



In This Issue...

The Bottom Line	1
Vacancy Rates	2
State of the Market	3-4
Rental Rates	5
Metro Spotlight	6-7

Office Market Trends

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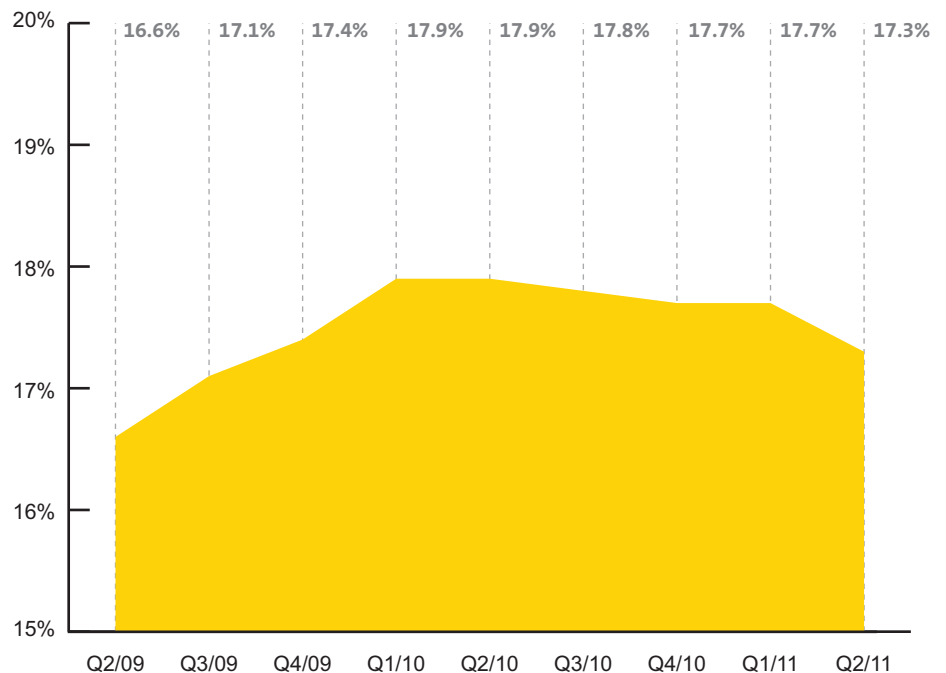
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Market Zigs as Economy Zags

US OFFICE VACANCY RATE*



* All classes of space

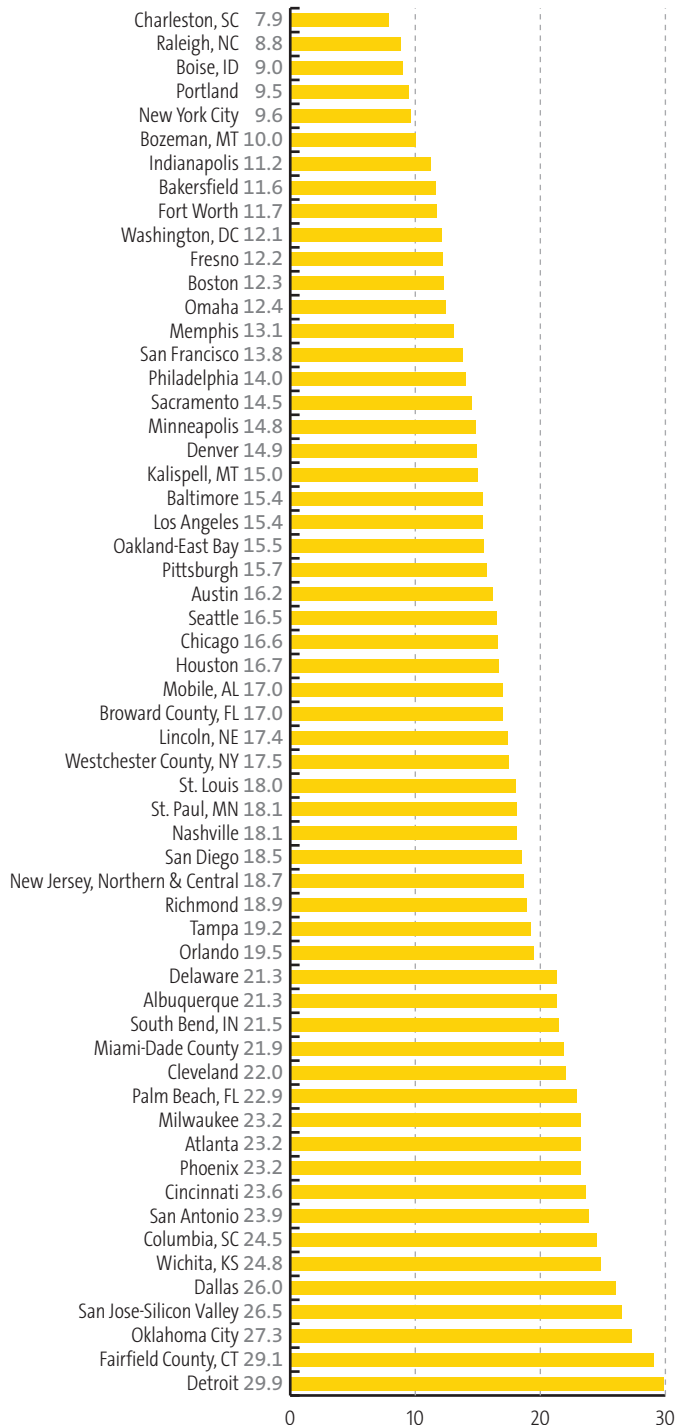
THE BOTTOM LINE

With the economy grinding down, one would think that the office market is close to stalling out. One would be wrong. Defying expectations, leasing activity surged in the second quarter, generating the strongest absorption since the last boom and pushing the vacancy rate lower by a stout 40 basis points... shades of recoveries past! Rental rates did not come along for the ride however, as average asking rates set new lows despite a noble assist from mini-rent spikes in a handful of tech markets. Concessions are less generous than they were a year ago for Class A space, but Class B and C buildings remain stuck in a tenants' market. Was the surprising second quarter absorption a delayed response to the stronger economy earlier in the year, or could it be that businesses, especially large and profitable ones, are more willing to take on multi-year space commitments than the recent economic data would suggest? Look for a modest recovery to continue in the second half of this year for both the economy and the office market.

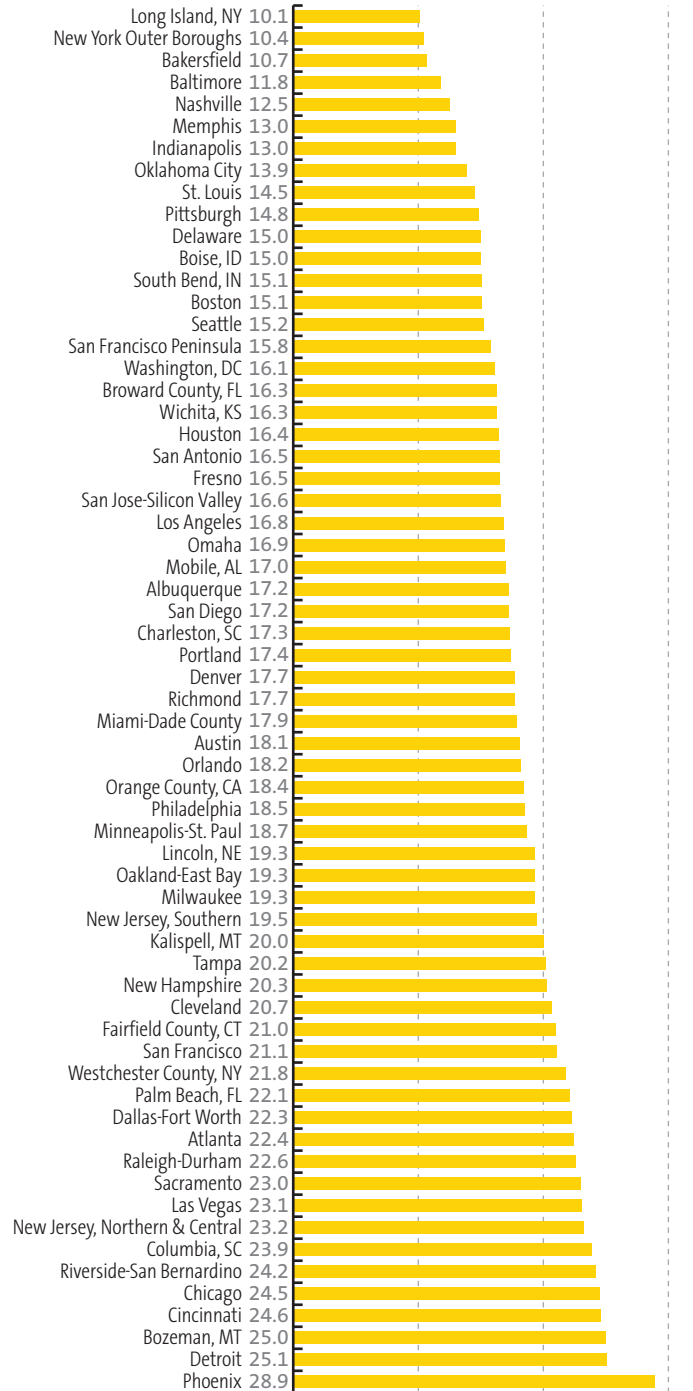
METRO VACANCY RATES

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

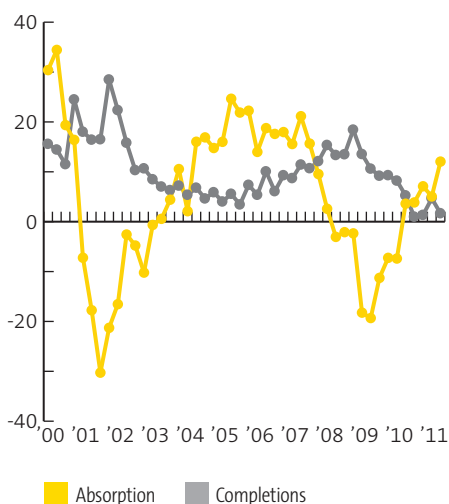


Suburban % Vacant

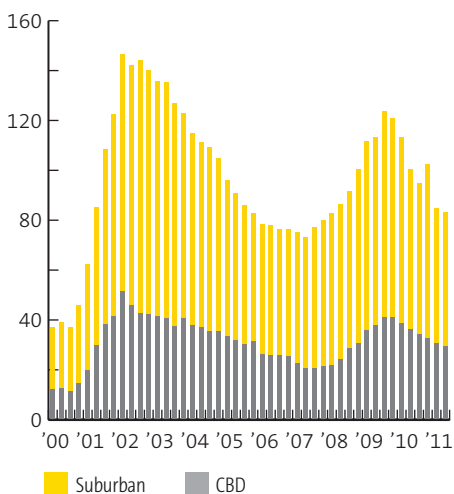


STATE OF THE MARKET

Absorption and Completions
in Millions of Square Feet



Available Sublease Space
in Millions of Square Feet



The market took a modest and—considering the poor economic news of late—an unexpected turn for the better in the second quarter. The vacancy rate fell by 40 basis points, which is a pace more in line with a typical market recovery than with the numbers posted in the last few quarters. However, at 17.3 percent, vacancy remains well above the 12–14 percent range that represents a balanced market.

- Some of the markets that flew the highest during the bubble years and fell the farthest when the Great Recession hit are now recovering the fastest. Over the past four quarters, vacancy declines were led by **Austin** (-316 bps), **Orange County, Calif.** (-252 bps), **San Francisco** (-219 bps) and **Seattle** (-206 bps). The technology industry is a common denominator shared by all of these markets.
- Some markets have yet to embark on a vigorous recovery cycle, however. Nineteen of the 60 markets tracked by Grubb & Ellis recorded year-over-year vacancy increases. **Southern New Jersey** (+268 bps) was at the top of the list as moderate demand from professional services tenants failed to offset downsizing by financial firms.
- At 14.7 percent, CBD vacancy remains well below the 18.7 percent rate in the suburbs, but the velocity of the recovery in the suburbs was greater in the second quarter—stronger absorption and less new space added. This is somewhat of a reversal from earlier trends that showed CBDs, particularly the 24-hour

downtowns, outperforming the suburbs. It's a positive sign in the sense that it suggests the recovery is spreading beyond a subset of markets.

Absorption totaled 12.0 million square feet in the second quarter. It was the strongest performance since the third quarter of 2007, which—not coincidentally—was the quarter when the financial markets first seized up, a harbinger of the collapse in September 2008.

- **Seattle** and **Washington, D.C.** topped all other markets, each absorbing just shy of 1.2 million square feet in the second quarter. In terms of velocity, absorption was strongest in **Seattle** and **Palm Beach County, Fla.** where occupied space expanded by more than 1.0 percent during the quarter.
- Second quarter absorption was negative in 14 markets with the highest negative totals in **St. Louis** at minus 218,000 square feet and **Cincinnati** at minus 114,000 square feet. In the first quarter, 23 markets posted negative absorption, and in the second quarter of 2010, that number was 26.

Deliveries totaled 1.7 million square feet in the second quarter, and space still in the construction pipeline remains very low at 19.5 million square feet.

- The new **Hess Tower** in downtown **Houston** accounted for about half of that. Hess will occupy the building in August, which will boost third quarter absorption at the local and national levels.

- About half the space under construction is in CBDs and half is in the suburbs.
- More than half of the total is located in **New York City** and the **Washington, D.C.** area, each of which have just over 5 million square feet in the pipeline.

This may be one of those rare occasions when the performance of the office market says more about the economy than vice versa.

Average rental rates showed little movement at the national level. The average Class A asking rental rate for space available at the end of the second quarter was \$31.06 per square foot per year, full service gross, a decline of 0.5 percent from the first quarter. The average Class B rate of \$22.91 was 0.1 percent below the first quarter. Preliminary numbers released last quarter suggested that rates might be turning, but those meager gains were revised away. Broadly speaking, the recovery has not yet progressed enough to push asking rental rates higher. But some submarkets, notably areas with growing technology companies, have already turned the corner.

- Class A asking rates in **San Francisco** are up by 15.5 percent over the past four quarters, leading all other markets, while Class B rates increased by an even more impressive 16.3 percent. The South of Market area has been especially strong as tech tenants seek creative space. **New York City**, with an increase of 10.2 percent, is the only other Class A market in the double-digits during this period, with gains particularly impressive in Midtown. Through the first half of the year, leasing volume in New York increased by 65 percent from the year-ago period.
- Markets posting Class A rent declines are huddled in Southern California and Arizona, including **Riverside-San Bernardino**, **Orange County**, **San Diego** and **Phoenix**, all down by 5 to 7 percent over the past four quarters. **Orange County**, with a sharp drop in second-quarter vacancy combined with rents that are still declining, shows how a volatile market can perform early

in a recovery cycle; asking rents are the last market indicator to show improvement in a recovery and, conversely the last to deteriorate in a recession.

- Effective rental rates have increased in a broader selection of markets as landlords have lightened up on concessions.

Sublease space moved lower by 1.5 million square feet to a total of 83.1 million square feet at the end of the second quarter. Sublease space has returned to a normalized level as it has been successfully leased or converted to direct available space when the leases expire.

- **New York City** topped all markets with 9.7 million square feet of sublease space. As a percentage of the total inventory, nearby **Westchester County** and **Northern and Central New Jersey** had the highest levels of sublease space at 3.6 percent and 3.4 percent, respectively versus 2.7 percent in New York. Both of those markets have various corporate headquarters facilities that were targeted for downsizing during the recession.
- Sublease space fell sharply in the **San Francisco Peninsula**, from nearly 1.2 million square feet in the first quarter to 735,000 square feet in the second quarter, a sign of strong demand from expanding tech companies.

FORECAST

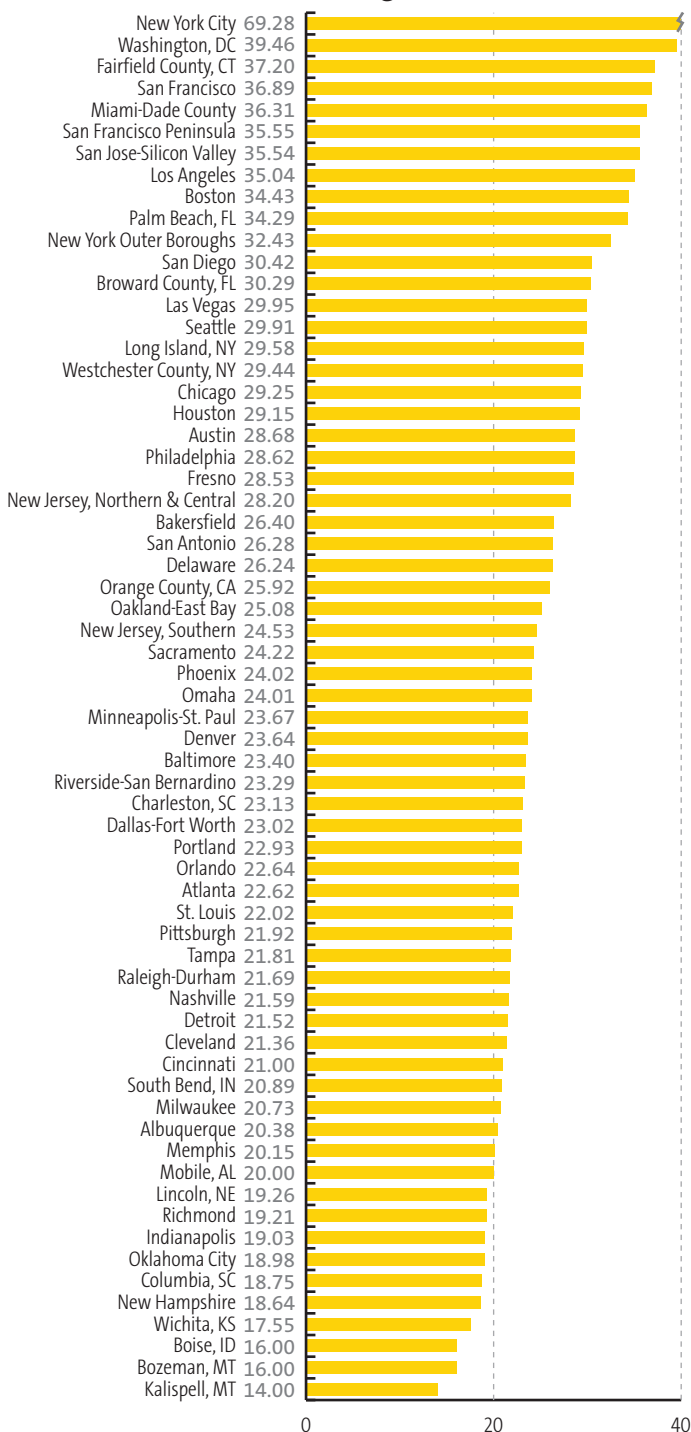
This may be one of those rare occasions when the performance of the office market says more about the economy than vice versa. Despite soft economic data in recent months, tenants absorbed space at a respectable clip in the second quarter, driving down the vacancy rate by 40 basis points to 17.3 percent. The office market is a lagging indicator, so this improvement could be related to the stronger labor market early this year, and it could be short-lived. But many economists still think a second-half pickup is possible, which would sustain the office market recovery. Like the economy and the labor market, the office market is recovering slowly. Look for the modest pace of recovery to continue through the remainder of this year.

METRO RENTAL RATES

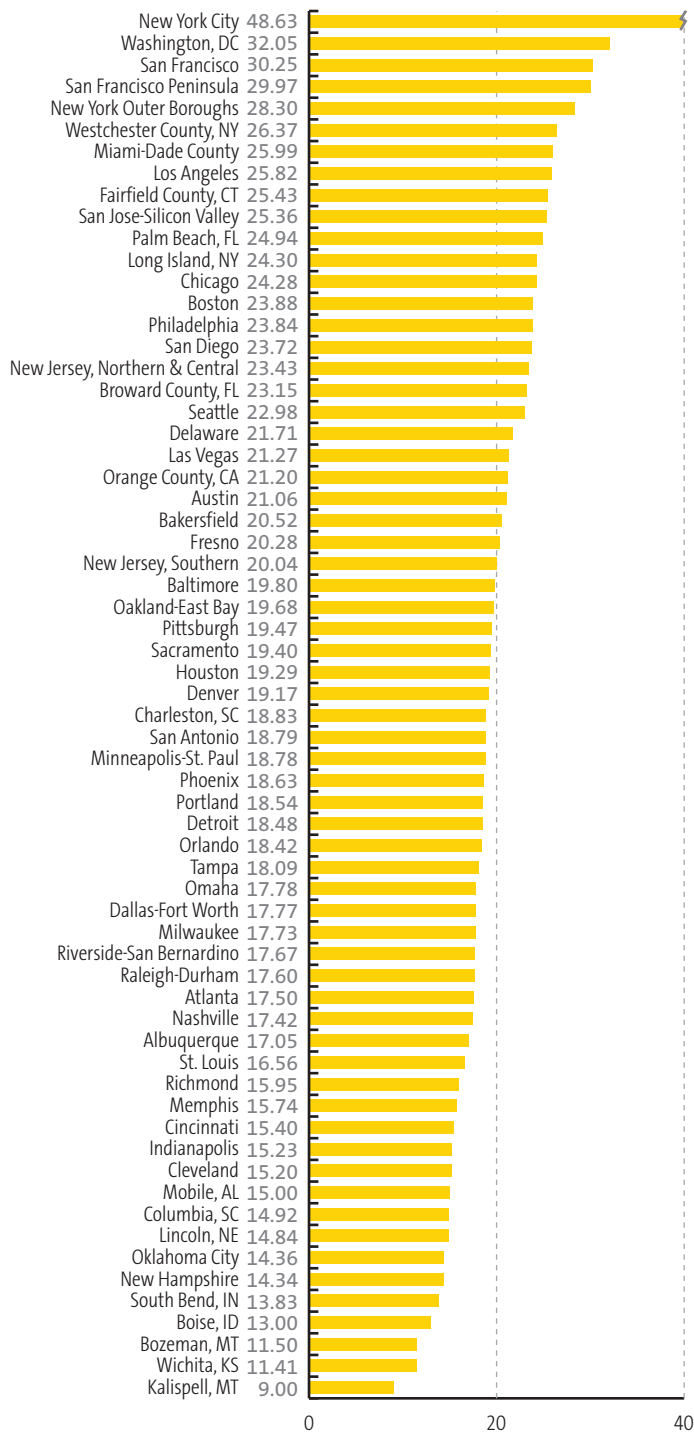
Note: Rental rate data refer to asking rates for space that is available on the market at the end of the quarter. Rates are per square foot, quoted on an annual, full service gross basis.

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





NORTHERN CALIFORNIA/ PACIFIC NORTHWEST

Fresno: The market has posted three quarters of positive absorption. With new construction still limited, expect the market to continue firming... **Oakland-East Bay:** PG&E is looking for 100,000 to 150,000 square feet for consolidation and expansion... **Portland:** The largest project currently under construction is owner-built; Fisher Investments' new 293,000-square-foot office building in the Orchards submarket is expected to house 400+ employees... **Sacramento:** As the state cuts back, the cushion historically supplied by state leasing activity is no longer around to break the fall... **San Francisco:** Technology companies dominated market activity as rapidly expanding tech tenants competed for creative space and pushed rents higher. Alexandria Real Estate purchased 409-499 Illinois Street for \$295 million, and TMG Partners purchased 500 Terry Francois Street for \$91 million... **San Francisco Peninsula:** Large tenant requirements in the market, including Huawei, YouTube, Responsys, Zynga, and Ac-tuate, will keep market momentum positive... **San Jose-Silicon Valley:** Good Technology leased 80,000 square feet on Mary Avenue while Microsoft took 237,000 square feet at Moffett Towers and Box.net-leased 112,000 square feet on El Camino Real... **Seattle:** Sentiment in the market has improved with vacancy down 200 basis points from a year ago.



SOUTHERN CALIFORNIA/ PACIFIC SOUTHWEST

Bakersfield: Suburban submarkets are tightening further with an increasingly limited supply of larger blocks of space (10,000 square feet and up)... **Los Angeles:** Houlihan Lokey will relocate in November from sole occupancy of a 56,271-square-foot Century City building to a Class A high-rise trophy building across the street. Houlihan's move to 80,808 square feet of former MGM space

is a welcome sign of improving confidence in the market... **Orange County:** 4 Hutton Drive in Santa Ana was purchased by an Asian investor for \$37 million from Legacy partners for 40 percent less than its price in 2007—an indication of where values are now relative to the height of the market... **Riverside-San Bernardino:** CCIC North America, Inc, a Chinese firm with ties to the shipping industry, purchased 23,855 square feet in Rancho Cucamonga while American Medical Equipment acquired 26,590 square feet in Ontario... **San Diego:** UCSD Extension committed to 49,109 square feet in Governor Park, and AutoAnything leased 40,431 square feet in Kearny Mesa.



MOUNTAIN/SOUTHWEST

Albuquerque: The majority of deals are occurring in smaller spaces totaling less than 5,000 square feet. Overall interest is gaining momentum, but tenants are still reluctant to make long term deals... **Boise:** Slow but stable; rates have remained consistent. Deals are getting done, but they are taking a long time... **Bozeman:** There has been some absorption in the CBD, but expect the next few quarters to remain flat... **Denver:** Tenants are feeling a sense of urgency to renew or lock in longer-term leases as rates are beginning to creep up for Class A space... **Kalispell:** Demand for Class A and B product has decreased. The market is generally stagnant with little hope for an increase during the next few quarters as job growth has been meager... **Las Vegas:** While transaction volume has been stable this year, a majority of the leases signed so far have been new, versus the renewals or relocations that were common during the first half of last year... **Phoenix:** Larger corporate tenants make up most of the activity, with Apollo Group, JP Morgan Chase, CyraCom International, and Cognizant expanding. Construction activity has made strides with 165,290 square feet of

space completed and an additional three projects totaling 553,212 square feet under construction, all of which are fully pre-leased... **Reno:** Several significant leases in the CBD, Meadowood and South Reno submarkets have been the result of companies transferring from existing space, creating a churning effect with little impact on net absorption.



TEXAS/GREAT PLAINS

Austin: Competition from tenants is heating up with large contiguous blocks of space becoming sparse in the CBD. Tenants are weighing costs of being downtown versus relocating to the suburbs... **Dallas-Fort Worth:** Celanese will relocate its corporate headquarters to 110,000 square feet in Las Colinas' Urban Towers by September, and Union Standard Insurance Group is set to occupy 56,000 square feet in the building by November. Ericsson is expanding into an additional 260,000 square feet in Richardson... **Houston:** ExxonMobil confirmed it will construct a large office campus on 385 acres in The Woodlands that it will occupy in phases, beginning early 2014 with full occupancy by 2015... **Oklahoma City:** Growth from the oil and gas sector is boosting occupancies and rents in the CBD and Northwest Suburban submarkets... **San Antonio:** Only 172,487 square feet of multi-tenant office space is under construction, and developers are unlikely to kick off any new projects over the next year... **St. Louis:** The market remains sluggish at mid-year with no real signs of improvement. Clayton leads the market with the highest rental rates and a vacancy rate of 11.4 percent... **Wichita:** Developers are planning to convert several CBD office buildings into mixed-use residential/retail space. This will reduce available office space by more than 100,000 square feet.



GREAT LAKES/ OHIO VALLEY

Chicago: Demand downtown has been a result of expanding companies like Groupon; its recent short-term sublease had a major impact on the once-failing East Loop submarket even as the company continues to expand in its headquarters building in the River North submarket... **Cleveland:** American Greetings announced plans for its corporate relocation from Brooklyn, a suburb, to the mixed-use Crocker Park development in Westlake... **Detroit:** Quicken Loans owner, Dan Gilbert, acquired the 371,000-square-foot Dime Building in the CBD. He plans to offer incentives to attract tech companies... **Milwaukee:** Despite positive absorption of almost 99,000 square feet this quarter and 144,741 square feet for the first half of 2011, the vacancy rate has remained around 21 percent over the past five quarters... **Minneapolis:** In the warehouse district, a \$50 million renovation of the historic Ford Center near Target Field is underway. The building has signed HGA Architects to lease 82,000 square feet and Olson, an advertising agency, for an additional 125,000 square feet... **South Bend:** Purchases have increased in all segments including office, which is a positive sign for recovery. However, sellers' expectations of value are rarely met.



NORTHEAST/ MID-ATLANTIC

Baltimore: The CBD has seen larger transactions recently. Tenants including PNC Bank, Ober | Kaler, Miles & Stockbridge, and Transamerica Life are moving from B+ buildings to older Class A buildings... **Boston:** Vertex Pharmaceuticals' 1.1 million-square-foot build-to-suit world headquarters broke ground with an expected completion date of 2013... **Fairfield County:** Bridgewater Associ-

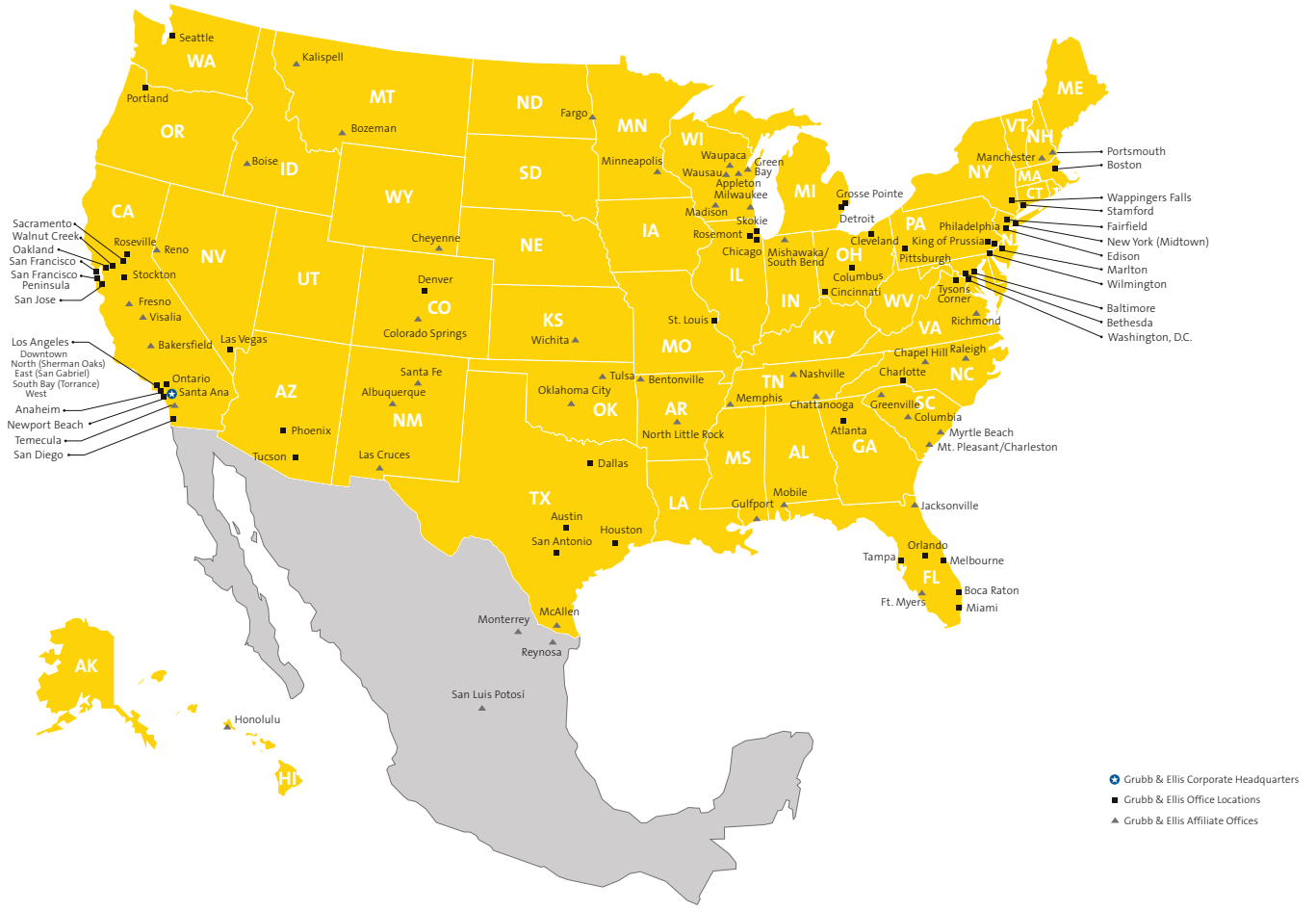
ates, a large investment manager, leased 227,998 square feet in Wilton... **New Hampshire:** Vacancy rose by 50 basis points in the second quarter... **New Jersey, Northern:** Despite the uptick in leasing velocity that produced nearly 1.5 million square feet of positive net absorption during the first half of 2011, any sustained improvement will hinge on a strengthening economy, which appeared to be stalling at mid-year... **New Jersey, Southern:** Financial service providers, the main source of occupancy losses in the recession, switched course and absorbed nearly 100,000 square feet over the last four quarters... **New York City:** A major Downtown tenant, Nomura, committed to a 900,000-square-foot, 20-year lease at World-wide Plaza in Midtown... **Philadelphia:** Growth is sluggish in the suburbs as the economy recovers in fits and starts. The CBD is doing better but not out of the woods just yet... **Pittsburgh:** The 2.3 million-square-foot U.S. Steel Tower was sold by AREA Property Partners and Winthrop Realty Partners to Mark Karasick and a group of investors... **Washington, DC:** Two speculative office buildings totaling more than 450,000 square feet, at the CityCenterDC mixed-use project, broke ground and are scheduled to deliver in two years... **Westchester County:** Atlas Worldwide Holdings signed a 120,000-square-foot renewal in Purchase, retaining 460 existing jobs and creating 50 new full time positions... **Wilmington:** Retraction by financial firms and pharmaceutical companies accounts for the bulk of occupancy losses over the past year. Looming space give-backs by the former Wilmington Trust, now M&T Bank, implies further demand deterioration for the CBD.



SOUTHEAST

Atlanta: North American Electric Reliability Corporation relocated its corporate headquarters from New Jersey into 40,000 square feet at Buckhead's Atlanta Financial Center, North Tower. ThyssenKrupp USA, Cotton States, Northpoint Ministries and BB&T cumulatively absorbed 158,706 square feet... **Broward County:** Second quarter absorption surged, approaching 182,000 square feet... **Charleston:** With less than 8 percent vacancy in buildings over 10,000 square feet, the CBD is healthy by any measure with limited choices for larger tenants looking to relocate downtown... **Columbia:** Many tenants have been migrating to higher quality space; the CBD has seen the most absorption... **Jacksonville:** A number of tenants are looking to expand, and some of this activity will translate into positive absorption by year-end... **Miami:** Payroll employment is up by about 15,000 from a year ago, generating first-half absorption of 466,000 square feet, evenly divided between the first and second quarters... **Mobile:** Activity remains the same with many lookers and few contracts. The employment outlook is bleak... **Orlando:** The CBD has weakened over the last few quarters while the suburban markets fared much better... **Palm Beach County:** The market absorbed nearly 300,000 square feet in the second quarter, but vacancy remains the highest of the three big South Florida metro areas... **Raleigh-Durham:** A few large new vacancies sent overall absorption back into the red, but Class A activity was positive as tenants migrated to higher quality space at discounted rates... **Richmond:** American Real Estate Partners purchased Riverside on the James, a 263,000-square-foot downtown Class A trophy building, for \$63 million or \$242 per square foot... **Tampa:** The market was tepid in the second quarter with net absorption of minus 95,000 square feet.

GRUBB & ELLIS OFFICE LOCATIONS



Office Market Trends United States Q2 2011