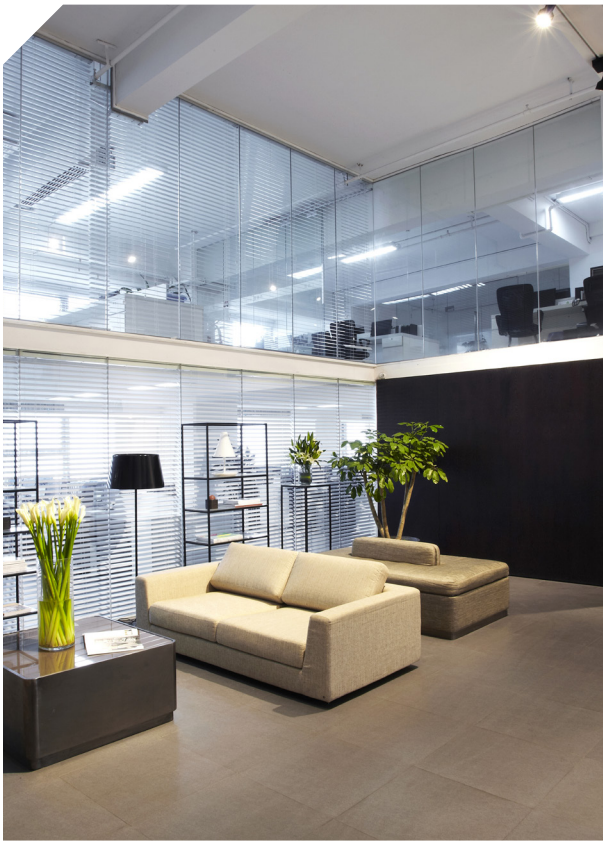
UNDERSTANDING THE ECONOMY

AUGUST 2013

DELTA ASSOCIATES



IS THE FLIGHT TO QUALITY FOR U.S. OFFICE SPACE FADING OR ENDURING?

During the recession of 2007-2009, and in its immediate aftermath, U.S. office tenants sought ways to reduce occupancy costs. One approach that some tenants chose was densification – a reduction in the amount of space leased per worker. This was often accomplished by either the downsizing or elimination of private offices, or by the implementation of telecommuting or hoteling programs. Smaller workspaces, shared desks, and fewer employees in the office at one time – all of these tactics could lead to less space under lease and lower occupancy costs.

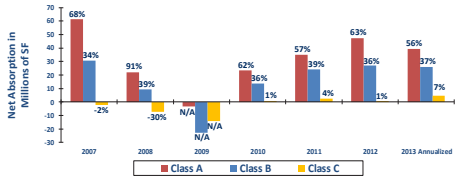
A second approach that some tenants chose was to seek more efficient space. Often, such a strategy required a move to newer space that was simply better constructed, with fewer columns, greener building systems, better built-in technology, and greater flexibility in the interior design. The notion that moving to newer, more functional space could also lead to a reduction in occupancy costs proved attractive, and it led to a "flight to quality" – an increase in the amount of Class A space that was absorbed compared with Class B and C space.

In 2007, as economic conditions began to weaken nationally, Class A space secured 68% of all net new demand. By 2008, that figure shot up to 91%, as indicators of a recession became clear and overall demand contracted; while fewer tenants were seeking new space, those that were found that better deals on premium accommodations were becoming available to them. In 2009, U.S. office absorption was negative, including for Class A space, though those top-tier assets were not hit as hard by vacating tenants as Class B and C assets were.

From 2010 through 2012, as overall demand accelerated, Class A product captured 55% to 65% of net absorption. During the first half of 2013, the pace of new demand decelerated while the share going to Class A buildings remained in that same range. This occurred despite overall improvement in the U.S. economy – real GDP growth accelerated from 0.1% on an annualized basis during

NET ABSORPTION OF OFFICE SPACE

United States | 2007 – First Half 2013

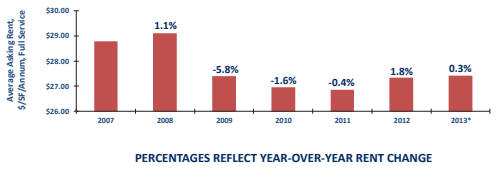


PERCENTAGES REFLECT SHARE OF TOTAL U.S. OFFICE ABSORPTION

Source: CoStar, Delta Associates; August 2013.

Note: Percentages may not total to 100% due to rounding. Shares for 2009 are not available because U.S. total absorption was negative.

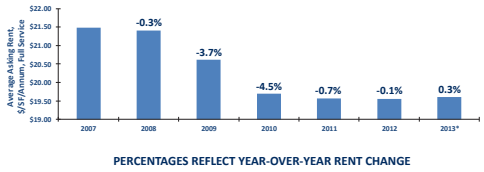
AVERAGE RENTS FOR CLASS A OFFICE SPACE
United States | 2007 – First Half 2013



Source: CoStar, Delta Associates; August 2013.

**Average rent as of mid-year 2013; percentage change from year-end 2012 through mid-year 2013.*

AVERAGE RENTS FOR CLASS B OFFICE SPACE
United States | 2007 – First Half 2013



Source: CoStar, Delta Associates; August 2013.

**Average rent as of mid-year 2013; percentage change from year-end 2012 through mid-year 2013.*

the fourth quarter of 2012 to 1.1% in the first quarter of 2013 and then to 1.7% in the second quarter of 2013.

Is the plateauing of the Class A share of absorption the new normal, or might the flight to quality that we saw during the recession continue? And if the flight to quality is tapering, why might that be?

If the flight to quality is tapering, it may be because the discounted Class A rents that tenants took advantage of from 2009 through 2011 are not as cheap anymore. In 2012, Class A asking rents were rising at an average rate of 1.8% while Class B rents were edging down 0.1% nationally, reflecting the flight to quality over the prior few years, driven by tenants' goal of greater efficiency in their use of space.

Tenants took Class A space off the market while rents were low, and this increase in demand caused owners to eventually push rents higher. Indeed, in 2013, Class A and Class B rents have increased at the same rate, 0.3% during the first half of the year. Higher-end space is no longer the bargain it was from 2009-2011.

Still, Class A space, particularly newer product, continues to offer the advantages of layout, energy efficiency, and technological amenities that most Class B and Class C properties cannot. For that reason, we expect the flight to quality to continue, though the gap between Class A and Class B demand may narrow some. Because economic growth has been modest, Class A rents remain affordable in most markets – by historical standards – with growth rates below the long-term average. This will encourage tenants to seek out better accommodations that in turn will allow them to stand out to potential employees as the competition for talent heats up along with the economy. At the same time, seeking out more efficient space today will allow long-term cost savings.

What can owners and tenants do at this pivot point in the real estate cycle? Owners, where feasible, may wish to renovate Class B space into Class A product that can compete over the long term. While Class A space is not commanding the same share of the market as it was five years ago, it is still the first choice many tenants will explore. Owners also may wish to acquire or develop product (where supply/demand fundamentals warrant) that stands out for its efficiency. Many large tenants have shown a willingness to pay a higher rent per square foot if they can lease fewer square feet.

For tenants, we suggest taking advantage of slowly-growing Class A rents to lock in deals that are favorable for the long term. In applicable markets, consider using the leverage of a modest pullback in net new office demand this year to secure concessions on higher-quality space.

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