JONES LANG LASALLE

Real value in a changing world

/pulse/

Americas Research

Sacramento Office Insight Q3 2009

Economy

Despite intensive government stimulus intended to improve employment and housing, Sacramento's office market continued to weaken through the third quarter of 2009. Preliminary payroll employment data shows that there are 4.8 percent fewer jobs in the region than there were at the same point last year, reflecting a 42,300 job decline. As a result of the job losses, unemployment has jumped from 7.4 percent in August of 2008 to 12 percent in August of 2009. However, expansion in the education and health services industries continued to bolster the waning job market. Overall Sacramento's job market remained anemic, which was consistent with other large service-oriented areas of the state.

Market Conditions

The Sacramento office market saw another quarter of significant negative absorption. Total absorption in the third quarter was negative 71,758 square feet and year-to-date total absorption was negative 360,581 square feet. Although developers cancelled or delayed the majority of new construction projects planned in 2008, nearly 350,000 square feet of new office space was delivered in the third quarter of 2009. Negative absorption, coupled with newly delivered stock, has pushed direct vacancy to 20.8 percent, notably higher than the 17.1 percent recorded a year ago. Sacramento's average asking rents decreased 1.4 percent in the third quarter, while net effective rates were estimated to have declined by more than 10 percent due to a significant increase in free rent being offered by landlords. The increased supply of quality subleases has forced landlords to continue to lower their rents and offer ever-competitive lease terms marked by large amounts of free rent and increased tenant improvement allowances. Leasing velocity has been moderate to weak as most of the second quarter's activity consisted of short term renewals. On a brighter note, the CBD has remained resilient, posting positive net absorption five consecutive quarters.

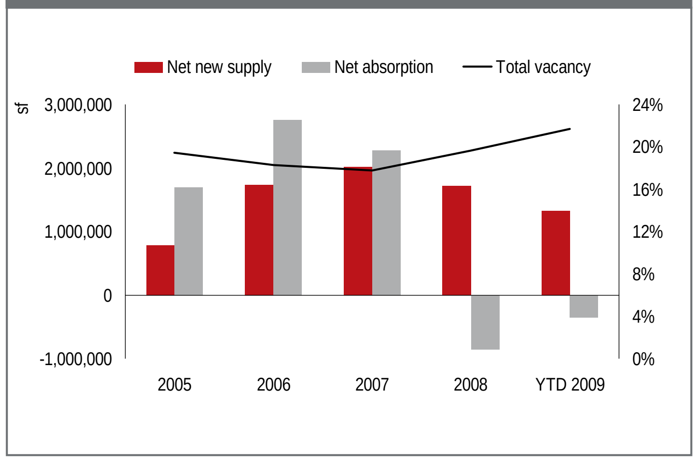
Outlook

With unemployment on the rise, office market fundamentals will continue to trend downward through mid-2010. While the government sector has historically insulated the Sacramento economy, current budget constraints have certainly compounded the region's economic challenges. Due to rising vacancy rates, maturing debt and depreciated asset values, distressed buildings have entered the foreclosure market and are expected to continue into 2010, creating opportunities for cash rich investors. Being that Sacramento was early into the recession; the region's economy should recover more quickly than neighboring regions and will again draw national attention as an attractive hedge opportunity.

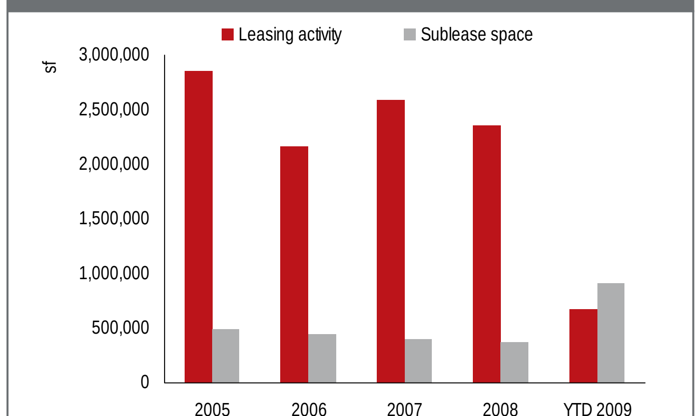
Key market indicators

	Key market indicators		12-month forecast
Supply	Supply	43,936,876 sf	↑
Supply	Direct vacancy rate	20.8%	↑
Supply	Total vacancy rate	21.7%	↑
Supply	Under construction (% preleased)	.25 msf (31.7%)	↓
Demand	Leasing activity 12 mo. % change	-12.8 %	↑
Demand	YTD net absorption	-360,581 sf	→
Pricing	12-month overall rent % change	-3.8%	→
Pricing	Class A overall asking rent	$27.39 psf	↓
Pricing	Class B overall asking rent	$22.67 psf	↓

Net new supply, net absorption and total vacancy



Leasing activity vs. sublease space



Sublease space includes available space or Sublease space only includes vacant space

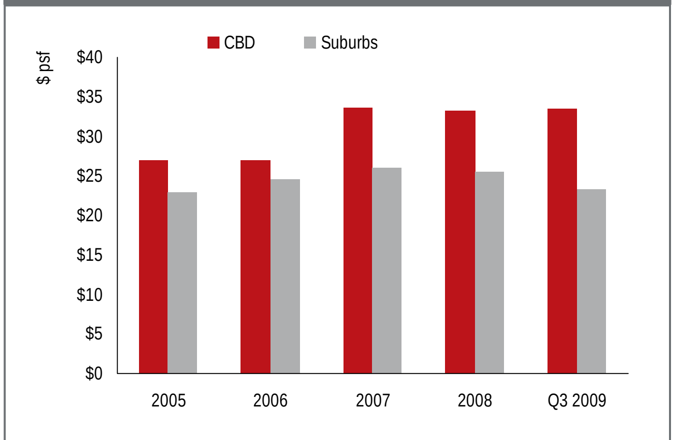
Tenant perspective

Uncertainty with the local and national economies, combined with the recently completed office stock, has created ideal conditions for tenants in the Sacramento region. With a record amount of office space available, tenants are able to take advantage of the market by benefiting from competitive rates, increased concessions and higher tenant improvement allowances. Average Class A suburban office rates have declined 4.6 percent since the third quarter of 2008, while vacancy has increased by 3.3 percent. Class A CBD office rates have remained more stable, but with the recent completion of 500 Capitol Mall, and 2020 West El Camino, concessions are on the rise. Additionally, Class A "plug and play" space is being offered throughout the region, providing tenants with additional cost effective ways to upgrade their space and reduce occupancy costs. Overall, office rates will remain under pressure providing tenants with a great opportunity to lock in long term cost savings.

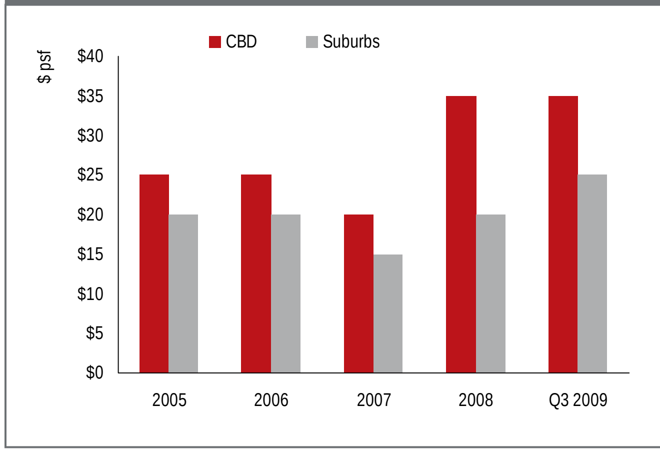
Landlord perspective

Landlords continued to feel the crunch of increased vacancy through the third quarter of 2009. Downward pressure on rents, increased concessions and a fiercely competitive marketplace are expected to continue into the foreseeable future. The amount of free rent being offered for new leases has jumped over the last 12 months, currently averaging 1.5 months per year of lease term. Tenant improvement allowances have also increased with landlords offering aggressive concession packages in order to stay competitive with newly introduced office supply and contend with the increased amount of "plug and play" sublease space. As the struggling economy forces more companies to reevaluate their occupancy needs, tenant retention has become owners' main point of emphasis. A handful of Landlords are more aggressively pursuing renewals and offering "blend and extend" options to tenants with expiration dates well into the future.

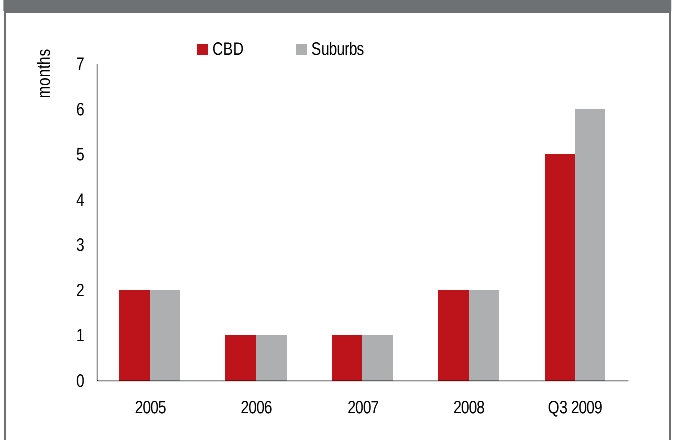
Class A overall asking rents



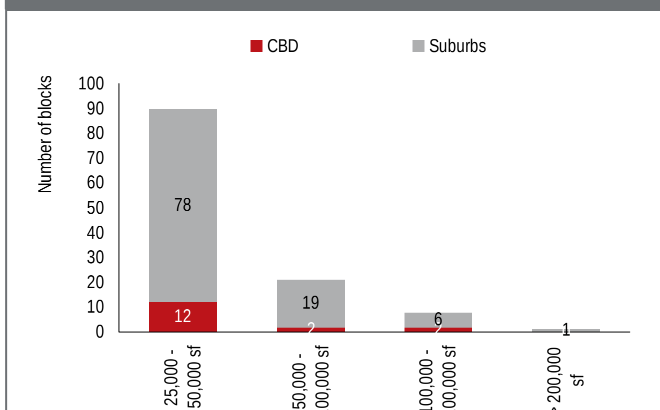
Class A tenant improvement allowance



Class A free rent

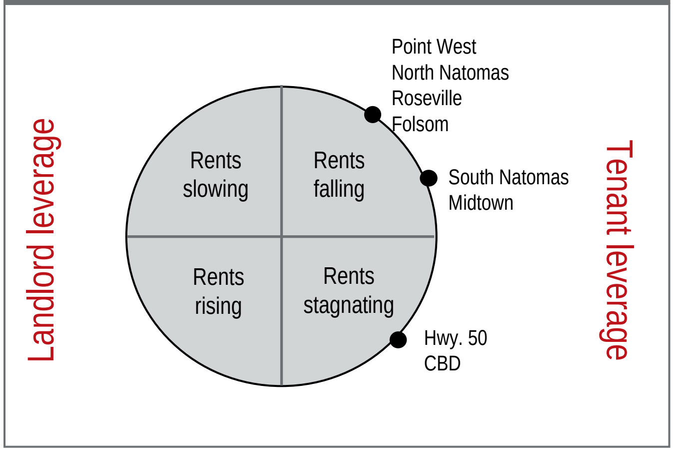


Class A blocks of contiguous space

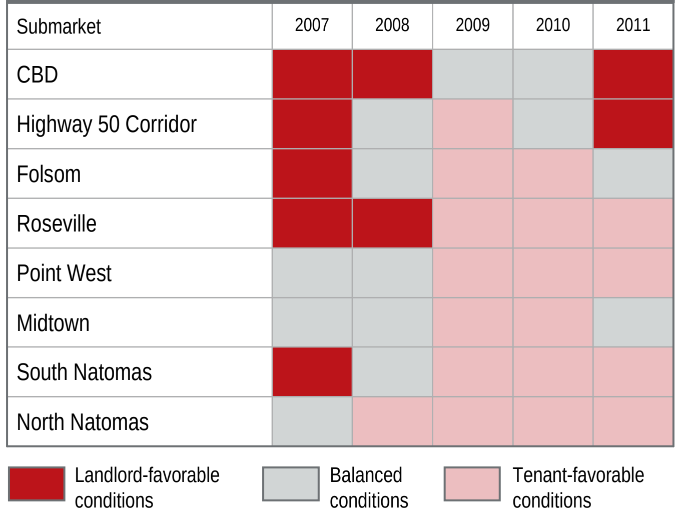


Includes vacant existing blocks and available UC/UR blocks

Property clock – current market conditions



Submarket leverage – market history and forecast



Completed lease transactions

Tenant	Address	Submarket	sf	Type
Kronick	400 Capitol Mall	CBD	41,000	Renewal
Sierra Nevada	145 Parkshore Drive	Folsom	40,000	New
National Career Education	11080 White Rock Road	Hwy. 50 Corridor	31,000	New
HDR	2379 Natomas Park	South Natomas	30,000	Consolidation
Montgomery Watson & Harza (MWH)	3321 Power Inn Road	Hwy. 50 Corridor	30,000	Renewal
Benefit and Risk Management Services	80 Iron Point Circle	Folsom	25,000	New
Seyfarth Shaw	400 Capitol Mall	CBD	15,000	Renewal
The Department of Military Recruiting	2880 Prospect Park	Hwy. 50 Corridor	14,500	New
Placer Insurance Agency	5 Sierra Gate Plaza	Roseville	14,000	Renewal

Q3 Delivered Construction

Address	Submarket	Developer	sf	Delivery Date
2020 West El Camino Avenue	South Natomas	Bannon Investors Ltd.	319,200	August 2009
604 Sutter Street	Folsom	A.P. Thomas	28,800	September 2009

Sacramento methodology: Inventory includes all Class A & B office properties > 10,000 square feet, excluding all condo, medical and government owned buildings, and owner occupied buildings

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