

A Baseline Forecast for the U.S. Office Market: 2001 - 2003

July 2001

The Office Market: Existing Conditions

The year 2000 will be remembered as one of the best years for the office market, characterized by historically high rental rates and sale prices, large amounts of construction, a major surge in absorption, and record, low vacancy rates. Indeed, if there were any surprises in our 2000 review of all property sectors, it was the office market. The vacancy rate for the largest 52 office markets tracked by RREEF bottomed at 8.3% at year-end 2000, the lowest level in 20 years. (Please refer to Table 1.) The lowest vacancy rates were concentrated predominantly in the high-tech, supply constrained bi-coastal metro areas, including San Jose, New York, Oakland, Washington DC, Boston, San Francisco and Seattle. The biggest net declines in vacancy rates in 2000 were also concentrated in the tech-heavy California metro areas.

Table 1
Office Market Conditions
Largest 52 Markets

	2000	2001	2002	2003
Office Employment*				
annual % change	3.3	1.0	1.9	2.4
net job creation (000s)	698	226	418	547
Office Completions (million square feet)	89.3	109.7	63.4	60.5
annual % change	-15.5	22.8	-42.2	-4.6
completion rate	2.9	3.4	2.0	1.8
Office Net Absorption (million square feet)	116.1	34.5	63.1	69.1
annual % change	46.2	-70.3	82.9	9.5
absorption rate	3.8	1.1	1.9	2.1
Office Vacancy Rate	8.3	10.4	10.2	9.8

*Office employment includes business services, legal services, engineering and management, and finance, insurance, and real estate. It also is calculated for the whole nation.

Source: Economy.Com, Torto-Wheaton Research, and RREEF Research

Up until last summer, the office market was a major beneficiary of the 10-year economic expansion and the bullish momentum in the high-tech sector. As presented in Table 1, net absorption of office space across the largest 52 metro areas increased over 46% to 116 million square feet, the highest level of demand recorded over the past 20 years. The office absorption rate rose to 3.8%, the highest it has been since late 1987.

Demand for office space was supported by robust job growth in the office-intensive sectors including finance, insurance, and real estate, business services, and the boom in the high-tech sector. Office employment growth increased 3.3% in 2000, adding around 700,000 new jobs.

This partially, but not wholly, explains the sharp increase in office absorption last year. A second explanation for the strength in office demand is strong leasing activity done in anticipation of future growth, especially by venture capital driven high-tech tenants. Financial and professional service firms were also leasing excess space in anticipation of future growth, amid fears of long-term supply shortages of quality office space.

The excess leasing activity experienced in 2000 was in advance of actual (and now in some cases unrealized) growth. The underlying fundamentals, (i.e., net gains in office-using jobs), did not support the heady pace of office absorption recorded for much of 2000. Regional markets that experienced the highest rates of absorption last year include Orlando, Charlotte, Oakland, Seattle, San Jose, and Atlanta.

The rapid deterioration in national economic performance that began in the latter half of 2000 and the bursting of the high-tech bubble, reflected in the sharp revaluation of tech stocks, has dampened, and in some cases, paralyzed office leasing activity through the first quarter of 2001. It is hardly a secret that the national office market is not performing as well as it did in 2000. Preliminary first quarter 2001 vacancy rates indicate a correction to the heady leasing environment of last year. The national office vacancy rate increased to 9.5%, 120 basis points above year-end 2000's 8.3% rate. Office vacancy rates rose in both the suburban and CBD office markets.

Table 2 presents the metro areas that witnessed the largest increases in office vacancy rates between year-end 2000 and the first quarter of 2001. Not surprisingly, these are the same markets that experienced significant leasing activity during most of last year. It should be noted that many of these same markets also had unsustainably low vacancy rates.

One cannot view current conditions in U.S. office markets as separate from their performance in 2000, however. The increase in vacancy and "negative absorption" currently being experienced are a "correction" to the unsustainable strong pace of demand last year. In 2000, there was an effective borrowing of absorption from 2001. Therefore last year's pace of office absorption was unsustainable and is contributing to the sharp decline in leasing activity and the significant amount of sublease space being put back on the market.

Baseline Office Outlook

The U.S. economy is at a critical point. Growth in real gross domestic product was revised down to 1.3% during the first quarter of 2001. The pace of economic growth remains sluggish with most of the weakness concentrated in the traditional and high-tech manufacturing sectors, as producers continue to "destock" unwanted inventories. Even though we do not expect an all-out recession, that is, two quarters of negative GDP growth, the economy is weak. The risks of recession are at an all-time high. Overall, the economy's landing is turning harder than that which we anticipated just six months ago. The whole year is expected to be bumpy, but by the fourth quarter, lower interest rates and a tax cut should set the stage for a new acceleration in economic growth. Real GDP should grow by a below-trend average rate of 1.7% in 2001 and 3.0% per year during 2002 and 2003.

Growth in office employment will also slow in this sluggish economic environment. We expect the office-intensive sectors to generate only 226,000 jobs this year, less than one-third of what was created in 2000. (See Table 1). This means that risks have shifted from supply concerns to those of demand. Indeed, supply remained restrained last year, as capital markets became more cautious even though office vacancy rates hit an all-time low. Office construction across the top 52 markets totaled 89.3 million square feet in 2000, roughly 16% below 1999 levels.

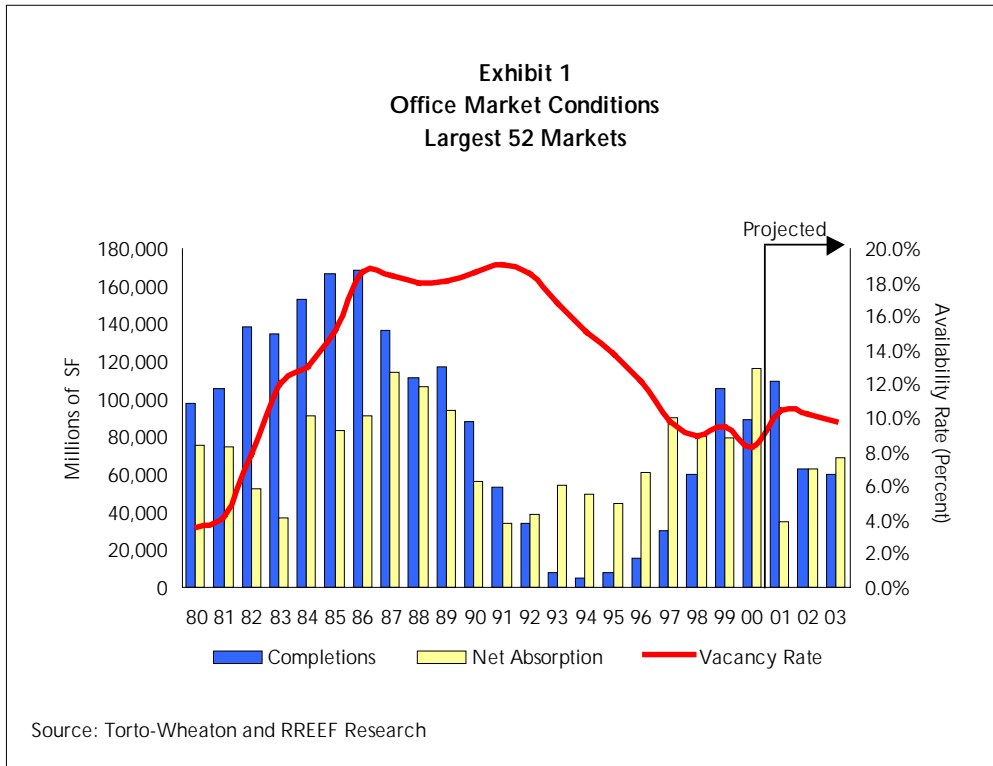
The substantial deterioration in overall economic growth and the technology sector will further impact office markets this year. Vacancy rates are expected to trend up. (Please refer to Exhibit 1.) The "correction" in office demand and the slower pace of office employment growth should lower net absorption significantly in 2001. At the same time, the supply of office space from both new construction and sublease space is expected to be much greater. Toward the end of last year, new office construction gathered momentum, responding to spiking rents, lower interest rates, and high occupancy rates. Office completions across the 52 markets are expected to increase roughly 23% in 2001 to total 109.7 million square feet of which 40% is pre-leased. The markets which have the largest pipeline of office projects this year, include Washington DC, Chicago, Boston, Northern New Jersey, Atlanta, Dallas, Seattle, Phoenix, Denver, and Los Angeles.

Table 2
Largest Change in Office
Vacancy Rates
Year-end 2000 to 1Q 2001

San Francisco	3.5%
San Jose	3.3%
Seattle	3.3%
Austin	3.1%
Oakland	2.9%
Phoenix	2.7%
Washington DC	2.7%
Miami	2.3%
Denver	2.2%
Fort Lauderdale	2.2%
US*	1.3%

*Sum of 52 Markets

Source: Torto-Wheaton Research



With a significant pipeline of new office construction underway and a huge drop in market absorption, office vacancy rates are projected to peak at 10.4% in 2001, a 210 basis point increase over 2000 rates, but still moderate by historical standards. This sharp increase in vacancy rates was last seen during the late 1980s when the office market faced massive overbuilding. Markets that will experience the largest increase in office vacancy rates are listed in Table 3.

	% Change
San Jose	5.8
San Francisco	5.1
Oakland	5.0
Miami	4.4
Seattle	3.5
Atlanta	3.3
Austin	3.3
Washington DC	3.1
Phoenix	3.1
Boston	3.1
*Sum of 52 Markets	
Source: Torto-Wheaton Research	

At 10.4%, the national office vacancy rate is still historically low, though. Indeed, the low office vacancy rates have acted like a shock absorber up till now. While investors outside of the real estate industry may not appreciate this, the office real estate market is in a better defensive position currently than in previous business cycle downturns. Despite the rise in vacancy rates and falling rental rates, office market fundamentals remain solid and vacancy rates are not expected to reach the 19%+ rates reached during the crash of the late 1980s/early 1990s. Across regions, even with the current run-up, vacancy rates remain low in many markets by historic standards. This is doubly true for Class A office space in CBD markets that have attracted significant adverse press (e.g., San Francisco and Boston).

Over the next three years, supply will moderate as market rents flatten or fall in the short-term, especially in previously frothy high-tech markets. The technology bust should be approaching a bottom and if the economy begins to recover during the latter half of 2001, net absorption of office space should rebound in late 2002. Indeed, as “economic visibility” reappears, leasing activity is expected to normalize. Office vacancy rates are expected to peak at 10.4% this year

under this “most likely” scenario and then fall slightly to 10.2% in 2002 and 9.8% in 2003 (See Table 1).

If the economy does not rebound later this year as we forecast, the office downturn will be extended through next year and into 2003. Lags between changes in economic conditions and the resulting impacts on office markets can often be two to three quarters long. Under any scenario, it is likely that office vacancy rates will continue to rise during the initial phases of economic recovery.

Trends to Watch

Sublease space (space put back on the market by tenants who no longer need it) will remain a key influence over the next 6-12 months. It may cause vacancy rates to peak in many markets this year. To date, the growth in sublease space has reinforced negative perceptions of the market but has not produced a wholesale decline in rents or valuations. There has not been a widespread reduction in lease rates by sub-landlords, who in many cases may still profit from the rental spikes seen in the late 1990s. Similarly, due to the impact of restrictive lease terms and customized build-outs, not all of the sublease space can be viewed as truly competitive with new, previously unoccupied product.

Cost saving moves could cause an upturn in leasing activity sooner than anticipated. Assuming a 5 or 10 year lease pattern, around 15-20% of the multi-tenant office inventory should be subject to lease expirations or renewals in any one year. However, absorption rates will be more subdued, as users move away from leasing extra space for possible future expansion.

In general terms, CBD locations are set to fare better than suburban ones, maintaining lower vacancy rates. This is, in part, due to the more traditional, less tech-oriented, user base of CBD markets and more restrictive development patterns. Conversely, this differential may lead to a greater interest in development activity in CBD locations.

The nature and focus of office development is set to evolve further. As the development market recovers in late 2003, activity, initially, will be more user-focused. Pre-leasing will continue to be the key requirement for new development. Where rental rates have fallen but supply is limited, renovation, rather than full-scale redevelopment, may become more commonplace.

Regional Performance

No region is immune to the current economic downturn that began during the latter half of 2000. The greatest impact, though, has been felt in the Midwest and the Southeast due to the sudden decline in consumer demand for durable goods such as autos and household appliances.

While the manufacturing belt remains weak, a more recent deceleration is evident in the West, a region that has a high exposure to the information technology industries. Weak business investment in high-tech equipment is driving up inventories of electronics and computer companies in the region and dot com firms are disappearing as their venture capital funding dries up.

New York and New England also face significant risks, not only because of their exposure to the contracting high-technology sector, but due to consolidations and cost-cutting measures among their financial services industries.

Over the next three years, localized differentials in office market performance will become more exaggerated both between and within different cities and at the submarket and asset class level. (The appendix provides full statistical forecast detail for all metro areas and the nation.)

Below we provide a broad review of several key office markets. Vacancy rate trends for 2000 to 2003 are presented in Table 4.

- **Atlanta**

Significant development activity and rising sublease space will pose short-term problems, particularly in Midtown. However, absorption remains positive driven by traditional users.

- **Boston**

There are marked variations between the CBD and the more outlying, tech-driven suburbs. The supply of Class A product in the Financial District remains tight.

- **Chicago**

Lack of dependence on the new economy and increasing developer caution should result in considerable market stability through the next cycle.

- **Dallas/Fort Worth**

Vacancy rates are set to remain among the highest in the US, at above 15%. However, there will be significant local variations within the DFW Metro area. Locations close to DFW Airport should perform well after the current hiatus.

- **New York City**

Despite the decline of Silicon Alley, the nation's premier office market should remain tight with vacancy rates rising little above 5%. Virtually all the new construction underway is pre-leased.

- **San Francisco**

The dot com collapse and the addition of 3.5 million square feet of sublease space have dramatically altered perceptions. However, the core CBD Class A market remains supply constrained. Rent softening is most pronounced in secondary locations and lower class buildings.

- **Seattle**

Seattle's image has been damaged by falls in the new economy, high construction levels and the Boeing headquarters relocation. A turnaround in fortunes is not anticipated prior to 2003.

- **Washington DC**

The District's CBD remains one of the most robust markets in the US. Outlying, Northern Virginia markets are feeling the worst impact of the tech collapse. Areas closer to the District, such as Tyson's Corner, will recover earlier.

Table 4
Regional Office Market Highlights

	Vacancy Rate			
	2000	2001	2002	2003
Atlanta	8.1	11.4	10.7	10.2
Boston	3.9	7.0	6.6	6.7
Chicago	7.6	9.8	10.1	9.8
Dallas/Fort Worth	15.3	17.0	16.3	15.4
New York City	2.8	4.4	4.4	4.6
San Francisco	6.3	8.1	8.2	7.9
Seattle	1.3	7.1	9.6	9.5
Washington DC	3.9	7.0	6.8	5.9

Concluding Remarks

Despite well-documented negative movements, such as rising vacancy and falling rental rates, market fundamentals remain relatively healthy. The current downturn is not like the crash of the late 80s/early 90s. The national vacancy rate rose to almost 20% last time around. This time we are forecasting a peak of 10.4%.

Vacancy rates are still low in many markets by historic standards. However, higher overall vacancy rates (circa 10%) will be a feature of many markets for the next 2 years. This is due to lower demand over the short-term, significant levels of office deliveries in 2001 and the overhang of sublease space.

There is no apparent danger of over development or over lending this time around. Construction deliveries are set to fall markedly in 2002 and remain around the same level (roughly 65 million square feet) the following year. New development activity is unlikely to rise notably prior to mid 2003.

Recovery will be demand driven. At present, many users are in “wait and see” mode, anticipating further reductions in rental rates while remaining cautious about short-term business prospects.

It is not expected that the gain in values seen during 1998 to 2000 will be lost through a comparable decline in rental rates. Prudently priced acquisitions that were made during this period should still generate acceptable returns over the medium-term.

Fortunes will vary markedly both between and within markets. In most markets, CBD conditions are presently stronger than in the suburbs. However, each market has its own individual fundamentals. For example a vacancy rate of 10% may still stimulate rental growth in one market but cause a decline in rental values in another.

In summary, while it is clear that the office market is going through a period of readjustment, we anticipate that by the end of 2001 much of the worst will be over. Barring an unexpected economic collapse, the office sector should begin to stabilize next year with its low point being much more shallow than in the previous real estate cycle.

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Appendix
Office Market Conditions
2001-2003

	Sum of Completions (2001 to 2003)		Percent of Inventory		Vacancy Rate				History Average Vacancy Rate (1988 to 2000)		Forecast Average Vacancy Rate (2001 to 2003)	
		Rank		Rank	2000	2001	2002	2003		Rank		Rank
Albuquerque	323	45	3.5%	43	12.8	12.8	12.8	12.3	14.8	24	12.7	20
Atlanta	13,242	3	11.8%	14	8.1	11.4	10.7	10.2	14.3	26	10.8	31
Austin	4,228	22	15.9%	4	5.0	8.3	8.3	7.8	14.9	23	8.1	41
Baltimore	4,274	21	10.3%	18	8.3	8.8	8.5	7.9	13.8	31	8.4	40
Boston	11,898	4	8.5%	28	3.9	7.0	6.6	6.7	10.8	46	6.8	48
Charlotte	3,500	25	11.9%	13	8.6	9.6	9.3	9.2	11.5	44	9.4	37
Chicago	13,604	2	7.0%	33	7.6	9.8	10.1	9.8	14.1	27	9.9	34
Cincinnati	2,700	32	9.3%	24	9.1	11.7	10.7	9.6	13.2	35	10.7	32
Cleveland	2,140	36	6.0%	36	13.2	13.7	13.1	13.5	15.2	21	13.4	12
Columbus	2,401	34	10.1%	20	13.4	13.9	12.7	11.6	11.4	45	12.7	19
Dallas	9,956	6	7.3%	31	15.3	17.0	16.3	15.4	21.2	3	16.3	3
Denver	7,493	9	9.2%	26	9.0	12.0	11.7	10.9	14.5	25	11.5	27
Detroit	2,003	38	3.2%	45	10.4	11.8	11.2	10.3	14.0	28	11.1	29
Fort Lauderdale	2,857	31	12.9%	10	9.7	12.8	11.6	10.7	15.8	17	11.7	26
Fort Worth	1,683	40	6.6%	34	15.1	16.7	16.5	16.5	18.5	8	16.6	2
Fresno	0	52	0.0%	52	15.6	14.9	12.9	11.1	15.5	20	13.0	18
Hartford	0	51	0.0%	51	12.6	12.2	10.1	8.1	20.2	4	10.1	33
Honolulu	0	50	0.0%	50	14.5	13.8	13.2	12.4	10.7	47	13.1	17
Houston	5,112	16	4.0%	41	13.0	14.7	14.0	12.1	19.5	7	13.6	11
Indianapolis	1,405	42	5.1%	38	14.6	17.1	15.4	14.7	17.0	10	15.8	4
Jacksonville	1,550	41	9.3%	22	12.0	11.9	11.7	11.4	13.8	33	11.7	25
Jersey City	11,815	5	9.3%	23	7.3	8.5	7.8	7.1	16.8	13	7.8	45
Kansas City	3,400	26	8.0%	29	11.1	12.6	12.8	12.5	13.8	32	12.6	21
Las Vegas	2,960	30	18.7%	2	11.6	14.0	14.6	14.9	12.3	41	14.5	7
Los Angeles	6,566	13	3.9%	42	12.6	14.6	14.0	13.6	17.5	9	14.1	9
Miami	4,009	23	11.5%	15	7.4	11.8	11.0	10.7	16.9	11	11.2	28
Minneapolis	4,350	20	7.0%	32	10.6	12.1	12.3	11.0	12.4	40	11.8	24
Nashville	2,004	37	9.0%	27	10.5	11.1	10.9	10.6	14.0	30	10.9	30
Nassau-Suffolk	1,300	43	4.5%	40	9.0	9.9	9.7	9.6	13.6	34	9.7	36
New Haven	0	49	0.0%	49	8.3	8.3	7.5	6.3	19.8	6	7.3	47
New York	7,294	10	2.1%	48	2.8	4.4	4.4	4.6	11.7	43	4.5	51
Oakland	5,073	17	10.1%	21	3.0	8.0	9.2	8.7	12.6	39	8.6	39
Oklahoma City	300	47	2.1%	47	20.1	19.7	19.0	18.3	22.8	1	19.0	1
Orange County	7,111	12	12.9%	9	11.4	13.0	13.6	13.4	15.5	19	13.3	16
Orlando	3,601	24	14.5%	6	12.0	14.0	14.1	12.3	13.1	37	13.4	13
Philadelphia	5,289	15	5.4%	37	9.9	12.0	12.7	12.6	14.0	29	12.4	22
Phoenix	7,944	7	15.3%	5	12.5	15.6	15.6	14.8	16.9	12	15.3	5
Portland	3,308	27	10.4%	17	7.1	8.6	8.0	7.4	10.7	48	8.0	44
Riverside	560	44	3.3%	44	15.5	15.6	14.0	11.9	22.4	2	13.8	10
Sacramento	2,500	33	6.6%	35	5.9	6.2	4.4	2.6	12.2	42	4.4	52
St. Louis	3,166	29	13.7%	7	10.9	10.6	12.8	13.0	13.1	36	15.0	6
Salt Lake City	5,425	14	12.8%	11	12.5	14.6	14.8	15.6	16.3	16	8.1	43
San Diego	7,705	8	10.3%	19	6.3	8.1	8.2	7.9	9.2	52	9.7	35
San Francisco	4,433	19	13.0%	8	4.1	9.2	9.5	10.5	9.7	51	8.7	38
San Jose	7,187	11	10.5%	16	1.3	7.1	9.6	9.5	10.1	50	7.7	46
Seattle	4,953	18	12.5%	12	4.4	7.9	7.8	7.3	13.0	38	12.1	23
Tampa	2,363	35	7.5%	30	14.1	15.0	14.2	13.5	16.4	15	14.2	8
Tucson	296	48	4.7%	39	7.9	9.2	7.7	7.3	15.7	18	8.1	42
Ventura	1,920	39	20.3%	1	11.6	13.3	13.1	13.6	16.7	14	13.3	15
Washington DC	21,414	1	9.3%	25	3.9	7.0	6.8	5.9	10.3	49	6.6	49
West Palm Beach	3,224	28	17.0%	3	10.6	11.5	13.4	15.4	20.0	5	13.4	14
Wilmington	300	46	2.6%	46	6.2	6.9	5.1	4.2	14.9	22	5.4	50
U.S.	233.5				8.3	10.4	10.2	9.8			10.1	



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