



In This Issue...

The Bottom Line1
Vacancy Rates2
State of the Market3-4
Rental Rates5
Metro Spotlight6-7

Office Market Trends

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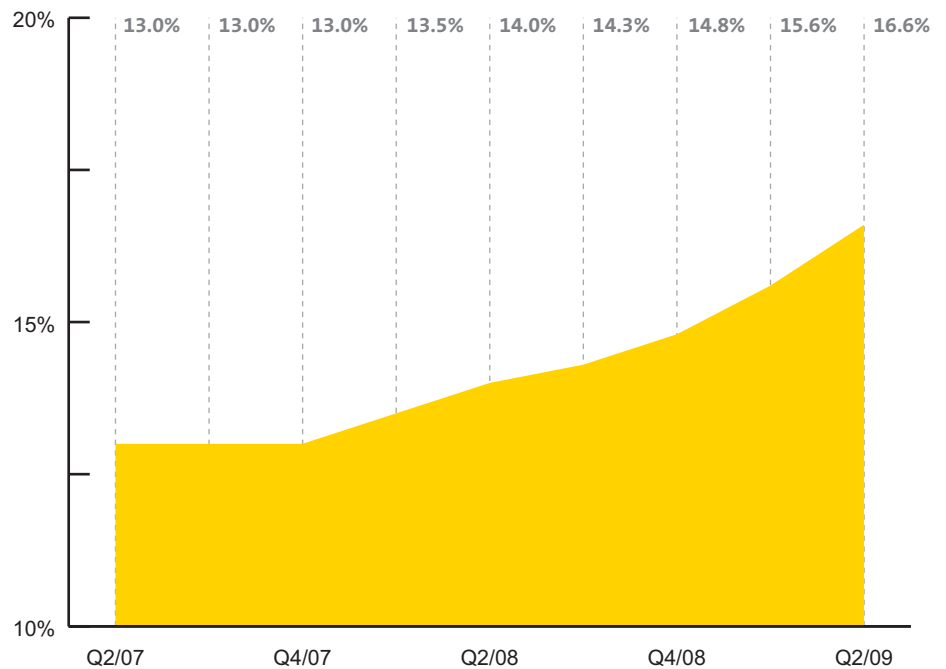
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Steep Ascent...

US OFFICE VACANCY RATE*



* All classes of space

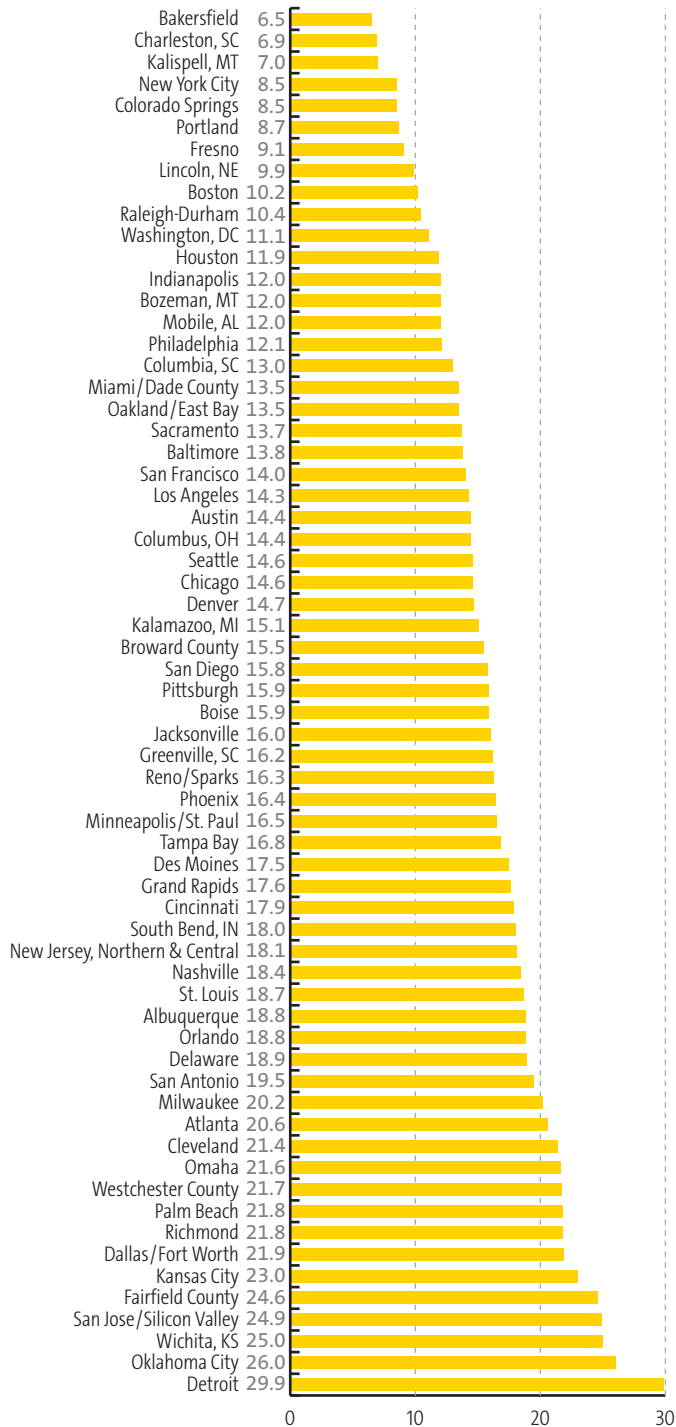
THE BOTTOM LINE

Absorption was deeply in the red for a second consecutive quarter, inflating the vacancy rate at a quickening pace. Asking rental rates fell by 3 to 4 percent over the last four quarters, though effective rates were off 16 percent. The silver lining is that the inventory of available sublease space added just 1.4 million square feet in the second quarter, suggesting a light at the end of the tunnel. This was by far the smallest quarterly gain since this indicator turned higher in the third quarter of 2007, a full quarter before the onset of the recession. Economists expect the recession to end later this year, but the recovery will be sluggish. Vacancy is unlikely to peak before the first half of 2011, with rental rates beginning to firm one or two quarters later.

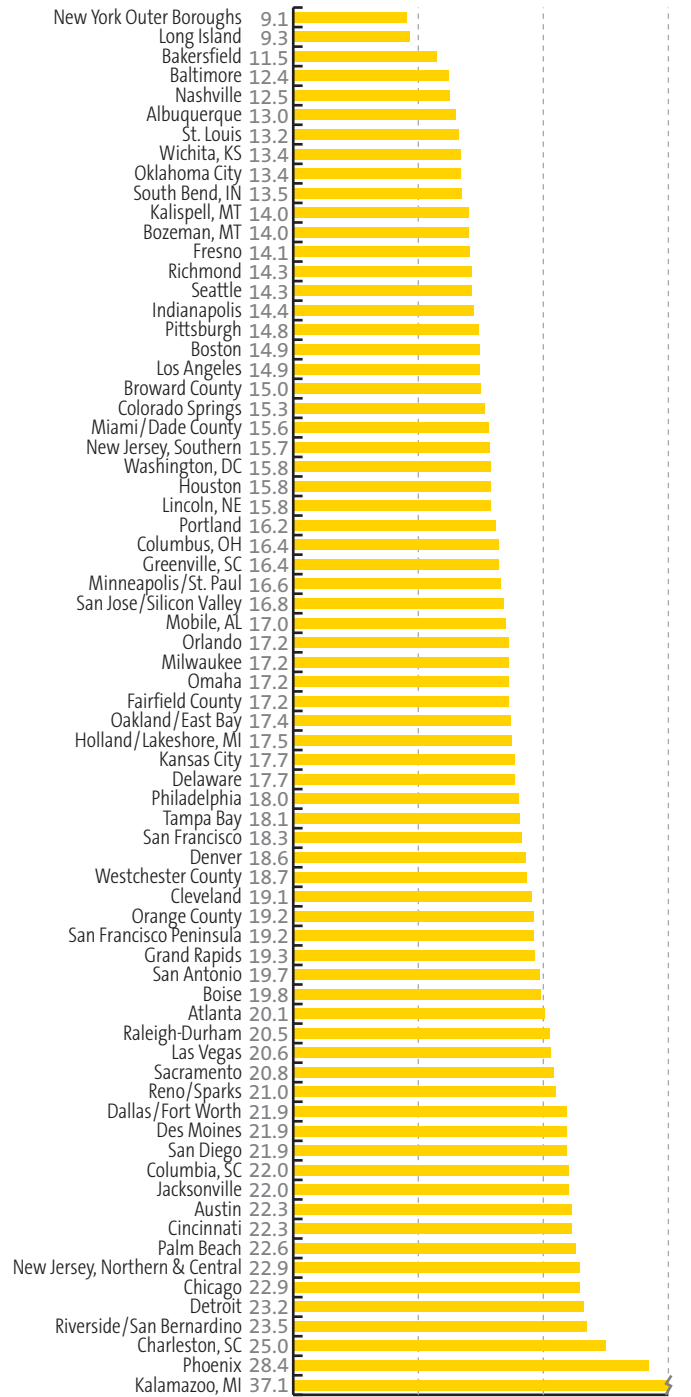
METRO VACANCY RATES

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.

CBD % Vacant



Suburban % Vacant

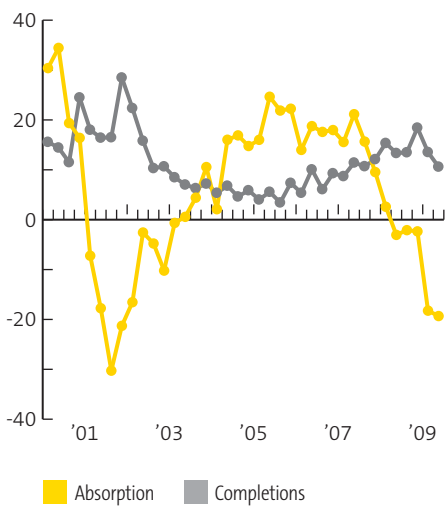


STATE OF THE MARKET

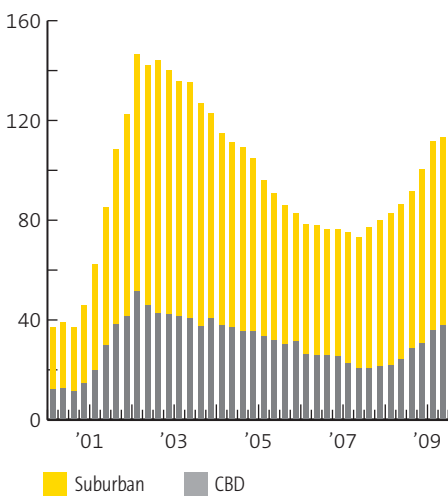
The office market has settled into an aggressive softening cycle, the length of which will depend on when job losses dissipate.

The vacancy rate ended the second quarter at 16.6 percent, an increase of 100 basis points from the first quarter and 180 basis points since the start of the year. These movements are on par with the 2001-03 softening cycle during which vacancy rose by an average of 85 basis points per quarter.

Absorption and Completions
in Millions of Square Feet



Available Sublease Space
in Millions of Square Feet



- **New York City, the New York Outer Boroughs and Long Island** are holding onto their sub-10 percent vacancy rates, but spiking availability rates and sublease inventories suggest they will lose their grip within the next quarter or two. Sixteen markets posted vacancy rates above 20 percent, double the number from the first quarter and quadruple the number from the year-ago quarter. More than one-quarter of **Phoenix's** office inventory is empty, followed closely by **Detroit** and California's **Inland Empire**.

Net absorption has recorded steep negatives this year at -19.3 million square feet in the second quarter and -18.2 million square feet in the first quarter. As with the vacancy rate, this performance is on par with the losses recorded in the thick of the softening cycle earlier this decade.

- **New York City** led all other markets on the downside by giving up 3.3 million square feet of occupied space in the second quarter, i.e. negative absorption. Markets posting between negative 1 and 2 million square feet included **Northern and Central New Jersey, Chicago and Los Angeles,**

a sign of how the recession has spread across all regions. A small handful of markets did manage to post positive absorption, led by **Seattle** with 561,000 square feet absorbed in the second quarter.

The construction pipeline is emptying quickly; space under construction plummeted by more than 18 million square feet to end the quarter at 48 million square feet, its lowest level in four years.

- The **Washington, D.C.** metropolitan area continues to lead all other markets with 7.9 million square feet underway, but this is down from 10.6 million square feet in the year-ago quarter. First half absorption was in the red at -608,000 square feet, a sign that even the government-anchored national capital is not immune to the recession. Fifteen markets have 1 million square feet or more left in the pipeline compared with 28 markets at mid-2008.

A hopeful sign was that the inventory of available sublease space added a negligible 1.4 million square feet, by far the smallest quarterly gain since the market began to soften. In each of the prior two quarters, sublease space had increased by an average of 10.2 million square feet. The sudden leveling off is one more indicator that the financial panic of last fall and spring has subsided. The sublease inventory totaled 113 million square feet at the end of the second quarter, its highest level since 2004-Q1 but well below the prior peak of 146 million square feet recorded in 2002-Q1.

- As might be expected, **New York City,** with its struggling financial sector, tops the list with 16.2 million square feet of

sublease space available on the market. As a percentage of the total inventory, New York ranks only third with 4.5 percent of its inventory offered for sublease. Ranking ahead of New York are the **San Francisco Peninsula** and **Northern and Central New Jersey** where 6.1 and 4.8 percent of their respective inventories are available for sublease. **Greenville, S.C.**, surprisingly, ranks just behind New York with 4.4 percent of its overall inventory and nearly 10 percent of its CBD inventory on the sublease market.

Asking rental rates, typically the last real estate indicator to register a change in the cycle, have turned lower. Year over year, the average rate across the U.S. is down by 3.2 percent for Class A space and 3.7 percent for Class B space. The average effective rate, however, is down by 16 percent for all classes of space. In the early stages of a softening cycle, landlords and tenants typically negotiate over free rent, improvement allowances and other incentives that figure in the calculation of effective rates but do not impact asking rates. In the later stages of a softening cycle, asking rates finally begin to come down.

- Asking rents over the past four quarters have declined most sharply in the technology-heavy **San Francisco Peninsula**, off by 30 percent, followed by neighboring **San Francisco**, down 23 percent. A small handful of markets have seen rental rates increase recently, but it's not a sign of strength. Rather, new projects are opening with little or no pre-leasing, meaning that a slug of space with top-of-market asking rents is keeping the average artificially high.

Sales of office properties greater than \$5 million totaled \$4.9 billion through May of this year, down 75 percent from the same period in 2008 according to Real Capital Analytics. The average cap rate for office transactions year-to-date was 7.4 percent, up from 7.0 percent in 2008 and 6.2 percent in 2007. Sales activity remains practically non-existent because buyers are waiting on the sidelines or out raising capital in anticipation of a wave of distressed assets coming to market. Nearly \$500 billion in commercial real estate loans are expected to mature in 2009 and again next year, and it is unclear how these loans will be refinanced. At the peak of the market, CMBS, Wall Street firms and international banks provided 60 percent of the financing used to acquire properties. Since September 2008, they have financed just 2 percent of acquisitions. Although the TALF (Term Asset-Backed Securities Loan Facility) and PPIP (Pub-

lic-Private Investment Partnership) programs have been extended to CMBS, they are unlikely to lure enough investors to stem the tide of foreclosures. Expect sales activity to begin to pick up in the second half of 2009, fueled by an increase in distressed sales. Cap rates are likely to rise consistently through next year.

FORECAST

As mentioned at the beginning of this note, the length of the office market softening cycle depends on when job losses finally abate. The following sequence of events seems plausible:

- GDP turns positive: 2nd half of 2009
- Labor market bottoms out: mid-2010 but growth is negligible until 2011
- Vacancies peak and begin to turn down: 1st half of 2011
- Rents bottom out and begin to turn up: 2nd half of 2011
- The strength of the office market recovery in 2011 and beyond will depend on the strength of the labor market recovery, which most economists expect will be weak.

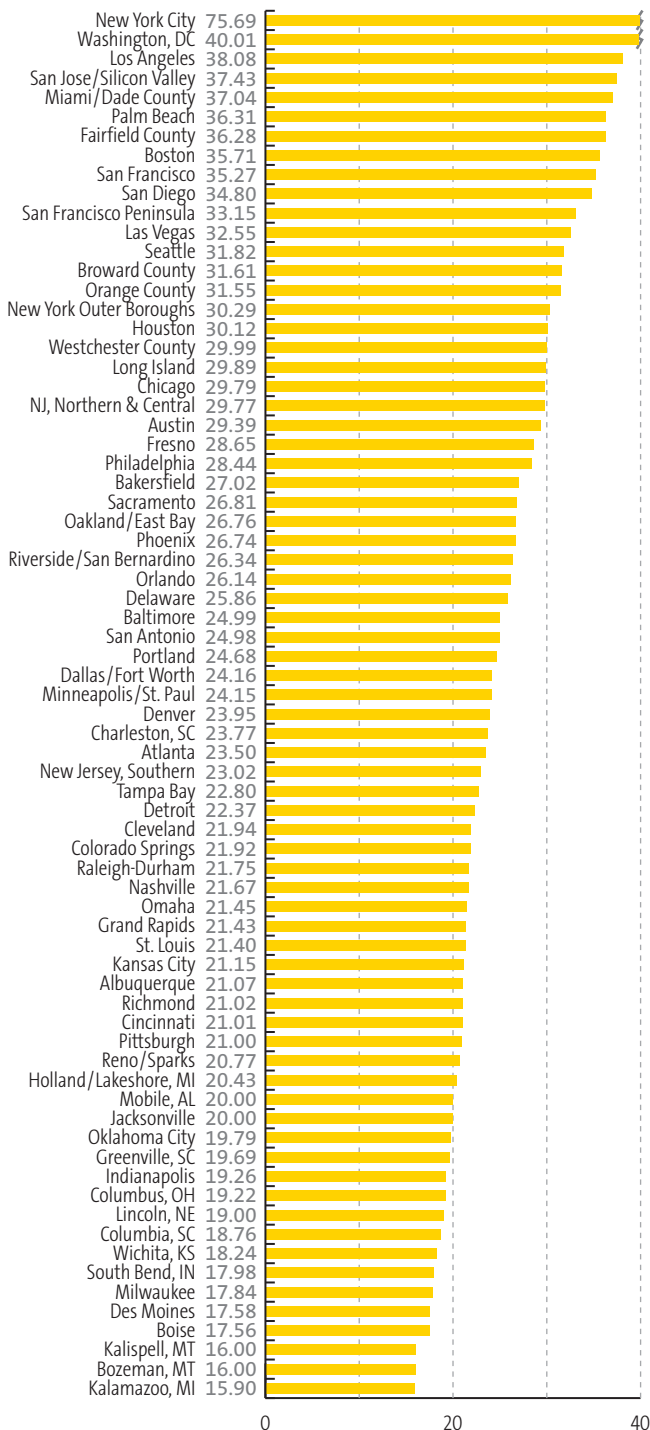
A forecast based on the loss of office jobs (information, finance and professional and business services excluding temporary positions) through the middle of next year suggests that the vacancy rate could rise above 20 percent in the first half of 2011 from its mid-2009 reading of 16.6 percent. Asking and effective rental rates may decline another 10 percent before they reach bottom sometime in 2011. The erosion in net operating incomes during this period will put additional pressure on owners who are struggling to refinance their loans in tight capital markets.

METRO RENTAL RATES

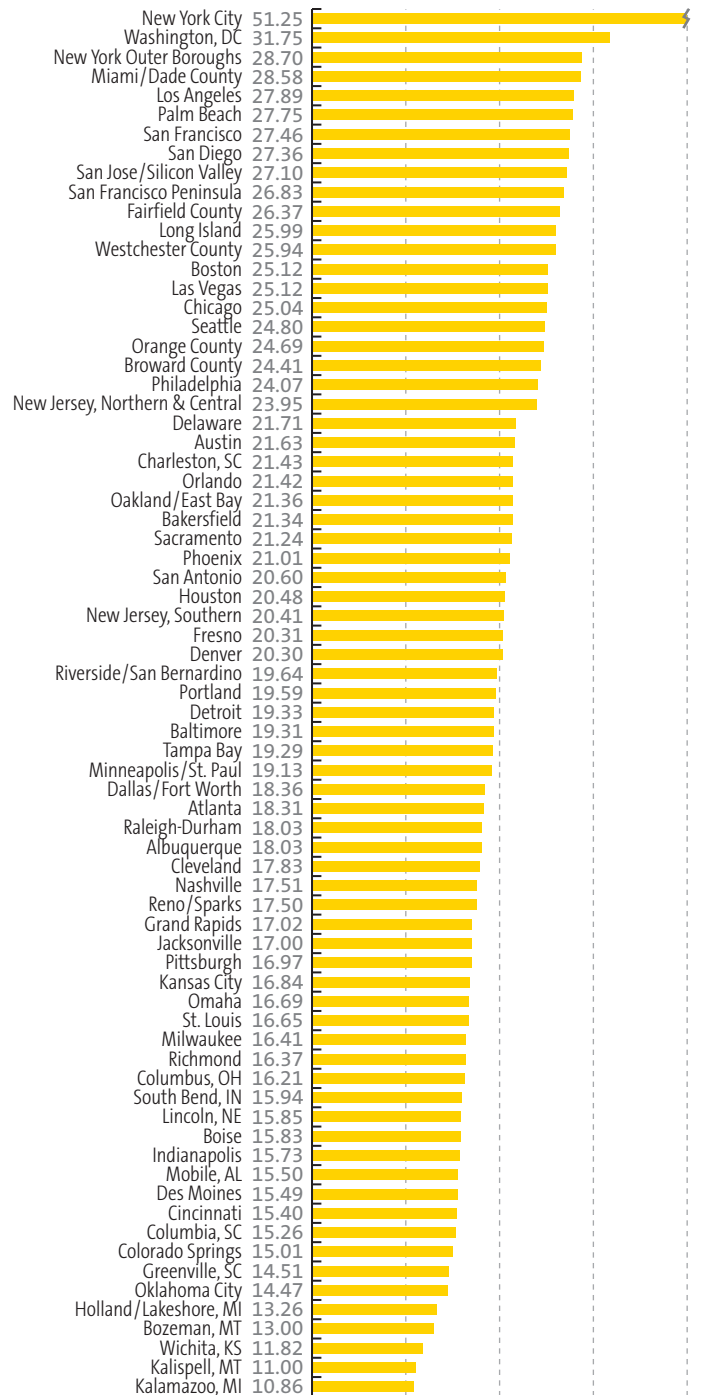
Note: Rental rate data refer to asking rates for space that is available on the market at the end of the quarter. Rates are per square foot, quoted on an annual, full service gross basis.

As of 2009-Q1, Grubb & Ellis adopted a new methodology to weight average office asking rental rates. When calculating the average for a market or submarket, we previously weighted the asking rate in each building by the size of the building. Now we weight the rate in each building by the amount of available space in the building. All historic rental rate data have been re-weighted using the new methodology, but the rental rates in this table will not be comparable to the data in our reports published prior to 2009.

Class A \$ Asking Rent



Class B \$ Asking Rent





PACIFIC

Bakersfield: The number of new vacancies hitting the market is leveling off... **Fresno:** With little new construction planned, lease rates should firm up and concessions should decline over the next few quarters... **Los Angeles:** Every submarket posted negative absorption in the second quarter and the first half of the year. Available sublease space continues to pile up, totaling over 6 million square feet...

Oakland-East Bay: Sublease space has only reached a third of the levels seen during the height of the previous recession. Rents continue their decline, already down nearly 20 percent from their peak... **Orange County:** Tenant retention is one of the biggest challenges facing landlords as many tenants downsize or shut their businesses... **Portland:** Young, educated workers are migrating to Portland despite the swelling unemployment rate, creating a strong labor base that employers will be able to tap when the economy turns the corner... **Riverside-San**

Bernardino: Landlords, contending with 4.7 million square feet of new speculative construction added since 2007, are aggressively competing to fill their space... **Sacramento:** With the region's largest tenant languishing in red ink, landlords are feeling the pain of the state budget stalemate... **San Diego:** The near-term outlook is difficult, but the long-term outlook is brighter due to the region's location, demographics and diverse tenant base... **San Francisco:** Total space availability is approaching dot-com bust levels. Rents continue to soften as tenants downsize and offer space for sublease... **San Francisco Peninsula:** Sony capitalized on the market's downturn by signing a lease renewal for approximately 320,000 square feet in Foster City... **San Jose-Silicon Valley:** Intel, located in Santa Clara, announced plans to purchase Alameda-based Wind River Systems, proving earlier predictions that corporate mergers and acquisitions would increase as compa-

nies with cash find desirably priced opportunities... **Seattle:** Microsoft occupied two newly completed buildings in the Bellevue CBD, City Center Plaza and the Bravern Office Complex, absorbing slightly more than 1 million square feet.



MOUNTAIN/SOUTHWEST

Albuquerque: The market is beginning to see signs of stabilization. Tenants in education, insurance, health care and legal are seeking new or larger spaces...

Boise: Leasing activity is on the upswing, but sales have been almost non-existent... **Bozeman:** Demand has picked up in the past month. Rental rates continue to decrease...

Colorado Springs: Vacancy is moving higher, while asking rents were mostly flat... **Denver:** The addition of 2,100 jobs in May marks the first net job gain for the metro since August of last year. Only three sectors posted declines: hospitality, manufacturing and mining... **Kalispell:** Tenant demand has slipped, and there is no new development in the pipeline... **Las Vegas:** Most of the 1.8 million square feet of planned projects are on hold...

Phoenix: Landlords have shifted their strategies to offering low cost occupancy for the near term.



CENTRAL/GREAT PLAINS

Austin: An estimated 23,000 new office jobs filling nearly 4.5 million square feet of space will be required in coming years for the market to return to a tolerable equilibrium of 10 percent... **Dallas-Fort Worth:** Year-to-date absorption was negative for the first time since 2003. Expect further increases in vacancy as nearly 2.5 million square feet still in the construction pipeline is completed... **Des Moines:** Deals are getting done, but term lengths are shorter. In some cases, landlords are giving one-year lease extensions with no rate in-

creases... **Houston:** Vacancy has reached the highest level in three years. Rent growth has clearly slowed, and landlords are offering generous concessions to stimulate leasing demand... **Kansas City:** Downtown tenants vacated a net of 260,000 square feet with the losses concentrated at Town Pavilion with TransAmerica. Capital One added 185,000 square feet to the available sublease inventory in South Johnson County... **Oklahoma City:** Devon Energy occupied 120,000 square feet of additional space in the First National Building, avoiding a hit to the downtown vacancy rate... **Omaha:** Having held out valiantly while other markets fell to the recession, the local office market may simply be late to the "party"... **San Antonio:** Significant deals included the 145,000-square-foot Medtronic lease in Overlook and the 39,855-square-foot Concorde Career College lease at Corporate Square Garden... **St. Louis:** Large corporate users Brown Shoe, Monsanto and Sara Lee announced layoffs, and it is not known whether they will try to sublease some space... **Wichita:** Sedgwick County recently leased 52,000 square feet of office space.



GREAT LAKES

Chicago: Some tenants are understandably wary of certain landlords' ability to live up to commitments to fund significant remodeling allowances, particularly in a relocation scenario... **Cincinnati:** Market activity has stalled as companies remain on the sidelines waiting for a definitive sign that a recovery is imminent. The majority of completed transactions have been tenants relocating to a smaller space in a similar building... **Cleveland:** The local vacancy rate cracked the 20-percent ceiling this quarter... **Columbus:** Water's Edge, a 106,500-square-foot, Class A building, was completed during the quarter. More than 86,000 square feet is available... **Detroit:** Quicken Loans may con-

solidate from suburban locations into the 1 million-square-foot Compuware Building downtown... **Grand Rapids/West Michigan:** The market struggled in the second quarter with vacancy remaining virtually flat. Hope springs eternal that the second half of the year will bring some improvement... **Indianapolis:** Transaction velocity is still slow. Lease terms do not display any particular trend... **Milwaukee:** Gannett Co. Inc., New-Page Corp. and The Milwaukee Journal Sentinel recently announced job cuts, and losses are projected to accelerate... **Minneapolis:** Landlords are willing to work with existing tenants to accommodate downsizing, early renewals, reduced rent and even free rent, concessions normally reserved for new tenants... **South Bend:** Vacancy remains high and is expected to increase in the third quarter as a large amount of Class A sublease space hits the market.



SOUTHEAST

Atlanta: NCR Corporation will move its headquarters to Atlanta from Dayton, Ohio. This comes on the heels of recent expansion announcements from First Data Corporation, Verizon Wireless, Gentiva HealthCare and TBS Productions... **Broward County:** Research in Motion expanded its lease to occupy all of the newly built 93,000-square-foot Sawgrass Pointe II... **Charleston:** Landlords have become more willing to accept shorter lease terms and reduced rental rates to bring in new tenants... **Columbia:** Users considering purchasing property have become more concerned with holding onto cash and are leasing instead. Lease terms have become shorter, and more tenants are requesting termination options... **Greenville-Spartanburg:** The South Financial Group will remain downtown and make 70 percent of its 213,000-square-foot suburban corporate campus available... **Jacksonville:** Landlords are offering significant concessions in the

form of free rent and TI allowances... **Miami:** 1101 Brickell Avenue sold for \$33 million, less than half of the \$70 million price paid in 2005... **Mobile:** The local economy is softening. Growth projections have been pushed further into the future... **Nashville:** Landlords are not ready to lower asking rates, instead offering free rent and other concessions or touting LEED certification and high-end finishes as reasons for maintaining rates... **Orlando:** Tenants will continue to have leverage in lease negotiations as landlords become frantic to fill vacant space... **Palm Beach County:** The market's three-year run-up in vacancy is slowing, but rising unemployment and negative absorption persist... **Raleigh-Durham:** Absorption was deeply in the red for a second consecutive quarter as large blocks of new vacancy impacted the market... **Richmond:** The 300,000-square-foot Deep Run I, formerly occupied by Circuit City, went into receivership as Lexington REIT turned the vacant property over to Bank of America... **Tampa:** Landlords are struggling to keep tenants.

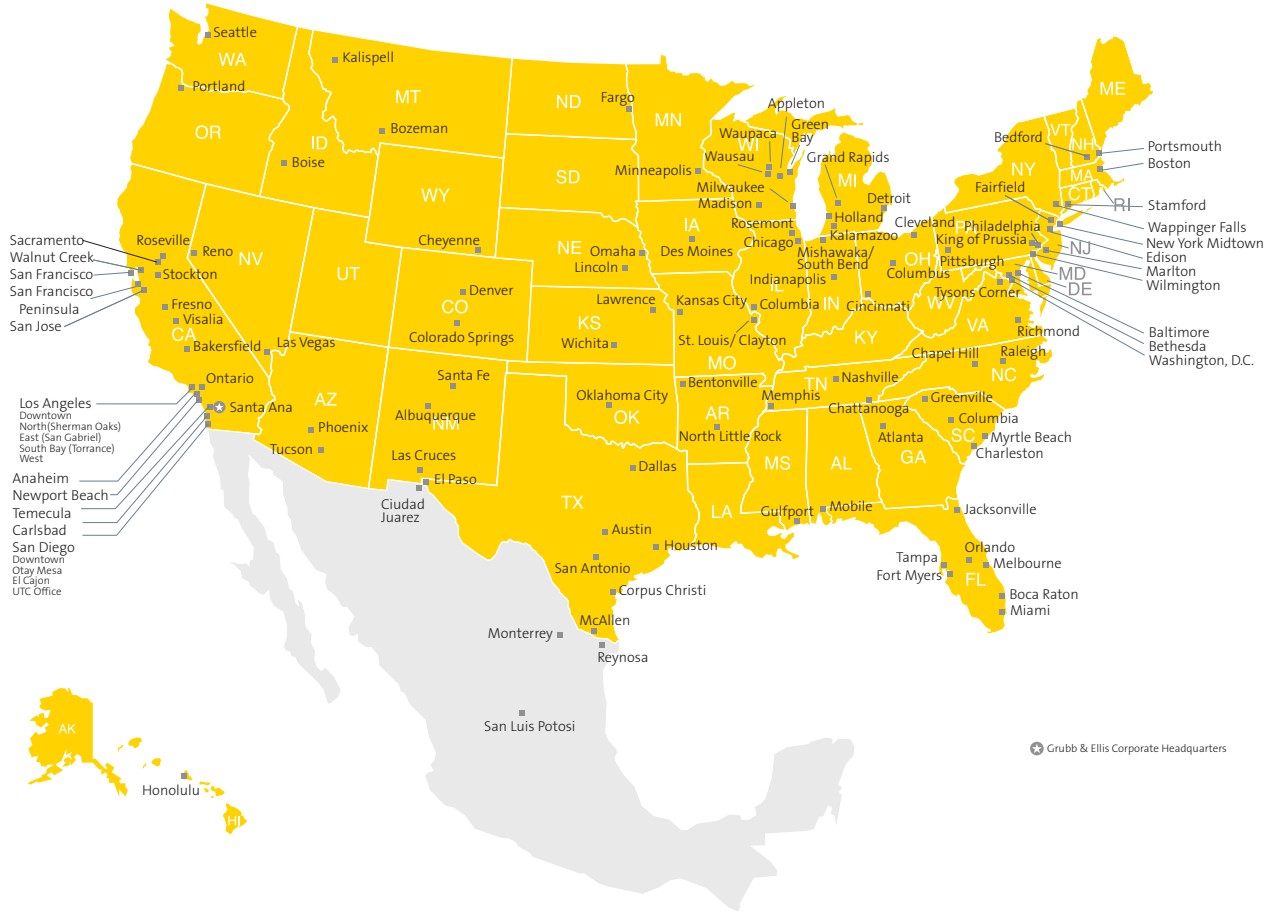


NORTHEAST/ MID-ATLANTIC

Baltimore: Most projects currently under construction are part of transit-oriented and mixed-use developments, urban redevelopment, waterfront projects and biotech parks that were financed pre-credit crisis... **Boston:** Tenancy loss will continue throughout the year with an additional 1 million square feet of negative absorption likely by year-end... **Fairfield County:** RBS signed the largest lease of the quarter, renewing 105,342 square feet at 1000 Lafayette Boulevard in Bridgeport... **Long Island:** Available space has been on the market an average of 20.6 months. Expect that to rise over the next few quarters as leasing activity remains tepid... **New Jersey, Northern & Central:** A growing supply of available space generated by corporate con-

solidations combined with diminished demand has boosted the availability rate to its highest level in six years... **New Jersey, Southern:** GMAC Mortgage's move-out of 89,000 square feet and Equity One's departure from 82,482 square feet accounted for the bulk of this quarter's reduction in occupancy... **New York City:** Landlords with large blocks of space in excess of 100,000 square feet are feeling the worst leasing pains, as these flooded the market in the last 12 months. Only 11 deals were completed this year over 100,000 square feet, seven of which were renewals... **Philadelphia:** The dissolution of the century-old law firm Wolf Block created a 175,000-square-foot vacancy in the West Market... **Pittsburgh:** Bank of New York Mellon's lease of 110,000 square feet at 4350 Northern Pike will offset a portion of the 480,000 square feet vacated by Westinghouse as it migrates to its new facility in Cranberry... **Washington, DC:** Despite lower leasing velocity, the region maintains a robust construction pipeline, adversely affecting vacancy rates... **Westchester County:** Diversified Investment Advisors signed the largest lease of the year, for 115,000 square feet in Harrison. Current tenant demand is for small space; 80 percent of the deals transacted in the second quarter were 5,000 square feet or less... **Wilmington:** Barclay Bank moved into 73,742 square feet at Iron Hill Corporate Center, formerly owned and occupied by MBNA/Bank of America. Amtrak occupied 23,700 square feet in the speculative Renaissance Centre.

GRUBB & ELLIS OFFICE LOCATIONS



Office Market Trends United States Q2 2009