### OFFICE MARKET REPORT: 2Q2012

# Weak office market fundamentals continue to hinder recovery of the sector.

- **INDICATORS:** During the second quarter, office-using job growth was positive, yet soft, adding 133,000 jobs. Despite a declining unemployment rate, labor force participation is at a long-term low. Overall, the story remains the same for the U.S. office market, with advances hinging on job growth and a positive resolution to broader economic concerns.
- **SUPPLY:** Office construction continued to trend downward with just 4.0 million sf delivered by mid-year, half of what was delivered at the same point in 2011. It is expected that continued constrained supply will drive occupancy and rental rate gains in the short term, with significant construction three to four years away.
- **DEMAND:** Second quarter office absorption was positive, yet not outstanding at 4.1 million sf, and marked the sixth consecutive quarter of positive trends. Class A space continues to account for the bulk of net absorption, approximately 90.0%, since absorption improvement began in 1Q2011.
- VACANCY: Total vacancy remained flat over 1Q2012 at 17.2%, the first quarter of zero vacancy decline since 1Q2010. Class A vacancy dropped 10 bps over the last quarter. YOY, overall vacancy declined 30 bps, with Class A vacancy declining 50 bps. As in quarters past, vacancy at 17.2% remains solidly above equilibrium, which is considered 12.0% to 14.0%.
- **RENTAL RATES:** Data sources report negligible positive movement over 1Q2012 with Reis citing 0.2% growth to \$28.17 psf and CoStar reporting a 0.4% increase to \$22.90 psf. While rental rates are projected to improve in light of no new supply, the pace of recovery slowed this guarter.
- CAPITALIZATION RATES: In 2Q2012, the average CBD cap rate was 6.35%, down slightly over last quarter and YOY. Average suburban cap rates were reported at 7.63% or relatively unchanged from last quarter. Investors appear to be broadening their focus with volume trends in secondary markets exceeding those in major markets.

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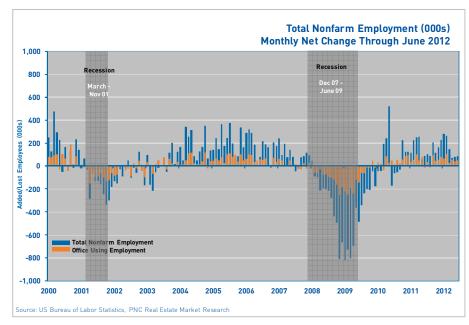


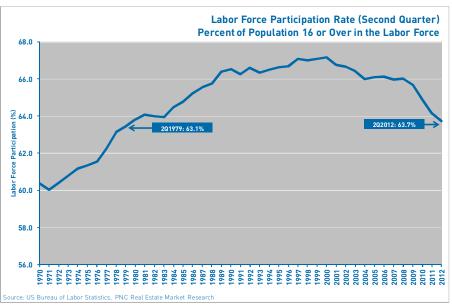
#### OFFICE INDICATORS

Second quarter 2012 office-using employment growth was positive, adding 133,000 jobs to the market. While positive, the growth was soft compared to the 193,000 office-using jobs added in the first quarter. Overall, second quarter job growth was considered disappointing as fewer than 100,000 total jobs were added each month, in comparison to an average of 226,000 jobs added monthly in the first quarter.

The unemployment rate experienced little movement in the second quarter, falling to 8.1% in April, but rising to 8.2% in May and remaining at that level in June. Unemployment near 8.0% was last seen in early during the run-up in unemployment as a result of the recession. However, despite a generally improving unemployment rate, the second quarter's labor force participation rate, 63.7%, was at its lowest point since the second guarter of 1979. According to the BLS, second quarter labor force participation has been on the decline since reaching a high of 67.2% in 1Q2000.

According to the June and July/August 2012 PNC National Economic Outlook reports, growth slowed in both the spring and summer of 2012, driven by higher energy prices early in the year, concerns about the situation in





Europe, the presidential election, possible tax increases, and government spending cuts. As mentioned in the May 2012 PNC National Economic Outlook, U.S. fiscal policy will remain a concern through the end of 2012 unless Congress solves the conundrum of impending tax increases and government spending cuts. The outcome of these "fiscal cliff" issues may have negative consequences for the continued improvement of the office sector due to the ripple effects that increased taxes and decreased government spending may have on the economy, employment and, therefore, office-using jobs. According to a recent survey of economists by the *Wall Street Journal* in August 2012, even the threat of higher taxes and cuts in government spending may cause businesses to reduce investment in the months leading up to the end of 2012. Business caution may limit office sector improvement in future quarters.

As has been the case in recent quarters, job growth continues to be concentrated in metros with an emphasis on tech and energy. For example, the BLS states that as of June 2012, the largest YOY percentage increase in office jobs occurred in tech markets including San Jose/Silicon Valley (5.3%), Austin (5.2%), and San Francisco (4.7%).

Overall, the outlook remains the same for the U.S. office market. With economic uncertainties looming, especially through the end of 2012 in regards to U.S. fiscal and political concerns, office market improvement will remain slight at best. Significant growth will be absent until a clear path to recovery is seen.

## OFFICE MARKET TRENDS Supply

Construction continued to trend downward with just 4.0 million sf delivered as of mid-year. This amount is half of that delivered as of mid-year 2011, indicating that construction has not yet reached bottom. During the last three years, office construction has declined sharply, with deliveries as of mid-year falling 50.0% in 2010, 2011 and 2012.

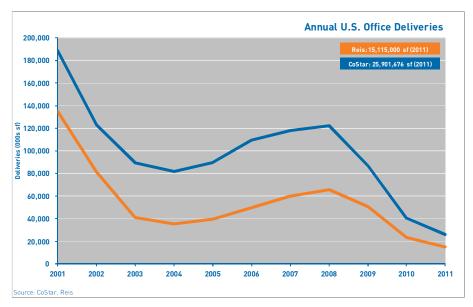
While the construction slowdown has not hit bottom nationally, there are indications of bottoming and increased construction interest in some markets. Murmurs of speculative construction are being heard in top markets, particularly those in the west. However, it is estimated that significant new deliveries are still three to four years away.

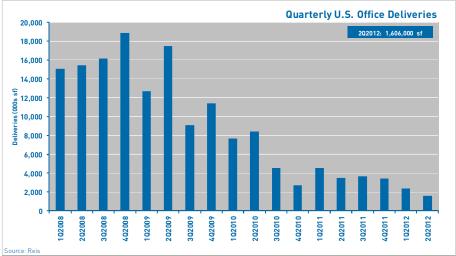
The good news behind a constrained construction pipeline is that limited deliveries will contribute to the near-term improvement of occupancy and rental rates in the absence of robust office-using job growth.

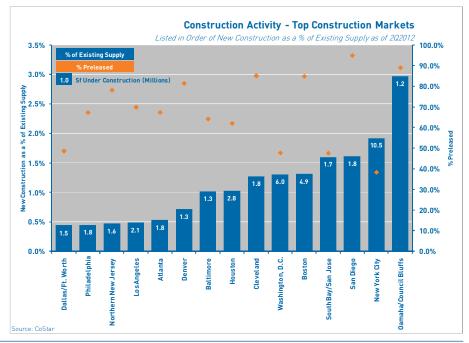
#### Markets

The second quarter saw continued construction in top markets such as New York and Washington, D.C. The most significant new addition to the list of top construction markets is South Bay/San Jose, which has 1.7 million sf underway, an indication of growing construction activity in tech markets.

Preleasing for new construction remains strong, with space nearly 70.0% preleased on average. Markets with the lowest preleasing, New York at 38.4% and Washington, D.C, South/Bay San Jose, and Dallas Ft/Worth all just shy of 50.0%, are historically strong office markets or those currently bolstered by the tech and energy sectors.







#### **Demand**

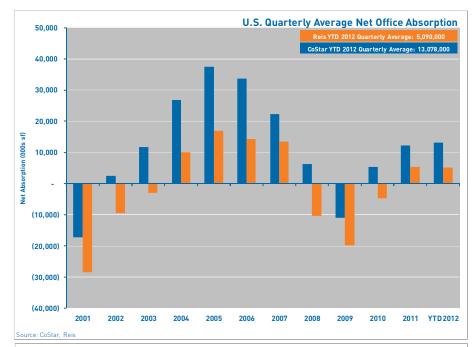
2Q2012 absorption marked the sixth consecutive quarter of positive office absorption. While positive, Reis cited 2Q2012 absorption of 4.1 million sf was the lowest level of quarterly absorption since improvement began in 1Q2011. Despite lowered absorption in the recent quarter. 2012 average quarterly absorption is on par with 2011 absorption.

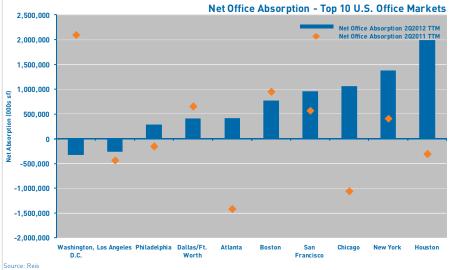
While total office absorption has been positive over the past 18 months. there is a difference between the absorption of Class A and BC space. According to Reis, national office inventory is split nearly equally between classes. However, since absorption turned positive in 1Q2011, Class A space has accounted for nearly 90.0% of positive net absorption. Also, Class A properties suffered lower negative net absorption during the downturn, with losses of 33.4 million sf. In contrast. Class BC properties logged losses of 106.1 million sf. Class A absorption will likely continue at the expense of BC absorption until the available supply Class Α space becomes significantly constrained.

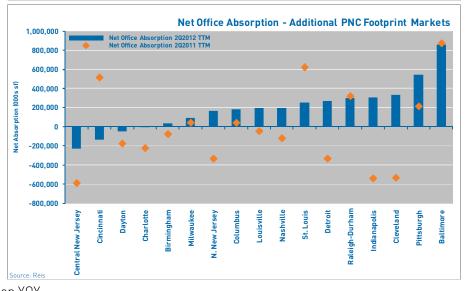
#### Markets

The majority of top ten U.S. office markets and PNC footprint markets\* experienced absorption improvement YOY. Seven of the ten top markets saw improvement, with Houston and Chicago seeing the greatest gains. Negative absorption continues in Washington, D.C. in response to political uncertainty and pullback by GSA tenants.

As was the case last quarter, 16 of 21 PNC footprint markets showed absorption gains over 2011. Gains continue to be slight, with footprint markets seeing absorption improvement of 250,000 sf on average. Among footprint markets outside of the top 10 U.S. markets, Cleveland leads with the greatest change in negative to positive absorption YOY.







\*See footnote Page 7

#### **Vacancy**

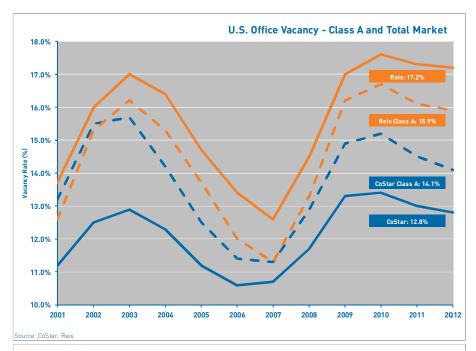
According to Reis, 2Q2012 total office vacancy remained flat over the last quarter at 17.2%. Class A properties saw some improvement in 2Q2012, with vacancy declining 10 bps over 1Q2012. YOY, total office vacancy declined 30 bps, with Class A vacancy dropping 50 bps. While declining, the rate is flattening as last guarter saw a reduction of 50 bps YOY for the total market and 60-80 bps for Class A office product. in quarters past, minimal vacancy decline does little to bring the market to the equilibrium rate, considered 12.0% to 14.0%

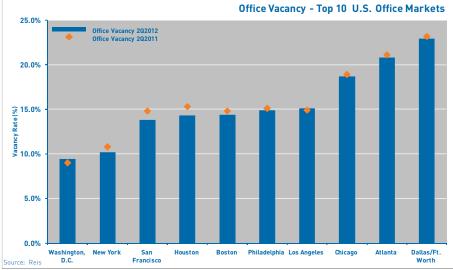
Since 2000, Reis reports that Class A and BC office space experience similar vacancy patterns, with Class A space having a vacancy rate 220 bps lower on average. As Class A vacancy has improved, the gap between Class A and Class BC vacancy has widened from 160 bps in 2009 to 260 bps as of 2Q2012. A widening gap over this time period is evidence of the trading up of tenants from Class BC to A Despite a recently properties. increased vacancy gap, the rate of increase appears to be slowing, an indication that the flight to quality may be easing.

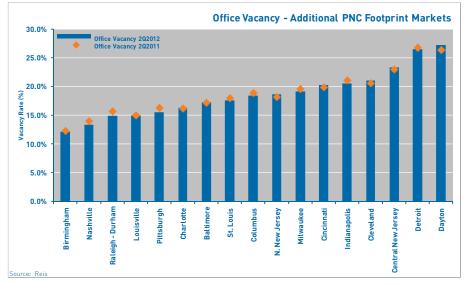
#### Markets

The top ten largest U.S. office markets saw vacancy drop eight bps on average from the prior quarter and 34 bps YOY. Quarter over quarter decline slowed slightly, with 1Q2012 reporting average quarterly vacancy falling 11 bps.

Like last quarter, PNC footprint markets\* saw a split in YOY vacancy movements with decreased vacancy in 11 markets and increased vacancy or no movement in ten markets. 2Q2012 brought continued improvement to markets such as Pittsburgh and Raleigh-Durham (both down 80 bps YOY), while Dayton's vacancy rate continued to climb (up 80 bps YOY).







\*See footnote Page 7

#### **Rental Rate**

As of 2Q2012, data sources report slight positive rental rate growth for the U.S. office market. Reis cited quarterly improvement of 0.2% growing to \$28.17 psf for all property classes. Class A properties reported similar improvement of 0.3% to \$33.62 psf. CoStar also reported quarterly growth at a rate of 0.4% for the overall market and 0.9% for Class A properties, reversing a trend of rental rate decline reported since 2009. YOY both Reis and CoStar reported positive growth for office rental rates, with Reis reporting growth of 1.6% and CoStar 0.8%.

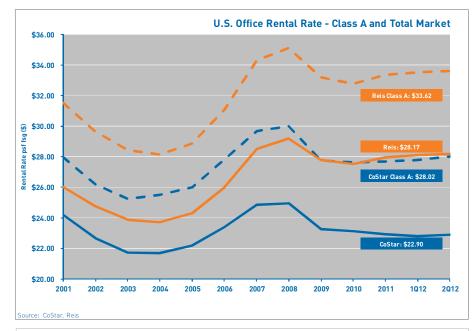
While we project that rental rates will see improvement moving forward, it will likely be a slow and bumpy ride in the short term. Limited new supply will work in favor of growing rental rates, but economic factors and business caution will still weigh heavy on office sector improvement. Also, despite rental rate growth seen this quarter, it should be noted that the pace has slowed with 2Q2012 Reis data showing the lowest quarterly growth since rental rates began improving in 4Q2010.

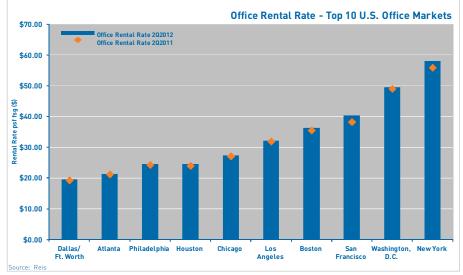
#### Markets

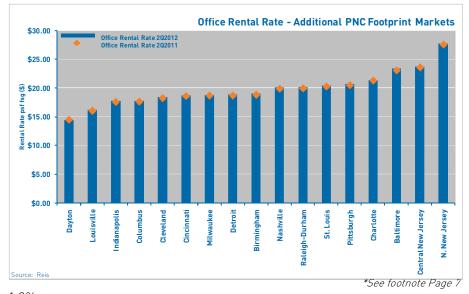
All top ten U.S. office markets reported rental rate growth both over the first quarter and YOY. Average growth was slight in the second quarter with top markets reporting 0.3% quarterly growth on average down from 0.6% quarterly arowth in 1Q2012. YOY arowth remained at 2.0%, the same as in the first quarter. YOY growth continues to be strong in both New York and San Francisco which saw annual improvement of 3.9% and 5.3% respectively.

In general, PNC footprint markets\* showed slightly positive rental rate movements YOY, 0.6% on average.

Among the 21 footprint markets tracked, Philadelphia and Baltimore led in YOY growth with rents improving 1.3%.





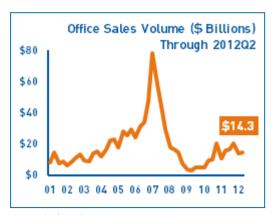


#### **OFFICE CAPITALIZATION RATE TRENDS**

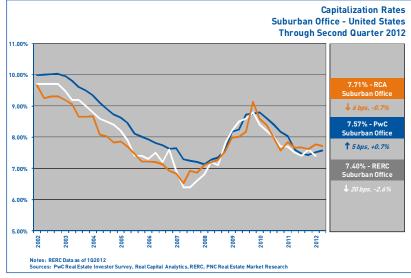
OFFICE CAP RATES			
Average	Quarterly	Annual	
CBD	<b>↓</b> 18	<b>↓</b> 39	bps ∆
6.35%	<b>1</b> 2.9%	<b>1</b> 6.2%	Value $\Delta$
Suburban	<b>↓</b> 7	<b>↓</b> 9	bps $\Delta$
7.63%	<b>1</b> 0.9%	<b>1</b> 1.2%	Value $\Delta$

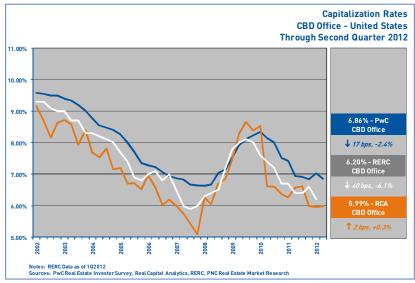
The average CBD cap rate was 6.35% this quarter, 128 bps lower than the relatively unchanged suburban average of 7.63%. Cap rate compression is still most evident within the 6 major

metro areas (Boston, Chicago, DC, LA, NYC, and SF). However, tertiary markets have posted the most robust increases in sales activity so far this year and volume trends in secondary markets have exceeded those in the major markets, indicating that investors are broadening their focus.



Despite a small quarterly increase of 3.5%, sales of significant office assets (>\$5M) in Q2 were down by 10% YOY. Despite the YOY sales slowdown, RCA reports that office investment has been resilient even as some pessimism returned to the financial markets. The Q2 decline was entirely due to an 18% YOY drop in CBD sales; suburban investment trends increased 3.0% YOY. The CBD sector drop is likely temporary, as RCA reports nearly \$5.0B of CBD towers either closed or under contract in July 2012.





\*PNC Footprint Markets: Defined as the 33 market areas that make up the PNC retail banking footprint. This report tracks 21 of those 33 footprint markets. Also, four PNC footprint markets are top 10 U.S. office markets: Chicago, Atlanta, Philadelphia and Washington, D.C. and are reported in the top 10 office market charts throughout this report.