

Commercial real estate industry analysis provided exclusively for **Coldwell Banker Commercial®** by *Boxwood Means, Inc.*

## National Overview

This edition of the **Coldwell Banker Commercial® Viewpoint** U.S. Market Trends provides key information regarding significant trends and developments in the commercial real estate industry for all of the United States.

- The South claimed the nation's most active demand for **retail** space during first half 2004, accounting for more than half the nation's net absorption. Nevertheless, in the West absorption has run far ahead of completions, resulting in a substantial drop in vacancy, where overall vacancies remain the nation's lowest.
- Led by the South, the national **office** market appears to be turning the corner toward recovery. Absorption was substantially positive during third quarter, exceeding construction delivered by about 2.5 million square feet. Vacancy, as a result, dropped by 20 basis points. Rents, while stabilizing, remain weak.
- **Apartment** absorption, led by Atlanta, Orlando, Austin and greater Washington DC, has exploded in the South. With vacancy at 4.6%, the perennially tight Northeast maintains the nation's highest occupancy.

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## Summary

Economic recovery at the national level continues, albeit unevenly. Still, while improvements are modest, they also are persuasive. During third quarter, GDP growth of 3.7% was recorded, above second quarter's 3.3%, though under-performing the 4.5% rate of growth recorded for first quarter. While analysts had expected a greater rate of increase for the latest period, the quarter's increase suggests that moderate expansion persists and inflation is in check. Following a worrisome increase of 3.1% in the Consumer Price Index during second quarter, fears of inflation were calmed by the 1.1% gain seen in the quarter following. With job creation and economic expansion proceeding at a measured pace, the anticipated moderate levels of inflation are not expected to pose a threat to economic recovery, barring the unexpected. Growth is broad based, with personal consumption expenditures, equipment and software, exports, government spending, and residential investment all contributing to the quarter's increase. Rising fuel prices notwithstanding, consumer spending showed a strong 4.6% gain, up sharply from the 1.6% rise of the previous quarter; included here was a 16.8% hike in the purchase of durable goods, a reversal of second quarter's 0.3% decline. Meanwhile, spending on non-durable goods grew 3.9%, up from 0.1%. At 5.4%, the September national unemployment rate remained unchanged from a month earlier amid a modest, 96,000-job increase in nonagricultural payroll employment, slower than the performance of recent months and well under expectations.

While national recovery clearly is underway, it is not distributed uniformly among the nation's regions and metropolitan areas. For example, the cities of Florida, with their service-oriented economies and ongoing population in-migration, have

escaped the worst effects of the recent national recession and slump, and now are showing some of the nation's strongest growth patterns. Palm Beach County led the U.S. in employment growth during third quarter with a 1.0% increase. Tampa Bay, Ft. Lauderdale and Orlando were close behind. Indeed, the 2.6% increase in employment in Ft. Lauderdale over the previous 12 months was second only to Phoenix during that period, for which a 2.9% increase (46,600 jobs) is reported. Also, Nashville's strong 0.9% employment increase is notable. Here, affordability and broad diversification have made this city a nationwide favorite for corporate expansion and relocation. Recovery dawns more slowly in Atlanta, however, where non-farm employment grew only 0.4% during third quarter.

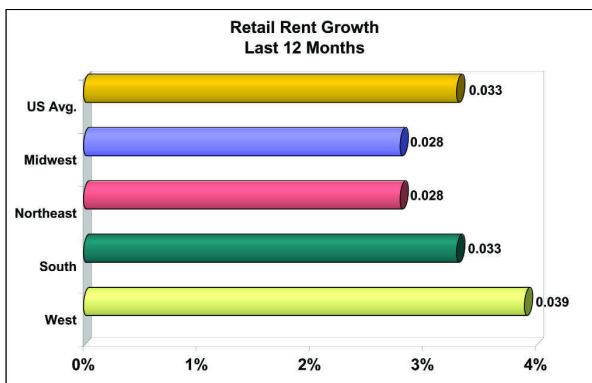
Quantitatively, employment growth over the last four quarters was strongest by far in greater Washington DC, for which a net increase of 66,050 jobs is reported. The huge federal apparatus, with its deep roots in the private sector, has kept this area more or less secure against the ravages of recession. New hiring in defense-related R&D has compensated Northern Virginia for the large losses in telecom and IT employment. In addition, biotechnology, firmly established in Suburban Maryland and a source of growth and stability on that side of the Potomac, now is spreading into Northern Virginia as well. The performance in the West remains mixed as Phoenix, the Inland Empire, Seattle and Phoenix, as noted, show substantial 12-month rates of gain while Northern California, still struggling with weak tech sectors, improves more slowly. Meanwhile, job growth in the Northeast and

	U.S. Snapshot		
	Rent/SF/Unit	Vacancy	Rent Growth-04
Retail	\$17.51	6.9%	1.9%
Apartment	\$932.00	6.8%	1.4%
Office	\$24.47	16.6%	-0.6%
Industrial	\$4.54	11.5%	0.2%

Midwest, with their low population growth numbers and large traditional manufacturing sectors, remains weak. Leading the Midwest over the past year are St. Louis and the Twin Cities with respective four-quarter gains of 2.4% and 1.7%. Meanwhile, New York leads the Northeast with a gain of 1.2% (about 48,000 jobs).

## Retail

All things considered, retail has performed exceedingly well nationwide during the recent period of recession and slump, out-performing all other real estate sectors by wide margins. Ongoing consumer spending and ongoing residential development have been key to this success. Now, with national recovery increasingly well established and household incomes increasing, there seems little reason to expect any deterioration of retail's favorable profile. Net absorption nationwide for the latest quarter was 5.3 million square feet, down slightly from 5.7 million the quarter prior, yet well above the 3.7 million absorbed net during the comparable period of 2003. The South, with its numerous growth-oriented cities, recorded absorption of 3.9 million square feet, nearly three-fourths of the U.S. net for the period. Leading the way here are Orlando, which absorbed more than half a million square feet during the quarter, and Atlanta and Raleigh-Durham, each of which absorbed more than 400,000. However, for the last two quarters combined Atlanta was the strongest city in the region-and the nation-with net absorption at close to 1.0 million square feet.



Strong absorption in the South reflects active construction, a byproduct of ongoing population growth and residential development. Accordingly, this region produced 3.6 million square feet of new retail space during the quarter, about 73% of the 4.9 million delivered nationwide. Prominent among the builders are Raleigh-Durham, Houston, Orlando and Jacksonville. The West, led by strong performances in Phoenix, Sacramento, and Southern California, followed with net absorption at 1.3 million square feet, down from second quarter's 2.1 million, yet still a substantially positive performance. Absorption performances were mixed in the Northeast and Midwest: the former, led by a favorable performance in Philadelphia, recorded a small net gain while the Midwest, a mixed bag of gains and losses, suffered a net decrease of 148,000 square feet. On a positive note for this region, however, the high 5% plus rates of household income seen in Cleveland, Cincinnati and Detroit could herald stronger retail demand.

The national retail vacancy rate held firm at 6.9% during third quarter, showing no change from mid-year and an insubstantial decrease from a year earlier. Vacancy remains highest in the sluggish markets of the Midwest at 8.4% (up 30 basis points from second quarter) and Northeast at 7.1% (down 20 points). Vacancy in the vibrant South dropped 10 basis points during third quarter, to 7.5%, while the West saw a 20-point decrease, to 4.7%. Accordingly, the low 3.1% vacancy rate in Northern Virginia is matched by only a small handful of markets in California, where a 2.5% vacancy in San Diego stands as the nation's lowest.

The strong rental performance continues, with all regions recording increases in both asking and effective lease rates for third quarter alone as well as year over year. The U.S. average asking and effective rates for the U.S. as a whole are \$17.51 psf and \$15.99 psf, up 3.1% and 3.3%, respectively, over 12 months. The highest prices-and largest gains-are recorded for the West (where occupancy is highest and development, generally speaking, is most difficult). Average quarter-end asking and effective prices here are \$21.22 psf and \$19.47 psf, up 3.7% and 3.9%. Lowest average rates are found in the Midwest, at \$15.35 psf and \$13.89 psf.

**Updated Forecast:** With retail vacancy expected to decrease in all the nation's regions, the national average rate is projected to fall 130 basis points through 2004, to 6.9%.

## Office

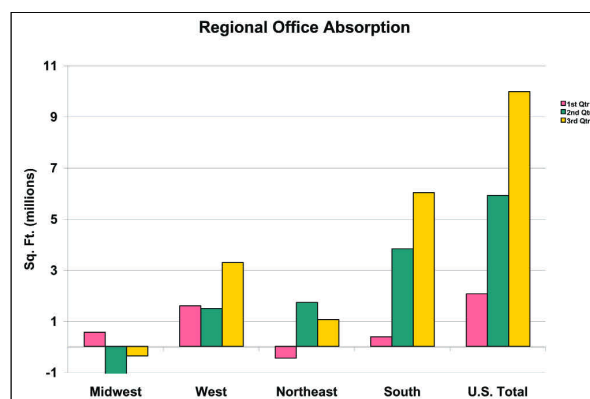
The national office market took a beating in the recent period of soft economic conditions, corporate contraction, and sharply diminished demand. Moreover, in many of the nation's markets the onset of negative absorption in 2001 coincided with a development cycle still running at full throttle. While development has adapted to the more stringent conditions of the post-2000 environment, it could not do so quickly. The development timetable is lengthy; many projects begun at times of economic vigor will enter a changed market unable to provide demand. Now, with economic recovery firmly underway, the national office market is beginning to show signs of recovery, although the return of full-bloomed good health will require time. As of third quarter, the national vacancy rate was 16.6%, down 20 basis points from mid-year yet well above the 11.6% mean recorded three years earlier. With the exception of the Midwest, which held steady at 18.9% (the nation's highest regional average), all of the nation's regions saw decreases in vacancy during the latest quarter. The rate in the West slipped 30 basis points to 16.7% while decreases on the order of 10 basis points were recorded for the South and the Northeast, which closed the quarter at 17.1% and 13.7%, respectively. Still, local performances within the regions, reflecting differing economic conditions and market trends, are mixed; increases in some areas are accompanied by decreases elsewhere. And some markets, decreasing or not, suffer very high averages, many near or above 20.0%. In Austin, for example, quarter-end vacancy of 22.1% was down 120 basis

points from a quarter earlier. The huge Dallas market endures vacancy at 26.1%, down 30 basis points from mid-year yet still the highest rate nationwide. Vacancy in Atlanta, recovering from a recent deluge of new supply, is 18.9%, down 40 points; and the 21.3% average reported for the tech-laden San Francisco market rose 20 points during the quarter. Indeed, single-digit vacancies are a rarity enjoyed only by special-case markets: the District of Columbia, perennially protected by large federal sector demand, enjoys vacancy at 7.7%, the nation's lowest rate; and the Inland Empire, a small, low-cost market in a high-growth area serving local needs and back office demand, enjoys vacancy at 9.5%.

Reflecting the decrease in national vacancy, net absorption nationwide was positive during the quarter at 10.0 million square feet, up from 7.4 million last quarter and, more importantly, a reversal of the earlier loss trend. In addition, the quarter's absorption volume exceeded its completion volume, reported at 7.5 million square feet. The South, with its many markets, led the nation in both categories, absorbing 6.0 million square feet while delivering 5.3 million. Indeed, only two markets in this region, Memphis and Jacksonville, suffered net losses during the quarter. At the other end of the spectrum were the 1.6 million square feet absorbed net in Northern Virginia due in large part to federal contracting. This market led the nation in absorption by a wide margin during the quarter. The West followed with absorption at 3.3 million square feet. Leading here are Los Angeles, Phoenix and Orange County at 1.0 million, 554,000 and 406,000 square feet. San Francisco, meanwhile, continues to struggle. Sluggishness in the Midwest persists: this region was alone nationwide in suffering negative net absorption during third quarter as losses in Chicago, St. Louis, Kansas City, Milwaukee and Cleveland were accompanied by gains elsewhere. Net absorption in the Northeast slipped to 1.0 million square feet, with Boston remaining weak with a third quarter net of minus 350,000 square feet.

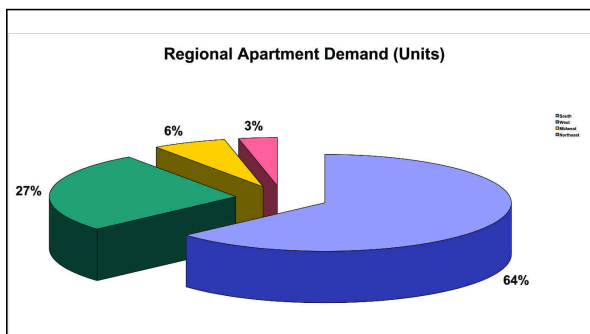
Rents remain the sore spot. The best regional performance was seen in the South, with minimal 0.1% increases in both average asking and average effective rents. Nationally, average asking and effective rates were recorded as \$24.47 and \$24.40 psf, both down substantially from several years ago. From these figures, an uncomfortable high rent spread of 19.9% is calculated. The spread represents the difference between asking and effective rents and is an indication of the relative pricing power of landlords. Spreads range from a low of 18.4% in the Northeast to the Midwest's high of 23.6%. The recovery of rents, generally speaking, is expected to be slow and gradual.

**Updated Forecast:** The year overall should bring a 40 basis point decrease in average vacancy, to 16.6%, as the gradual recovery of the market proceeds. Rental growth is not yet ready to turn the corner, however. A 0.6% decrease is anticipated by year-end 2004 although gains are expected for the years to follow.



## Apartment

On a nationwide basis, the apartment market shows clear signs of ongoing recovery. Vacancy during third quarter slipped from 7.0% to 6.8% as approximately 27,500 units were absorbed net, fewer than were taken off the market during second quarter, yet nonetheless a sign of firm demand. The performance by region varies, however. The South, which still has the nation's highest vacancy average at 8.1%, enjoyed a decrease of 30 basis points during the period. Here a wide range of conditions tells the tale-high vacancies in the neighborhood of 10% in a number of major markets such as Atlanta, Dallas, Ft. Worth and Houston, in which hefty development cycles were hit in mid-stride by the collapse of demand. Austin, with one of the nation's highest vacancy rates at 10.5%, enjoyed the nation's largest decrease, falling 140 basis points during the period. With nearly 2,200 units absorbed during the quarter, Austin was superseded only by Atlanta, which absorbed more than 3,500 units. Meanwhile, the large markets of the greater mid-Atlantic-Washington DC, Northern Virginia, Suburban Maryland, Baltimore and Norfolk enjoy low single-digit averages. Negative absorption was a rarity in the South during the latest period. The West also enjoyed a decrease in average vacancy, its level dropping from 5.5% to 5.3%. Denver, with the region's highest vacancy, saw its largest decrease as the rate fell to 9.7% from 10.2% at mid-year as demand returned in force to this seriously overbuilt market. That said, net absorption in this region was strongest in the L.A. Basin, where Los Angeles and Orange counties combined to raise occupancy by nearly 3,500 units. During the past two quarters only one market in the West-San Diego-suffered overall negative net absorption. It's a different story in the Midwest, where a generally sluggish performance occasioned by a generally sluggish economy and weak absorption kept vacancy steady at 7.3%. With the meager sum of 1,716 units net absorption throughout this region was, typically, minimal. Vacancy in the Northeast rose from 4.5% to 4.6% (still the nation's lowest) as rising levels in Pittsburgh and Philadelphia were accompanied by decreases in New York and Boston.



Not surprisingly, construction is vibrant in the South, with its Sun Belt boom towns, though activity is moderate in the West and tepid elsewhere. Of the 21,768 units completed nationwide during third quarter, 12,165 (56% of the total) were in Southern markets. With Atlanta and Dallas recuperating from oversupply, Houston (forging ahead despite its worrisome glut), Palm Beach and Tampa Bay each delivered more than 1,000 units. And Charlotte, bringing 1,145 on line, was the regional leader. Indeed, Charlotte, with its resurgent economy, was second nationwide-and not by much-only to Los Angeles for third quarter deliveries. And in terms of rate of inventory growth, Charlotte led with a 2.7% increase. Moreover, vacancy here, at 9.9% and up during the quarter, is not low. Of the 5,271 units delivered to the markets of the West, huge Los Angeles and vibrant Phoenix combined to account for 60% of total deliveries. Although vacancies are not high here, the entire greater San Francisco Bay area, still burdened by weak economics, completed only 200 units during the quarter, all of them in Oakland.

Effective rents, prominent among recovery indicators, took a big step forward during the period, rising 1.1% to \$875 per month nationwide. Meanwhile, the average asking price grew 0.8% to \$932. Noteworthy here is the decrease from 6.8% to 6.6% in the rent spread. The best performance is seen in the ever-tight Northeast, where asking and effective rents increased 1.3% and 1.9% to \$1,403 and \$1,343 per unit, the nation's highest average prices. Moreover, at 4.4%, the rent spread in the Northeast was down markedly from second quarter's 5.0%. With respective increases of 2.1% and 2.9% and a 3.4% rent spread, the huge New York market can claim much of the credit for the region's favorable numbers.

**Updated Forecast:** With signs of recovery abundant, the national vacancy rate is expected to shed 90 basis points year over year to close 2004 at 6.9%. The average asking rent is forecast to increase 1.4% to \$929 per month.

## Industrial

The national industrial real estate market proceeded farther along the road of recovery. Net absorption nationwide is reported at nearly 15.0 million square feet, lead by 5.8 million in the West. Here, Riverside-San Bernardino (the "Inland Empire," located directly east of Los Angeles and Orange counties) led the region-and the nation-at 1.5 million square feet. Superb fundamentals including a state-of-the-art transportation network, an abundance of affordable land, a pro-growth business climate, and proximity to coastal Southern California's huge centers of business and population have made the inland counties a prime choice for the development of large distribution facilities. The 3.7% increase in occupied stock seen here over the past year is far and away the most robust performance nationwide. Not surprisingly, this area led both the region and the U.S. in completed construction at 1.5 million square feet. Los Angeles followed with net absorption at nearly 1.4 million square feet. Phoenix, posting large recent job growth numbers, and San Diego followed with close to 600,000 and close to 500,000 square feet absorbed, respectively, with the remainder of the region's markets achieving modest positive sums. The South followed with 5.2 million square absorbed net, led by strong activity in Dallas-Ft. Worth, Houston, Miami, Orlando and Atlanta. Too, Florida, with its ongoing strong population growth and residential development, also records formidable absorption numbers.

Relative weakness on the other hand, is recorded for those markets in both South and West that claim large proportions of flex space, such as Raleigh-Durham, Austin, San Jose and San Francisco. Indeed, Boston, another major high-tech market, was alone nationwide for suffering negative net absorption during the latest period. Absorption in the Midwest, at 4.0 million square feet, was dominated by Chicago's 1.3 million square feet, third greatest nationwide. Strong performances also were recorded for Indianapolis and Columbus, each of which saw their volumes of occupied stock increase 0.3%. With the negligible sum of 12,500 square feet, the Northeast is by far the weakest market nationwide for absorption. It also claims the highest average vacancy, at 15.1%. Vacancy is best in the West, at 10.4%, although levels vary greatly from place to place. San Jose, the region's major tech market, suffers vacancy at 16.4%, third nationwide only to Boston's dubious 20.0% and to the 17.4% average reported for Memphis, where a large distribution industry was waylaid by recent substantial job losses. Vacancy in San Francisco, another major tech center, is high too at 15.2%. Pockets of strong occupancy nationwide include Los Angeles, with a 7.6% vacancy rate; Palm Beach, at 8.1%; Tampa and Miami recorded averages of 8.4% and 8.5% respectively. Nationwide, industrial vacancy is 11.5%, down from 11.6% as construction stays close to absorption.

Rents nationwide showed small recent increases; national asking and effective averages are reported at \$4.54 psf and \$4.27 psf. With Boston as a chief liability, the Northeast shows the weakest profile with a rent spread of 9.0%. This compares poorly with the national 6.4% average and the low of 5.4% reported for the South.

**Updated Forecast:** The latest forecast calls for a 20-basis-point decrease in industrial vacancy to 11.6% through 2004 while the average asking rent is expected to grow 0.2%.

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