

2006 CORPORATE REAL ESTATE SURVEY

A SPECIAL RESEARCH REPORT

Expansion Plans Slow

Modest job creation and high worker productivity lead companies to lower expectations for real estate growth.

The principal driver of real estate absorption — job growth — closed 2005 at an underwhelming pace and dimmed hopes for a surge in demand for commercial real estate. December's employment gain of 108,000 new jobs fell below many analysts' expectations and marked the weakest increase in more than a year, excluding those months most affected by hurricanes Katrina and Rita.

Even at the current pace of adding about 2 million jobs each year until 2010, U.S. employment growth from 2000-2010 would total about 14 million — the lowest figure of any decade since the 1950s, according to Boston-based Torto Wheaton Research.

"Part of that is a demographic change," says Jim Costello, senior economist at Torto Wheaton. "The labor force in general is not growing as fast as it once did. Baby Boomers are approaching retirement, and some sectors may even face labor shortages."

Incremental job growth seems at odds with the economy's strong production gains. Annualized GDP growth surprised analysts by climbing to 4.1% in the third quarter, up from 3.3% at midyear 2005. Economists say today's more efficient companies have simply learned to increase production with fewer new hires.

How will corporations balance hiring control with their need to expand production in 2006? Where will they add space, and what types of properties will they require? *National Real Estate Investor* and Coldwell

Banker Commercial sought answers to those questions in an exclusive market study conducted in late 2005. The third-annual survey queried hundreds of corporate users, developers, owners and managers on their plans for the next 12 months.

Survey highlights

Corporate respondents are most likely to own or lease office space. More than two-thirds of owners and developers, on the other hand, are involved in multiple property types and are most likely to own retail assets [Figure 1]. Overall, respondents have a median 418,181 sq. ft. in their commercial real estate portfolios [Figure 2].

On the job creation front, the survey found little hope for an improved climate in 2006. Half of corporate respondents expect some hiring in the next 12 months, but only 4% plan significant hiring compared with 10% in last year's survey.

In fact, the percentage of respondents who anticipate some employee downsizing at their company increased slightly to 6% from 4% last year [Figure 3].

"It's difficult to ascertain all the factors that led to more respondents projecting downsizing this year," says Fred Schmidt, senior vice president of business development for Coldwell Banker Commercial. "The major hurricanes of 2005 [which led to extensive property damage in Louisiana, Mississippi and Florida] and their impact on employment stability certainly play a

Survey Methodology

Data for the 2006 Corporate Real Estate Survey conducted jointly by National Real Estate Investor and Coldwell Banker Commercial was collected in November 2005. The purpose of the survey was threefold: to investigate which markets — primary or secondary — will experience the most growth over the next 12 months; to determine the commercial real estate usage or holdings of corporations and their near-term plans; and to assess potential opportunities for commercial real estate owners, managers and developers in these markets.

Both providers and users of commercial real estate were surveyed. An email link containing the survey questions was sent to NREI subscribers, including developers/owners/managers and corporate users. The results are based on responses from 363 industry professionals. This report can also be viewed online at www.nreionline.com.

NREI covers trends in commercial real estate with an emphasis on finance. Approximately one-third of the publication's 36,000 qualified readers are developers/owners/managers, while lenders, corporate users and brokers make up the balance of the readership.

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large part.”

Here are some of the study’s other key findings:

- Corporate real estate users, and the space providers who serve them, are most likely to own or occupy space in secondary markets [Figure 4]. This year, 55% of corporate respondents own or occupy space in secondary markets, and 41% own or occupy space in primary markets. Among developer/owners, 54% own space in secondary markets and 50% own space in primary markets.

- Both groups are most likely to enter secondary markets in 2006, including 42% of corporate respondents [Figure 5]. Only 30% of corporate respondents plan to enter primary markets, and 20% plan to enter tertiary markets.

- Some 28% of corporate respondents expect primary markets to experience the most growth, down from 41% in last year’s survey. Meanwhile, 48% of developer/owners expect secondary markets to experience the most growth.

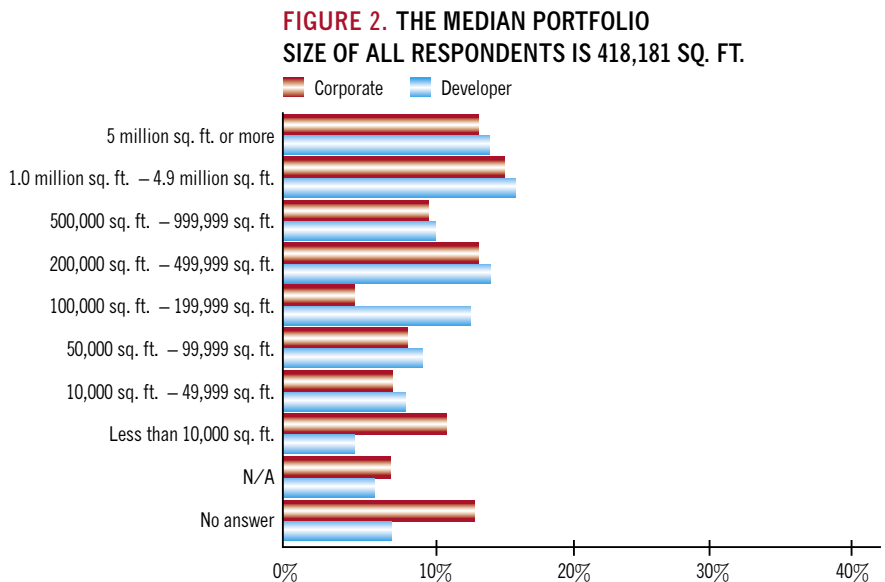
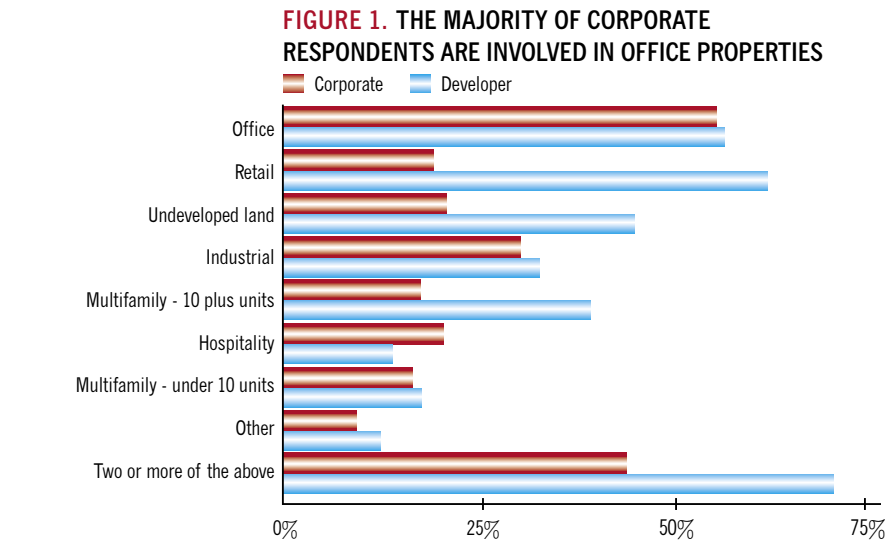
- Among corporate respondents, 38% plan portfolio increases in primary markets, compared with 57% a year ago. More owners, developers and managers plan increases in primary markets this year than last year (41% vs. 32% in 2005).

- Respondents plan a range of real estate activities in 2006. Developers are most likely to purchase real estate (69%) or develop (63%), sell (52%), or lease commercial space (51%). Corporate real estate users are most likely to purchase real estate (49%) or renovate existing space (47%) [Figure 6].

- Both groups expect to be net acquirers of commercial real estate, and plan to buy and sell in greater volume than they did a year ago. Nearly 70% of developer/owners and 53% of corporate respondents plan to acquire a median 121,621 sq. ft. of space. On the disposition side, 53% of developer/owners and 41% of corporate users expect to shed a median 68,571 sq. ft.

Rising costs, slow growth

The steady improvement in real estate fundamentals — occupancy and rents — presents a growing challenge to Corporate America. With the nation’s largest cities well into a real estate recovery, corporate



users of commercial real estate in primary markets face rising occupancy costs in 2006, regardless of whether they plan to buy or lease space.

Absorption of space in some primary office markets has been dramatic. For example, New York City absorbed a whopping 2.4 million sq. ft. of office space in the third quarter of 2005, and the greater Washington, D.C. area was close behind with 2.1 million sq. ft. of absorption, reports Grubb & Ellis. Vacancy in the Big Apple fell from 9.6% at mid-year to 8.9% in the third quarter. In D.C., vacancy dropped 30 basis points to 7.9%.

As tenants soak up more of the available supply in primary office markets, rents that were already among the high-

est in the nation have been increasing. Average asking rents in D.C. rose slightly to \$39.85 per sq. ft. in the third quarter from \$39.64 at mid-year. New York City’s average asking rent edged up to \$48.37 from \$48.22 the previous quarter.

Clearly, Corporate America is expanding in the largest metropolitan areas and is willing to pay higher rent in order to do so. But with markets growing even more expensive, it’s little wonder that corporate respondents are most active in secondary markets.

“Secondary markets remain strong candidates for growth,” says Coldwell Banker Commercial’s Schmidt. “Lower rents, more space and vibrant communities make these

markets highly desirable opportunities. That’s probably why 53% of surveyed developers and owners say they plan to enter secondary markets in 2006.”

Secondary markets benefit

Corporations are paying more attention to the affordable labor pools and space available in secondary markets as rent and property prices increase elsewhere, says Martin Woodrow, executive vice president for portfolio management at real estate services provider Equis Corp.

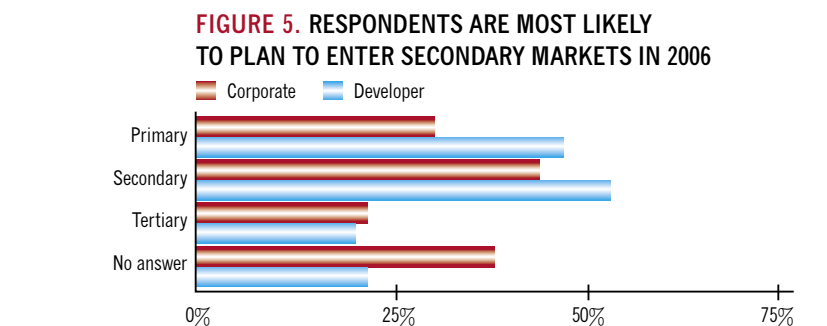
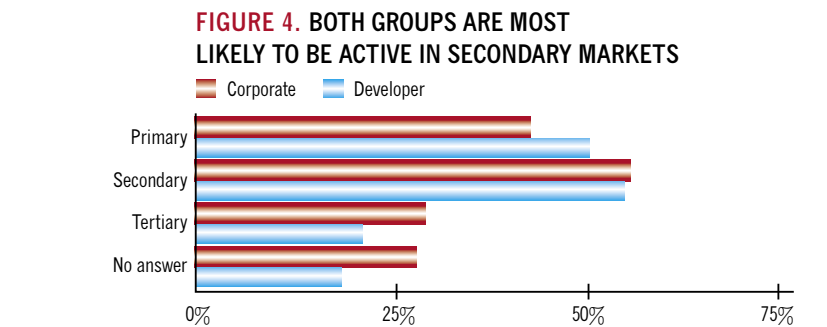
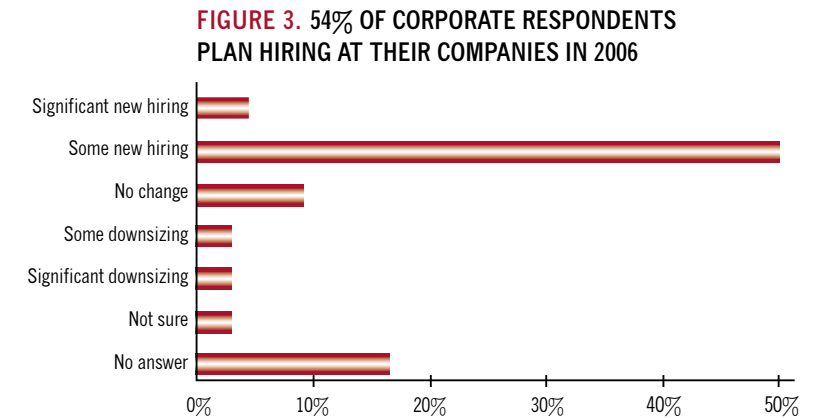
Labor costs vary by specific markets, but a comparison of average wages gives an idea of the savings available by shifting jobs out of the nation’s biggest cities. Average annual wages in New York and Washington, D.C. are \$47,066 and \$43,723, respectively, according to Moody’s Economy.com. By contrast, average annual wages in Minneapolis are \$35,968.

Equis is helping a client evaluate whether it should move several call centers from primary to secondary markets to cut costs. “And coming into a secondary market, you can get some pretty substantial incentives, such as tax abatements, for space requirements that are too small to get that kind of attention in a primary market,” Woodrow says.

Yet corporate respondents to the 2006 survey are more conservative in their growth projections than last year’s group. Fewer respondents plan portfolio increases this year, and the largest group of corporate users (33%) plans to hold the line on real estate holdings in secondary markets. Fewer corporate respondents in 2006 plan increases in secondary markets (29% vs. 42% last year).

Why have space users tightened the reins? Rising real estate acquisition costs may be the major reason, according to Paul Paradis, senior vice president in the San Francisco office of Hines, one of the nation’s largest developers of office space. “The survey doesn’t necessarily imply that corporations have stopped growing or need less space,” he says.

Corporations attempting to acquire properties face new competition from investors. Until recently, space users might be the only potential buyers for an



unoccupied property, but that is changing. Investors, unable to find strong upside potential in fully leased assets, are increasingly buying vacant properties with the intention of increasing value through leasing.

In the 12 months ended Oct. 31, 2005, investors acquired almost \$30 billion of properties for redevelopment/repositioning — double the level of the previous year, according to Real Capital Analytics.

Competition to acquire properties has driven prices to all-time highs in most of the major markets and raised average prices to nosebleed levels. Manhattan office properties traded for an average price of \$398 per sq. ft. in the first 11

months of 2005; for the same period, the average price in Washington D.C. was \$405 per sq. ft., and \$237 in Los Angeles, according to Real Capital Analytics.

That isn’t to say a corporation can’t beat out investors to close an acquisition. Last year, Kaiser Permanente, a California-based HMO, purchased the former Peoplesoft headquarters in Pleasanton, Calif., in a competitive bid against re-developers. “We bid on that and were beaten quite handily by Kaiser,” says Paradis of Hines.

Tapping into corporate demand for owned space, Hines has adopted a strategy of acquiring some properties specifically for resale to corporate users. In suburban

FIGURE 6. NEARLY HALF OF CORPORATE USERS PLAN TO PURCHASE OR RENOVATE EXISTING ASSETS

Corporate Developer

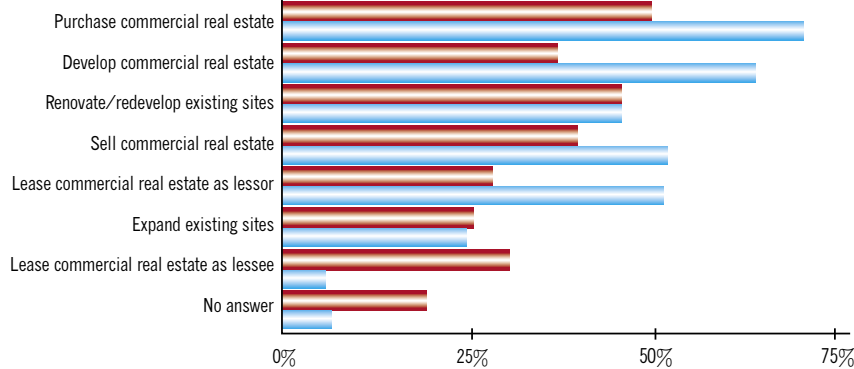
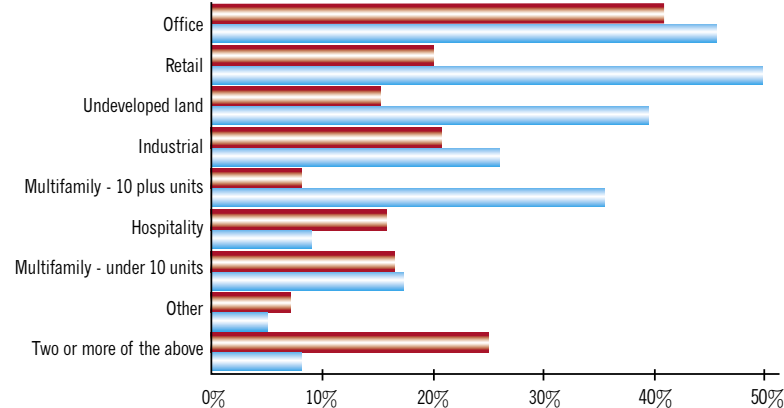


FIGURE 7. USERS ARE MORE LIKELY TO HAVE PLANS FOR OFFICE PROPERTIES

Corporate Developer



Seattle, for example, the company recently acquired a business park of more than 20 small buildings and has been selling individual buildings to users as existing leases expire.

Outlook by sector

Responses from developer/owners and corporate respondents reveal a varied focus, with 50% of developers most likely to plan acquisitions, development or sales of retail property [Figure 7]. Economists say limited construction in recent years has kept the supply of retail space in check, so the sector should perform well in 2006, even if consumer spending begins to wane.

“The retail sector remains strong as rents continue to grow, thanks in large

part to a vigorous economy,” says Jacklene Chesler, senior vice president of marketing at Coldwell Banker Commercial. “However, concerns do exist about energy prices, consumer demand and the full effects of Hurricane Katrina and other weather-related disasters.”

But office, not retail, garnered the most attention from this year’s corporate survey respondents. Only 20% of corporate users plan retail real estate transactions, down from 40% last year. As Figure 7 shows, corporate respondents are most likely to plan office deals (41% vs. 31% in 2005).

Developers are slightly more likely this year to plan office deals or projects (45% vs. 43% last year). Some 39% of developers plan transactions involving undeveloped land, up from 33% in 2005, and 35%

plan multifamily projects of more than 10 residential units.

The industrial sector’s strength adds fuel to the economic engine driving growth in secondary markets, says Coldwell Banker Commercial’s Chesler. “The industrial sector looks to be a star within secondary markets, with decreased vacancy and increased rents.”

Some secondary markets offer advantages beyond affordable labor and space, particularly for corporations relying on distribution networks. “For our business, labor isn’t nearly as important as the transportation costs associated with moving goods around,” says Larry Harmsen, managing director in the Denver office of ProLogis, a global provider of distribution space.

From a distribution perspective, a secondary market may be of primary importance due to its access to rail, trucking or shipping routes. Examples include port cities like Tacoma, Wash., and Charleston, S.C.; or cities like Indianapolis or Reno, Nev., that are at critical crossroads for accessing larger metropolitan areas. “For regional distribution, they’re very strategic, effective locations,” Harmsen says.

The bottom line

Corporate America’s highly conservative approach to growth, its drive for efficiency, and quest for ways to stretch the dollar, will continue to focus corporate interest on the secondary markets, says Dave Lawton, executive managing director in the New York office of Cushman & Wakefield. “There is cautious optimism in the marketplace, and there is probably a little more optimism in the secondary markets,” he says.

Until job creation accelerates beyond the plodding pace of recent years, however, growth in any market will likely be gradual.

“The economic indicators are going in the right direction, but not in the increments we would like to see,” Lawton says. “Therefore the corporate users and the space providers are taking a conservative approach to their expansion plans. It’s eating the elephant, one bite at a time.”