Delta Outlook
A market report for commercial real estate executives

THE NEXT RENT SPIKE IN SELECT OFFICE MARKETS? WHEN DEVELOPERS SHOULD BEGIN NEW CONSTRUCTION

A special report for customers of the firm
Prepared with our research partner Transwestern Commercial Services

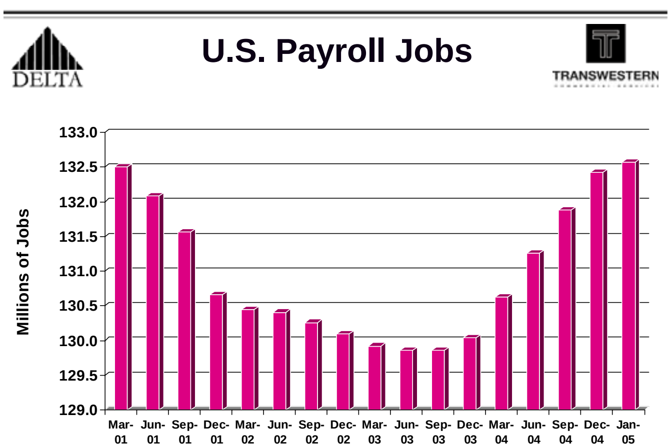
Economic Growth Continues on Solid Footing

The U.S. economy continues to expand at a steady pace in 2005, with both the consumer and business sectors fueling growth. The housing market remains strong and business spending has taken off, particularly on high-tech equipment and software. Spending in this category now surpasses the previous peak period in 2000. As a result, companies are hiring at a steady pace to meet demand. However, the leading economic indicators are pointing to a slower rate of economic growth by mid-2005. That will likely translate to slower Gross Domestic Product (GDP) growth but not a reduction in payroll job growth.

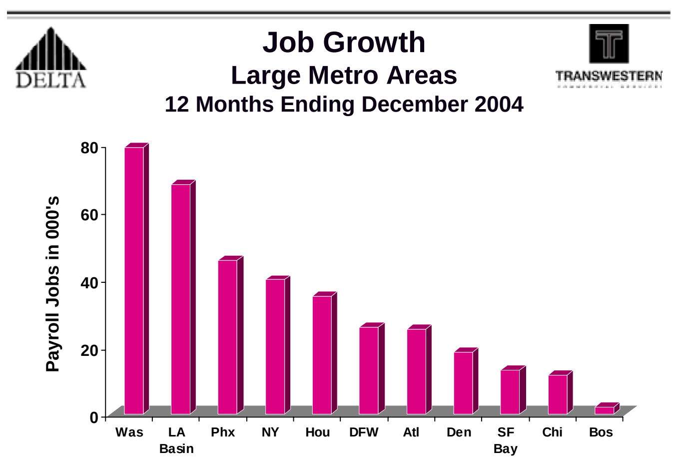
Payroll jobs rose by 2.2 million in 2004 – an average of 186,000 per month – as increased economic activity and business confidence led companies to hire.

The national economy will likely maintain steady growth over the next several years, with payroll job growth increasing in 2005 while GDP growth may moderate. Job growth will likely ramp up to 3 million per annum over the next several years – a 2.3% rate of growth. While modest by historic standards, this is sufficient to support job growth at the 3 million per annum level.

Robust business spending and the addition of payroll jobs have propelled us into a self-sustained phase of the national growth cycle. All major markets have now moved into positive job growth territory, with Boston finally turning around at year-end 2004. ***Rising interest rates will accompany our job growth and increased spending, which will have a profound impact on a capital intensive industry like real estate.*** Therefore, as we enter the expansion part of the business cycle, interest rates bear watching.



Source: Bureau of Labor Statistics; February 2005.



Source: Bureau of Labor Statistics; February 2005.

Office Market Conditions Rebounding

Office market conditions have improved significantly around the country over the past year. Absorption of office space is ramping up and the vacancy rate is declining steadily. As a result, office rents have stabilized nationwide and have been rising in several metro markets since the summer of 2004.

With market conditions rebounding, we are being asked the following questions:

1) **When will rents begin to spike in this cycle?**

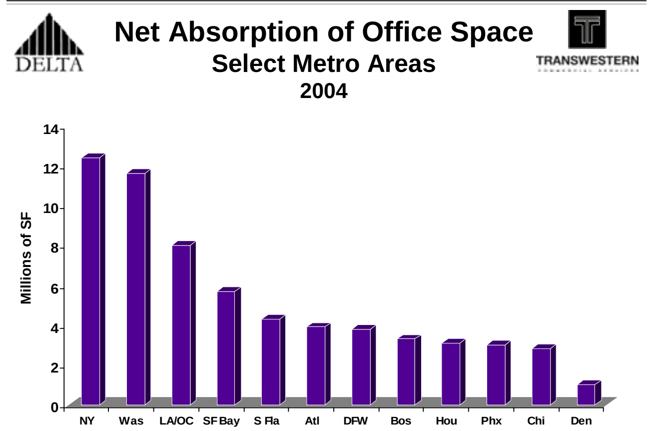
2) **When should developers begin speculative construction in order to deliver product into the sweet spot of rent spikes?**

To answer these questions, let's start with a look at the market fundamentals of absorption, vacancy and construction outlook.

Absorption of Office Space Increasing

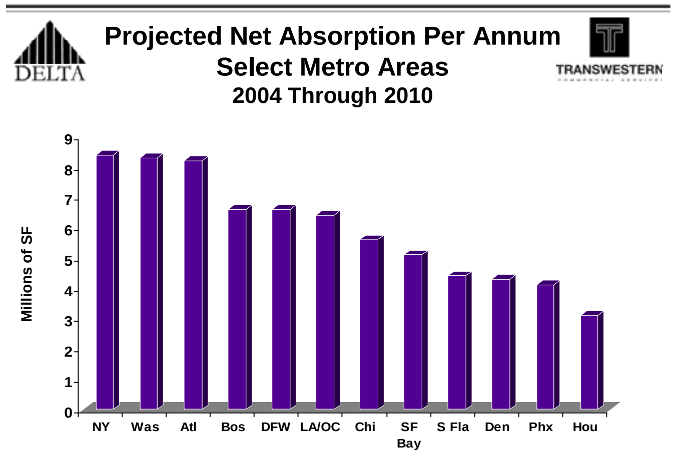
Net absorption of office space has rebounded in most markets, due to strong corporate profits and the resumption of payroll job growth. In addition, much of the sublease space that was thrown on the market in 2001/02 has now been leased or reverted to direct space; for the most part, it is no longer acting as a drag on the market in most metro areas.

The **New York** area bounced back strongly in 2004, after a very rough period from 2001 to 2003. Meanwhile, the **Washington** metro area held up well throughout the downturn, due to the presence of the Federal government and government contractors. And **Southern California** performed well due to strong government contracting combined with port activities.



Source: CoStar, Delta Associates; February 2005.

As detailed in our 2004 publication, "National Office Market Recent Trends and Forecast," **New York**, **Washington, Atlanta, Boston, Dallas and LA** will likely lead the nation in office space absorption in the period 2005-2010, fueled by strong job growth and a high proportion of office-using jobs. Annual average net office absorption will likely increase in most markets during this expansion, due to an increase in the absolute number of new jobs being created. In spite of improved productivity and off-shoring of some service jobs, our surging population and the creation of new technologies will drive job growth higher, even while employment growth rates slow.



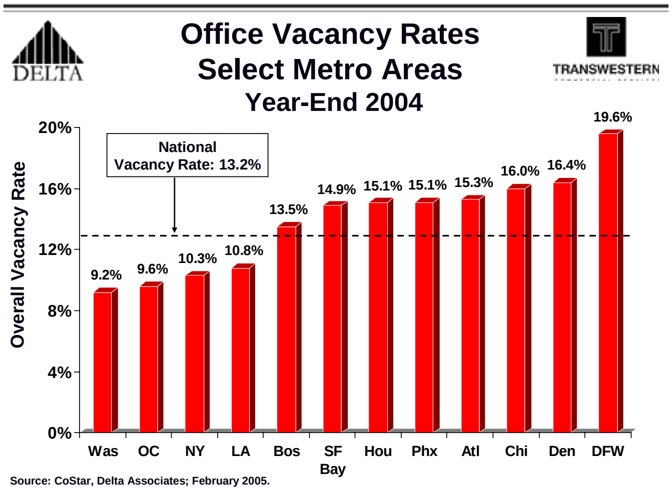
Source: Delta Associates' "National Office Market Recent Trends and Forecast, August 15, 2004"

Delta Outlook
A market report for commercial real estate executives

Office Vacancy Rates Declining

The nation's overall vacancy rate (including sublease vacancy) for office space declined to 13.2% at year-end 2004, from 16.0% a year ago.

Larger and more mature markets – those with high barriers to entry – generally maintain the lowest vacancy rates, while those with lower barriers to entry – generally the Sunbelt cities – are at the upper end of the spectrum.



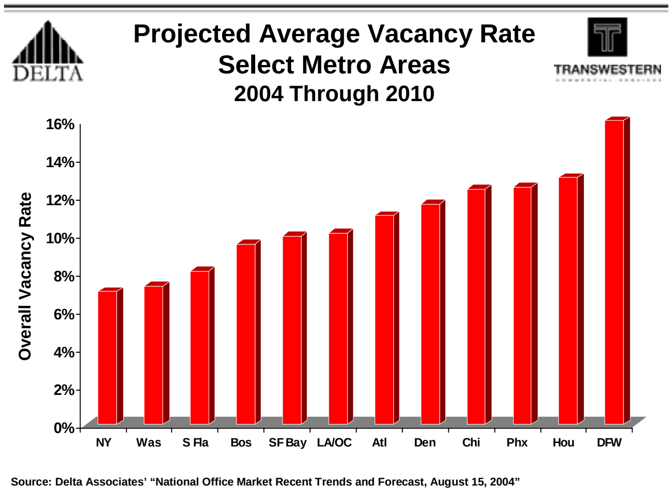
Source: CoStar, Delta Associates; February 2005.

Average vacancy rates have trended lower over the past two decades, as markets have matured, and the cycle ahead will likely be no exception. Current vacancy rates, though still elevated, are lower in most markets compared to the level of the early to mid-1990s. Unless new development in these markets returns to 1980s-like levels, then the average vacancy rates in these markets through 2010 will be lower than they were in the 1990s.

New York, **Washington** and **South Florida** will likely maintain the lowest average vacancy rates during the next expansion – below 9%. While this rate is very low, these markets came out of the recent downturn with very low vacancy rates, compared to the previous cycle:

	1992	2003
• New York	17.2%	11.2%
• Washington	15.6%	11.2%
• S. Florida	18.7%	12.3%

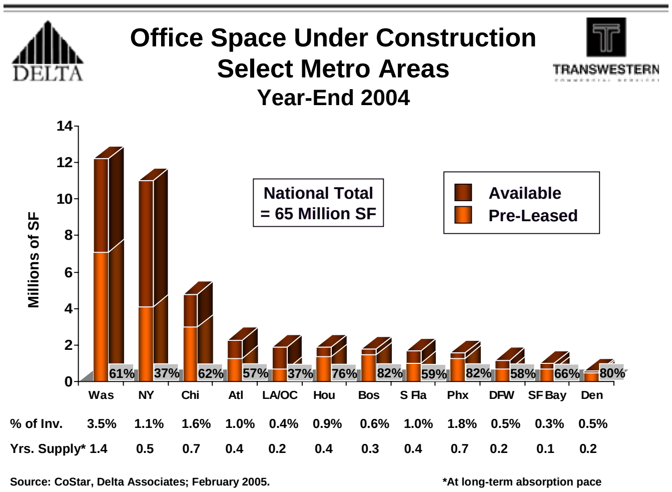
At the other end of the spectrum, Dallas will likely maintain an elevated vacancy rate, although well below its average of the prior cycle.

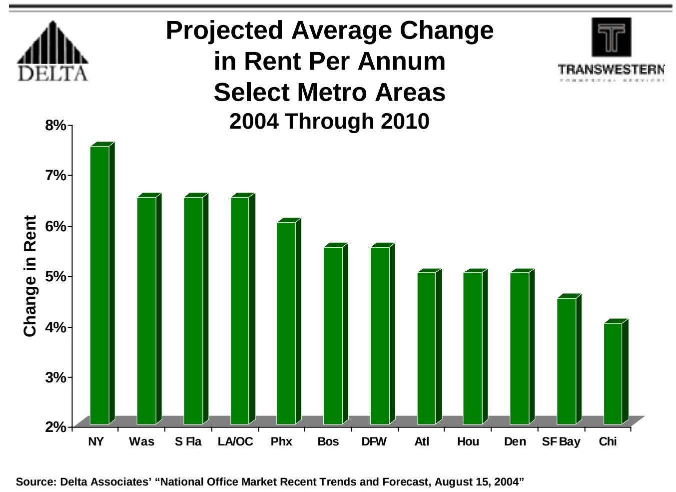


Source: Delta Associates' "National Office Market Recent Trends and Forecast, August 15, 2004"

Office Construction

Levels of new office construction remain modest in most markets, except for Washington and New York. However, much of the new supply in the Washington metro is pre-leased to the Federal government. Nationally, 51% of the office space under construction at year-end 2004 is pre-leased.





Office Rents Consolidating

Rents have begun rising modestly in some of the stronger metro markets – Washington, Los Angeles, Orange County – while they have stabilized in most other markets around the country. However, concessions continue to impact the bottom line in many others.

Rents in most markets will likely begin rising this year, although increases will vary substantially by market. Rent growth of approximately 3% to 4% per annum should be realized from 2005 to 2007, with rent spikes occurring as soon as 2006 – in Los Angeles and Orange County. Rents spikes in Northern Virginia will likely ensue in 2007.

New York, **Washington**, **Southern California** and **South Florida** will likely experience the greatest rent growth during this expansion cycle. In addition to low vacancy and substantial economic growth, the average vacancy rate in these markets during the expansion will likely be well below their historical equilibrium vacancy rates.

Office Market Outlook: Bright

The expansion cycle of the office market is underway, powered by steady economic growth, corporate profits and the elimination of excess capacity over the past several years. As businesses re-invest in technology, plants and equipment, economic growth has become self-sustaining. As a result, companies will continue to add employees and demand for office space will increase.

We expect absorption of office space to increase to very healthy levels over the next several years, as the economic expansion matures and sublease and shadow space burn off. Vacancy rates will decline steadily and rent growth will ensue. As a result, the need for new office supply will increase over the next several years and rising rents will eventually support the cost of new development.

This expansion cycle will likely run through the latter part of this decade – barring any external shocks.

DELTA ASSOCIATES
A TRANSWESTERN COMPANY

Conclusions

1) When will rents begin to spike in this cycle?

Rents will likely begin to spike as early as 2006 in Los Angeles and Orange County, as vacancy rates there plummet. Northern Virginia will experience rent spikes as early as 2007 in select submarkets, as market conditions there continue to strengthen. Rent spikes will likely follow in select submarkets in 2008 in Suburban Maryland and the District. Rent spikes will likely follow in other select submarkets in various metro markets around the country in 2008/09.

2) When should developers begin speculative construction in order to deliver product into the sweet spot of rent spikes?

With a construction timeline of 12 to 18 months (presuming land, zoning, and permits already obtained), developers should move forward with speculative construction the year before rent spikes will likely occur in order to hit the market in stride.

This means developers in Los Angeles and Orange County should already be preparing to move forward, while they should be gearing up in Northern Virginia.

Summary Conclusions for Select Markets

When Will Rents Spike in Select Submarkets?		When to Start Spec Constr. at Prime Locations?	
LA/OC	2006	LA/OC	2005
Washington	2007/08	Wash	2006/07
Atlanta	2008	Atlanta	2007
Chicago	2008/09	Chicago	2007/08
Houston	2008/09	Houston	2007/08
D/FW	2009	D/FW	2008

Source: Delta Associates; February 2005.

Note: For Select Submarkets in these Metros.

Delta Associates

Delta Associates, the research affiliate of Transwestern Commercial Services, is a firm of experienced professionals offering appraisal, consulting and data services to the commercial real estate industry for 25 years. The firm's practice is organized in three related areas:

1. ***Appraisal*** and valuation services for commercial real estate assets, loans secured by same, and real estate companies and fractional interests in them.
2. ***Consulting***, research and advisory services for commercial real estate projects, including market studies, market entry strategies, asset performance enhancement studies, pre-acquisition due diligence, and financial and fiscal impact analyses.
3. ***Subscription Data*** for select metro regions for office, industrial, retail, condominium and apartment markets.

For further information about Delta Associates and to see all of our publications, please browse our web site at: www.DeltaAssociates.com

Headquarters
Gregory H. Leisch, CRE
Chief Executive
500 Montgomery Street, Suite 600
Alexandria, VA 22314
703/836-5700; Fax: 703/836-5765
Greg_Leisch@DeltaAssociates.com

Consulting and Advisory Group
David Weisel
President, Consulting Division
500 Montgomery Street, Suite 600
Alexandria, VA 22314
703/535-3551; Fax 703/836-5765
David_Weisel@DeltaAssociates.com

Appraisal Group
David Lennhoff, MAI, SREA, CRE
President, Appraisal Division
8614 Westwood Center Drive, Suite 800
Vienna, VA 22182
703/749-9451; Fax 703/734-0214
David_Lennhoff@DeltaAssociates.com

Mid-Continent Office
Sara Rutledge
Associate Research Director
5001 Spring Valley Road, Suite 600W
Dallas, TX 75244
972/774-2520; Fax 972/991-4247
Sara_Rutledge@DeltaAssociates.com

Market Publications Group
Scott Price
National Research Director
901 MoPac Expressway South, Suite 520
Austin, TX 78746
512/314-5204; Fax 512/328-9309
Scott_Price@DeltaAssociates.com

Cyber Contacts
Website: http://www.deltaassociates.com

General eMailbox:
info@DeltaAssociates.com

DELTA ASSOCIATES
A TRANSWESTERN COMPANY