OfficeLease

# OfficeIntelligencer

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Commercial Real Estate Planning
Tenant & Buyer Representation
Since 1981

Paul Suzman,
Managing Director

## 2003 REVIEW 2004 PREVIEW

Landlords perceive a recovery and perception is reality when it comes to their forecasting lease rates and negotiating long-term leases. But temper this perception with the facts presented in this newsletter and you will understand that 2004 will remain a good year for companies who have positioned themselves to make long-term real estate commitments. If the duration of the last two real estate cycles is repeated then a ten year lease today will likely put a tenant back in the market during the next down cycle. Consider therefore that this might be the right time to take advantage of market conditions even if your current lease has time to run. Keep in mind, landlords want to avoid the expensive 'downtime' of space sitting empty. Deals are to be made now for space which will not be vacated until 2006!

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## NEW TAX BENEFITS FOR TENANTS IMPACT IMPROVEMENTS

An accelerated depreciation provision passed in legislation last year could result in significant tax savings on personal property acquisitions and the cost of some tenant improvements constructed after May 5, 2003.

The new law allows half of eligible tenant improvement costs to be depreciated in the first year with the other half depreciated over the normal schedule, typically 39 years. A second category that's eligible for this acceleration is newly acquired personal property with a depreciation period of 20 years or less.

Unless space is being leased 'as-is', it's important that provisions in the lease reflect the extent of each party's depreciable interest in tenant improvements. Tenants that understand this benefit may have an edge in negotiating improvement allowances this year. Be sure to contact your tax advisor for all of the details.

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## THOUGHTS ON EFFECTIVE NEGOTIATIONS

The market will determine what you can negotiate.
You always have control over how you negotiate.
A lease is both a document and a relationship.
How the document is negotiated will determine the relationship.
So, irrespective of market conditions, be direct and courteous.
It's good business and makes the process much more enjoyable.

## EVENTS AND ACTIVITIES IMPACTING LOCAL COMMERCIAL REAL ESTATE CONDITIONS

**UW's Capital Campaign:** Almost $1 Billion and counting; much of which will go into building construction; mostly for Health Sciences and much of that around South Lake Union.

**South Lake (Union) Allen:** Several significant biotechnology firms including Merck, research firms such as Battelle and institutions such as Seattle Biomedical Research Institute and UW are committing to space in the neighborhood. Fred Hutch continued its expansion.

**Global Health:** The Gates Foundation's expanding influence and investment in non-profits such as PATH (Program for Appropriate Technologies in Health). Seattle is becoming a mecca for global health care givers, issues, research and grant making.

**Washington Mutual:** As this local savings and loan powerhouse grows so does its appetite for space and the announcement of a One Million plus square foot office tower adjacent to and expanding the Seattle Art Museum will help delay a tightening of vacancy rates. Similarly Amgen/Immunex, Airborne, NBBJ's and some other moves will offset net absorption.

**Law firms move out of CBD**: Graham & Dunn moved from the CBD to Pier 70 and Davis Wright Tremaine is reportedly considering anchor tenancy in a new building south of the new Federal Courthouse on Westlake Avenue. Might others follow? And might we see a shift of the apparent CBD to the North?

**Regrade:** Residential and ongoing health science development in and around the Denny Regrade is all positive as Seattle and its neighborhoods continue their evolution as a '24 hour' city.

**Bellevue:** Kemper Freeman's decision to buy a stalled Lincoln Square development; while not adding significant office space to the Bellevue market is a positive. No city wants a mothballed building complex in the middle of town. And the City of Bellevue adopted a thoughtful Downtown and Subarea Plan to make the environment more pedestrian friendly and accessible. An interesting fact pointed out to us by Arlan Collins of Architects CollinsWoerman is that on street parking actually results in a healthier street level retail environment. People feel more secure having parked cars as a barrier between them and the traffic! I never thought of that cause and effect.

**Greater Eastside:** Microsoft's quiet expansion into its 153 acre Issaquah Highlands development. The software giant continues to impact commercial space valuation on the Eastside. Up to 15,000 MSFT employees are expected to work there eventually!

**Boeing's 7E7 'Dreamliner'** assembly remaining in Everett will have neutral impact on real estate availability or local values but it provides a useful psychological boost–primarily to Boeing employees and their local suppliers. It also makes a statement that Washington State is aggressive and reasonably competitive when it comes to attracting and retaining business. At the end of the day the cost of these jobs is probably out of proportion to the direct measurable benefit but winning this competition will likely provide other long-term benefits and help in bids to attract and retain other businesses in Washington.

**Two more factors inhibiting net space absorption**

**Phantom space:** Office space that is leased but yet unoccupied. (a hangover from the dot.com era) This causes a lag in space absorption during a recovery

**Reduced space standards:** It has been estimated that the average space required per office worker has declined over the last 15 years from over 215sf to 185sf per person. To put this in perspective, a large company, say Premera, with 3,000 employees, would require 90,000sf less space today than in 1990. This adds up! Or should we say, subtracts.

**To conclude:** Despite the many space alternatives apparently available (a 10-12,000 sq ft office space user would have over 100 options on the Eastside and 140 in Greater Seattle) be aware that blocks of existing contiguous space suitable for larger users (50,000 sq ft +) are more limited.

And despite depressed lease rates, the purchase price of quality commercial space remains high while availability remains very limited (which says that most owners have a long term perspective, are optimistic about the future and are willing to ride out the market cycles)

As always, we welcome your comments and questions.

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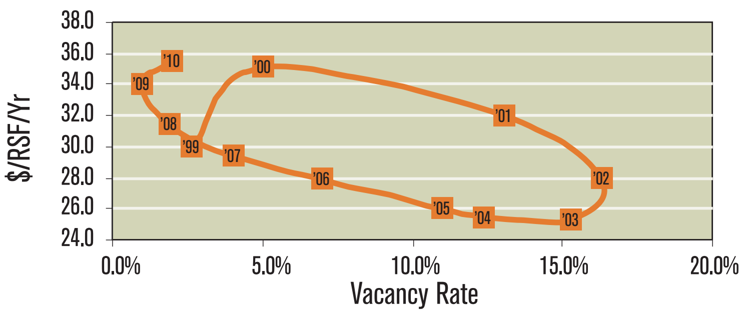
# HYSTERESIS LOOPS, THE MARKET RECOVERY AND OUR FEARLESS FORECAST

As 2003 drew to a close there was little doubt that the Seattle CBD office market had "bottomed out." Average full service rents had "stabilized" at about $25/RSF/year and the vacancy rate, including subleases, had dropped slightly from its peak of over 16%. The question now is: "how fast might the market recover?"

The Hysteresis Loop concept provides a model on which to base a forecast. A Hysteresis Loop is observed when the stress-strain plot of a material being stressed doesn't match that of the same material as it is restored to its original unstressed state. In the office rental market, the stress-strain relationship plots vacancy rate vs. rental rate. The following graph shows the Seattle CBD relationship first in the recent falling rental market as vacancy increased, and then the predicted recovery relationship as vacancy rate falls with an improving leasing market.

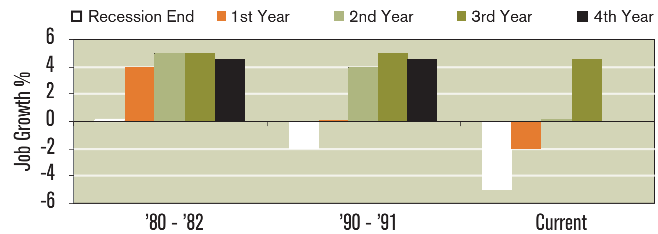
### Hysteresis Loop Forecast




The graph illustrates that the peak rental rate does not occur at the minimum vacancy rate as the rising market brings more space on line while landlords can still demand ever-higher rents. Similarly, the minimum rental rate does not occur at the maximum vacancy rate as landlords increase lease incentives to fill their buildings.

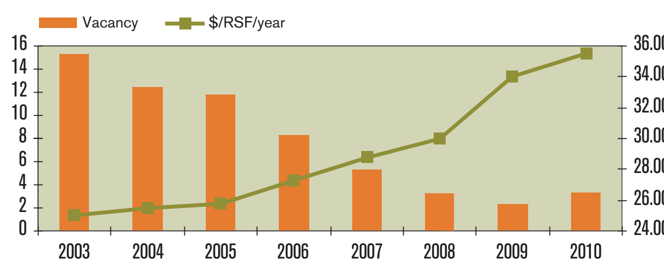
Now all we have to do is to forecast vacancy rates. This reflects the increase in demand versus the existing vacant space, plus any new buildings coming on line. Predicting demand is the key input. A recent article in the UBS Portfolio Managers Spotlight provides a relationship between business and service job growth in the four years following each of the last three recessions.

### Job Growth After Recession




The growth in space demand was assumed to be the indicated 4.5%/year of the then existing RSF inventory. The vacancy rate was then calculated by deducting this growth from the vacant space in a given year, including new space being added following a pattern from previous recoveries. This recovery will have a notable exception to the usual modest new space additions in the early years of recovery due to the new one million plus RSF WaMu Tower coming on line in 2005. This early large addition, as demand picks up, will moderate the reduction in vacancy rate and lengthen the recovery. The forecasted recovery is:

### Recovery Forecast




Needless to say, the forecast is the product of the specific assumptions, any and all of which can be debated. However, testing various combinations of assumptions still indicates that rental rates will not return to their previous peak until late in the decade.

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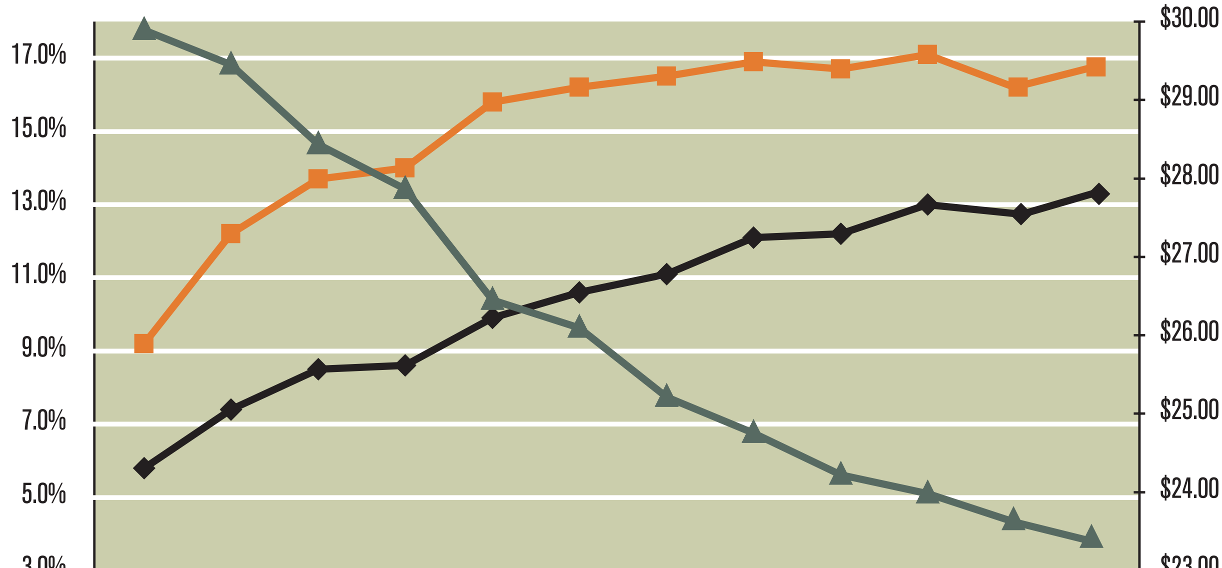
## JUST WHEN YOU THOUGHT IT WAS SAFE TO GO BACK IN THE WATER…

Last quarter it appeared that office vacancy rates had crested and were starting to subside. The data this quarter shows that we're still in the frothy foam at the top of the wave as vacancy rates increased half a point. This increase does not appear to be a reversal and we're still predicting that the market will improve, albeit slowly. Asking rental rates trended lower to $23.42 per square foot fully serviced, continuing the trend that started in the first quarter of 2001. Recently, economists have been more upbeat in their predictions and are expecting job growth in the Puget Sound area of over 1% in 2004 and over 2% in 2005, reversing three years of job losses. Outsourcing of jobs overseas is a big concern of landlords as well as the addition of new space through the upcoming completion of the Ninth & Stewart Life Sciences building and the 401 Broadway Office building.

## HISTORICAL VACANCY AND RENTAL RATES




| | Q1 '01 | Q2 '01 | Q3 '01 | Q4 '01 | Q1 '02 | Q2 '02 | Q3 '02 | Q4 '02 | Q1 '03 | Q2 '03 | Q3 '03 | Q4 '03 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Vacancy (w/Sublease) | 9.2% | 12.2% | 13.7% | 14.0% | 15.8% | 16.2% | 16.5% | 16.9% | 16.7% | 17.1% | 16.2% | 16.8% |
| Vacancy | 5.8% | 7.4% | 8.5% | 8.6% | 9.9% | 10.6% | 11.1% | 12.1% | 12.2% | 13.0% | 12.8% | 13.3% |
| Asking Rental Rate | $29.89 | $29.45 | $28.43 | $27.86 | $26.45 | $26.09 | $25.21 | $24.75 | $24.22 | $23.98 | $23.65 | $23.42 |

Office space available for sublease increased 5% to nearly 3.3 million square feet, primarily due to increases in the Downtown Seattle and Southend submarkets. This increase in sublease space reverses another positive trend seen last quarter. Unknown is the amount of phantom space; space that is leased but unused that will delay tenants from absorbing new space as they begin to grow.

## MARKET OVERVIEW

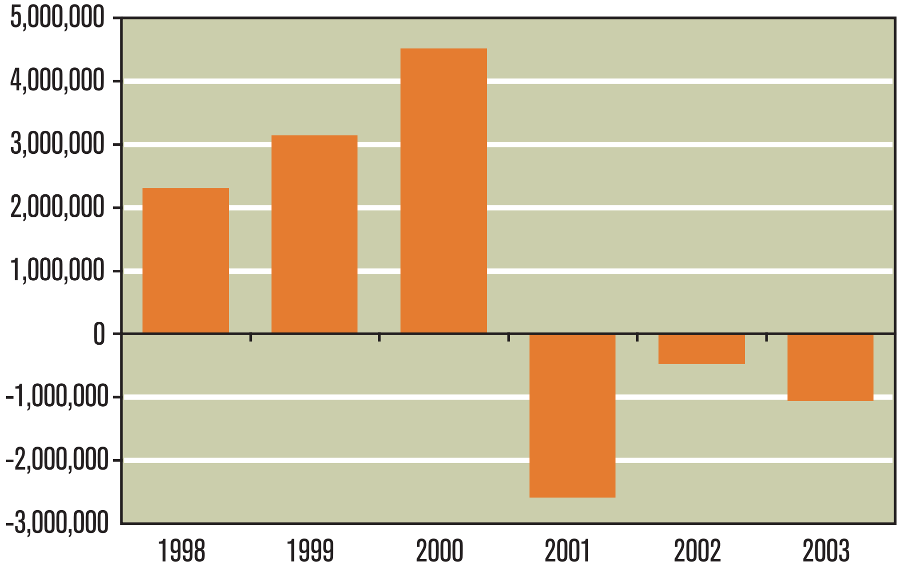
| | | | AVAILABLE SPACE | | | VACANCY RATES | | UNDER CONSTRUCTION | | PROPOSED | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Market Area | Bldgs. | Total Sq. Ft. | Direct Vacant | Sublease | Total Vacant | Direct Vacant | w/Sublease | Bldgs | Sq. Ft. | Bldgs | Sq. Ft |
| Downtown | 451 | 41,942,394 | 4,834,926 | 1,764,923 | 6,599,849 | 11.5% | 15.7% | 4 | 518,960 | 19 | 5,370,982 |
| Eastside | 642 | 27,049,562 | 3,418,739 | 1,306,590 | 4,725,329 | 12.6% | 17.5% | 2 | 903,000 | 22 | 4,488,863 |
| Northend | 166 | 6,134,652 | 982,576 | 44,291 | 1,026,867 | 16.0% | 16.7% | 1 | - | 5 | 1,015,072 |
| Southend | 277 | 11,984,903 | 2,293,478 | 157,330 | 2,450,808 | 19.1% | 20.4% | 0 | - | 5 | 1,885,000 |
| Tacoma | 125 | 4,490,502 | 611,224 | 15,568 | 626,792 | 13.6% | 14.0% | 0 | - | 1 | 120,000 |
| TOTAL | 1,661 | 91,602,013 | 12,140,943 | 3,288,702 | 15,429,645 | 13.3% | 16.8% | 6 | 1,421,960 | 52 | 12,879,917 |

## AVERAGE ASKING RENTAL RATES

| | Gross Rental Rate | | | |
|---|---|---|---|---|
| Market Area | Class A+ | Class A | Class B | Class C |
| Downtown | $33.45 | $27.23 | $20.14 | $18.29 |
| Eastside | $25.91 | $23.35 | $20.09 | $18.72 |
| Northend | | $21.83 | $18.58 | $15.86 |
| Southend | | $21.10 | $17.89 | $14.66 |
| Tacoma | | $20.41 | $15.53 | $13.10 |

Asking rental rates were down slightly across the board. Absorption ended the year at a negative one million square feet. Tacoma and the Northend experienced small positive absorption but were heavily outweighed by the negative absorption in the Eastside, Southend and Downtown markets. A bright spot was the Waterfront submarket where 280,000 feet were absorbed. The CBDs of Seattle and Bellevue led in negative absorption, followed closely by the Renton/Tukwila submarket.

## ABSORPTION
### SQUARE FEET




Through November, the labor force and employment grew 0.1% while the unemployment rate average 6.9%. If economist's current predictions are correct, we should start to see some improvement in the employment numbers in 2004 with significant improvement in 2005. The table below shows the employment statistics for the combination of the Seattle/Bellevue/Everett and Tacoma PMSA's provided by the U.S. Department of Labor's Bureau of Labor Statistics.

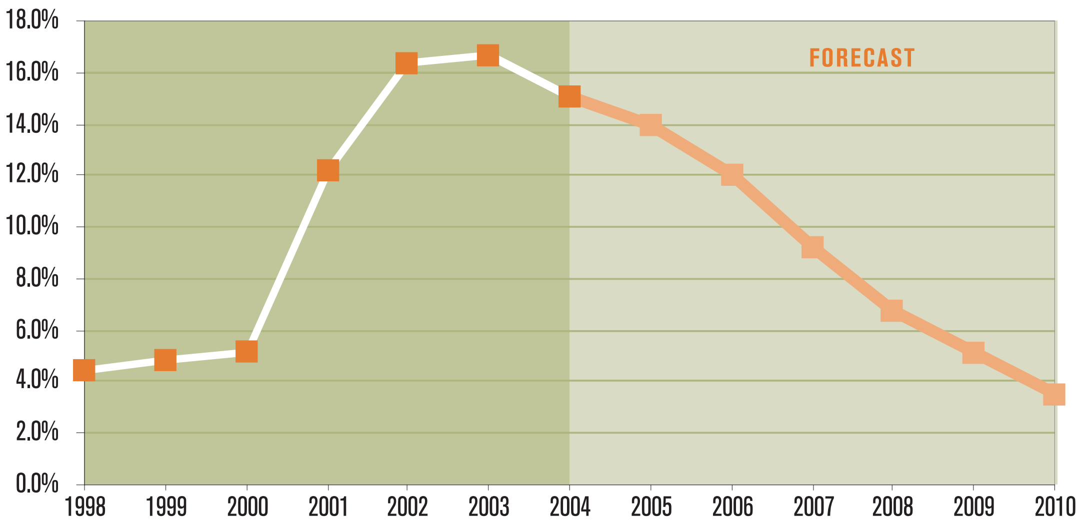
## EMPLOYMENT

| | Labor Force | Growth | Employment | Growth | Unemployment |
|---|---|---|---|---|---|
| 2003 * | 1,741,905 | 0.1% | 1,621,011 | 0.1% | 6.9% |
| 2002 | 1,740,984 | 2.1% | 1,620,176 | 0.5% | 6.9% |
| 2001 | 1,704,660 | -1.2% | 1,612,632 | -2.6% | 5.4% |
| 2000 | 1,725,463 | -0.8% | 1,656,415 | -1.2% | 4.0% |

* 2003 YTD (average through November)

Another way to forecast vacancy is to assume that the space required per employee remains constant. Then by forecasting employment growth and the rate at which new buildings are brought to the market; the resulting vacancy may be derived. Employment projections by local economists are for growth of over 1% for 2004 and over 2% for 2005. Most economists are smart enough not to project further into the future. The following vacancy forecast assumes employment growth of 1.5% in 2004, 2.5% in 2005, 3.5% in 2006 and 2007 and then 2.5% through 2010. These job growth assumptions result in office vacancy, including space available for sublease, declining to under 4% by 2010. Growth greater than these assumptions will spur demand and decrease vacancy faster but slower job growth, perhaps due to outsourcing of white-collar jobs, could lead to a slower recovery. And then there is the supply side. There are a lot of projects planned, the timing of their completion and coming to market, will likely have the largest impact on the office market. The most interesting point is that both this forecast and the Hysteresis Loop forecast project that the office market won't fully recover until near the end of the decade.

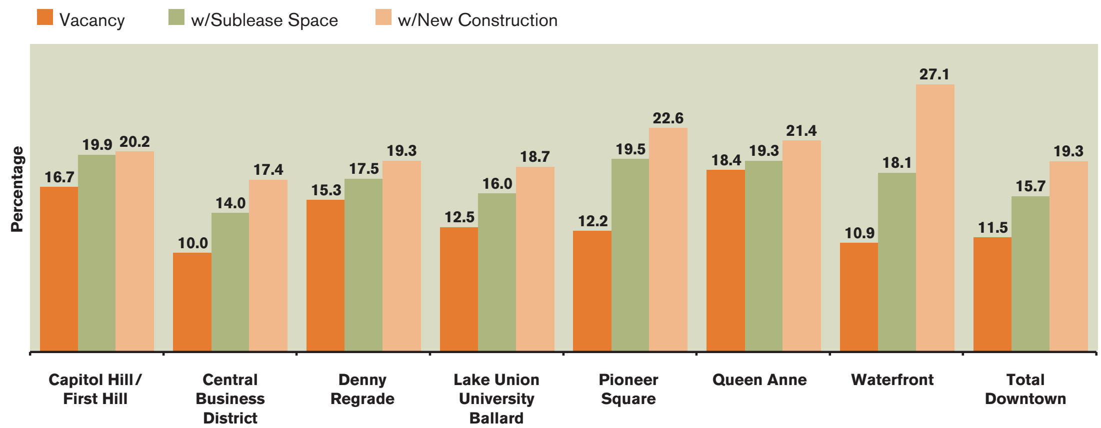
## VACANCY FORECAST
### INCLUDING SUBLEASE



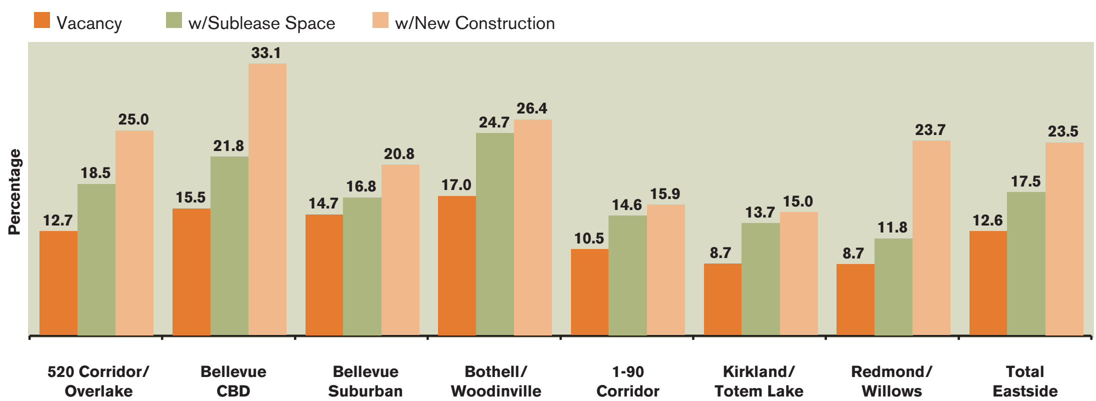

## PUGET SOUND OFFICE


Only the Tacoma office market improved in occupancy this quarter. Improvement in the Tacoma CBD resulted in direct vacancy decreasing 0.6% to 13.6% and vacancy including sublease space decreasing 0.6% to 14.0%. Increases in vacancy in the Bellevue Suburban and Bothell/Woodinville submarkets were the leading contributors to the 0.8% decline in direct vacancy and 0.8% decline in vacancy including sublease space for the Eastside. Northgate/North Seattle increases in vacancy drove the Northend vacancy up 1.2% and 1.1% for direct vacancy and sublease vacancy to 16.0% and 16.7% respectively. Overall, vacancy including new construction increased 0.5% to 20.7% with SeaTac and the Waterfront being the largest contributors to the increase. The new construction rates are really availability rates as they include all available space, including space that is marketed now as available in the future, which may currently be occupied.

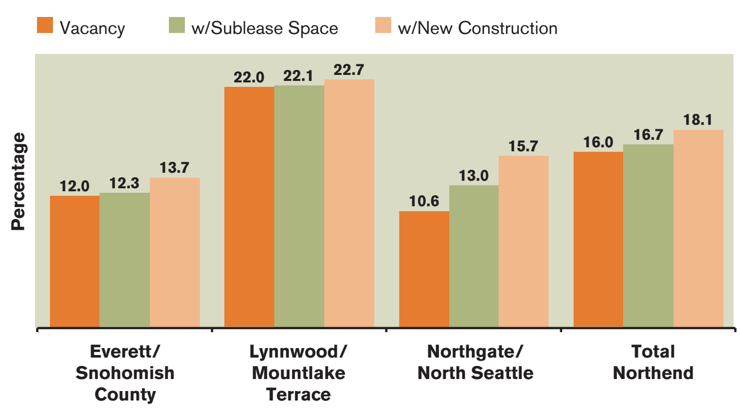
## DOWNTOWN SEATTLE



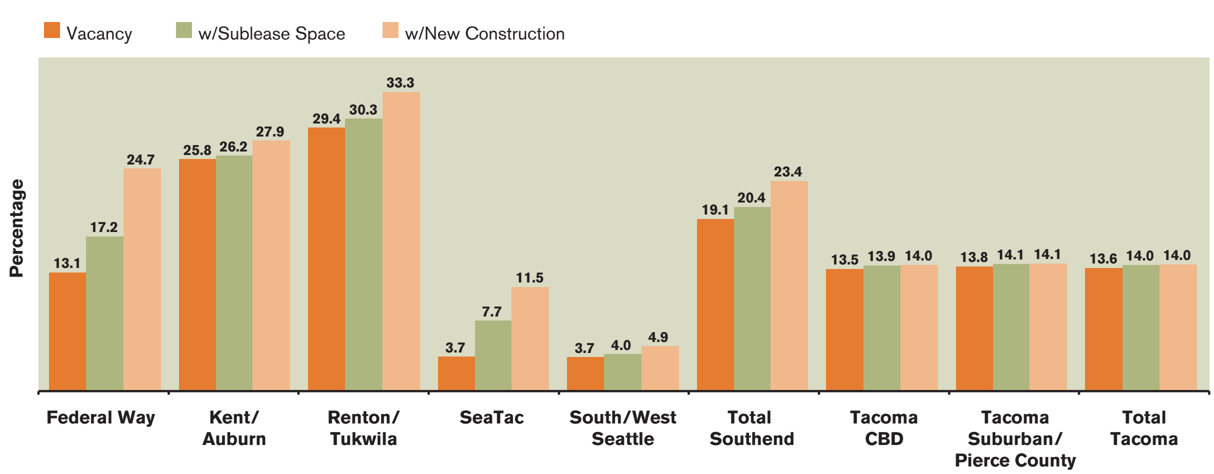

## EASTSIDE




## NORTHEND




## SOUTHEND AND TACOMA



# Child Care Resources

www.childcare.org


OfficeLease is proud to have assisted this outstanding organization with real estate planning and lease negotiation. If your human resources department has any child care related questions please contact Nina Auerbach, CCR's CEO at 206-329-1011.

Child Care Resources is a private non-profit agency, serving King County, that has the vision of ensuring that all families can find safe, affordable, high quality child care. The agency was formed in 1990 by a coalition of local governments and United Way when they identified child care as a major regional issue in the Puget Sound. With over 70% of mothers with young children in the work force, child care provides a critical support to working families and to the economic viability of the region. In addition, we are learning how important the early years are for children's later school success and success in life. Nationally, the majority of kindergarten teachers say that over 40% of the children entering their classes are not ready for school! We now know that improving the quality of child care is the key to helping children be ready for and do well in school.

CCR has three major areas of focus:

1. They provide information and referral services to families seeking quality child care, available both by phone and on the web (www.childcare.org).

2. They recruit, train and offer technical assistance to child care providers in order to improve the quality and increase the supply of child care.

3. They educate, advocate for and coordinate efforts on child care issues in our community.

Recently, CCR consolidated their regional offices into a brand new office near the International District in Seattle. **CCR had this to say about working with OfficeLease: "They provided invaluable services that resulted in our getting an optimal situation for our agency. Every step of the way, they were right there, working on our behalf. It allowed us to concentrate on getting our other work done and we did not get mired down in all the details!"** *Nina Auerbach, CEO*