle of 2009; however, levels have fallen over the past two quarters and registered a 3.3 percent decline in the first quarter 2010. Lenders in today's market are more willing to give up free rent than part with upfront capital in egregious TI allowances. In the past three years, free rent has more than doubled from a 2.3 month average abatement in 2007 to a 5.2 month average abatement in the first quarter of 2010, the same level as the end of 2009. Free rent levels will continue to increase through 2010, but at a slower pace of growth before topping out in the first half of 2011.

### ***Corporations right-size***

After increasing in the second half of 2009 from recent historical lows, leasing activity levels registered a sharp decline in the first quarter, due in part to significant winter storms that battered the East coast, the cyclicity of market and the reality that fourth quarter levels in any given year are usually the highest and tenants' continued hesitancy to commit to long-term decisions.

In an increasing number of instances around the country, companies with leases expiring leases are choosing to right-size their space needs and continue to rescind through 2010. What used to be the termed the flight to quality is now the flight to efficiency.

"We're seeing an increasing number of examples of tenants looking of reduce occupancy from current leases of 100,000 square feet to 85,000 square feet. Corporations are choosing more efficient layouts and eliminating any unnecessary occupancy costs," said Sikaitis.

### ***Industry demand drivers***

As the economy begins to stabilize, there are isolated pockets of strong industry sector growth. In Denver, the natural gas industry is driving expansion and this will continue throughout the remainder of 2010. The green technology market is supporting growth in San Francisco's Peninsula and Silicon Valley. Small-cap technology companies, which have been the recipients of new venture capital spending, are also fueling leasing growth in the market and are expected to fuel demand over the next six months in Austin, Boston, Denver and Silicon Valley, among others. And finally, the federal government will continue to generate substantial new demand in Washington, DC and other high-concentration federal government markets like Baltimore and Denver.

***Regional outlook***

While stabilization levels around the country are one to two quarters away, several key gateway markets have shown signs of tightening and stabilization over the past several months. Markets such as New York, San Francisco, and Washington, DC typically act as bellwether markets for national U.S. office market trends.

- San Francisco: Increased tenant activity is driving optimism notably higher, resulting in asking rents creeping up in certain space categories. Although market-wide demand remains negative as vacancies grew during the quarter, prime Class A space is becoming scarce enough to compel landlords to test the market with higher rents. This same trend is pushing values higher in the capital markets as pricing premiums emerge for sparsely available listed property. "Optimism may be ahead of fundamentals, but better alignment should be established by year-end," added Colin Yasukochi, Research Director for the Northwest U.S.
- New York: The first quarter of 2010 was considerably different from the same period one year ago. In contrast with the first three months of 2009, when vacancy levels increased dramatically and average asking rents dropped sharply amid weak leasing activity. Positive absorption levels in 2010 indicate that activity has finally outpaced new supply coming to the market. As a result, overall vacancy levels improved slightly in Manhattan for the first time in several quarters and average asking rents showed signs of flattening. Jim Delmonte, Research Director for the Tri-State region said, "While overall indications point toward slow improvement, there are a few factors that warrant caution: the labor markets remain weak and there are significant impending space dispositions in lower Manhattan."
- Washington, DC: The national capital region will outpace and outperform the nation as a whole in 2010, as large-scale government initiatives become implemented and the federal government continues its massive expansion. "More than 5.0 million square feet of federal demand is queued in the local pipeline, which may exceed the growth of all other markets across the country combined in 2010," said Scott Homa, Research Manager for the Mid-Atlantic. "This demand driver will continue to propel the DC region and restore a sense of balance in the market."

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