# sublease

## Report

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## EXECUTIVE SUMMARY

- The second half of 2007 saw a trend of increasing sublease availability, foreshadowing a slowdown in the office leasing markets after a four-year trend of sustained growth. Over the past year, more than 13 million square feet of sublease space has returned to the competitive market, with two-thirds of the nation's metropolitan office markets seeing an uptick. While tenants representing many different sectors of the economy are vying to monetize excess space, firms aligned with the housing and financial services sectors have been the most visible thus far.

- The good news is this: If the tempo and tenor of the sublease market is indicative of what the broader market can expect over the relative short-term, the market is not likely to contract as quickly or to the same degree as we saw during the previous cycle in 2000-2001.

## INTRODUCTION

Office leasing activity generally lags job creation, which itself lags the broader economy. An exception to this chain of causality is sublease space, which tends to be a coincident or even a leading economic indicator. This report will examine the office sublease market, including metropolitan-level dynamics, the type and nature of space hitting the market, and the industries likely to have the most significant impact over the short-to-mid term.

Responding to the sluggish economy, the office market cycle has clearly shifted into a softening phase as the national vacancy rate increased 100 basis points, arriving at 14.0 percent midyear. The second quarter bore witness to the end of a five-year trend of positive net absorption, reversing course by registering 3.25 million square feet of net negative absorption.

After 19 quarters of decreasing availability, sublease inventory began its ascent during Q307 - three quarters before the overall market reversed its course. However, the softening in the sublease market has been muted compared with the comparable four-quarter start of the prior cycle (Q400 through Q301). This raises the possibility that the correction in the broader office market also may be muted compared with the weakness following the dot-com bust and corresponding recession earlier this decade.

Comparing current market conditions and those of the previous cycle provides some context and shows that there are more differences than similarities.

## MAJOR DIFFERENCES

- From Q307 to Q208, the market experienced a 13 million-square-foot increase in the amount of space being marketed for sublease, just 18 percent of the 71 million-square-foot spike during the same four-quarter period of the last market contraction.

- The pace of the give-backs has been relatively steady, compared to the rapid quarter-over-quarter increases that initiated the last cycle.

- Turmoil in the housing and primary and secondary mortgage markets has been a key driver of sublease increases in many regional markets, with a variety of sectors playing a supporting role. This contrasts with the tech-heavy flavor of the prior cycle.

- In the run-up of sublease space earlier this decade, 30 percent of available sublease space was concentrated in the tech/telecom-laden markets of Austin, Boston, San Jose, San Francisco and Seattle. The recent increases have been more geographically dispersed because the sectors that have driven the uptick have a presence in most markets.

- Broader market fundamentals remained positive for the majority of the period despite a concurrent uptick in sublease availability:
    - The market experienced 24.5 million square feet of positive absorption from Q307 through Q208 (posting its only net negative quarter in Q208), compared with 38.85 million square feet of net negative absorption in the earlier benchmarked period.
    - Rental rates have moved with the same magnitude but in opposite directions as overall Class A asking rents increased 7 percent compared to a 6.3 percent decline in the earlier period.

- During the earlier period, developers reacted to dissolving demand by tabling new projects. This time around, developers have continued to kick off new projects even as the construction pipeline passed the 100-million-square-foot mark during Q208 for the first time since 2001.

## MAJOR SIMILARITIES

- Sublease space is most predominantly seen in Class A properties, with this sector accounting for two-thirds of total availability - a distribution on par with the trend during the past decade.
- The past four quarters saw suburban markets provide 74 percent of new sublease offerings, which is consistent with the suburban markets' share of vacant space (73 percent) and just slightly higher than this sector's share of total inventory (66 percent).

### What is happening at the local level?

| METRO AREA | SUBLEASE SPACE AVAILABLE Q208 (SF) | SUBLEASE SF AS OF % TOTAL INVENTORY | SUBLEASE % INCREASE DURING STUDY PERIOD |
|---|---|---|---|
| SC - Columbia | 64,025 | 0.6% | 392.5% |
| TX - San Antonio | 258,475 | 0.9% | 390.4% |
| VA - Richmond | 1,007,310 | 3.7% | 166.6% |
| TX - Austin | 803,152 | 1.7% | 152.1% |
| MI - Southern Mid | 11,462 | 0.2% | 151.6% |
| NY - Outer Boroughs | 1,281,523 | 3.4% | 139.4% |
| NJ - Southern | 447,451 | 2.4% | 88.6% |
| NV - Las Vegas | 480,429 | 1.3% | 88.1% |
| CA - San Jose/Silicon Valley | 1,404,649 | 1.9% | 87.0% |
| CA - Inland Empire | 414,198 | 1.3% | 62.5% |
| MN - Minneapolis/St. Paul | 1,444,772 | 1.9% | 54.2% |
| CA - Orange County | 3,176,621 | 3.5% | 51.5% |
| TN - Nashville | 610,265 | 1.8% | 50.8% |
| FL - Southern | 2,045,412 | 1.8% | 48.7% |
| CO - Denver | 2,376,921 | 2.0% | 48.6% |
| AZ - Phoenix | 1,480,058 | 1.9% | 43.2% |
| CA - Fresno | 228,802 | 1.1% | 43.1% |
| OR - Portland | 828,380 | 1.6% | 40.0% |
| SC - Greenville | 135,959 | 1.3% | 36.8% |
| CA - Sacramento | 971,091 | 1.5% | 30.5% |
| OK - Oklahoma City | 63,757 | 0.4% | 30.0% |
| CA - San Mateo | 1,271,088 | 4.8% | 29.7% |
| OH - Cleveland | 868,521 | 2.3% | 27.9% |
| IL - Chicago | 6,428,457 | 2.7% | 27.6% |
| GA - Atlanta | 4,740,150 | 3.3% | 27.1% |
| CA - Los Angeles | 4,410,344 | 2.3% | 24.6% |
| NY - Manhattan | 7,471,426 | 2.0% | 21.4% |

| | | | |
|---|---|---|---|
| WA - Seattle | 1,748,525 | 1.8% | 20.3% |
| TX - Houston | 2,573,283 | 1.5% | 17.5% |
| MI - Detroit | 1,314,706 | 1.8% | 17.3% |
| PA - Pittsburgh | 351,635 | 0.7% | 17.0% |
| SC - Charleston | 100,095 | 1.1% | 15.9% |
| NJ - Northern & Central | 7,420,841 | 4.8% | 12.4% |
| PA - Philadelphia - Greater | 1,922,841 | 1.8% | 9.0% |
| IN - Indianapolis | 485,501 | 1.0% | 8.6% |
| Washington DC/MD/VA | 7,577,751 | 2.0% | 7.6% |
| NY - New York - Southern | 849,104 | 3.2% | 6.4% |
| CA - San Francisco | 1,562,690 | 2.5% | 6.2% |

**Here is a summary of trends in a few of the key markets with the largest supplies of sublease space or the largest increases over the past four quarters.**

## Atlanta

Atlanta's market fundamentals remain strong despite an increase in the size and number of sublease offerings appearing in the marketplace. Generally, Atlanta has mirrored the national market as the increase of sublease supply has emerged largely in suburban Class A properties and has been driven by the consolidation of firms linked to the mortgage market and the residential construction sector. However, despite ongoing consolidation and contraction seen in some sectors, rapid growth in medical and life sciences industries has served to keep the market in positive absorption territory as of mid-year.

## Austin

Austin, another market with a high concentration of technology firms, saw a 152 percent increase in sublease space in the most recent four quarters, with 81 percent of the space in Class A properties and 85 percent in suburban areas. The majority of the space coming online lies in the southern submarkets, where several information technology-related firms have put large blocks back onto the market at rates as low as 35 percent below market rates for direct space. What most notably distinguishes Austin from other markets is that the space contractions in the housing and financial sectors have not significantly impacted the market as of yet.

## Chicago

A notable 1.15 million square foot increase in sublease supply during Q208 nudged Chicago atop the national ranking of overall increase of sublease availability during the study period. Countering the larger national trend, the Chicago Central Business District accounted for the majority of the increase in sublease availability, driven largely by M and A activity in the financial services sector.  Despite the recent uptick to 6.4 million square feet, the market has a long way to go to reach the peak of the last cycle which crested at 12.6 million square feet.

## Central and Northern New Jersey

As of Q208 the Central and Northern New Jersey market has in excess of 7.4 million square feet of sublease space on the market compared to 6.6 million square feet available one year ago. Sublease space accounts for nearly 25 percent of the total available space in the Northern and Central New Jersey office market in mid 2008 compared to nearly 40 percent of the total available space during the timeframe spanning 2001 to 2002. Mirroring the national trend, the overwhelming majority of available sublease space is concentrated in the Class A market which, with a supply of 5.4 million square feet, represents 73 percent of the total sublease market.

## Denver

The Denver office market experienced a 49 percent increase in sublease availability during the study period driven by contractions of firms aligned with the housing and mortgage sectors. Unique to Denver are the large blocks of sublease space that have come online as firms relocated to newly-delivered buildings.

## Los Angeles

The Tri-Cities and L.A. North submarkets, home to residential real estate and related firms, such as the corporate headquarters of Countrywide Financial, have been particularly hard hit. On average, sublease space is being marketed at a 20 to 30 percent discount to market, with the 10,000-square-foot mark having emerged as the median in terms of the size of blocks coming back to market.

## Manhattan

The progression of balance sheet write downs, employee reductions, and space contractions, has been the story of the New York office market in recent quarters. The overwhelming majority of new sublease offerings are attributable to contractions and consolidations by tenants in the financial and professional services sector, with the Midtown and Downtown submarkets feeling the most pain. There are multiple new offerings in the 100,000-square-foot range, a testament to the pains being felt on Wall Street. An average discount to market of around 25 percent has contributed to the first decline in asking rental rates in four years.

## Orange County, California

The Orange County office market witnessed a 1 million-square-foot increase in sublease inventory during the past year, a 52 percent relative increase. This was driven by consolidations and reductions in the mortgage banking, software, training and legal industries. Like most other metro areas, the uptick has been seen predominantly in suburban Class A properties.

## Richmond

The Richmond office market has seen a 167 percent increase in sublease space in the past four quarters due primarily to M&A activity in the commercial and consumer finance sector and subsequent relocations/consolidations. The emergence of large blocks of Class A space tells the Richmond story. The five largest sublease offerings account for over 70 percent of the total sublease availability, which crested the million-square-foot-threshold in the second quarter. Generous discounts to direct space on the order of 20 to 30 percent, plus free rent concessions, demonstrate the aggressive posturing by tenants looking to monetize excess capacity.

## San Jose/Silicon Valley

Sublease supply in San Jose/Silicon Valley increased 87 percent due partly to several technology companies tabling expansion plans and putting large blocks up for sublease, testifying to the volatile nature of technology research and commercialization. However, despite the heavy influence of the technology industry on the market, the majority of space coming onto the market came from firms outside of the tech industry. The increase has been a decidedly suburban dynamic, with 97 percent of available sublease space existing outside urban submarkets.

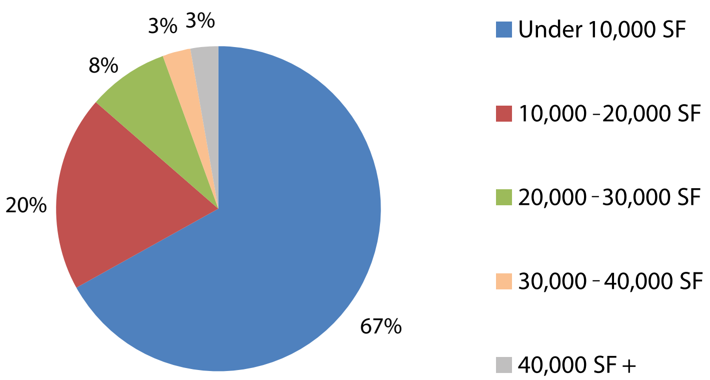
## South Florida

Consolidations, downsizings and bankruptcies by firms in the housing sector, as well as back-office tenants sensitive to high operating cost escalations, contributed significantly to the increase in the supply of sublease space. During the study period, suburban submarkets accounted for 80 percent of new sublease space coming online.

# What size spaces are being returned to market?

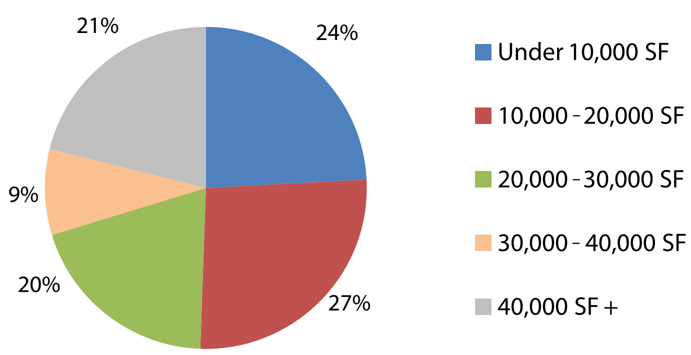
An analysis of 363 subleases being actively marketed by Grubb & Ellis in July of 2008 suggests that while smaller size blocks dominate in terms of the number of offerings (67 percent market share), these only account for 24 percent of all available sublease space in terms of total square footage. On the flip side, large blocks, with just 3 percent market share in terms of sheer quantity, account for 21 percent of total square footage.

DISTRIBUTION BY # OF SUBLEASE OFFERINGS




| BLOCK SIZE | # | % |
|---|---|---|
| Under 10,000 SF | 243 | 67% |
| 10,000-20,000 SF | 71 | 20% |
| 20,000 - 30,000 SF | 29 | 8% |
| 30,000 - 40,000 SF | 10 | 3% |
| 40,000 SF + | 10 | 3% |
| **TOTAL** | **363** | **100%** |

DISTRIBUTION BY TOTAL SF OF SUBLEASE OFFERINGS

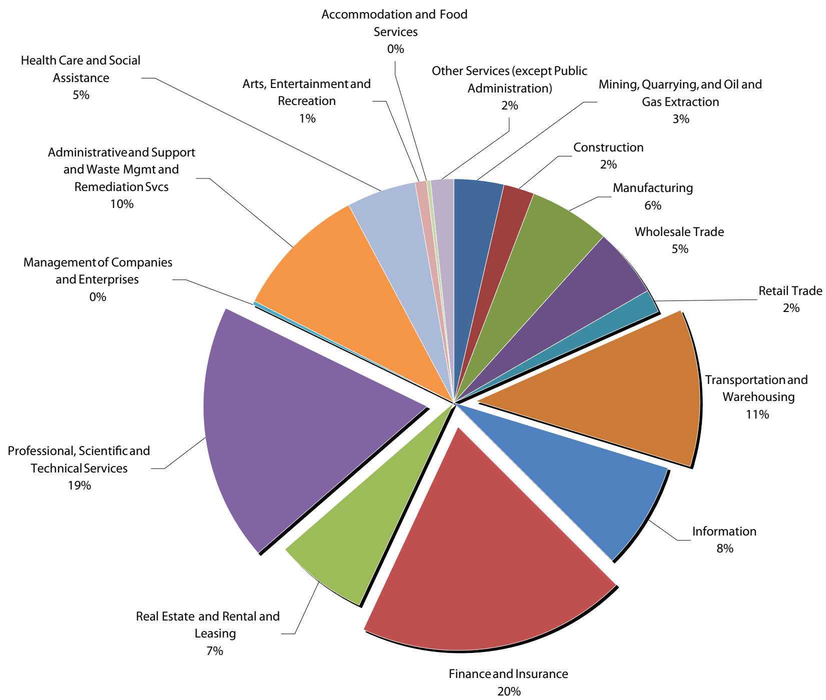



| BLOCK SIZE | SF | % |
|---|---|---|
| Under 10,000 SF | 906,610 | 24% |
| 10,000-20,000 SF | 1,001,986 | 27% |
| 20,000 - 30,000 SF | 736,341 | 20% |
| 30,000 - 40,000 SF | 333,786 | 9% |
| 40,000 SF + | 792,242 | 21% |
| **TOTAL** | **3,770,965** | **100%** |

## Who is absorbing sublease space?

An analysis of 225 sublease transactions negotiated by Grubb & Ellis during the study period sheds some light on which industries have been able to extract value from the sublease market. The transportation and warehousing sector; professional, scientific and technical services; and surprisingly, the finance and insurance sectors have accounted for half of the sublease absorption over the past four quarters, perhaps a result of these industries looking to reduce their occupancy costs and choosing cheaper space alternatives compared to leasing direct space.

| SECTOR | % |
|---|---|
| Finance and Insurance | 19.5% |
| Professional, Scientific and Technical Services | 18.6% |
| Transportation and Warehousing | 11.3% |
| Administrative and Support & Waste Management & Remediation Services | 9.7% |
| Information | 7.8% |
| Real Estate and Rental & Leasing | 6.7% |
| Manufacturing | 6.0% |
| Health Care and Social Assistance | 5.1% |
| Wholesale Trade | 4.9% |
| Mining, Quarrying, and Oil & Gas Extraction | 3.5% |
| Construction | 2.3% |
| Retail Trade | 1.8% |
| Other Services (except Public Administration) | 1.7% |
| Arts, Entertainment & Recreation | 0.8% |
| Accommodation and Food Services | 0.4% |
| Management of Companies and Enterprises | 0.2% |




## What should we expect over the short term?

According to the Bureau of Labor Statistics, the first seven months of the year saw a 463,000-job reduction in non-farm payrolls, representing the first sustained retreat in nearly five years. This included an estimated 286,000 net jobs lost in professional and business services, information and financial services--sectors that are particularly vital to office space demand. The national unemployment rate bounced off its low, increasing from 4.4 percent in March 2007 to 5.7 percent in July - its highest level since March 2004. Projections of sluggish GDP growth for the balance of the year and continued malaise in the credit markets suggest the office market is not out of the woods quite yet. As such, recent events and projections point to a continued bumpy economic road into the first half of 2009.

Expect additional sublease space to become available over the coming quarters, the majority of it in suburban Class A buildings. In the end, the impact of sublease space on the market boils down to how competitive the space is compared to existing alternatives. Criteria include the remaining term of the existing lease obligation, relative discount to similar alternative space options and the nature of existing fit out.

## What and where are the opportunities looking forward?

With rental rates at or just off the cyclical peak, tenants looking to market sublease space are in a more favorable pricing environment compared to the previous cycle, as a generalized contraction of rental rates has yet to emerge. Thus, current conditions better position tenants to mitigate their losses than in the previous softening cycle, particularly in cases where leases were executed below current market levels.

High-credit tenants, particularly in countercyclical or recession-resistant industries such as the healthcare, legal and education sectors, are best positioned to extract value from the sublease market. Tenants exploring the Class A suburban office market also find themselves relatively well positioned, given that the majority of sublease space has cropped up in Class A suburban buildings, in addition to 49.5 million square feet of direct space available in the suburban development pipeline as of Q208. Tenants are projected to benefit from ample space alternatives, bringing negotiating leverage to the bargaining table.

From a landlord's perspective, opportunities exist in exercising recapture rights, particularly in situations where a potential subtenant's lease obligation is well below current market rents.  Another landlord opportunity exists in leases with minimal residual term, as the capital outlay associated with the original transaction has largely been recaptured. In such instances, landlords willing to negotiate extended term with a sublesee beyond the sublessor's obligation can benefit from generating renewal momentum and conserving capital by pooling capital needed for tenant fit out with the sublessor.

***Source:*** *U.S. Bureau of Labor Statistics*

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