

UNITED STATES OFFICE MARKET REVIEW AND OUTLOOK

By Hugh F. Kelly, CRE

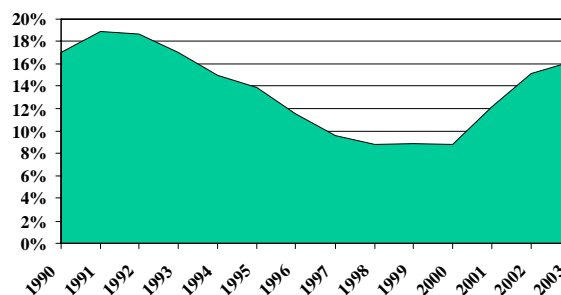
Real estate market cycles are not one-year events. That sentence introduced our statistical discussion of the office market a year ago, and bears repeating. The nature of office market supply and demand relationships dictates that the cycle in this property type invariably takes longer to work out than the turning points in GDP would suggest. Lags are built into the system, and it does not seem likely that we can fully adjust for the lags. If that is so, not only do real estate cycles have longer durations than the business cycle generally, but the amplitude is more extreme. In our business, peaks are higher and troughs are lower. Since this comes with the territory, the question facing real estate professionals comes down to this: how do you manage the risks?

The first tool, of course, is knowledge. Knowledge is not merely information or data, but an understanding arising out of integrating the facts into a coherent perspective. It helps to know what a cycle is, and how it differs from other kinds of change. In primer fashion, we might define some of the various kinds of change that affect real estate markets in the following way.

Cycles can be described as periodic fluctuations around equilibrium, having some regularity in their characteristic movements around the norm. The keys to the measurement of cycles are their volatility (or amplitude) and their duration (or frequency). *Amplitude*, in turn, is determined by practical constraints marking peaks and troughs. Rising markets reach unsustainable limits, and it helps to know what sets those limits. Likewise, cyclically falling markets do not normally decline to the point of disappearing, so there must be some factors setting lower limits as well. *Duration* relates to the fluidity of the market system in accommodating change. The more rigid

the elements of the market, the slower they are to react to change and the longer they take to make corrections. Cycles are only one kind of change that real estate must confront. While coping with cycles, the industry is also faced with more fundamental changes that can be termed “trends.” **Trends** are long-term shifts in system behaviors, very basic but gradual alterations of the quality or quantity of elements in the market. Many of these seem to follow patterns similar to Newton’s Laws of Motion: objects in motion tend to stay in motion, objects at rest tend to remain at rest; energy tends to flow from being concentrated in one place to being spread out. The primary insight is that the world is dynamic, and that change tends to have a fundamental direction. So, real estate practitioners need to understand that, behind cycles, there are fundamental forces like basic demography, or the employment shift from manufacturing to services, or globalization, or technological advancement that are at work no matter in which what phase of a cycle we might be.

Vacancy Rise Moderates in 2003, Suggesting Peak Is Near in 2004

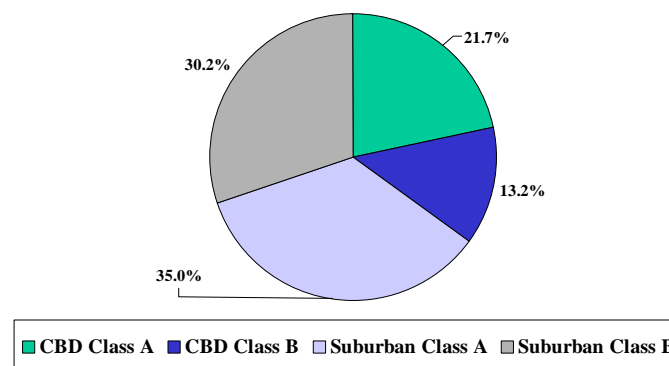


A third, and distinct, type of change might be termed **maturation**, an organic adaptation and “unfolding” of the market’s potential. In order to recognize and properly react to this process, we need to know about resource availability, the way the market system consumes and transforms its resources, how niches (submarkets, peer groups, competitive sets) are defined, and what might indicate sustainability over time. For example, commuting time cannot be extended indefinitely, so how far can an office market extend its reach into the labor pool? What is the optimal size of an office market relative to the employment base? When do industry clusters form in sufficient density that they will support mutual growth.

Next is what we might term **changes of state**. Fundamental yet short-run (potentially reversible) alterations in market conditions may signal a **discontinuous** shift, the way that the attributes and behaviors of water change when it passes the boiling point or the freezing point. While such change may be related to cycles, they require a deeper level of understanding of critical values and boundaries. For example, vacancy rates may shift along a continuous line, closer to or further from equilibrium as the market goes through its cycle. But at some point, the fundamental condition becomes a “landlords’ market” or a “tenants’ market” and beyond those points the market participants behave in substantially different ways than they do in more balanced markets. If they are to anticipate how market activity will be altered as the cycle progresses, real estate players need to think through the idea of cycles to this next level.

The last, and most extreme, kind of change can be simply termed **disruption**. A sudden and profound shock can present a radical challenge to the market's integrity. Such changes can lead to an alteration of the business paradigm, a reconceptualization of the way the market is shaped. Right after the September 11th attacks, many believed that "things have changed forever." Certainly we are seeing very different ways in which building security is handled and insurance is written, and these may be permanent shifts. Corporate boards are thinking about business redundancy needs and catastrophe back-up systems that may affect location patterns substantially. But not all disruptions lead to revolutionary change; after the shock is absorbed, markets may make a compensatory return to a new, only slightly modified, way of doing things. Frankly, we are still too close to September 11th to know how this will work out. But this disruption did affect the national economic and real estate cycle, without a doubt, and may influence the way the market behaves in recovery.

Distribution of Office Inventory



All of that said, the office markets are unquestionably in the grip of a downward cycle in terms of their basic demand and supply balance. Many have remarked that this cycle differs from the last one, because we did not so much overbuild as find demand suddenly disappearing. The observation about construction volumes and employment trends are factually accurate, as far as they go, but the conclusion that this cycle is somehow "basically different" is economic nonsense.

The characteristic signs of the cycle (supply and demand imbalance) are exactly the same, and its effects (loss of rent, rise in subleasing, increased concessions to attract tenants, etc.) are identical. Even more fundamentally, the structural causes are also similar.

Yes, we might say that there has been more discipline in development this time, and that the "jobless" initial phase of recovery has gone on much longer. But the basic problem remains that the supply cycle and the demand cycle are not synchronous with one another. Buildings take a long time to build; corporations can change their hiring plans overnight. On the other side of the cycle, banks demand to see feasibility rent studies before they will grant construction loans; by the time rents are high enough to satisfy the underwriters, it will take a couple of years to build

the building... by which time either the market is too tight and rental costs have skyrocketed, or another downturn has begun, and the building opens in a recession.

It is the latter scenario that has gripped the markets at the start of the 21st Century, and the employment lag we saw from 2001 through mid-2003 is going to translate into a lengthy lull in the development market, fundamentally weak rents, and a “tenant’s market” with double digit vacancies for the next several years. A realistic look at the cycle should tell us this.

However, trend analysis should offer us some hope. It is a common mistake at both peaks and troughs of cycles to extrapolate extreme conditions indefinitely into the future. But the fundamental trend in the GDP and office employment in the United States is on a long-term upward trajectory. From the trough, it can be expected to move at an accelerated rate until it not only meets, but temporarily exceeds the trends line.

We never maintain the economists’ ideal “potential GDP” and “non-inflationary full employment” for more than a moment. As John Meynard Keynes observed early in the last century, there are always animal spirits abroad in the marketplace. Probably none of us would want to be in the business if that were not the case. So just as those gloomy forecasters who told us back in the early nineties that America would not need to build a single office building for a decade were proven wrong by a vigorous rebound, today’s predictors of an unsatisfactorily slow return of demand are likely to be apologizing for underestimating accelerating absorption through the middle years of this decade.

Why shouldn’t we believe those who claim that the United States now has a mature economy and that past patterns of growth do not give us confidence that the future will continue the upward trend? Recently, that argument has taken the form that globalization is leading to the outsourcing of white collar jobs and that low-cost venues around the world (such as China and India) will not only be siphoning off manufacturing jobs, but call center operators, computer programmers, and Wall Street analysts.

There are several responses for those with such fears. One is that economic growth is not a zero-sum game, and that as emerging nations enter the modern economy they provide markets for the kinds of advanced business and financial innovations in which we specialize. The pie grows bigger and growth abroad is not necessarily threatening for us.

Another, often overlooked, item is that as those economies grow, workers need to see their standard of living improving, and that makes the “low-cost provider” strategy a temporary one. Japan, Hong Kong, Singapore, and Korea at one time provided low cost environments; but they succeeded and now have U.S.-style cost structures.

The last variable is that the United States has a secret weapon. That weapon is population growth. Unlike Europe and Japan, we are expanding demographically—both by natural increase (more births than deaths) and by immigration. That is a powerful propellant for GDP. And it keeps us competitive in jobs. The other side of the India and China story can be seen in most major U.S. cities, especially those with great universities and attractive life styles for young people—a new generation of citizens, whose parents are from India, China, Bangladesh, and

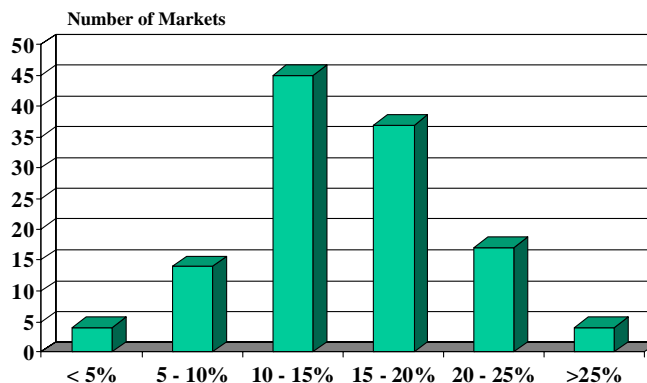
other emerging nations, who elect to come to the United States, if possible, because they see the opportunities in the United States more attractive than those at home. Here's a startling fact to consider: between now and 2025, in percentage terms, the U.S. population will grow faster than China's (22 percent here versus 15 percent there). In thinking about important long-term trends, that is something to ponder.

National Office Statistics in Brief

The nation's 4.25 billion square foot office market has grown in size, despite the softening of demand that began in 2000 and that has affected vacancy rates ever since. For this edition of *Comparative Statistics*, we have compiled information from 125 U.S. office markets, both in terms of numerical data and, equally valuable, the insights of SIOR's professional members who actively help shape these markets every day.

A year ago, we reported a troubling 2.9 percent increase in the national vacancy rate, to 15.1 percent. Based upon the conditions of the employment situation, and the then-existing pipeline of 61 million square feet of new construction, we warned that vacancy was likely to go up, and further retrenchment in the development industry was in store for 2003.

Histogram of Vacancy Rates



Now the numbers are in, and although they fulfilled our sober forecast, they carry within them some very hopeful prospects. Vacancy did indeed move upward in 2003, to 16.2 percent, or a 1.1 percentage point increase. While we do not expect that this will be the absolute peak (as we will explain further on), the moderation of the upward curve of vacancy is encouraging. Indeed, it puts into place one of the preconditions for a turnaround.

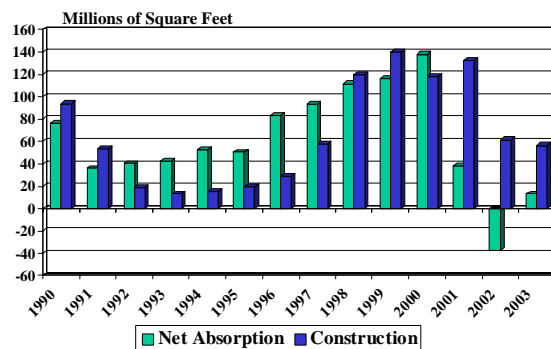
Still, when we examine the histogram of vacancy rates, showing the number of markets in various ranges of vacancy, we find that it has shifted well to the right this year. This means that more and more markets are falling in very high vacancy categories. There are 21 markets with a 20 percent or higher vacancy—in other words, in serious distress. The number of markets with single digit vacancy, 24 a year ago, has fallen to 18.

The development community, and those who finance it, is not naïve. The number of projects underway has dropped substantially, to a total volume of 56.4 million square feet, an eight percent drop from last year's already reduced level. The development volume in 2003 was 60 percent below the level of the late nineties, and that was an amount widely heralded as "disciplined."

Why would there be any construction at all? Businesses do not see office space as a purely interchangeable commodity. At any given point, companies will be shifting locations, consolidating staff, be engaged in M&A activity, or simply need more modern space in which to function. We learned in the last downturn that there is some irreducibly small level to which development will shrink. Last time around, that got as low as 16 million square feet in 1993. The rather more modest retrenchment today might suggest that the trough might not be so deep this time.

A lot depends upon absorption, but the lower limit will also be affected by liquidity. No money was available for financing either real estate or corporate growth in 1992 – 1994. The banks, you will remember, were essentially out of business. Not so today. Banking profits are very high; interest rates are low; and financing can be very creative. In estimating the amplitude of this cycle, such factors need to be taken into account. At present, it would seem safest to expect that development will fall to no lower than 45 million square feet at its cyclical trough.

Absorption Turns Modestly Positive; Construction Drops to Seven Year Low



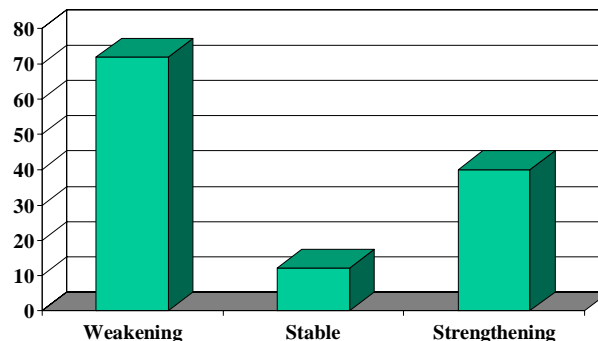
Doesn't that imply that the market will be falling into a deep abyss? After all, a 16 percent vacancy rate represents almost 680 million square feet of empty offices. Visualize that: it means the equivalent of emptying out every office in Manhattan plus every office in the New Jersey, Long Island, Westchester, and the Connecticut suburbs of New York. And that's not all. There's also about 125 million square feet of sublet space overhanging the market. That's about the size of the entire Northern Virginia market. Imagine adding more space to the problem!

The issue is a serious one, and deserves careful consideration. Here is where some understanding of current market forces, some historical perspective, and a grasp of underlying trends is absolutely critical. One rather shocking discovery lurking in this year's statistical trove is that the office sector had 21.5 million square feet of positive net absorption over the past year. That

admittedly is not a whole lot, just one half percent of the national inventory. The entire Northeast quadrant of the country (New England, the Middle Atlantic, and the Great Lakes states) is still recording occupancy loss. But the economic recovery has started to take hold already in the South and West, and that has started the comeback in demand.

History tells us that coming out of the last recession absorption stood at 40 million square feet in 1993, reached 80 million square feet in 1996, hit 115 million square feet in 1998, and spent four consecutive years between 115 and 140 million square feet before things fell apart again. Such figures tell a lot about anticipating the duration of the tenant's market. Factoring in the residual drag of the long "jobless recovery," vacancy looks like it will peak at about 17 percent in 2004 and stay high into 2006. But then the trajectory looks like a steep decline to eight percent or less by 2010.

Office Market Demand Ratio



What are the demand assumptions behind such a forecast? The implied growth rate for office employment is a very moderate 2.3 percent per year on average, and the model assumes that we will have a net addition of 300 million square feet of inventory by 2010. Like all forecasts, this is not so much a precise prediction of the future as it is a systematic way of thinking about probabilities, trying to help in forming reasoned judgments and good decisions.

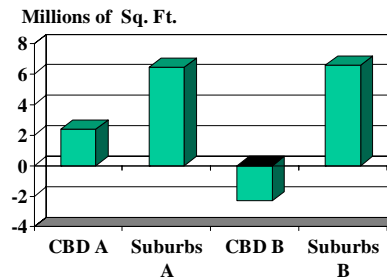
A look at absorption figures can help us distinguish where demand is flowing. We will address the geographic distribution of net demand in 2003 in the regional discussion that follows. But the analysis of downtown and suburban trends, as well as Class A and Class B shifts, is instructive.

As the pie chart showing the distribution of inventory shows (at the beginning of this commentary), CBD space accounts for about 35 percent of the national office inventory, with 65 percent in the suburbs. Class A space represents roughly 57 percent of the inventory, with 43 percent classified as Class B property.

The net absorption figures for 2003 indicate that Class A space had positive growth in both the downtowns and in the suburbs. But Class B space continued to shed occupancies in the cities, while the suburbs found enormous demand for Class B space. There seem to be two, somewhat countervailing trends at work. The first is the "flight to quality" movement typical of office cycles, where tenants see an opportunity to upgrade their accommodations. The second is the

cost-consciousness that comes as businesses seek to safeguard their bottom line in difficult economic times. That shifts demand generally from the CBD to the suburbs, and in the suburbs may afford an advantage to the most economical space. Such an explanation is consistent with this year's data.

Net Absorption by Building Class and Location



While upward movement in the direct vacancy rate was revealed in the data, there was also a decline in the volume of sublease space on the market. That decline of 15 million square feet (to 125 million square feet) has to be welcome news especially in suburban areas, which have 69 percent of the sublease space with which to cope. Construction activity is mostly in the Class A building category, and about evenly divided between the CBD and suburbs. But this is very localized: Manhattan, Washington (DC), and Boston are the only downtowns reporting a million square feet or more of new development. And it is only in the suburbs of Manhattan (e.g., Northern New Jersey) and the Virginia and Maryland suburbs surrounding the Nation's Capital that significant office building is underway.

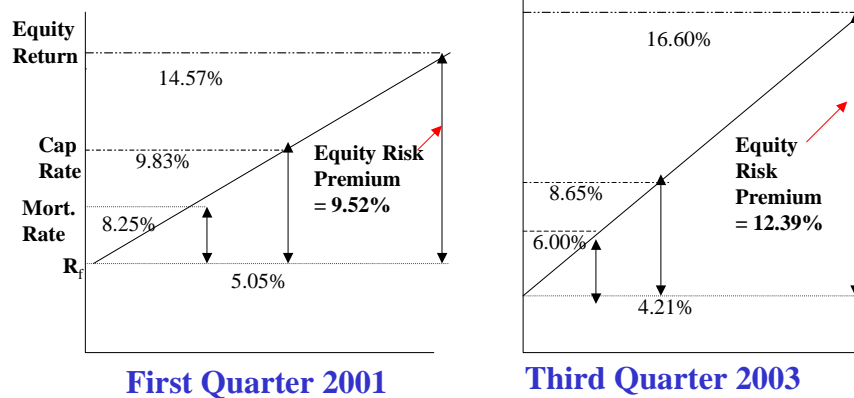
Not coincidentally, these are the markets where investors have poured enormous amounts of capital into office properties, at prices of \$250 to \$500 per square foot. This is the so-called “disconnect” between market fundamentals like vacancy rates and the perceived “overpaying” for office properties. How foolish are these investors really?

Top prices are being paid, it is true, but only in a handful of markets. These are some of the healthier occupancy markets in the nation, especially for Class A properties, as the detail compiled in this year's survey indicates. Also, within those markets, investors are selecting properties with strong tenant rolls and minimal lease renewal risks in the short term; but, most importantly, they are acquiring assets at equity yield rates that are adjusted for the risk of the market cycle.

How could we measure this? One way would be to compare how three variables have shifted since the markets began to weaken seriously in 2001—capitalization rates, mortgage interest rates, and the benchmark Treasury bond that represents the “risk free” rate of return. The graph below presents all three variables for the first quarter 2001 and for the third quarter 2003, when our *Comparative Statistics* market data was compiled.

Holding a 75 percent loan to value ratio constant, to represent a typical level of leverage in office transactions, we find that although capitalization rates have declined by more than a full percentage point, equity yields have **increased** by more than two percentage points, and the Equity Risk Premium (the difference between the yield rate and the risk free rate) is up 287 basis points. That is the adjustment that investors require to reflect the riskiness of market conditions. Yields in the teens, and a spread over Treasuries of more than 12 percentage points, make offices look very attractive on a risk-adjusted basis. Competitive markets do not suffer fools gladly. However, it looks very much like the buyers are going into these deals with a sharp eye to making sure they are being paid for the riskiness of the deals. Don't assume that billions of dollars are being spent carelessly as we go through this market cycle.

Equity Risk Premiums Are Pricing Market Fundamentals



National Office Market Regional Overview

New England

(Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont)

The year has not been kind to the office markets of the New England Region, which saw its vacancy situation deteriorate from 16.6 percent in 2002 to 18.1 percent in our current survey. That stands as the highest regional vacancy rate in the nation, not a surprise as we measured 4.7 million square feet of construction a year ago when occupancy was already in a serious slide. This time, absorption is still negative, but only by one million square feet, versus 6.7 million square feet in 2002. And construction eased to three million square feet of new space in 2003. An immediate turnaround cannot be predicted based on those numbers.

Three of the region's markets have vacancies greater than 20 percent: Boston, Hartford, and Nashua (NH). Although Nashua earned the dubious distinction of making the list of the 10 highest vacancy markets in the nation, Boston has the most serious problem. It is the economic center of the region and the New England market with by far the largest office inventory, 140.5 million square feet. A year of further weakness is expected before the occupancy figures start to improve in Boston. Hartford does not anticipate a strong 2004, either, so the biggest markets in the region are the most afflicted.

New England is not without its bright spots. Portland (ME) and Providence each find themselves on the honor roll of the country's 10 tightest office markets and Stamford/Norwalk in southwestern Connecticut also boasts a single-digit vacancy rate. Both Providence and Portland credit a quick contraction in development, rather than soaring demand, for their healthy occupancy. Stamford/Norwalk, on the other hand, is measuring more than 360,000 square feet of positive net absorption from the financial services and legal sectors and expects more of the same in 2004.

Middle Atlantic

(New Jersey, New York, and Pennsylvania)

The fourteen markets in the three Middle Atlantic States range from the nation's largest market in Manhattan, to the smallest in our survey, tiny upstate Batavia (NY). Vacancy shifted sharply upward during 2003, rising to 14.9 percent from a 13.2 percent rate a year ago. The region's 835.2 million square foot inventory saw its net occupancy dip by 11.0 million square feet, even as 10.9 million square feet of new development was in progress.

The contrasts in the region's markets are not merely in relative sizes. Seven of the region's markets are below the national vacancy rate benchmark of 16.0 percent. These included Albany, with a 9.3 percent vacancy and positive net absorption for the year. Manhattan and its Long Island suburbs, as well as the upstate New York markets of Syracuse and Buffalo are all in the 11 to 12 percent vacancy range, and Harrisburg comes in at 10.2 percent. The New Jersey markets are in the upper teens, Philadelphia exceeded twenty percent vacancy, and Allentown has one-third of all its office space empty.

Spirits in the major markets are buoyed by continued strong office investment pricing, and a very lively market for Class A office buildings. Although corporate layoffs and generally weak employment is hammering the demand side, continued buyer confidence in the region is

translating into a belief that economic growth will be coming soon. The very best sign of that is a projection that Wall Street will end up marking 2003 as its most profitable year *ever*. If that is the case, it is almost certain that financial services employment will be turning up again soon. A harbinger of such a change might be seen in the recent request of Goldman Sachs for tax breaks to build a new office tower in Lower Manhattan—a shift in its plans to use nearby Jersey City for its expansion needs.

East North Central

(Illinois, Indiana, Michigan, Ohio, and Wisconsin)

Right now, no region of the country is having the extended difficulty in its job losses as the Great Lakes States, with Indiana, Michigan, and Ohio all dropping more than a full percent in non-agricultural jobs over a year ago. Illinois was down 0.8 percent; and Wisconsin eked out a slim 0.2 percent gain. In that context, it is not surprising to find a 1.7 percentage point rise in vacancy to 17.1 percent in the East North Central Region.

The critical manufacturing businesses of the region have suffered severely in this downturn, especially with the high value of the dollar constraining their export capability. White collar employment in the front offices has been cut back, and the demand for support services of all kinds reduced as corporate cost-cutting measures have been implemented. It is remarkable that only one million square feet of net negative absorption ensued in 2003, a positive sign compared to the 6.1 million square feet of occupancy lost in 2002. These markets are apparently nearing bottom.

While Quad Cities (IA/IL) and Ft. Wayne (IN) have vacancy less than 10 percent, nine of the 19 markets in the region registered positive absorption in 2003, indicating local growth below the aggregate regional decline. Absorption in Milwaukee and Madison were especially strong, a reflection of the Wisconsin economy's leading the region in employment recovery. The large cities—Chicago, Cincinnati, Cleveland, and Columbus—are all expecting a slow march back to equilibrium, and caution that even if improvements are seen in 2004, it will be several years before their office markets reach a healthy supply-demand balance.

West North Central

(Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota)

The Plains States earned the distinction of bringing their overall vacancy rate down over the year, from the 2002 plateau of 18.4 percent to 17.7 percent in 2003. Net absorption across the seven markets in this region measured 5.8 million square feet, a remarkable achievement when compared to the nation's larger and more renowned office centers. All seven markets reported occupancy increases on a year-to-year basis.

However, these markets are still feeling the bruising downturns of 2001 and 2003 and none are reporting high enthusiasm for 2004. Rather, "cautious optimism" and a sense that a long, slow road of recovery lying ahead is the dominant mood. The region has a rather interesting diversity to its economic base. Farming and agribusiness, of course, are an important part of the picture. But manufacturing of all sorts, particularly transportation equipment, is a significant element in St. Louis and in Wichita. Insurance and financial services play a key role in Omaha and Des Moines. And 3M is still a force in the Twin Cities. This mix gives the region several opportunities to piggyback on the national economic expansion currently underway.

South Atlantic

(Delaware, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, and West Virginia)

Vacancy rose by one-half percentage point to 16.1 percent in 2003 for the 22 markets making up the vast South Atlantic Region. The South Atlantic led the nation in net absorption, with 12.8 million square feet, but also in construction volume at 19.3 million square feet, suggesting that future improvements will be quite incremental. Sixteen of the individual markets posted positive absorption over the year. Both tiny Gainesville and the downtown market of Washington (DC) had single digit vacancy rates that placed them in the top ten cities nationwide.

There are a number of laggard markets, though. Greenville (SC) secured a place among the 10 weakest markets in the nation with a 25.3 percent vacancy rate; and the much larger Atlanta market had a vacancy of 22 percent. The prospects in South Carolina are clouded by that state's continued loss of jobs, while Georgia has seen a strong turnaround in 2003 and can reasonably expect office demand to pick up in 2004. With the exception of Charlotte, with its financial services base, the North Carolina economy is also struggling, with Raleigh-Durham and the Greensboro MSA seeing vacancies in the 17 to 18 percent range and no obvious near-term prospects to regain balance. Recovery will be a matter of several years, not several quarters, in these markets.

More positively, the Florida markets look like they should be able to work their way back more quickly. Miami, West Palm Beach, and Orlando all have vacancies in the 11 to 14 percent range and solid prospects for employment expansion. Indeed, job recoveries are already underway. Together with Georgia, Florida forms a springboard for a more widespread regional revival during 2004.

East South Central

(Alabama, Kentucky, Mississippi, and Tennessee)

The Mid-South States have recaptured their title as the region with the lowest vacancy in the United States for 2003, with a 12.9 percent rate, more than three percentage points lower than the U.S. average. A year ago, virtually no construction was underway in this region and so it was able to turn its absorption directly to advantage, rather than finding it diluted from tenant movement from existing office space to newly opened buildings.

There are nine markets reporting from the four states in this region, which has the smallest inventory of any part of the country, 126.6 million square feet. However, three of the markets lead the nation in occupancy rates, including Chattanooga, which places number one at a mere 3.8 percent vacancy rate. Jackson and Huntsville also make our top 10 list, though Louisville and Mobile have vacancies greater than 20 percent.

The large Tennessee markets are somewhere in the middle. Nashville reports weakening rents and rising concessions still the trend. Memphis indicates that inroads on the sublease problem will make 2004 a year in which the market will witness gains. Looking at national trends, this region is a transition zone between an employment expansion moving north and east as time goes on and the still-troubled manufacturing economy of the East North Central. It is more in the path of growth, though, than in danger of spreading decline. Given the relatively small office inventory, this could be the first U.S. region to witness more than 90 percent occupancy in recovery.

West South Central

(Arkansas, Louisiana, Oklahoma, and Texas)

The Oil Patch is in trouble... again. Not only does it rank second behind New England in terms of high regional vacancy, it also ranks second behind the Middle Atlantic Region in negative absorption. Moreover, three of its markets—Lake Charles (LA), El Paso, and Oklahoma City—have vacancies greater than 24 percent. Dallas, with a 21.9 percent vacancy factor, barely missed making the “10 worst” list.

The problems are myriad. But they are easily reduced to just two. Number one: supply. Number two: demand. On the supply side, there is always a propensity to build here, especially in the Texas markets. The demand side reflects an economic base that is still first and foremost energy related, and whose “diversifiers” have been technology and air transportation, industries that bring volatilities of their own. The resulting diet has not been a healthy one in recent years.

Of the major markets, Houston looks like it will be earliest to turn around. Demand is already improving, particularly in its suburbs, and the MSA reported more than four million square feet of net absorption. Austin also stemmed the bleeding, and expects vacancy to drop in 2004.

Mountain

(Arizona, Colorado, Idaho, Montana, New Mexico, Nevada, and Wyoming)

2003 proved to be a fairly steady year for the Mountain office markets, with overall vacancy in the nine reporting cities up just four-tenths of a percentage point to 15.7 percent. Absorption and construction were well balanced, with 2.7 million square feet of improved occupancy reported, together with a development volume of 2.6 million square feet.

Led by Las Vegas, with 1.3 million square feet of net absorption, several cities in this region have resumed vigorous growth. Boise, Reno, and Tucson, are also solidly in the plus column. Colorado Springs, Phoenix, and Salt Lake City are improving at a somewhat more restrained pace, but this should accelerate in 2004. Denver had a quarter-million square feet of occupancy improvement, but this is in the context of a 113 million square feet of inventory and 16.8 percent vacancy factor.

As 2003 progressed, this region saw more and more of its states with strengthening employment trends. Nevada recently became the first state in this cycle to post a year-over-year job improvement of greater than three percent. Momentum is building in the Mountain Region, and the outlook for an even better statistical showing in 2004 is very promising.

Pacific

(Alaska, California, Hawaii, Oregon, and Washington)

All in all, the West Coast acquitted itself well over the year. Our sample of 23 markets, comprising 638.8 million square feet of space, yielded a vacancy rate of 15.9 percent, a bit less than the U.S. average and next best after the East South Central. Absorption and construction were tallied identical at 5.6 million square feet, indicating a potential for a downward adjustment in vacancy if demand accelerates as anticipated in 2004.

The region is not without its trouble spots to be sure. Tacoma makes the “10 worst” list at 23.3 percent. At the other extreme is the robust collection of Southern California markets, led by Orange County’s 1.5 million square feet of net absorption. Seattle, too, marked a year of surprisingly positive absorption and began to make inroads on its 14.5 million square feet of vacancy.

The gyrations in the Pacific Region forced everyone into a serious reconsideration of this market’s ability to turn suddenly and sharply. Risks are high, obviously, but volatility can cut both ways. Certainly the long-term history of this region provides encouragement that it can outperform the nation in the expansionary phase of the cycle. Investors continue to give the market here a strong vote of confidence and the excellent discipline on the supply side in 2003 should pay dividends into the future.

LARGEST AND SMALLEST OFFICE MARKETS IN SIOR SURVEY *(Millions of Square Feet)*

Largest Markets	Inventory	Smallest Markets	Inventory
NYC-Manhattan, New York	331.6	Batavia, New York	0.5
Chicago, Illinois	237.1	Lake Charles, Louisiana	0.6
Dallas, Texas	208.6	Savannah, Georgia	1.5
Houston, Texas	173.4	Peoria, Illinois	2.1
San Diego, California	150.4	Nashua, New Hampshire	2.3
Atlanta, Georgia	149.9	Spokane, Washington	2.5
Boston, Massachusetts	140.5	Corpus Christi, Texas	2.7
Washington, DC NoVa, Virginia	123.9	Youngstown, Ohio	2.8
Denver, Colorado	113.1	South Bend, Indiana	3.0
Philadelphia, Pennsylvania	112.3	Gainesville, Florida	3.1

LOWEST AND HIGHEST OFFICE VACANCY RATES

Lowest Vacancy	Vacancy Rate	Highest Vacancy	Vacancy Rate
Chattanooga, Tennessee	3.8%	Allentown, Pennsylvania	33.5%
Gainesville, Florida	4.3%	Nashua, New Hampshire	27.4%
Portland, Maine	4.4%	Greenville, South Carolina	25.3%
Jackson, Mississippi	4.5%	Lake Charles, Louisiana	24.9%
Providence, Rhode Island	6.0%	El Paso, Texas	24.7%
Huntsville, Alabama	6.9%	Oklahoma City, Oklahoma	24.4%
Bakersfield, California	7.8%	Tacoma, Washington	23.3%
Fresno, California	8.4%	Mobile, Alabama	23.2%
Washington, DC	8.5%	Peoria, Illinois	22.4%
Monroe, Louisiana	9.1%	Atlanta, Georgia	22.0%

OFFICE REGIONAL SUMMARY — SIOR SURVEY
(Millions of Square Feet)

Region	Number of Markets	Inventory	Vacant Space	Vacancy Rate	Sublease Available	Absorption	Construction
New England	8	236.8	42.8	18.1%	11.1	-1.0	3.0
Middle Atlantic	14	835.2	124.6	14.9%	27.5	-11.0	10.9
East North Central	19	568.2	97.2	17.1%	19.8	-1.0	4.9
West North Central	7	183.6	32.5	17.7%	4.3	5.8	4.3
South Atlantic	22	810.1	130.2	16.1%	22.7	12.8	19.3
East South Central	9	126.6	16.4	12.9%	3.8	1.3	2.4
West South Central	14	535.5	95.2	17.8%	12.5	-2.0	4.6
Mountain	9	247.1	38.9	15.7%	6.3	2.7	2.6
Pacific	23	637.2	96.5	15.1%	15.7	3.7	5.0
US Totals	125	4,180.7	674.3	16.1%	123.5	11.2	55.7