The Office Market Recovery Ahead

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Research

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For nearly three years, the office sector has epitomized the disconnect between the real estate investment markets and the space markets. Despite the sharp deterioration in office space market fundamentals in recent years, low interest rates and strong investor demand for core, income-producing properties have kept asset values from adjusting to the weaker underlying fundamentals. Unlike a decade ago, when excessive new construction and financial regulatory changes caused a wholesale withdrawal of capital from the real estate industry amid weakening demand and supply fundamentals, the ample liquidity and availability of relatively cheap capital in the current market downturn have continued to drive prices higher for certain assets while minimizing the distress among other property owners.

Although the dynamics in the real estate capital markets today and the catalysts for the current weakness in the office space markets differ radically from the market collapse in the early 1990s, conditions in the office space markets bear a striking and unfortunate resemblance to the depressed conditions a decade ago. The national office vacancy rate is nearly as high today as in the last downturn, and market rents have suffered declines similar in magnitude to the last cycle.

As the US economy gains strength and job growth resumes, however, the office space markets will recover. Exactly when, where and how quickly the recovery will occur is less certain, of course. Some markets will recover more quickly and more strongly than others. But the familiar space market cycle provides some insights into which office markets will be the most dynamic during the recovery phase of the cycle and how investors can take advantage of the opportunities the recovery creates. This report assesses the near-term outlook for the office space markets by reviewing the market recovery in the mid-1990s and examining the forecasts for the office market recovery over the next three years.

National Perspective of Two Recoveries

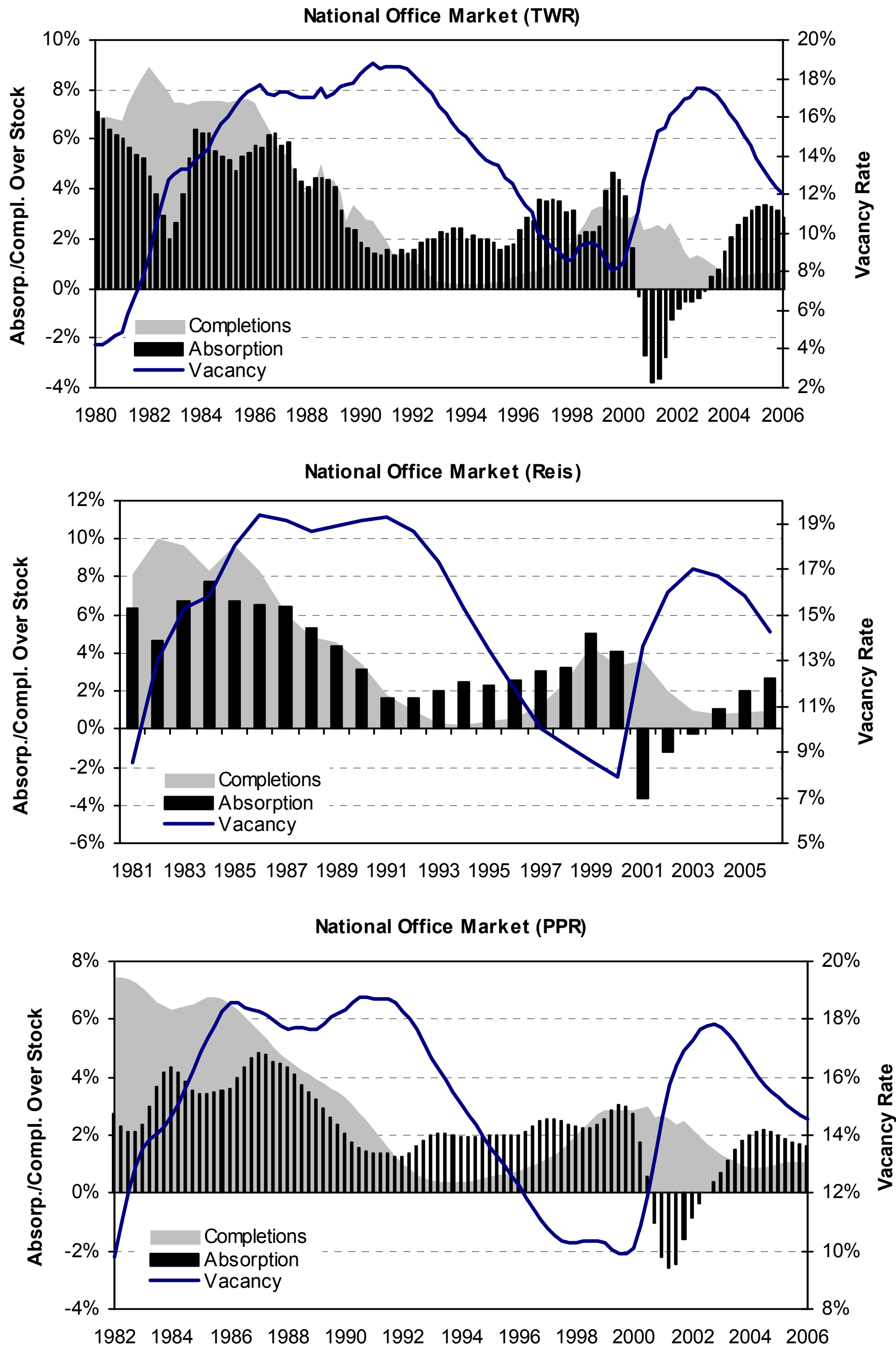
Exhibit 1 shows historical figures and forecasts for the national office vacancy rate, as well as absorption and completions (as a percentage of stock) from three data providers. As the charts clearly show, the national office vacancy rate is nearly as high now as in the early 1990s. According to Torto Wheaton Research (TWR), the average national office vacancy rate should peak this year at about 17.5%, roughly 130 basis points lower than the peak in 2Q92. Although vacancy rates in several office markets are higher today than during the last market downturn, the national vacancy rate is not expected to hit the peak reached in 1992.

After peaking this year, the vacancy rate should decline gradually over the next three years as the balance between supply and demand returns. By the end of 2006, TWR forecasts the national office vacancy rate will be about 12%, a relatively healthy level that should permit modest rent growth. Although forecasts from Reis and Property and Portfolio Research (PPR) are somewhat less optimistic than TWR's, both firms show a similar pattern of office vacancy peaking this year at levels close to the last downturn, before space market conditions improve in 2004 through 2006.

The charts also reveal an important (and widely discussed) distinction between the current market cycle, which was precipitated by a collapse in demand, and the supply-driven downturn in the early 1990s. All three data providers show the unprecedented period of negative absorption in the US office market that coincided with the collapse of the tech bubble and subsequent steep decline in the stock market. While this aspect of the current downturn has comforted some investors and suggests that better transparency and underwriting standards have benefited the real estate industry, the net effect on the space markets is the same. Too much space is too much space, whether it stems from excess supply or insufficient demand. Before rents can recover, the office market must work through the excess supply the same way it did during the last cycle, with rising vacancies, falling rents and increasing tenant concessions until the supply/demand balance returns.

Still, the familiar space market cycle offers hope that the office market recovery will resemble past recoveries. As the charts in **Exhibit 1** illustrate, new office supply has fallen dramatically since 2001 and should remain relatively constrained for several years before the supply pipeline begins delivering new space. This bodes well for market fundamentals once tenant demand resumes, which should occur sometime after the economy begins creating jobs again. Although job growth has been stubbornly weak since the US economy officially emerged from recession in 2001, employment data from the Bureau of Labor Statistics and weekly unemployment claims have shown favorable trends recently, which eventually should translate into increased demand for office space.

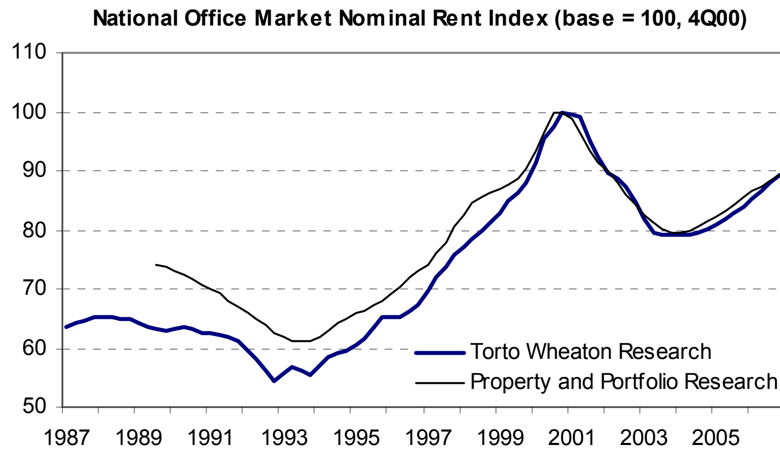
Exhibit 1: The Space Market Cycle is Alive and Well

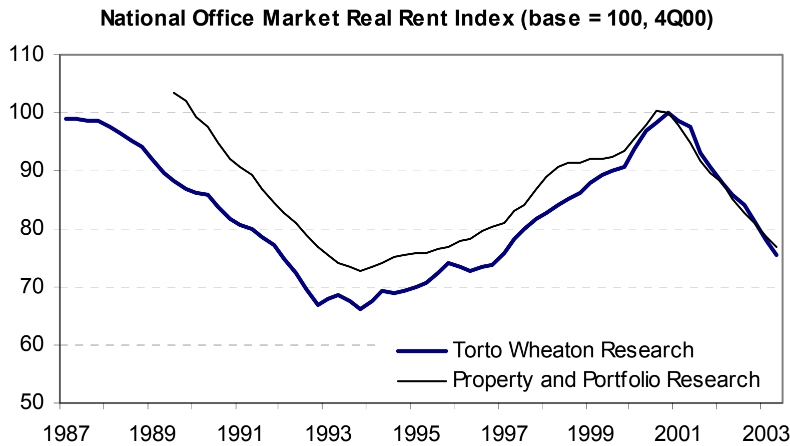


Sources: Torto Wheaton Research; Reis; Property and Portfolio Research; Prudential Real Estate Investors

Constrained supply will be essential for property owners to increase rents as the balance of power in the leasing market shifts back in their favor. Since peaking in 2000, nominal office rents have fallen by about 20%, and effective rents are down even more. Although rents will likely fall further as demand accelerates and landlords compete more aggressively for tenants, national office rents are near the bottom of the rent cycle and should resume growth over the next few years (see **Exhibit 2**).

Exhibit 2: Office Rents Approaching Cyclical Low





Sources: Torto Wheaton Research; Property and Portfolio Research; Prudential Real Estate Investors

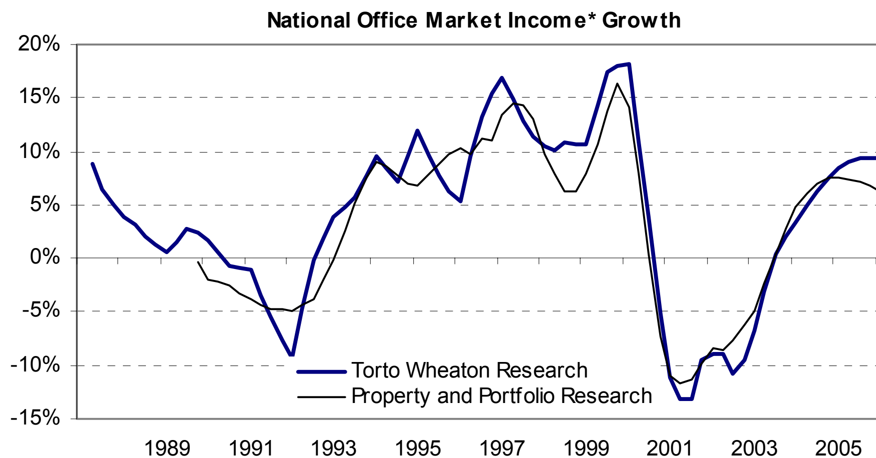
In the market downturn of the early '90s, real office rents fell more than 30% from peak to trough, according to TWR. After rents hit bottom, rent growth did not begin to climb steadily until 4Q93, seven quarters after national office vacancy peaked. If office vacancies peak this year and the rent cycle follows a pattern similar to the last recovery, office rent growth should resume in 2005, or about one year later than is currently forecast by TWR and PPR. (Both firms are forecasting modest nominal rent growth in 2Q04.)

When office rent growth will resume and how quickly rents will rise depend heavily on the strength of the ongoing corporate recovery and on employment growth. Between 1993 and 2000, nominal rent growth averaged 11.5% per year. The robust growth during the previous recovery

pushed the national office market real rent index up to its late-1980s peak, where it remained briefly before tenant demand collapsed in 2000. The 20% decline since the most recent peak provides ample room for rent growth over the medium- to long-term. But without some clearer indication of which sector(s) will lead the recovery in office demand, most analysts expect a more muted rebound than during the mid-1990s. TWR and PPR, for example, forecast about 4% nominal rent growth over the next three years.

Even a modest pickup in demand along with renewed rent growth could give a significant boost to office property income, however. **Exhibit 3** shows the severe decline in office income after the market peaked in 2000. The sharp drop underscores the suddenness of the collapse in demand. Income growth plummeted from more than 16% in the 3Q02 to below –11% in 2002. But income growth should rebound, as it did during the last office market recovery, if the occupancy and market rent forecasts are realized. Based on TWR's estimates, office income growth should reach about 9% in 2006 – about the same as in 1994.

Exhibit 3: Falling Vacancies and Rising Rents Lead to Income Growth



* Income = Rent x Occupancy

Sources: Torto Wheaton Research; Property and Portfolio Research; Prudential Real Estate Investors

MSA Perspective of the '93-'95 Recovery

While the unprecedented capital market conditions hamper predictions of office investment performance in the near-term, investors can be sure that the space market recovery will occur unevenly across markets and regions. This was certainly true during the last cycle, when southern office markets began to rebound first, while markets in California, which lagged the rest of the country in the last economic cycle, recovered much more slowly. As **Exhibit 4** shows, the different regional recovery rates caused wide variations in investment performance. The south region of the NCREIF Property Index (NPI) significantly outperformed the overall NPI and the west region in particular from 1993 through 1995.

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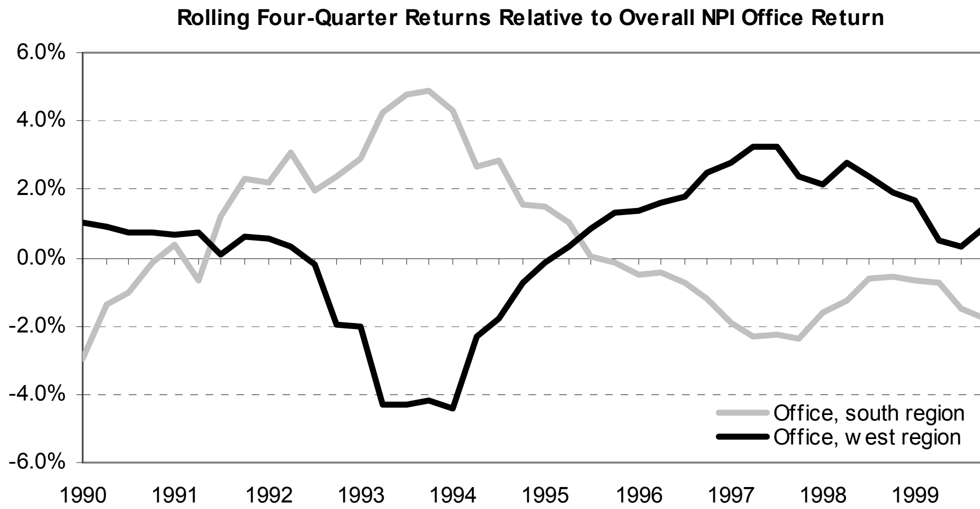
Exhibit 4: Regional Performance Can Vary Widely



Sources: NCREIF; Prudential Real Estate Investors

Generally, the markets where the supply/demand balance improved the most also had above-average employment growth. **Exhibit 5** shows the top and bottom 20 MSAs based on employment growth from 1993 through 1995.[1] Over these three years, employment growth ranged from about 10% to nearly 30% in the top 20 MSAs and from less than 1% to about 6% in the bottom 20. Most of the high-growth markets (16 of 20) are in the Sun Belt, where population growth has outpaced the national growth rate for several decades. Most of the bottom 20, by contrast, are in the northeast and California.

Exhibit 5: Employment Growth Over 1993-1995 (%, not annualized)

Top 20 MSAs		Growth (%)	Bottom 20 MSAs		Growth (%)
1	Las Vegas, NV	28.4%	1	Milwaukee, WI	5.7%
2	Phoenix, AZ	22.5%	2	Norfolk, VA	5.6%
3	Austin, TX	21.1%	3	San Diego, CA	4.8%
4	Salt Lake City, UT	17.9%	4	Washington, DC	4.7%
5	Atlanta, GA	17.2%	5	Nassau-Suffolk, NY	4.5%
6	Orlando, FL	15.6%	6	Oakland, CA	3.9%
7	Nashville, TN	15.0%	7	Bergen-Passaic, NJ	3.5%
8	Tampa, FL	14.7%	8	New Haven, CT	3.5%
9	Jacksonville, FL	14.4%	9	Baltimore, MD	3.4%
10	Grand Rapids, MI	14.4%	10	Orange County, CA	3.4%
11	Portland, OR	14.2%	11	Philadelphia, PA	3.1%
12	Raleigh, NC	14.1%	12	Seattle, WA	3.1%
13	Charlotte, NC	13.3%	13	Rochester, NY	2.8%
14	W. Palm Beach, FL	13.0%	14	Pittsburgh, PA	2.7%
15	Fort Lauderdale, FL	12.8%	15	Newark, NJ	2.6%
16	Denver, CO	12.5%	16	Buffalo, NY	2.5%
17	Dallas, TX	12.4%	17	New York, NY	2.4%
18	San Antonio, TX	12.2%	18	San Francisco, CA	1.9%
19	Memphis, TN	11.5%	19	Los Angeles, CA	-0.2%
20	Fort Worth, TX	10.4%	20	Hartford, CT	-0.8%

Source: Economy.com

[1] Rankings are based on employment growth in the 60 largest markets (by population).

Exhibit 6 shows the top and bottom 20 markets (from TWR's universe of 54 markets) based on changes in the office vacancy rate between 1993 and 1995. The office vacancy rate in the top 20 markets improved by about seven to 15 percentage points in the first three years of the recovery, or significantly faster than the 150-basis-point average decline per year at the national level. As the elevated ending vacancy rates in a few of the top 20 markets suggest, even the healthiest absorption rates fell short of restoring market equilibrium. Not surprisingly, most of the top 20 markets (14 of 20) suffered from above-average vacancy (more than 18.5%) at the start of the recovery, compared with just five of the bottom 20 markets.

Exhibit 6: Change in Office Vacancy Rates Over 1993-1995

	Top 20 MSAs	Ending Vacancy	Change (% pts)		Bottom 20 MSAs	Ending Vacancy	Change (% pts)
1	**W. Palm Beach, FL**	15.2%	-14.6%	1	Oakland, CA	11.1%	-4.3%
2	**Salt Lake City, UT**	6.6%	-11.8%	2	Philadelphia, PA	13.4%	-4.3%
3	**Charlotte, NC**	7.6%	-10.9%	3	San Francisco, CA	8.0%	-4.2%
4	Stamford, CT	16.6%	-10.8%	4	**Jacksonville, FL**	13.4%	-4.1%
5	**Phoenix, AZ**	11.5%	-10.7%	5	Orange County, CA	14.6%	-3.9%
6	Albuquerque, NM	7.2%	-10.6%	6	San Jose, CA	9.2%	-3.9%
7	Tucson, AZ	11.4%	-10.3%	7	Washington, DC	9.6%	-3.9%
8	**Fort Lauderdale, FL**	12.7%	-10.1%	8	Fresno, CA	12.8%	-3.5%
9	**Atlanta, GA**	10.1%	-9.7%	9	Seattle, WA	9.4%	-3.5%
10	Wilmington, DE	13.1%	-9.6%	10	Cincinnati, OH	13.4%	-3.0%
11	Minneapolis, MN	8.8%	-9.0%	11	Los Angeles, CA	19.2%	-2.3%
12	Miami, FL	13.9%	-8.6%	12	Long Island, NY	13.8%	-2.2%
13	Ventura, CA	14.5%	-8.4%	13	Houston, TX	20.0%	-1.6%
14	Indianapolis, IN	12.6%	-7.9%	14	New York, NY	14.9%	-1.5%
15	Baltimore, MD	14.0%	-7.7%	15	Pittsburgh, PA	13.0%	-1.1%
16	**Nashville, TN**	9.5%	-7.7%	16	**Las Vegas, NV**	10.8%	-1.0%
17	**Denver, CO**	10.5%	-7.6%	17	Hartford, CT	23.5%	0.2%
18	**Dallas, TX**	19.5%	-7.1%	18	Riverside, CA	23.3%	0.8%
19	**Memphis, TN**	12.6%	-7.1%	19	Westchester, NY	22.3%	0.8%
20	**Tampa, FL**	14.3%	-6.8%	20	Honolulu, HI	14.2%	5.3%

Note: Markets shown in **bold** also appear in the top 20 markets with the highest employment growth over the 1993-1995 period.

Sources: Torto Wheaton Research; Prudential Real Estate Investors

Eleven of the top 20 markets, shown in bold, also fall within the top 20 employment-growth markets, compared with just two of the bottom 20 markets. The two markets that experienced strong employment growth but only modest improvement in office vacancy rates, Las Vegas and Jacksonville, are relatively small office markets dominated by industries that use relatively little office space. The tourism and entertainment industry in Las Vegas and large military presence in Jacksonville create demand for office space indirectly but use little space per employee.

The different recovery rates should not obscure important characteristics of the individual markets, such as size and beginning and ending vacancy rates, which must be considered when evaluating the relative attractiveness of each market. Many of the markets that experienced the biggest decline in office vacancy during the last recovery are smaller, more volatile secondary markets, like Salt Lake City and Charlotte. The recoveries in the larger markets, like New York and Los Angeles, were more protracted, with much smaller declines in vacancy during the initial years of the recovery.

MSA Forecasts for the '04-'06 Recovery

With little new office supply expected over the next three years, the recovery rates of the different office markets will depend heavily on MSA demand growth. **Exhibit 7** shows Economy.com's employment growth forecasts for the 60 largest markets by population. As expected, the employment growth forecasts vary widely by market, but the difference between the forecasts for the highest and lowest growth markets is much smaller than the realized growth rates in the previous recovery. While the narrower range is partly due to the nature of forecast models, the current employment recovery is expected to be more modest. Economy.com forecasts that employment growth over the next three years will range from 7% to 14% in the top 20 markets and between 3.4% and 5% in the bottom 20.

Exhibit 7: Forecast Employment Growth Over 2004-2006 (%, not annualized)

Rank	MSA	2004-2006 Growth (%)	1993-1995 Growth (%)	Rank	MSA	2004-2006 Growth (%)	1993-1995 Growth (%)
1	Austin, TX	**13.9%**	44.5%	31	Oakland, CA	**5.8%**	19.4%
2	Phoenix, AZ	**11.8%**	47.6%	32	Grand Rapids, MI	**5.6%**	17.4%
3	San Antonio, TX	**11.8%**	28.0%	33	Greensboro, NC	**5.6%**	9.9%
4	Las Vegas, NV	**11.6%**	72.5%	34	San Francisco, CA	**5.5%**	6.6%
5	Orlando, FL	**11.4%**	40.7%	35	Chicago, IL	**5.5%**	9.0%
6	Ft. Lauderdale, FL	**10.5%**	31.0%	36	Portland, OR	**5.5%**	18.4%
7	W. Palm Beach, FL	**10.5%**	45.4%	37	Miami, FL	**5.3%**	13.6%
8	Raleigh, NC	**10.0%**	32.4%	38	Cincinnati, OH	**5.3%**	13.7%
9	Riverside, CA	**9.8%**	46.8%	39	San Jose, CA	**5.0%**	7.5%
10	Tampa, FL	**9.6%**	34.8%	40	Baltimore, MD	**5.0%**	13.7%
11	Fort Worth, TX	**9.6%**	26.8%	41	Oklahoma City, OK	**4.9%**	19.3%
12	Atlanta, GA	**9.6%**	32.8%	42	Kansas City, MO	**4.9%**	14.0%
13	Dallas, TX	**9.3%**	28.2%	43	Cleveland, OH	**4.8%**	4.8%
14	Middlesex, NJ	**9.1%**	19.7%	44	Los Angeles, CA	**4.8%**	9.2%
15	Orange County, CA	**8.2%**	25.9%	45	Minneapolis, MN	**4.7%**	15.8%
16	Monmouth, NJ	**8.0%**	20.0%	46	Boston, MA	**4.6%**	12.4%
17	San Diego, CA	**7.8%**	30.0%	47	Nassau-Suffolk, NY	**4.6%**	13.9%
18	Salt Lake City, UT	**7.5%**	25.5%	48	St. Louis, MO	**4.5%**	8.0%
19	Sacramento, CA	**7.4%**	32.9%	49	Philadelphia, PA	**4.2%**	12.4%
20	Houston, TX	**7.3%**	25.1%	50	Detroit, MI	**4.2%**	8.0%
21	Seattle, WA	**7.2%**	17.5%	51	Pittsburgh, PA	**4.1%**	7.2%
22	Nashville, TN	**7.1%**	22.4%	52	New York, NY	**4.0%**	7.8%
23	Columbus, OH	**6.9%**	18.8%	53	New Haven, CT	**3.9%**	7.8%
24	Washington, DC	**6.9%**	20.4%	54	Bergen-Passaic, NJ	**3.8%**	8.5%
25	Charlotte, NC	**6.8%**	25.8%	55	Rochester, NY	**3.7%**	1.6%
26	Denver, CO	**6.5%**	22.9%	56	New Orleans, LA	**3.7%**	7.9%
27	Jacksonville, FL	**6.3%**	27.8%	57	Milwaukee, WI	**3.5%**	5.8%
28	Norfolk, VA	**6.2%**	19.2%	58	Hartford, CT	**3.5%**	2.1%
29	Indianapolis, IN	**5.8%**	12.5%	59	Buffalo, NY	**3.5%**	2.7%
30	Memphis, TN	**5.8%**	16.2%	60	Newark, NJ	**3.4%**	12.4%

Source: Economy.com

Considerable overlap exists between the top and bottom 20 MSAs in **Exhibit 7** and those in **Exhibit 5**, which shows the actual three-year employment growth from 1993 to 1995. Twelve of the 20 markets with the highest employment-growth forecasts appear in the top 20 employment-growth markets in the '93-'95 recovery. Likewise, 12 of the 20 markets with the lowest employment growth from 1993 to 1995 are forecast to have relatively weak employment growth. While several of the lower-growth MSAs are large cities with significant employment bases that make it difficult to achieve high growth rates on a year-over-year basis, the list also includes a handful

of long-suffering secondary cities in the central and northeast regions, like Hartford, Buffalo and Newark, that have been declining for decades. All but three of the top 20 are in the Sun Belt.

Strong employment-growth forecasts do not necessarily portend a strong recovery in the office space markets, however. **Exhibit 8** shows the top and bottom 20 office markets based on the expected changes in office vacancy rates from 2004 through 2006. Although seven of the top 20 (shown in bold) also appear in the top 20 list of highest employment-growth markets, five of the bottom 20, where vacancy rates will likely improve only modestly (also shown in bold), are forecast to have above-average employment growth over the next three years.

Exhibit 8: Forecast Change in Office Vacancy Rates Over 2004-2006

	Top 20 MSAs	Ending Vacancy	Change (% pts)		Bottom 20 MSAs	Ending Vacancy	Change (% pts)
1	**Austin, TX**	10.1%	-13.7%	1	Pittsburgh, PA	15.1%	-3.3%
2	**Dallas, TX**	15.9%	-10.1%	2	Boston, MA	13.3%	-3.2%
3	San Francisco, CA	11.0%	-10.0%	3	Philadelphia, PA	12.8%	-3.2%
4	Wilmington, DE	8.1%	-9.0%	4	Portland, OR	15.9%	-2.9%
5	**Atlanta, GA**	13.0%	-8.3%	5	**San Diego, CA**	11.7%	-2.6%
6	Columbus, OH	15.9%	-8.1%	6	Westchester, NY	12.9%	-2.6%
7	Jacksonville, FL	10.4%	-8.1%	7	**Houston, TX**	17.1%	-2.2%
8	Cincinnati, OH	11.1%	-7.7%	8	**Orlando, FL**	17.3%	-1.7%
9	N. New Jersey, NJ	10.0%	-7.6%	9	Cleveland, OH	18.4%	-1.6%
10	**Raleigh, NC**	14.8%	-7.3%	10	Hartford, CT	18.9%	-1.6%
11	**Las Vegas, NV**	9.7%	-7.1%	11	**Fort Worth, TX**	14.5%	-1.5%
12	**W. Palm Beach, FL**	8.7%	-6.8%	12	Los Angeles, CA	16.6%	-0.7%
13	Kansas City, MO	14.6%	-6.7%	13	New York, NY	11.0%	0.2%
14	Sacramento, CA	9.1%	-6.5%	14	Tucson, AZ	16.1%	0.2%
15	Seattle, WA	10.9%	-5.9%	15	Honolulu, HI	14.4%	0.8%
16	Minneapolis, MN	12.9%	-5.8%	16	Stamford, CT	19.6%	1.0%
17	Miami, FL	11.3%	-5.6%	17	Indianapolis, IN	22.1%	1.6%
18	Albuquerque, NM	13.4%	-5.5%	18	Ventura, CA	11.5%	2.7%
19	Oakland, CA	11.0%	-5.5%	19	St. Louis, MO	24.8%	2.9%
20	**Phoenix, AZ**	14.5%	-5.5%	20	**Riverside, CA**	15.2%	4.6%

Note: Markets shown in **bold** also appear in the top 20 markets with the highest employment growth forecast over the 2004-2006 period.

Sources: Torto Wheaton Research; Prudential Real Estate Investors

As in the last market cycle, many of the markets that experienced the sharpest rise in office vacancies, in this case from the 2000 market peak to mid-year 2003, are among the markets likely see the largest declines in office vacancies. However, three markets where office vacancy rates have risen sharply in recent years, Boston, Portland and Stamford, with increases of 13.1%, 12.8% and 10.9%, respectively, are not expected to recover strongly over the next three years, suggesting a slower or later-cycle recovery in these markets.

Although a few of the markets where vacancy rates probably will not improve much (and may even increase slightly) are relatively healthy already and do not need significant net absorption for rent growth in the medium-term, space market conditions likely will remain weak in several MSAs. For example, TWR forecasts the office vacancy rate in Houston will improve only 220 basis points over the next three years to about 17%, despite fairly healthy employment growth.

But in most markets where office space-market fundamentals are projected to improve over the next three years, property income should grow strongly during the initial stage of the office

market recovery. **Exhibit 9** shows the top and bottom 20 markets based on office income-growth forecasts over the next three years. The average income-growth forecast for the top 20 markets is 27.4%, significantly higher than the 3.5% average income growth for the bottom 20. Most of the income growth will come from improving occupancies as absorption accelerates and supply remains flat. Fifteen of the top 20 markets in **Exhibit 9** also appear in the top 20 markets where vacancy rates are predicted to improve most in 2004-2006, while only two high income-growth markets, Hartford and Cleveland, expect relatively little change in office vacancy rates.

Exhibit 9: Projected Office Income Growth Over 2004-2006

	Top 20 MSAs	Change (% pts)		Bottom 20 MSAs	Change (% pts)
1	**Austin, TX**	55.6%	1	Columbus, OH	12.9%
2	**W. Palm Beach, FL**	42.1%	2	Philadelphia, PA	12.2%
3	**Dallas. TX**	38.9%	3	Memphis, TN	9.8%
4	San Francisco, CA	31.4%	4	Los Angeles, CA	9.8%
5	Charlotte, NC	31.0%	5	Pittsburgh, PA	8.8%
6	Jacksonville, FL	29.4%	6	Ventura, CA	7.5%
7	N. New Jersey, NJ	26.6%	7	**Orlando, FL**	7.3%
8	Wilmington, DE	26.5%	8	Portland, OR	6.7%
9	Cincinnati, OH	26.4%	9	Minneapolis, MN	6.4%
10	Miami, FL	25.6%	10	Denver, CO	6.2%
11	**Orange County, CA**	24.6%	11	San Jose, CA	6.0%
12	Cleveland, OH	24.4%	12	New York, NY	5.3%
13	**Raleigh, NC**	23.9%	13	Detroit, MI	4.0%
14	**Las Vegas, NV**	23.5%	14	**Riverside, CA**	1.4%
15	Seattle, WA	22.6%	15	Tucson, AZ	-2.3%
16	Chicago, IL	21.4%	16	Fresno, CA	-3.2%
17	Oakland, CA	20.7%	17	Stamford, CT	-3.7%
18	Hartford, CT	18.2%	18	Indianapolis, IN	-4.1%
19	**Sacramento, CA**	17.6%	19	Boston, MA	-4.5%
20	**Phoenix, AZ**	17.2%	20	St. Louis, MO	-15.8%

Note: Markets shown in **bold** also appear in the top 20 markets with the highest employment growth forecast over the 2004-2006 period.

Sources: Torto Wheaton Research; Prudential Real Estate Investors

Investment Implications

If history is any guide, the office market recovery will create attractive investment opportunities at many different points along the risk-return spectrum, from relatively low-risk, low-return core investments to higher-risk, higher-return opportunistic investments. The opportunities, however, will be unevenly distributed across markets. Employment growth and current market supply/demand fundamentals are important factors but clearly are not the sole determinants of office investment performance at the MSA level. Although individual investment opportunities will take many forms, three basic strategies offer the best approaches to earning attractive risk-adjusted returns during the recovery.

Perhaps the most obvious strategy during the initial phase of the recovery involves exploiting the rebound in "commodity" markets that likely will see the biggest bounce in occupancy and rents over the next two to three years. Commodity markets include cities like Atlanta, Austin, Charlotte, Dallas, Denver, Orlando, Phoenix and Raleigh, with readily available land and few barriers to development. The recovery play in the commodity markets is to buy low (i.e., below replacement cost) and sell high. Many of these cities appear among the top 20 markets by

employment growth and/or forecasted changes in vacancy rate over the next three years, and should provide opportunities to acquire Class A office buildings that will benefit from the recovery in tenant demand.

However, because the availability of construction financing is the biggest (and often only) constraint to new supply growth in most of these markets, this is a relatively short-term strategy that can only be effective if assets can be acquired at prices below replacement costs. To maximize returns and minimize downside risks, holding periods for most of these investments should be limited, more or less, to the recovery phase of the cycle, while occupancy and rent growth are the highest. Although office supply growth has fallen sharply across virtually all major markets and should remain depressed for several years, the supply pipeline in commodity markets will respond fairly quickly as rents recover, limiting the long-term upside potential.

For a longer-term strategy, the office market recovery should also create attractive opportunities to increase core exposure in large, strategic markets, like New York, Washington, DC, and Los Angeles. These cities have significant inventories of office stock, diverse sources of tenant demand and relatively high barriers to new supply. Due to their large size and high concentrations of office properties, strategic markets attract substantial institutional capital. **Exhibit 10** shows the six largest metros for office property investments in the NCREIF property database. These six markets account for more than 60% of all office investments in the NCREIF database.

Exhibit 10: Major Markets Dominate Office Investment

Metro	NCREIF Share
New York Area, NY-NJ-CT	13.9%
Washington, DC – Baltimore, MD	11.7%
San Francisco Bay Area, CA	10.5%
Los Angeles, CA	9.6%
Chicago, IL	7.5%
Boston, MA	7.0%
Total	**60.2%**

Sources: NCREIF 2Q03; Prudential Real Estate Investors

Values of well-leased, core office properties in most major office markets have not fallen and, in many cases, have continued to rise as property market fundamentals have deteriorated. But the decline in market rents provides significant downside protection to investors who underwrite at current market rents. As **Exhibit 2** shows, real office rents are only about 10% higher than at the bottom of the last market cycle and are roughly comparable to real rents in the first half of 1997. Current contract rents for office leases that will expire over the next year or two, assuming an average lease term of about seven years, should be only marginally higher (due to upward adjustments in rental rates over the lease term) than current market rents. With assets trading at or above replacement costs, cap rates could rise in the near term, particularly as interest rates rise and capital expenditures for items like tenant improvements grow. However, the rent and leasing cycles should limit the downside risks of the income component of core office property returns. The generally favorable longer-term outlook for supply-constrained markets should, therefore, offset near-term declines in asset values, especially as rent growth resumes.

Finally, market recoveries almost always create value-added investment opportunities, and the current market cycle should not be an exception. Value-added strategies typically involve improving the physical, financial or operational characteristics of a property. Although the sharp deterioration in office market fundamentals over the past two-plus years has severely limited opportunities to add value through development and redevelopment (i.e., physical value-added strategies), historically low interest rates have created abundant opportunities to add value through financial techniques, such as using leverage.

While financial value-added strategies will probably remain a popular approach as long as interest rates stay low, the demand recovery will also provide attractive opportunities for investors to add value in other ways. Weak investor demand for properties that suffer from higher vacancies or other income-related risks has created opportunities to buy assets in certain markets below replacement costs. In the near-term, investors should be able to acquire certain office properties, mostly those struggling with occupancy issues, at discounts to replacement costs and to participate in the market recovery by improving occupancies through leasing and/or redevelopment and repositioning. Somewhat ironically, perhaps, the lack of distress during the current market cycle may also provide opportunities for well-capitalized investors during the recovery phase. Property owners that have managed to survive the weak space markets by refinancing and/or reducing operating expenses and highly leveraged owners may face increasing pressure as interest rates rise and properties require higher capital expenditures to attract and retain tenants.

Assumptions and Intangibles

The office market recovery forecast is predicated on two basic (and perhaps obvious) assumptions. First, we assume that office vacancy rates will decline dramatically over the next three to five years. Current forecasts from TWR, Reis and PPR predict the national office vacancy rate will fall by 0.9 to 1.83 percentage points per year over the next three years. New supply will likely remain modest over the next few years, but the near-term outlook for a recovery in tenant demand is decidedly less certain.

Renewed job growth is essential for a recovery in office space demand. Although recent improvements in the employment figures from the Bureau of Labor Statistics and weekly unemployment claims are encouraging, the US job market has been surprisingly weak since the recession officially ended. Clearly, the office market cannot begin to recover until the economy starts producing jobs in meaningful numbers. If employment growth does not resume in 2004 as expected, the recovery in the office market will be postponed, and property values will suffer, at least until job growth begins.

Secondly, we assume real office rents are approaching a cyclical low and will start to rebound as demand recovers. According to TWR and PPR, real office rents are only marginally higher today than at the bottom of the last trough (see **Exhibit 2**). While office rents may decline more as demand accelerates or may remain flat for several quarters before property owners regain some pricing power, we expect some rental growth over the next three years. TWR and PPR, for example, both forecast nominal rent growth of about 4% per year over the next three years.

While we believe that the consensus view among many, if not most, analysts supports these basic assumptions, analysts' forecasts for the strength and timing of the recovery of individual markets vary greatly. **Exhibit 11** shows the wide range of year-end 2006 office vacancy rate forecasts for a few markets. Although different starting points (i.e., estimates of current market vacancy rates) explain some of the variance, the broad range of forecasts for markets like Austin and San Francisco underscores the uncertain strength and timing of the recovery at the MSA level.

Exhibit 11: Office Market Recovery Forecasts for Year-End 2006 Vary

MSA Name	TWR	Reis	PPR
Austin, TX	10.1%	17.2%	15.2%
San Francisco, CA	11.0%	16.5%	19.2%
Minneapolis, MN	12.9%	17.0%	16.9%
Atlanta, GA	13.0%	16.3%	17.7%
Tampa, FL	13.0%	14.7%	15.5%
Columbus, OH	15.9%	17.8%	16.1%
Los Angeles, CA	16.6%	13.7%	15.6%
Houston, TX	17.1%	12.6%	15.9%
Denver, CO	19.0%	17.2%	15.7%

Sources: Torto Wheaton Research; Reis; Property and Portfolio Research

The office market outlook is also clouded by a few intangibles that could affect future demand for office space. International outsourcing of "white collar" jobs to lower-cost countries, like India, China and the Philippines, sits at the top of this list, if for no other reason than the recent flurry of media attention. Clearly, a loss of office-using jobs similar in magnitude to the manufacturing job losses in recent decades would have severe consequences for office investment properties, but the issue is more complex. On the one hand, global competitive pressures argue strongly in favor of reducing corporate costs wherever possible. On the other hand, unless the US economy creates higher-value-added jobs to replace those that could be sent overseas, international outsourcing could undermine demand for goods and services in the long run. To the extent that office demand is affected by outsourcing, however, suburban markets seem to be at greater risk. As Moody's Investors Service recently observed, most of the jobs that could be outsourced today are "back-office" positions that are usually in suburban locations.[2]

Changing office space use patterns and tenant needs also pose a potential threat to future office demand. This issue is certainly not new. For more than a decade, analysts have debated the potential impact of technologies like fax machines, teleconferencing and the Internet on office demand. Although advances in technology over the last decade have made it much easier to work from remote locations, the debate is no closer to being resolved now than it was a decade ago. In the near term, the same competitive pressures driving the international outsourcing issue could reduce incremental demand for office space as corporations try to save costs. But with market rents at or near a cyclical low, tenants could take advantage of the low rates to secure space for future growth.

Finally, despite the similarities in the space market cycle between today and the downturn a decade ago, conditions in the real estate capital markets are radically different today. So, while the space market recovery may follow a similar path, investment performance could differ meaningfully. At the very least, opportunities for 20%-plus "opportunistic" returns will be fewer

[2] "Office REITs Sector Commentary, Fall 2003," Moody's Investors Service

and farther between in this recovery due to relatively little distress in the market today versus the early 1990s. This assumes, of course, that office demand and rents begin to recover in 2004 and that no further unexpected events occur, like another terrorist attack or military conflict, to derail the economic recovery and postpone the real estate market recovery.

Concluding Thoughts

As improbable as it seemed a few years ago, when the US economy and tenant demand for office space were both growing rapidly, the conditions in the office space markets are as dire today as the depressed conditions during the real estate market collapse in the early 1990s. Although the catalysts for the weak space market conditions today and the current investment environment are quite different from the last market downturn, the fundamental features of the space market cycle are, nevertheless, the same. As vacancy rates peak and rents stabilize, the space market recovery should be similar to the last market recovery. Supply growth should remain subdued. Tenant demand should accelerate as employment growth resumes. And office vacancy rates should fall, allowing property owners to increase rents as the supply/demand balance returns.

While the office space market recovery is fairly predictable at the national level and forecasts from various data providers for the overall office market are quite similar, the recovery at the MSA level is less certain. Investors can be sure, however, that the speed and strength of the recovery will not be uniform across markets and regions. As in the past, some markets will recover more quickly and strongly than others. In markets that experience the sharpest rebound in tenant demand, the dramatic turnaround should provide attractive opportunities for investors to earn excess returns.

Investors should not, however, expect the 20%-plus opportunistic returns that were common during the last office market recovery. The strong capital flows and intense competition for core, income-producing assets with credit and term have pushed cap rates to historic lows in certain markets. While the lofty pricing for well-leased, core office properties may limit the upside potential and increase the risk that declining asset values will erode investment performance, the downside risks for investments that are underwritten at current market rents are considerably lower today than a few of years ago, when rents were unsustainably high. For investors seeking value-added returns, the office market recovery will provide opportunities to buy assets with leasing risk (due to above-average vacancies or near-term lease rollovers) in high-growth markets.

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