SIOR Index – Office and Industrial Markets Impacted by Financial Crisis

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By Lawrence Yun, Senior Vice President & Chief Economist and George Ratiu, Economist

Economic Overview

The economy maintained slow but steady growth during the first half of 2008. However, third quarter 2008 experienced several major shocks that stressed the economy severely. September saw the collapse of Merrill Lynch, Lehman Brothers, Washington Mutual, and Wachovia. In addition, the government placed Freddie Mac and Fannie Mae in conservatorship and organized the rescue of AIG.

Prompted by a severe loss of confidence and a broad sell-off, October experienced wild swings in the financial markets, the demise of major banks, a mounting volume of non-performing assets (which squeezed liquidity), and frozen financial credit.

Even the aggressive measures undertaken by the Treasury to insure bank deposits and buy stock in financial institutions did not help the downward slide. The gravity of the economic situation was underscored by the Fed's emergency decision, in coordination with central banks worldwide, to cut the federal funds rate by half a percentage point, to 1.5 percent. A move made in spite of the Fed's concern over mounting inflation.

These factors are adding to several existing conditions that are driving the economic decline. The residential real estate market saw a 2.2 percent sales decline during August. Although there are variations in sales volume and prices across the country, the overall performance of mortgages is still troublesome. The second quarter saw an increase in the national foreclosure rate, to 2.75 percent. In the meantime, falling new home construction, although decreasing the inventory, signals a drop in construction employment. The number of construction jobs lost between the second and third quarter 2008 amounts to 268,000. For the overall economy, the unemployment rate is also up to 6.1 percent, and is forecast to increase to 6.5 percent by the end of the year.

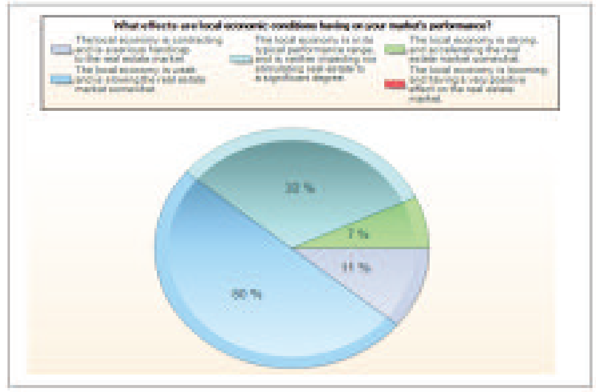
This situation is clearly having an influence on consumers. The Consumer Confidence Index dropped 14.4 percent in the third quarter of 2008. Consumer spending, which has been the main driver of economic growth over the past few years, grew by only 1.4 percent in the second quarter, and is expected to stall in the third and fourth quarters. Rising prices for most consumer goods have curtailed spending. This deceleration is in marked contrast to the three to four percent real growth in consumer spending during the past five years. Consumers have trimmed their spending on all fronts, except necessities.

The current economic situtation has spilled over into the commercial sector. Based on the SIOR Index survey, 40 percent of respondents indicated that construction activity is down, and 33 percent indicated that there is virtually no new construction taking place in their markets. Moreover, 92 percent of respondents pointed out that the national economy is having a negative impact on their local markets.

Industrial production decreased 2.8 percent in September, driven by declines in mining and business equipment outputs. On a yearly basis, production dropped by a significant 4.5 percent. Vacancy rates for industrial space are up to 10.1 percent for the third quarter of 2008. In addition, the troubles in the financial markets are leading to a general decline in demand for office space. In turn, this is pushing the office vacancy rate up to 13 percent nationwide for the third quarter.

The only major components of the GDP that are still proving resilient are exports and government spending. For the second quarter of the year, exports grew by 5.6 percent, aided by a weak dollar. Government spending increased 2.7 percent for the same period. Government expenditures cannot sustain economic growth over the long term. Based on current indicators of economic activity, we are facing a recession. The big question: Will be a short and shallow or prolonged and deep?

SIOR Commercial Real Estate Index September/October 2008—Reflecting 3rd Q 2008 Conditions



SIOR Index Survey Results

The results of the Fall 2008 SIOR Index survey point to an ongoing decline in members' sentiment about the condition of the economy and commercial real estate. The Commercial Real Estate Index, representing third quarter 2008 data, compiled by the SOCIETY OF INDUSTRIAL AND OFFICE REALTORS® (SIOR) and evaluated by the NATIONAL ASSOCIATION OF REALTORS® (NAR), is at its lowest since SIOR began its indexation project in late 2005. The National Index, which measures

10 variables pertinent to the performance of U.S. industrial and office markets, dropped 10 points to 66.4.

The SIOR Commercial Real Estate Index is a diffusion index (see Methodology) where a score of 100 indicates markets in balance. Therefore, a score of 66.4 reflects negative conditions in the commercial real estate industry for landlords and sellers. This is also the fourth consecutive quarter with values below 100, pointing to a difficult environment for commercial real estate activity.

The financial crisis and lack of credit brought on by a recessionary national economy is reflected in local industrial and office market conditions because firms are curtailing expansion plans. Looking at the two sectors of the survey, the industrial index declined at a faster rate (9.5 point drop) than the office index (8.5 point decrease) this quarter. Although all major regions are down, the South registered the highest drop, despite its continued resiliency. The Northeast posted the second highest decline, while the Mid-West and West recorded smaller declines.

The survey, which painted the picture of a general slowdown, measures practitioner sentiment and is based on anecdotal evidence from SIOR members across the country. The majority of SIOR respondents reported that the national economy is negatively affecting local markets. And 61 percent of respondents found that the local economy is also placing stress on the market's performance by weakening, contracting, and slowing the commercial real estate market.

In conjunction with the overall trend, a significant 82 percent of respondents feel that leasing activity in their market is below historic levels. Subleasing conditions seem mixed, with 40 percent

SIOR Index Reflecting 3rd Q 2008 Conditions

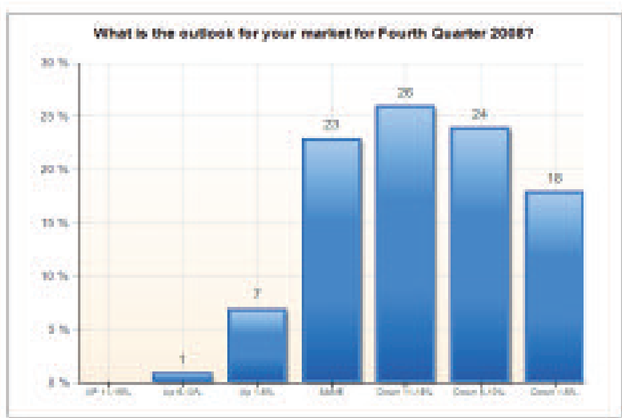
of practitioners feeling that there is a normal volume of sublet space and the remaining 60 percent are evenly split between markets with ample sublet space and those with little space available.

The slowdown in activity is having an impact on fundamentals, as 61 percent of respondents think that vacancy rates are higher than normal. Stemming from increased vacancies, tenant concessions also are increasing and asking rents are declining. Fifty-two percent of members feel that asking rents are below where they were one year ago. According to the respondents, it seems to be a "tenants' market." Sixty-four percent feel that tenants are benefiting from moderate levels of concessions. Whereas only five percent indicated concessions were insignficant.

Mirroring major economic indicators, construction activity is clearly in a slowdown, according to 40 percent of respondents, with 33 percent indicating that there is virtually no new commercial construction in their market. In terms of development acquisitions, 56 percent of respondents find it a buyer's market with stable prices, and 11 percent see a strong buyer's market with falling prices.

On the investment side, the volatility in the financial markets and the lack of liquidity are taking a toll on transactions. Prices are falling in 58 percent of the markets and 29 percent see prices in line with replacement costs.

SIOR Index Reflecting 3rd Q 2008 Conditions



When asked about the outlook for the next three months, 68 percent indicate that they expect business to be down from current levels and 23 percent feel that their market will maintain the current level of activity during the next three months.

SIOR Index Results by Property Type

Although leasing activity is below historic levels across the board, industrial specialists are experiencing less leasing activity than are office respondents. This trend carries to sublease space, where the volume is close to normal conditions, but less so in the industrial market than the office market.

Both office and industrial specialists see lower rents and higher vacancies, but industrial respondents report a steeper decline in rents, higher vacancy rates, and more tenant concessions than those in office markets.

Construction levels for both sectors are below the historical average, with industrial building slightly lower than office. SIOR industrial and office brokers feel that prices are somewhat stable, but it is a buyer's market.

Stemming from the decline in office employment and the financial crisis, the national economic turmoil is having a stronger negative impact on SIOR office practitioners. Consequently, it is not surprising that the prospects for the next three months are lower for office practitioners.

Regional Breakdown

The **West** continues to experience the lowest sentiment about the market. The SIOR Index for the West dropped 2.8 points, to 65.6. This was the smallest decline this quarter; however, it follows a 16.2 point drop the previous quarter.

In the **South**, the SIOR Index declined 6.4 points (following a 9.4 point drop last quarter) to 78.2, to again be the highest index level of the four regions. The South continues to maintain somewhat higher resiliency than the other major regions.

The **Northeast** SIOR Index fell from 76.4 in July to 71.9 in October. The collapses of major financial institutions on Wall Street are clearly taking a toll on the office market in the Northeast. This is mirrored in SIOR members' sentiment about the market, as evidenced by the second largest decline in the regional indices.

The **Mid-West** index recorded the second smallest decline—3.9 points, from 73.1 in July to 69.2 in October. Markets in the Mid-West are strongly influenced by slowing local economies, which are placing downward pressures on prices and availability rates.

Leasing

Respondents in the West see the lowest level of activity, while respondents in the South are closer to leasing levels of one year ago. Subleasing conditions are fairly close to normal conditions for all regions, with the West experiencing slightly higher volume.

Vacancy Rates

Vacancy rates are higher than they were one year ago for most regions. Practitioners in the West reported higher vacancy rates in their markets than that of members from the other regions. The South is experiencing somewhat smaller increases. All regions indicated that they felt that rents were down slightly, with the West seeing the largest decline. Practitioners from the South are finding asking rents to be closer to those of a year ago. Although overall it is certainly a "tenant's market," concessions are more available in the West and Mid-West, with respondents in the West indicating that tenants are obtaining moderate to deep concessions. The South and Northeast are seeing the smallest concessions

Development

Development activity is markedly below historical averages. Development has been curtailed more in the West and Mid-West, than in the South and Northeast. Cost for land to development reflects a buyer's market especially in the West.

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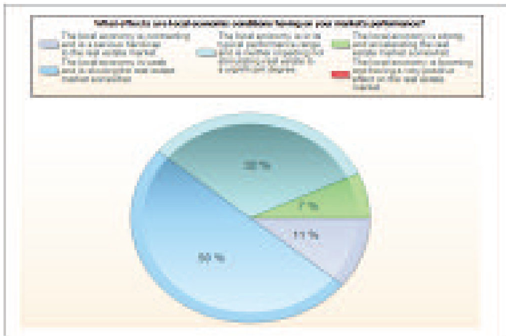

The Economy's Influence

Most respondents feel their local economy is having a negative influence on the market, with the Mid-West respondents feeling the strongest impact. The national economy is also having a negative impact on most markets, but much more so in the Northeast. The short-term outlook is the lowest for the Northeast and Mid-West.

Outlook

The SIOR Index for October 2008 is clearly trending downward, right in step with the major economic indicators, pointing to a downslide in office and industrial leasing and sales activity. The national economy and the financial crisis are affecting both local economies and the real estate markets. The lack of liquidity in the financial markets is causing tenants and investors to delay major real estate decisions.

METHODOLOGY

The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's Purchasing Managers' Index. In the SIOR Commercial Real Estate Index, a value of 100 represents a well-balanced market for industrial and office property. Values significantly lower than 100 indicate weak market conditions; values significantly higher than 100 measure strong market conditions. The theoretical limits of this Index are a low of zero, and a high of 200, though it is unlikely that such limits would be approached as long as the property markets are operating efficiently.

The Index is based on a survey questionnaire with ten topics. The topics covered are (1) recent leasing activity; (2) trends in asking rents; (3) trends in vacancy rates; (4) subleasing conditions; (5) levels of concession packages in leases; (6) development activity; (7) site acquisition activity; (8) investment pricing levels; (9) the impact of the local economy on the property market; and, (10) the effect of the national economy on the property market. Survey respondents are given five choices. For each topic, five choices are provided, corresponding to conditions that are very weak, moderately weak, well-balanced, moderately strong, or very strong.

For each question, answers are tallied and the percentage of responses for each of the five choices is calculated. If survey panelists indicate "very weak" conditions (the "a" choices in the questionnaire), the answer is assigned 0 (zero) points; "moderately weak" ("b" answers) earn 5 points; an indication of "market balance" ("c") receives 10 points; "moderately strong" indications ("d") score 15 points; and "very strong" ("e") responses receive a maximum 20 points. Thus a score of 10 for a given question can be earned if responses are evenly distributed across all five choices, if all responses were "c", or if the answers form a "bell-shaped curve" centered around the "c" choice. The total index value is derived by summing the scores for all ten questions. Index values for each of the two property types are similarly calculated.

The survey was developed by Hugh F. Kelly, CRE, clinical professor at New York University, who worked with SIOR on research projects since 1989.