

The Growing Disparity Between Job Growth and Office Absorption Washington Metro Area

The Washington metro area continues to experience economic growth, as the office vacancy rate remains low and jobs are added at an above-average pace. **However, office demand has been light relative to job growth this year.** Since job growth typically translates into need for office space, the light demand experienced to date in 2006 has questions about the factors contributing to this apparent disconnect. Here we explore the reasons for this phenomenon, including:

1. A transition in the economy
2. The timing of leases and shadow space
3. Construction activity
4. Office design and tenant preferences
5. Hesitation by the GSA
6. Advances in technology/productivity

Payroll Job Growth and Absorption

Through the 3rd quarter 2006, the Washington metro area experienced below-average office absorption, while jobs continued to be added at an above-average pace. During January to September 2006, 4.5 million SF was absorbed. Job growth is forecasted to tally 65,500 new jobs in 2006, which translates into a need of 7.2 million SF of office space for the year. In order to reach the absorption level based on job growth, roughly 2.7 million SF needs to be absorbed during the 4th quarter of 2006. This is possible but unlikely to materialize.

In 2004 and 2005, tenants leased more space than they needed, as absorption was greater than the need for space as derived by job growth. In 2006, tenants have not leased space at the same pace compared to the two prior years, despite a slight increase in the rate of employment growth compared to 2005. In an expanding economy tenants typically lease space beyond their needs, while tenants become more reserved about inking deals during the contraction phase of the economic cycle. This is explored further in this study.

Office Absorption vs. Payroll Job Growth Washington Metro Area 2004 – 2006			
	Actual Absorption	Job Growth	Need for Space ¹
2006	6.0 MSF ²	65,500 ³	7.2 MSF
2005	7.6 MSF	64,700	7.2 MSF
2004	11.6 MSF	71,200	8.9 MSF

¹ Absorption based on job growth.
² YTD absorption annualized.
³ Forecasted job growth.

Source: Delta Associates; October 2006.

Although absorption picked up in the 3rd quarter of 2006 after a soft 1st half, the 3rd quarter absorption total was not due to strong current leasing activity, but rather pre-leased deliveries where the deal was inked before 2006 and counted as positive absorption this year. YTD, 17.1 million gross SF of lease deals have been inked, which is below the pace of 37.7 million SF achieved in 2005. Absorption will remain solid during the 4th quarter, but is expected to be primarily due to deliveries, as YTD gross leasing activity has been sluggish.

Gross Leasing Activity Washington Metro Area 2004 – 3 rd Quarter 2006	
	Total Leased
YTD 2006	17.1 million SF
2005	37.7 million SF
2004	42.3 million SF

¹ Includes renewals.

Source: CoStar, Delta Associates; October 2006.

Factors Contributing to the Disparity

What possible factors could have contributed to the light demand experienced YTD in 2006? There is not one single contributor to the light demand, but rather several factors that appear to be occurring simultaneously. Many of these factors are themes we have discussed for several years with our clients, but never before have they occurred with enough impact, and at the same time, to depress demand in the way that the Washington area office market has experienced so far this year.

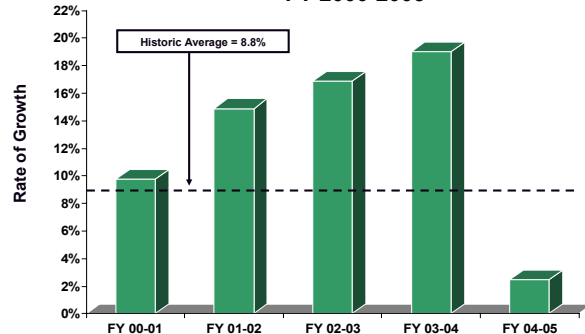
Transition in the Economy

Although the Washington metro area economy remains strong, the growth rate is slowing as the highest rates of employment creation are behind us for this cycle. With rising inflationary pressures driven particularly by increasing energy and construction costs, coupled with an easing in the rate of increase in Federal procurement spending, confidence in the future health of the area's economy is tempering. This has an impact on the attitude of tenants.

The greatest impact on the regional economy is Federal procurement spending. The presence of the Federal government is a major factor in the metro area's economy, given it generates one-third of the area's Gross Regional Product (GRP). Procurement spending represented 16.6% of GRP in 2005.



Year-Over-Year Increase Federal Procurement Spending Washington Metro Area FY 2000-2005



Source: Dr. Stephen Fuller, Delta Associates; October 2006.

The health of the commercial real estate market typically follows on the coattails of the economy. The metro area experienced robust growth during 2004 and 2005 – the height of procurement spending. But current conditions reflect that the office market is in the plateau phase of the real estate cycle. This phase occurs when economic conditions are peaking, as new supply outpaces slowing demand, causing vacancy to edge up and rent growth to ease.



Core Sectors of the Economy Washington Metro Area

	2004		2005	
	\$	%GRP	\$	%GRP
Total Federal \$s	\$108.2	36.4%	\$117.2	37.2%
Portion Procurement	\$51.1	17.2%	\$52.4	16.6%
Technology	\$47.3	15.9%	\$51.2	16.2%
Building Industry	\$18.7	6.3%	\$20.2	6.4%
Int'l Business	\$16.7	5.6%	\$17.3	5.5%
Hospitality	\$6.9	2.3%	\$7.2	2.3%
Other/Multiple Sectors	\$99.7	33.5%	\$102.3	32.4%
Total GRP	\$297.5	100.0%	\$315.4	100.0%

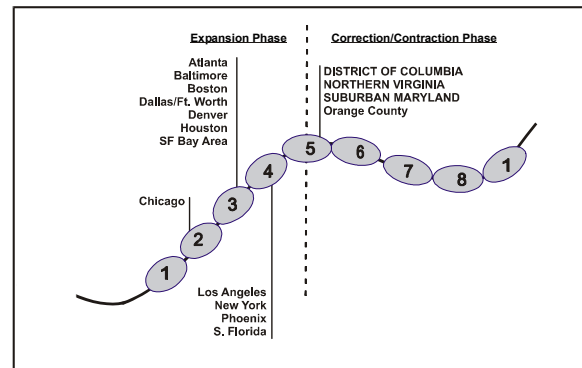
Sources: Dr. Stephen Fuller, Delta Associates; October 2006.

Note: 2004 figures are actuals; 2005 figures are estimates. Procurement figures do not include US Postal Service and FAA purchases.

Procurement spending has grown an average of over 8% per annum in the long term, and in double digits since 9/11/01. But in the most recent Federal fiscal year, it grew only 2.5%, and procurement spending growth is expected to ease even further in the period ahead, contributing to a slowdown in the area economy.



Commercial Real Estate Cycle Washington Metro Area



Source: Delta Associates; October 2006.

As procurement spending ramped up in 2003 and 2004, area contractors benefited and expanded in 2004 and 2005, leasing more space to accommodate growth. Notably, the Professional and Business Services sector's share of gross leasing activity expanded to 41.5% in 2005, from just 9% in 2001.

Growth in Gross Regional Product (GRP) Washington Metro Area 2004 – 2008

	Growth Rate
2004	4.6%
2005	4.2%
2006*	4.0%
2007*	3.8%
2008*	3.6%

*Projected

Source: Dr. Stephen Fuller, Delta Associates; October 2006.

Delta Outlook

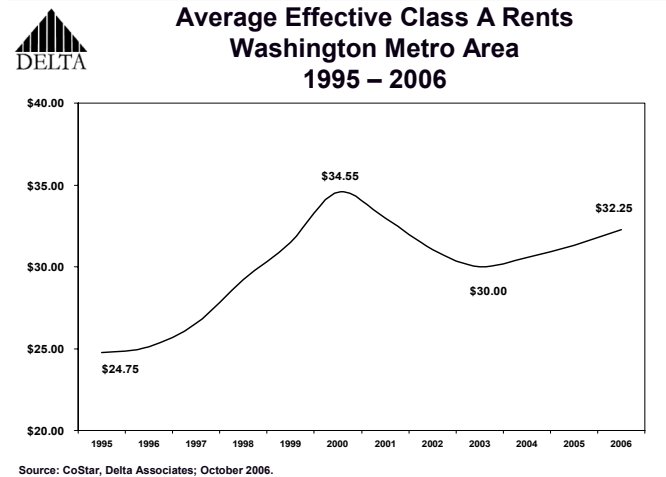
A market report for commercial real estate executives



The slowing of economic conditions, particularly procurement spending growth, is reducing the amount of office space needed. When future conditions are unknown, tenants become more cautious about leasing space, choosing to make no decision on leasing office space until the economic future is clearer. In addition, companies are more likely to hire contract or part-time help, as these types of workers require less work space than a full-time hire, which allows the company to “expand” its productive capacity without having to lease any additional space. The hesitation to lease space in 2006, given current economic conditions, is indicated in the gross leasing activity, as the YTD gross leasing activity is only 45% of the total achieved in 2005. Overall, this hesitation has impacted YTD absorption.

Timing of Lease Transactions and Shadow Space

During the expansion phase of 2003 - 2005, the Washington metro area experienced strong demand, as the direct vacancy rate declined by 220 basis points from the end of 2003 to the end of 2005. During the same time period, effective Class A rents increased by 4.3%, with the greatest increase occurring in 2005, with growth of 2.7%.



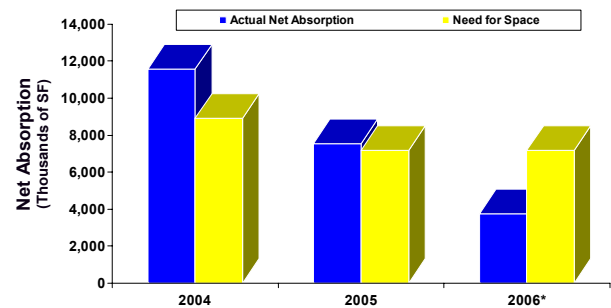
In the expansion phase, leasing activity ramps up, as companies are concerned they will not be able to find space in the future to suit their needs or budget. This is particularly true of larger tenants.

This was the case in 2004 and 2005, as absorption outpaced need for space, as derived from job growth. During this time period, companies in the Washington metro area leased more space than they needed, as growth was anticipated and executives feared few block options at a favorable rate would be available in the

future. In addition, the 2004 absorption was inflated by the Patent and Trademark Office (PTO) lease deal at the Carlyle development in Alexandria. However, absorption still outpaced the need for space in 2004 even if the 2.5 million SF of space leased by PTO is removed.



Net Absorption of Office Space in Washington Metro Area 2004 Through 2006



Source: Delta Associates; October 2006.

*Actual Net Absorption is Annualized.

Notable Lease Deals Signed for Future Occupancy Washington Metro Area 2004 - 2005

Sign Date	Move Date	Tenant	SF
4/2004	1/2006	GSA: Federal Supply Service	234,000
1/2005	1/2006	Fairfax County Public Schools	209,000
12/2004	6/2006	Chemonics International, Inc	138,000
10/2004	2/2006	Public Broadcasting Service	115,000
11/2005	6/2006	Development Alternatives, Inc	90,000
12/2005	5/2006	Federal Protective Services	65,000
8/2005	4/2006	Bates White, LLC	62,000
6/2005	1/2006	RTI International	51,000
10/2005	3/2006	General Electric Company	51,000
8/2005	7/2006	Natl. Endowment for Democracy	49,000
9/2005	2/2006	Buchanan Ingersoll PC	49,000
11/2005	6/2006	On-Site Sourcing, Inc.	43,000
6/2005	1/2006	Chicago Tribune Company	42,000
10/2005	4/2006	Constella Group, Inc.	42,000
9/2005	2/2006	Reed Technology Services	42,000
12/2005	5/2006	Robins, Kaplan, Miller & Ciresi	42,000

Source: CoStar, Delta Associates; October 2006.

Several large lease deals for existing space were signed in 2004 and 2005 and were captured as positive net absorption at that time. With many major tenants executing office space needs during 2004 and 2005, the need to seek space during 2006 has been diminished. This factor, coupled with changing economic conditions, has worked to curb absorption of space in 2006.

In addition, several companies that leased space during 2004 and 2005, which was captured as positive net absorption at that time, vacated their older space during January to September 2006. With move dates occurring during January to September 2006, the vacated space was placed back on the market and therefore generated "dis-absorption," leading to weaker YTD absorption totals.

Notable Move-Outs Washington Metro Area January to September 2006			
Chemonics International			
Sign Date:	12/2004	1717 H Street, NW	138,000 SF
Move Date:	5/2006	1133 20th Street, NW	83,000 SF
Public Broadcasting Service			
Sign Date:	10/2004	2100 Crystal Drive	115,000 SF
Move Date:	2/2006	1320 Braddock Place	145,000 SF
Development Alternatives, Inc			
Sign Date:	11/2005	7600 Wisconsin Ave.	90,000 SF
Move Date:	7/2006	7232 Woodmont Ave.	42,000 SF
Bates White, LLC			
Sign Date:	8/2005	1300 Eye Street, NW	62,000 SF
Move Date:	4/2006	2001 K Street, NW	57,000 SF

Source: CoStar, Delta Associates; October 2006.

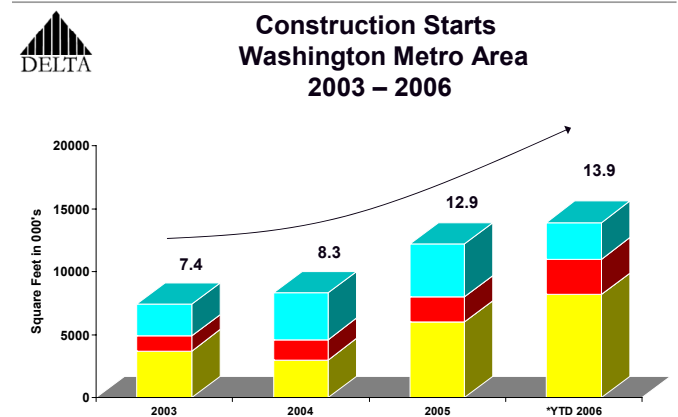
It should be pointed out that our net absorption figures are based on an economic vacancy rate. This vacancy rate more closely ties with job growth and economic performance and is a better indicator of market conditions than the physical vacancy rate.

In an expanding economy, most companies will lease more space than needed, typically around 5%. However, some companies will sign deals for roughly 20% more space than needed in order to lock-in a large block of space with ample room for future growth. This is typically referred to as **shadow space**, when companies purposefully lease extra space, even though it is not utilized at the moment. In a survey of metro area brokers, shadow space does not appear to be a significant factor impacting demand at this point in the cycle. However, we believe it plays a modest role. We believe that a handful of tenants leasing space in 2004 and 2005 signed for shadow space as they prepared for growth. Government contractors in Northern Virginia who may prefer single-tenant occupancy for security purposes are a source of shadow space. Also, some shadow space was created unintentionally, as decision makers overestimated space needs.

Construction Activity

As vacancy declines and rents increase during the expansion phase, developers begin to break ground on new construction projects in order to satisfy demand. However, during the start of the contraction phase, developers continue to break ground in hopes to deliver before a shift in the market occurs. When this occurs, supply may start to outpace demand.

An increase in construction activity occurred during the expansion phase of 2004 and 2005, as groundbreakings increased by 12% in 2004 and by 55% in 2005. YTD 2006, 10.5 million SF of new product was started. If construction starts continue at this pace, groundbreakings for all of 2006 will total 13.9 million SF, likely leading to overbuilt conditions in the metro area.



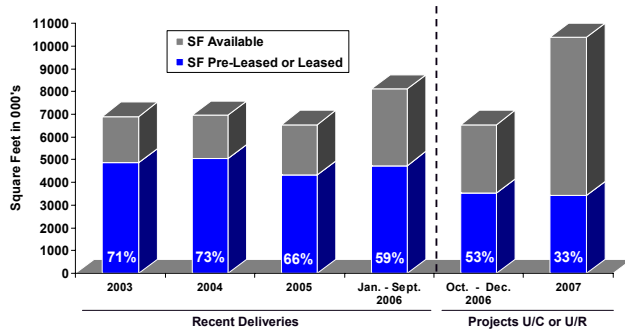
Source: CoStar, Delta Associates; October 2006.

*YTD 2006 Annualized.

As construction ramped up, occupancy rates for newly delivered space have declined. Since 2004, the occupancy rate on recently delivered space has decreased, from 73% pre-leased upon delivery in 2004 to 66% in 2005 and to 59% YTD 2006. Just over 6.5 million SF of new product is expected to deliver during the 4th quarter of this year and is currently 53% pre-leased.



Pre-Leasing on Recent Deliveries and Projects U/C or U/R
Washington Metro Area
2003 – 2007



Note: Recent deliveries are based on % pre-leased upon delivery.
Source: CoStar, Delta Associates; October 2006.

In the contraction phase, when construction starts to outpace demand as pre-lease rates are declining steadily on new product and more spec development is underway, additional options become available to tenants. At this stage, rent growth may ease. Tenants are better informed than ever before and will take extra time to find the best space possible for their needs. Given the inflated pipeline in the metro area and decline in occupancy rates, tenants have myriad choices, causing them to be reluctant to sign lease deals too quickly as space continues to break ground in the area. This phenomenon also contributes to a slowdown in leasing activity and, hence, absorption.

Office Space Design and Tenant Preferences: A Reduction in Space Use Per Worker

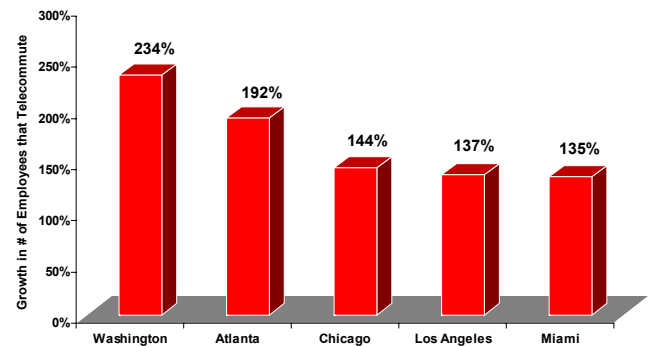
According to the Metropolitan Washington Council of Governments (MWCOC), the Washington metro area has the third longest and the most costly commute in the nation. In fact, *Sperling's Best Places* has named the metro area the best place for telecommuting based on commute times, fuel prices, broadband availability, and the number of people able to telecommute given their job functions.

The telecommuting trend has caught on in the Washington metro area. The 2004 *State of the Commute* survey by MWCOC, released in June 2005, notes that a total of 12.8% of all regional employees telecommute, an increase from 11.3% in 2001. Respondents who telecommute use this arrangement, on average, 1.3 days per week, an increase from 1.1 days per week in 2001.

The Washington metro area ranked number one in telecommuting growth among top metros. The number of telecommuters in the metro area grew by 234% from 1980 to 2000.



Telecommuting Growth
Top Metro Areas
1980 Through 2000



Source: U.S Census Bureau; October 2006.

The number of metro area telecommuters has the potential to increase, as 16% of MWCOC survey respondents who do not currently telecommute are able and would telecommute in the future.

As economic growth slows, and gas prices and congestion remain high, more employees and employers will start to take advantage of telecommuting. According to MWCOC, one Washington employee telecommuting one day a week can save \$488 in transportation costs and \$2,708 in time savings each year. Given that a typical office is 20% to 40% unoccupied at any given moment, regardless if employees telecommute, employers can save on real estate costs, as companies are spending roughly \$350 billion in excess commercial real estate per year.

One method to reduce office space is hoteling, particularly in offices where staff, such as telecommuters, are frequently out of the office. Companies that implement hoteling do not assign employees to office space; rather, employees who intend to work in the office reserve space for however long they intend to work.

Hoteling allows companies to reduce their space needs based on physical occupancy. For instance, if a company with 100 office employees realizes that its space is 30% vacant at any given time, switching to hoteling can eliminate up to 30 offices, or approximately 6,000 SF. Such a reduction in space could save the firm \$180,000 in rent alone, if the tenant is paying \$30/SF.

In March 2006, the General Services Administration (GSA) issued a statement for agencies to implement telecommuting programs for their employees and to consider telecommuting as an alternative to acquiring more office space or facilities. Given that GSA leases 46 million SF in the metro area, or 13% of all office space, leasing activity will be significantly impacted as some agencies begin to implement this program.

Notably, the U.S. Patent and Trademark Office, located in the Carlyle development in Alexandria, started a telecommuting and hoteling program at the beginning of 2006. The agency plans to hire 1,000 new employees every year through 2008. Starting in 2006, the agency began moving 500 employees into the telecommuting program each year, which will free up office space to accommodate the addition of new employees without having to rent additional space. Due to PTO's space saving measures, PTO forgoes having to lease approximately 200,000 SF per year more for its new employees.

Private companies are also taking advantage of hoteling. Accounting firms KPMG and Deloitte and Touche, both with offices in the metro area, intend to operate hoteling programs in their offices nationwide. In addition, Cisco Systems and Bank of America, with area offices, are following suit.

Companies are also reconfiguring the office floor layout in order to generate a more productive workforce and save on real estate costs. According to RTKL, an architecture firm, companies are using built-in office furniture, consolidating conference rooms, storing files electronically instead of in hard copy, reducing the number of offices and increasing open floor work environments with modular cubicles.

The International Facility Management Association (IFMA) reports that the average space allotted per worker has been decreasing consistently, as companies reconfigure office space and reduce the amount of space per worker in order to improve the bottom line. This trend is occurring in the Washington metro area, as the average office space per employee has declined steadily from 201 SF in 1997 to 192 SF in 2006.

Average SF Allotted Per Worker 1994 vs. 2002			
	1994	2002	% Change
Executives	289 SF	239 SF	17.3%
Sr. Managers	200 SF	169 SF	15.5%
Middle Managers	151 SF	126 SF	16.6%

Source: International Facility Management Association; October 2006.

For example, the American Council of Life Insurers, located at 101 Constitution Avenue, reduced its space by converting its floor plan from all private offices to smaller offices and an open workstation environment. In addition, the company consolidated several meeting rooms into one meeting room in a separate location, which could be rented out by other tenants.

The National Association of Industrial and Office Properties (NAIOP) states **the growth of alternative work environments will have a significant impact on the real estate industry, as demand for space will be reduced**, given that companies can cut real estate costs by up to 40%. A 2006 national study by the Boston Consulting Group found that 85% of executives expect a rise in the number of alternative work environments over the next five years.

Although tenants in the CBD and urban corridors are currently transitioning their office space into alternative work environments, some area architecture firms believe this trend will continue to strengthen and within 10 years more companies located outside the Beltway will follow suit.

As tenants reconfigure space needs in the Washington area, the changes will impact absorption. On average, tenants can reduce occupied space by 30%. This figure increases with offices that have transient staff that spend a significant portion of their time working outside the office.

It is very unlikely that every tenant in the metro area will adopt an alternative work environment, although if the total office space leased in the metro area is reduced by 10%, approximately 33.1 million SF would be returned to the market, accommodating four years of absorption at normalized levels of growth. Although this is an extreme example, leasing activity has and will be impacted as metro area tenants discover new ways to minimize occupancy costs.

% of Office Space Reduced and SF Returned to Market Washington Metro Area		
	Total SF Leased	Total SF Returned
20% Reduction	331 MSF	66.2 MSF
30% Reduction	331 MSF	99.3 MSF
40% Reduction	331 MSF	132.4 MSF

Source: Delta Associates; October 2006.

Hesitation by GSA

With the Base Realignment and Closure (BRAC) announcement came security guidelines for the GSA to follow. The security guidelines include such measures as shatter resistant windows and 82-foot building setback requirements. Given these guidelines, locating space that fits the security criteria is a difficult task for the GSA, which is made more difficult as the government continuously changes the criteria to keep up with new security threats.

The security standards became mandatory for new GSA leases in late 2005 and will become mandatory for lease renewals in 2009. Numerous GSA leases are currently active with contracts expiring in 2008 and 2009. Given the lack of buildings adhering to the security guidelines in the metro area, evolving security criteria, and ample time before current lease contracts are up, the GSA is likely to be quieter on leasing space until an efficient approach is determined for transferring employees to security-conscious buildings. Due to GSA's vast presence in leased space in the metro area, the hesitation from this agency is being reflected in tempered demand.

Advances in Technology/Productivity

Technology has advanced, to the point where automated systems are able to handle tasks once performed by employees. Companies continue to hire skilled workers, but are discovering ways to automate clerical roles.

For example, over the past three years, Focuspoint, Inc., a Washington area company, has expanded its number of skilled workers, but has not expanded its clerical staff due to advances in technology, according to a recent article in the *Washington Post*. Some companies have eliminated the need for payroll staff, as technology companies now provide affordable automated payroll services, many located outside the metro area.

Given advances in technology, the need for certain types of workers has diminished in the metro area. When companies expand, but do not increase administrative positions, the need to lease additional space for those positions is eliminated. We can grow our businesses without growing our staffs or the space we occupy.

Outlook

The Washington metro area continues to experience solid economic and commercial real estate growth. However, a change is occurring in the way we utilize office space. With economic uncertainty, coupled with Federal procurement spending growth easing, tenants are becoming judicious about leasing space, and are trying to make decisions that ultimately will generate efficiencies and improve the bottom line. As tenants have become more careful in approaching the leasing process, demand has lessened relative to job growth. Although this study delves into several possible factors behind this disparity, there is no single factor that is responsible. Rather, the combination of all the factors working simultaneously is weakening leasing activity in what remains a healthy regional economy. We expect office space absorption to be lower relative to job growth in the future than we have seen in the past.

Delta Associates

Delta Associates, the research affiliate of Transwestern, 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.

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