



By
Lloyd Lynford
CEO
Reis, Inc.

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The U.S. office sector has managed to record positive net absorption for six consecutive quarters, and modestly falling vacancy for three quarters, but investors have been waiting for the third leg in the recovery's tripod: rent growth. Effective rents remained flat at \$20.11 during the last half of 2004 after fourteen consecutive quarters of decline. Finally we can report that the momentum in the office leasing market is sufficient to allow the average owner to ask for, and in many cases to receive, higher rents. During the first quarter of 2005, effective rents rose by an average of 0.6% to \$20.23, the first quarterly increase in four years. Simultaneously, the average vacancy rate continued its descent, falling by 20 basis points to 16.0%, as modestly positive absorption of 10.5 million square feet was recorded.

While the good news embedded in the national averages is welcome, it does not follow that all risks have been removed from office building investments. The aphorism "a rising tide lifts all boats" may be rooted in nautical truth, but it does not translate easily into a philosophy of real estate investing.

The damage inflicted upon effective rents during the past four years is such that many buildings still house tenants who signed leases during the boom, and who continue to pay rents that are well above current market rates. As a result, average in-place rents in these buildings, and the net operating income that they support, are vulnerable to rollover risk as these older leases expire. Given the magnitude of the Reis office building database, we have a privileged view of this reality confronting investors. If an investor were to pull his next office building out of a grab bag, what are the odds that he would choose a building exposed to the type of rollover risk described above? The answer is one in five, which, depending on your profile as a gambler might be perfectly acceptable. Or not.

Among the entire universe of 80 U.S. markets tracked by Reis, 19.0% of office properties are currently rented at rates that are above their current market rents. How much of a hit will the average investor take when he replaces an average seasoned tenant with an average new tenant? The answer to *that* question is 10.1%, representing the average differential between in-place rents and market rents. Of course, since most investors eschew the grab-bag approach to acquisitions, instead relying on thoughtful due diligence, it is useful to discriminate between markets where rollover risk is greatest versus those where it is muted.

Reis's statistics indicate that the risk is highest in metropolitan markets that saw a frenzy of dot-com leasing activity just before the crash. Just under 60.0% of buildings in San Francisco, for example, have in-place rents that are, on average, 21.3% above market rates. At least one-third of buildings in Boston, San Jose Oakland-East Bay, Seattle, and New York at present enjoy in-place rents that are not replicable on the open market.

Concerns about legacy leases aside, we can state with confidence that, on average, market indicators are moving in favor of landlords. Among the top 64 U.S. markets tracked by Reis, 44 recorded positive absorption. Leaders included New York (1,305,000 square feet), San Francisco (994,000), Northern New Jersey (874,000), Orange County (808,000), and Northern Virginia (781,000). At the other end of the scale were Columbus (-382,000), Kansas City (-377,000), and Detroit (-372,000).

The Reis Recovery Index Number of Top 64 Office Markets Experiencing Positive Symptoms			
	Positive Absorption	Falling Vacancy	Rising Effective Rent
Q1 2005	44	39	44
Q4 2004	57	49	32
Q3 2004	46	38	25

Vacancy fell in 39 markets, with leaders including Raleigh-Durham, with a decline of 1.6

percentage points, followed by Memphis, Tucson, Fort Worth, and Orange County, each of which dropped by 1.3 to 1.5 percentage points. Twenty-four metropolitan markets recorded vacancies declining by at least 0.5 percentage points. Only one market recorded a vacancy bump of greater than 1.0%: Columbus, with 1.4%.

Forty-four markets registered rising effective rents, with the leaders tending to be proximate to the larger employment centers of Los Angeles, New York, and the District of Columbia. Orange County saw effective rents rise by 1.9% in the quarter, followed by Nashville (1.8%), Northern Virginia (1.7%), the District of Columbia (1.6%), Norfolk (1.4%), Los Angeles (1.4%) and New York (1.3%). San Jose and Minneapolis brought up the rear with declines of 1.3% each.

The pace of job formation during the first quarter continues to raise questions regarding the depth and breadth of the nation's economic recovery. An average of 157,000 new jobs were created each month, down from the monthly average of 181,000 during 2004. Nonetheless, Reis believes that the current economic trajectory will continue to support an improving office market throughout 2005 and over the remainder of the decade. Job formation is sufficient to support absorption of 66.3 million square feet this year, up from last year's total of 40.0 million square feet. As absorption exceeds the anticipated completion of 37.9 million square feet in 2005, Reis projects that the national vacancy rate will continue to fall by an additional 80 basis points to 15.2% as of year-end. Effective rents will continue the trend

begun during the first quarter; Reis projects a 2005 total increase of 1.6%. The recovery will pick up additional steam in 2006 through 2009. Vacancies will fall by 120 and 140 basis points in 2006 and 2007, respectively, while increases in the rate of effective rent growth will accelerate. In 2006, average effective rents will rise by 2.7%, followed by gains of 3.8% and 4.3% in 2007 and 2008. The next five years should prove a more congenial operating environment for those investors who exercise discretion with respect to both market and submarket selection and carefully manage the "downward draft" posed to asset-level cash flows by the rollover risks noted above.

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