

Office Market Trends North America

Grubb & Ellis Research

Third Quarter 2008



Market Weakens...

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North America Office Market Trends

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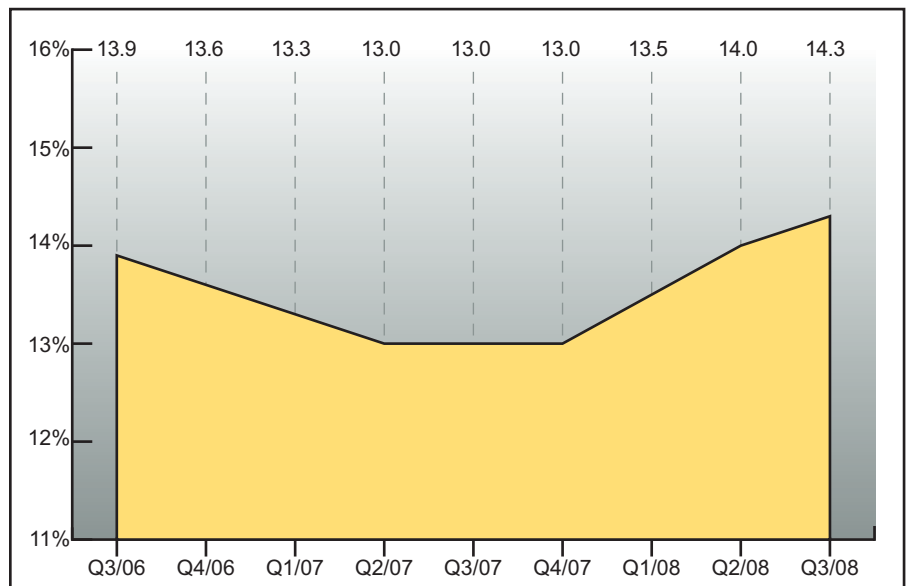
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U.S. Office Vacancy Rate*

* All classes of space

The Bottom Line

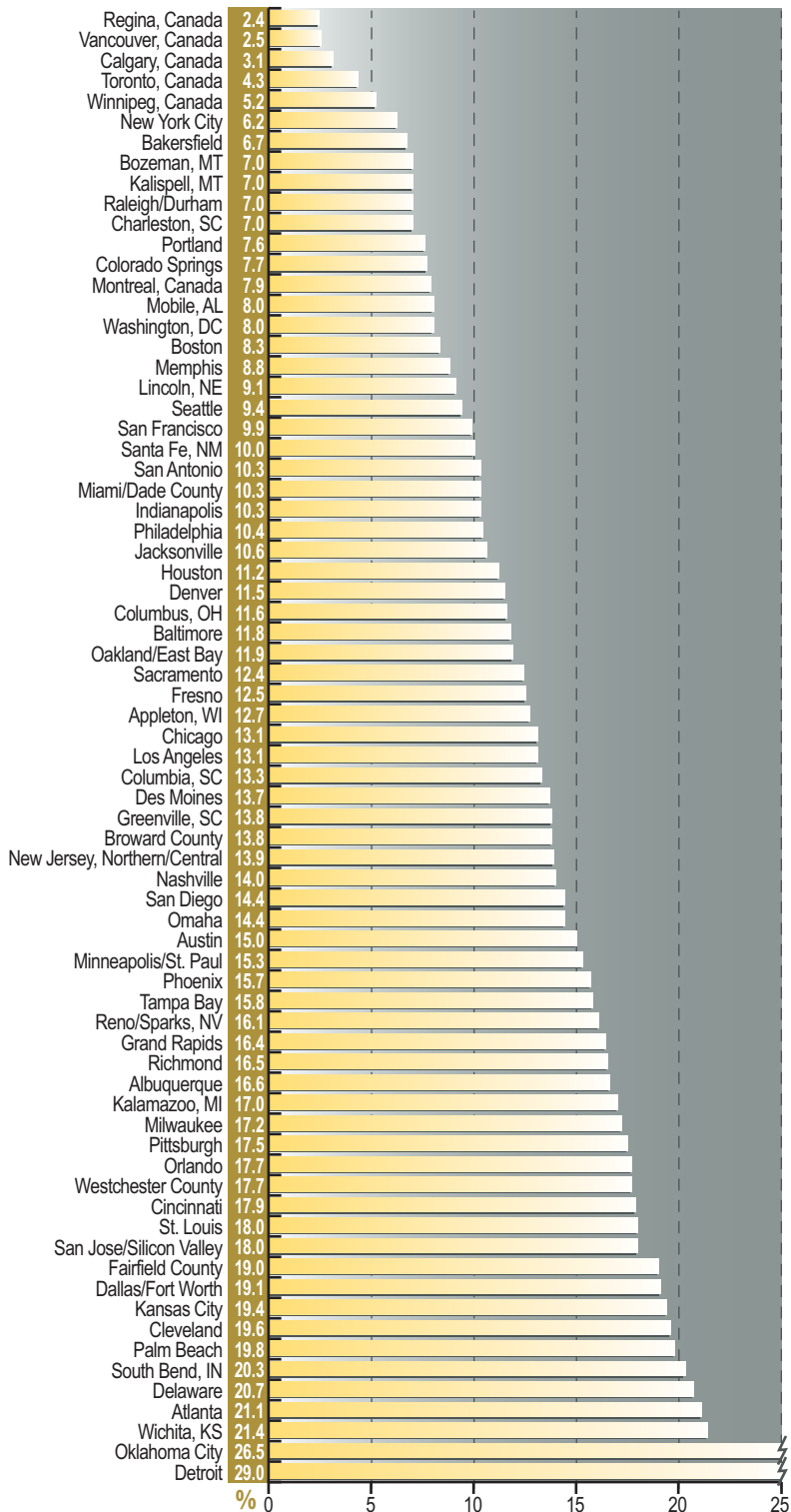
The U.S. office market softened for a third consecutive quarter with vacancy now 130 basis points above the cyclical low point at the end of last year. This is a small increase compared with the 300 basis-point increase in the opening three quarters of the prior softening cycle early in this decade. But the economy took a turn for the worse in September and early October, portending steeper job losses, rising sublease inventories and negative absorption even as the construction pipeline continues to deliver the 94 million square feet still under way. Expect the vacancy rate to peak around 17 percent by year-end 2009, not far below the peaks of the prior two cycles in 2004-Q1 and 1991-Q3.

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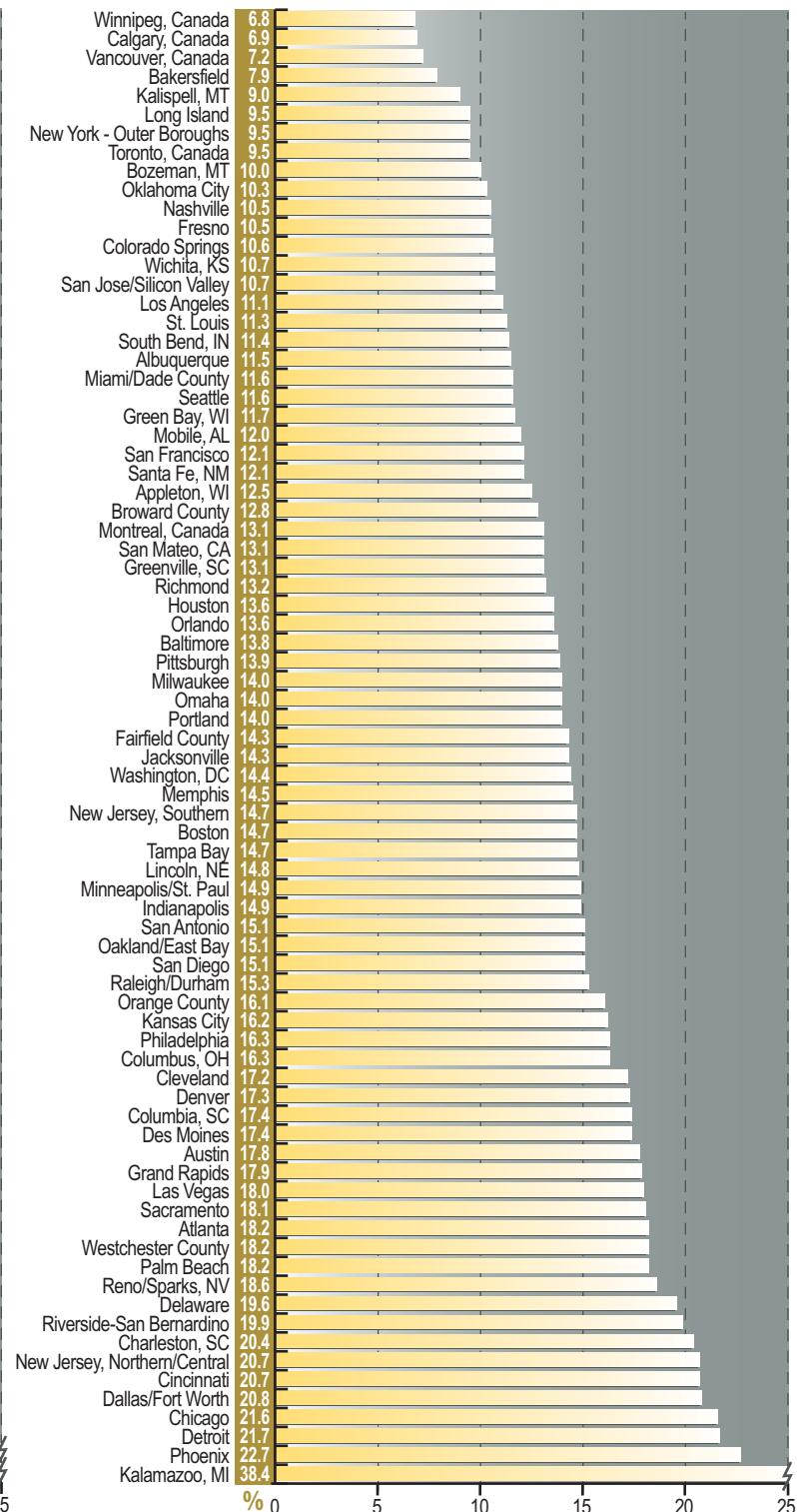
Metro Vacancy Rates

Note: Vacancy data refer to all classes of buildings with a minimum size threshold ranging from 5,000 to 30,000 square feet depending on local market conditions. The inventory includes single and multi-tenant properties and excludes owner-occupied properties and specialized properties such as medical office buildings. The data refer to direct and sublease space that is physically vacant at the end of the quarter. Canadian data are courtesy of Avison Young.

MARKET: CBD



MARKET: SUBURBAN



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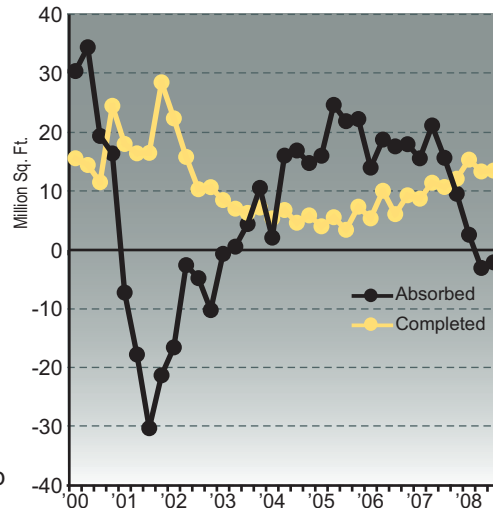
State of the Market

With a full-blown panic gripping global debt and equity markets, one might expect a dramatic softening in office leasing market fundamentals with sharply higher vacancy rates and plunging rents. One would be wrong. Leasing market fundamentals softened for a third consecutive quarter, but the pace of softening remained moderate. This may not last, unfortunately.

The U.S. office vacancy rate added 30 basis points to end the third quarter at 14.3 percent. This is less than the 50-bp increases registered in the first and second quarters. Since bottoming at 13.0 percent in the fourth quarter of 2007, vacancy has increased 130 bps. By comparison, vacancy rose by 300 bps in the opening three quarters of the prior softening cycle in 2001 and 2002. Of the 63 markets tracked in detail by Grubb & Ellis, third quarter vacancy increased in 44 markets and fell in 19.

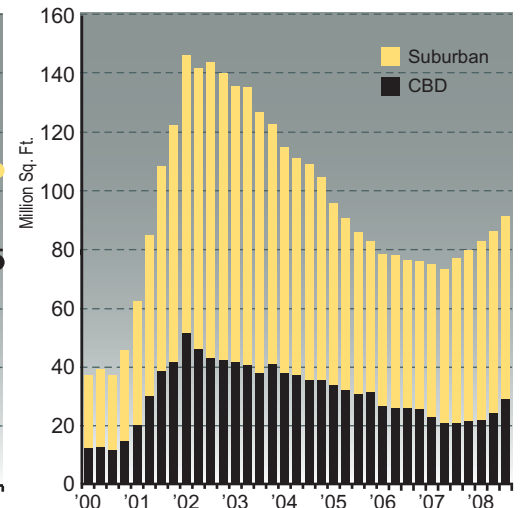
Despite the conflagration on Wall Street, New York retains the lowest vacancy rate among major U.S. markets at 6.2 percent, up from a cyclical low of 4.5 percent in the fourth quarter of 2007. Vacancy is highest in Detroit at 23.0 percent, though Phoenix, with nearly 4 million square feet in the construction pipeline and absorption in the red, may

Absorption and Completions



soon overtake Detroit. Over the past four quarters, vacancy nearly doubled in Southern California's Inland Empire (the Riverside-San Bernardino-Ontario metropolitan area), from 10.7 percent to 19.9 percent. Other markets with dramatic year-over-year vacancy increases included Phoenix, Austin, Las Vegas, Palm Beach County, Orange County, San Diego, Tampa and Orlando. With the exception of Austin, all of these markets, not coincidentally, have been hit particularly hard with falling home prices and weak demand. An unusual mix of markets recorded lower vacancy rates compared with a year ago, including Greenville, S.C.; Wichita, Kan.; Pittsburgh and San Francisco.

Available Sublease Space



Net absorption fell into the red for a second consecutive quarter, but just barely at -2.1 million square feet. Absorption year-to-date totals -1.9 million square feet, which is minimal compared with the prior softening cycle in 2001 and 2002 when the decline in occupied space (i.e. negative net absorption) totaled -111 million square feet. Year to date positive net absorption exceeded 2 million square feet in both Washington, D.C. and Boston. On the downside, New York led all markets with negative absorption of -5.3 million square feet. Southern California dominated the second through fourth slots, with Los Angeles, Orange County and San Diego collectively shedding 5.1 million square feet of occupied office space.

Office Market Terms and Definitions

Inventory: Office inventory includes all multi-tenant and single tenant buildings with a minimum size threshold ranging from 5,000 to 30,000 square feet. Owner-occupied, government and medical buildings are not included.

Construction Type: Speculative ("spec") construction is designed to attract tenants likely to be in the market when the project is leasing. Build-to-suit construction is designed for a specific tenant.

Office Building Classifications: Grubb & Ellis adheres to the BOMA guidelines. Class A properties are the most prestigious buildings competing for premier office users with rents above average for the area... Class B properties compete for a wide range of users with rents in the average range for the area... Class C buildings compete for tenants requiring functional space at rents below the area average.

Vacancy and Availability: The vacancy rate is the amount of physically vacant space divided by the inventory. The availability rate is the amount of space available for lease divided by the inventory.

Net Absorption: The net change in physically occupied space over a period of time.

Asking Rent: The dollar amount asked by landlords for available space expressed in dollars per square foot per year in most parts of the country and dollars per square foot per month in areas of California and selected other markets. Office rents are reported as full service where all costs of operation are paid by the landlord up to a base year or expense stop.

Average Weighted Asking Rent: An average market rent where the asking rent for each building in the market is weighted by the building size.

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State of the Market (continued)

Space under construction finally moved lower by 6 million square feet, ending the third quarter at 94 million square feet. This followed several quarters when the pipeline remained stubbornly high even as demand was slowing. With absorption falling into the red, new space completions will push vacancy higher over the next few quarters. Metropolitan Washington, D.C. led all other markets with just under 10 million square feet under way, some of which no doubt will be used for expansion of the nation's financial regulatory agencies. Houston developers, now with 8.7 million square feet in the pipeline, are doing their best to catch up.

Space offered for sublease increased for a fifth consecutive quarter to 91.5 million square feet, the highest level since the first quarter of 2005. Not surprisingly, New York led all markets with 8.9 million square feet offered for sublease, while three other markets have between 6 and 7 million square feet: Washington, D.C.; Northern and Central New Jersey; and Chicago. As a share of total inventory, Northern and Central New Jersey and San Mateo (the San Francisco Peninsula) have sublease availability rates of 4.4 percent, the highest in the U.S., compared with the national average of 2.3 percent.

The weighted average asking rental rate for Class A and B space ended the third quarter, respectively, at \$36.30 and \$26.96 per square foot per year gross. Asking rates dropped from the second quarter by 12 cents for Class A space and 20 cents for Class B space.

Compared with a year ago, rates remain higher by 2.3 percent and 2.0 percent for Class A and B space, respectively, though the rate of increase has been decelerating for several quarters. Asking rates typically are the last indicator to reflect a change in the cycle because landlords will adjust their concessions packages, reflected in effective rates, before they adjust asking rates.

The Outlook

With the carnage in the global debt and equity markets for a backdrop, the performance of the office market in the third quarter was blessedly dull in comparison. This does not mean that the office market will get by unscathed. Market fundamentals trail changes in employment, which itself is one of the last economic indicators to respond to a shifting cycle. And that is what we have now as economists busily mark down their forecasts. Most likely the U.S. has been in a shallow recession since the first of the year. The lack of credit, spending cutbacks by businesses and households, and the vaporizing of trillions of dollars in stock wealth and home equity are conspiring to drive the economy into a deeper recession. Gross domestic product, the broadest measure of U.S. economic output, is expected to fall in the first half of 2009 before embarking on a sluggish recovery in the second half of next year. Payroll job losses, 760,000 year-to-date through September, are likely to extend well into next year, with the final tally in the range of 1.5 to 2 million jobs eliminated. The office-using sectors of infor-

mation, finance, and professional and business will account for about one-fourth to one-third of those losses.

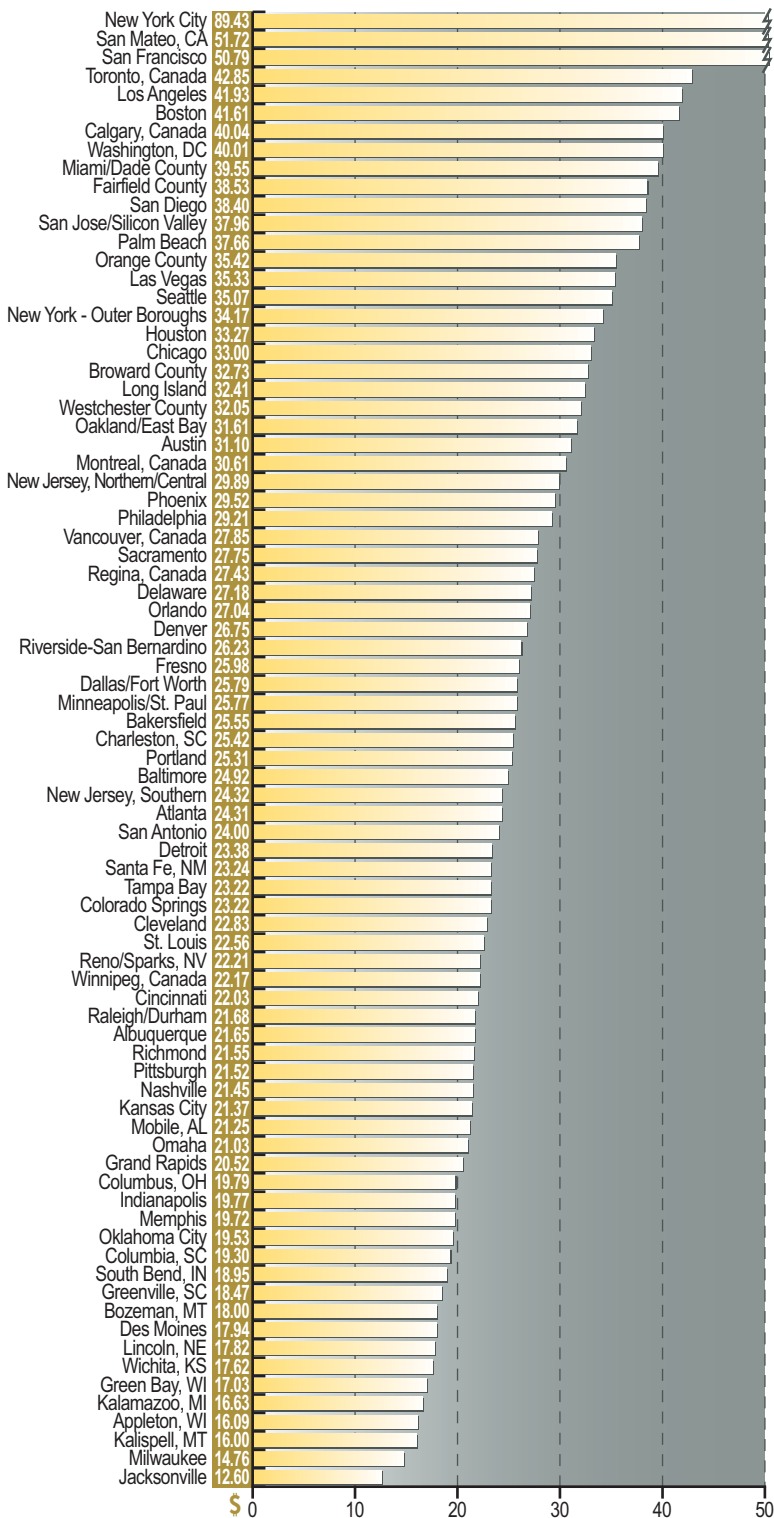
The construction pipeline has 94 million square feet under way, which will add about 200 basis points to the vacancy rate as the space is delivered. Accounting for about 50 million square feet of negative net absorption, the year-end 2009 vacancy rate is expected to peak in the vicinity of 17.0 percent, not far off the prior cyclical peaks of 17.9 percent in 2004-Q1 and 18.0 percent in 1991-Q3. Because commercial real estate is a lagging indicator, leasing market conditions may not begin to recover until the first half of 2010 even if the economy begins to grow again in the second half of 2009. Negotiating leverage will shift in favor of tenants as 2009 progresses, with concessions packages looking more generous by year-end. As the banking system consolidates, there could be nasty surprises for office landlords both large and small such as the hits that downtown Charlotte (Wachovia) and downtown Seattle (WaMu) are going to take, not to mention the elimination of overlapping bank branches. Tenants will be able to drive a hard bargain if they are confident enough in their own profit outlook to take advantage of their expanded negotiating leverage.

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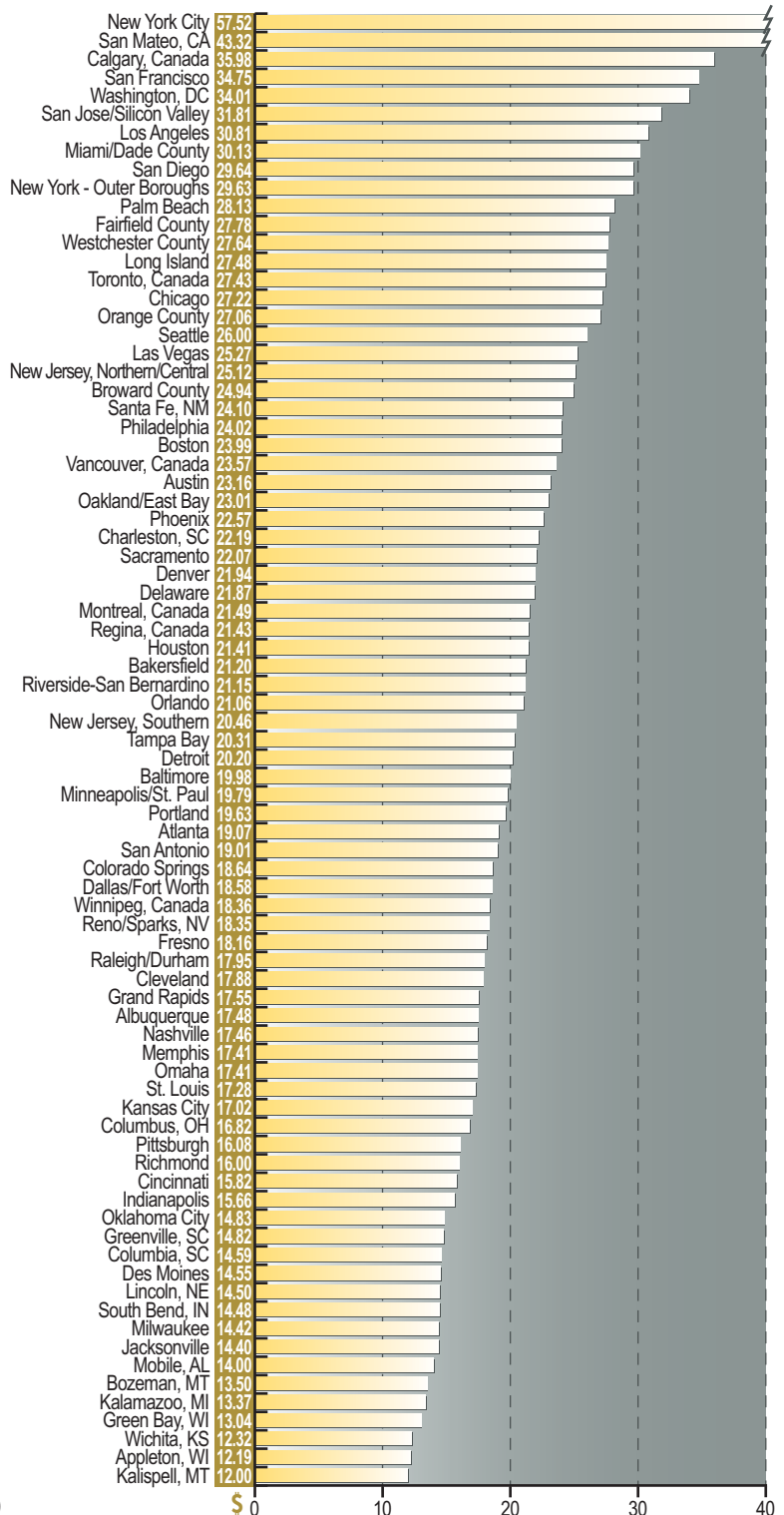
Asking Rental Rates

Note: Rental rate data refer to asking rents for space that is available on the market at the end of the quarter. Rates are per square foot, quoted on an annual, full service gross basis. Rates for each available suite are weighted by the size of the building in which the suite is located. Canadian data are courtesy of *Avison Young*. Canadian rental rates are in US dollars using the exchange rate of \$1 Canadian = \$0.8571 US.

CLASS A



CLASS B



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Metro Spotlight



NORTHERN CALIFORNIA/ PACIFIC NORTHWEST

Fresno: Few tenants are lined up for the nearly 500,000 square feet of new space nearing completion... **Oakland-East Bay:** The housing slump and credit crisis pushed absorption well into the red this quarter at 462,000 square feet... **Portland:** The construction pipeline will add to supply just as demand is slowing.

Portland's concentration of intellectual capital and innovative, sustainable businesses will boost growth in the long term...

Sacramento: The State of California has posted over 1 million square feet of new space requirements this year despite a \$15 billion budget deficit, keeping local absorption in the black... **San**

Francisco: Sublease space has increased significantly but nothing like the dot-com collapse. Sublease availabilities present tenants with opportunities that have not existed in several years... **San**

Jose-Silicon Valley: Developers will be challenged to lease up the 2.4 million square feet under construction... **San Mateo:**

Advantageous lease terms stirred up enough activity to cause a slight reduction in available sublease space... **Seattle:** The Boeing strike, the Washington Mutual collapse, and layoffs at other blue-chip locals like Alaska Air have cast a pall over the region.



SOUTHERN CALIFORNIA

Bakersfield: Further downsizing in the residential real estate sector pushed up office vacancy a bit... **Los Angeles:** The market is taking a hit with year-to-date negative absorption approaching 2.3 million square feet. Sublease space is pouring

into the market... **Orange County:** Exposure to the financial services and homebuilding sectors continues to plague the market, but steady leasing by law, technology, gaming software and healthcare firms has cushioned the blow... **Riverside-San Bernardino:** Class A asking rents have not experienced a noticeable decline—a function of new construction—although effective rents have... **San Diego:** Absorption was negative for a fourth consecutive quarter.



MOUNTAIN/SOUTHWEST

Albuquerque: Vacancy tightened thanks to strong leasing activity by insurance, medical and legal tenants... **Bozeman:** Demand for Class A product remains strong... **Colorado Springs:**

Financing difficulties are slowing small business expansion and property sales... **Denver:** Landlords are moving to button down portfolios via renewals and deal volume, while tenants are opting to renew or sign short-term lease extensions rather than commit to new space... **Kalispell:** Demand for Class A and B space remains strong with little new product being built... **Las Vegas:** Asking prices for shell office buildings in desirable submar-

kets have decreased to levels not seen in two or three years...

Phoenix: Developers in the emerging submarkets along Loops 101 and 202 are being hit hard with vacancy rates from 30 to 50 percent. Phoenix has a history of rebounding rapidly from economic slowdowns, but the risk in the national economy and financial markets may delay the next upturn... **Reno:** The cost to build out shell space makes new projects unable to compete with second generation space.



TEXAS/GREAT PLAINS

Austin: Vacancy leaped above 17 percent due to new space deliveries totaling nearly 900,000 square feet in the Northwest and Round Rock submarkets... **Dallas-Fort Worth:** Leasing velocity has slowed, but the market still managed to absorb more than 400,000 square feet this quarter mostly in Class A product... **Des Moines:** Vacancy rose slightly this quarter, but the bigger concern is the newly listed available space that will become vacant by February 2009... **Houston:** Vacancy is expected to rise into 2009 due to the 8.4 million square feet of spec space under construction coupled with slower leasing demand... **Kansas City:** Tenants are choosing short-term lease extensions versus expanding into new space... **Lincoln:** Developers are cautiously moving forward with new projects... **Oklahoma City:** The Devon Energy and the Oklahoma City Thunder took large blocks of space downtown... **Omaha:** The suburbs have absorbed over 312,000 square feet year to date, an impressive performance... **San Antonio:** AT&T's headquarters relocation to Dallas and the downsizing of banking and mortgage companies has chilled the market. The third quarter brought forth a stream of lease renewals on three year terms instead of the more common five years... **St. Louis:** The Clayton and Chesterfield submarkets remain strong with few large blocks of contiguous space available... **Wichita:** Market fundamentals remain strong with year-to-date absorption of 340,000 square feet, an up-tick in rental rates and a nominal amount of available sublease space.

GREAT LAKES/OHIO VALLEY



Appleton: Smaller deal sizes are the norm... **Chicago:** Tenants have frozen their expansion plans... **Cincinnati:** The market has seen some modest growth this year... **Cleveland:** Locally headquartered National City Bank is rumored to be for sale, which would impact the office market... **Columbus:** Market conditions are stable... **Detroit:** The credit crunch has multiplied the problems facing the automotive industry. Ann Arbor has benefited as some major companies have consolidated there... **Grand Rapids/West Michigan:** Priceline.com opened a 45,000-square-foot call center, creating 250 new jobs... **Green Bay:** Vacancy fell sharply due to the reclas-

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Metro Spotlight (continued)

sification of a vacant building... **Indianapolis:** Tenants were on the move in the third quarter with Hamilton County attracting a number of new leases... **Milwaukee:** With minimal absorption and light deal velocity, landlords are doing everything possible to retain existing tenants. Short-term renewals are increasing... **Minneapolis:** Budget-conscious tenants may give Class B and C buildings a second look... **South Bend:** Lease rates have increased due, partially, to higher operating expenses. This makes it even more difficult for tenants to justify increased square footage.



NORTHEAST/MID-ATLANTIC

Baltimore: Concessions are more the rule than the exception. Face rates are coming down... **Boston:** Downtown will face challenges from downsizing financial firms, but other sectors continue to expand such as education, biotech and healthcare... **Fairfield County:** Sublease space is at its *lowest* level since 2001-Q4... **Long Island:** Vacancy dropped 40 basis points this quarter even as leasing activity slowed sharply... **New Jersey, Northern & Central:** Businesses are reluctant to make new capital investments, curbing their appetite for office space... **New Jersey, Southern:** With significant contractions by firms including Cigna and IndyMac, the market posted negative absorption for a third consecutive quarter... **New York City:** The market is headed for a two- to three-year downturn resulting from the collapse and mergers of major financial firms. Rental rates are slowly dropping. Available sublease space increased to 8.9 million square feet as 1.5 million square feet was placed on the market in the third quarter, with more expected... **Philadelphia:** Vacancy rose by 30 basis points as a result of negative absorption and new projects coming online vacant... **Pittsburgh:** Several large leases were signed this quarter. Medium to large blocks of contiguous Class A space are limited. The CBD is a hotbed of activity... **Washington, DC:** Core submarkets have enjoyed steady tenant interest and leasing velocity up to this point, but tenants are not pursuing new space unless they are up against an expiration date or have outgrown their space. Renewals have claimed a noticeably large percentage of the deal volume in 2008... **Westchester County:** On the heels of a rough first half of the year, leasing activity outpaced space deliveries in the third quarter, pushing availability lower by 30 basis points... **Wilmington:** The DuPont lease expiration placed 252,000 square feet of vacant space on the CBD market.



SOUTHEAST

Atlanta: There is no exodus of companies from core submarkets despite a rise in sublease availability... **Broward County:** The completion of three buildings in the suburbs elevated the vacancy rate by 30 basis points this quarter...

Charleston: Quoted lease rates are declining, and incentives are becoming more generous. Tenants are getting shorter term leases and renewals... **Columbia:** The market absorbed 55,715 square feet in the third quarter with activity focused in the suburbs... **Greenville-Spartanburg:** Absorption was positive for a sixth consecutive quarter. However, sublease space has quadrupled over the past five quarters, concentrated among the best spaces in top locations... **Jacksonville:** Year-to-date absorption is negative, and sublease space is on the rise... **Memphis:** The market is bucking the national trend thanks to a drop of 30 basis points in the vacancy rate and a slight decline in sublease availability... **Miami:** Vacancy continues to rise at a steady pace. Another major lease was announced at a Class A project under construction in the CBD... **Mobile:** The new RSA Battle House tower is 80 percent leased with tenants moving into the new space each week... **Nashville:** CBD vacancy jumped when Nissan opened its new headquarters in Cool Springs, vacating 280,000 square feet... **Orlando:** More than 300,000 square feet of positive absorption in the suburbs this quarter offset negative absorption of 142,000 square feet in the CBD... **Palm Beach County:** Vacancy continued to rise at a steady pace in the third quarter, increasing 100 basis points... **Raleigh-Durham:** While asking rates are still increasing, due in large part to new completions, landlords are becoming more generous with concessions... **Richmond:** Extraordinary lease deals are available on spaces of 50,000 square feet or more. Class A landlords are offering generous concessions in order to preserve face rates, while Class B landlords are more likely to discount face rates by 10 to 15 percent with fewer concessions... **Tampa:** Tenants are negotiating shorter lease terms and more favorable rent and incentives. New construction will be hard to fill.



CANADA (COURTESY OF AVISON YOUNG)

Calgary: Rents are anticipated to remain close to their current levels for at least another year... **Montreal:** Available space in the downtown core is quickly being absorbed... **Regina:** With a number of companies coming to Regina, there is a strong need for more office space... **Toronto:** There has been a spike in sublease space being brought to market... **Vancouver:** Leasing activity has moderated due to the shortage of available quality space as well as increasing caution among tenants. There is some relief in sight for tenants as developers will add approximately 700,000 square feet of new product in 2008 and a similar amount in 2009... **Winnipeg:** Absorption of both Class A and B space has been significant in the past 12 months.

