The Knowledge Report

OFFICE OVERVIEW | SECOND QUARTER | 2007

Sacramento Office Overview

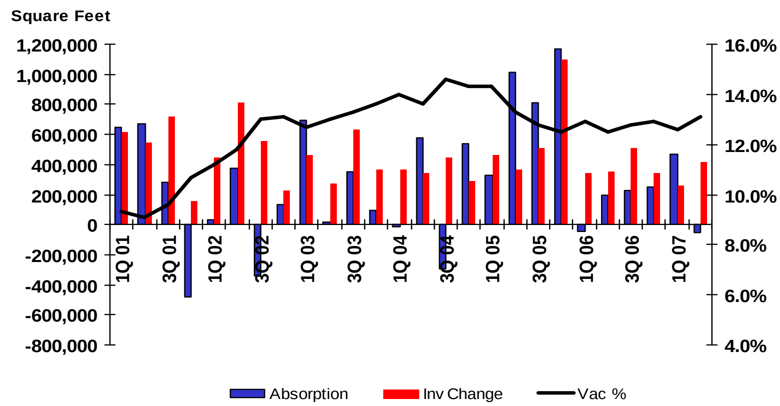
A PAUSE IN THE ACTION

Vacancy for the Sacramento office market currently stands at 13.1%, up slightly from the 12.6% mark recorded as of the close of the first quarter of this year. This uptick in vacancy comes after what could best be described as a lackluster quarter in which the market recorded negative occupancy growth to the tune of just under 50,000 square feet. Aggressive office development continues to add additional upward pressure to vacancy rates, with an additional 415,000 square feet of new office space delivered during the second quarter of this year. Yet despite this, the number of tenant requirements in the deal pipeline remains high—thanks primarily to the surging needs of the State of California. While one of these major deals landed during the second quarter, most remain in the deal pipeline. This pause in the action played out in the form of increased vacancy and negligible occupancy losses for the second quarter of this year. ▸

2007 MARKET INDICATORS

QUARTER	2ND	3RD
VACANCY	↑	↑
NET ABSORPTION	↓	↑
CONSTRUCTION	↑	↑
RENTAL RATE	↔	↔

Sacramento Office Market
2nd Quarter 2007
Change in Inventory, Net Absorption & Vacancy



Source: Colliers International Research Department

COLLIERS INTERNATIONAL

The sale-leaseback of DST's 220,000 square foot Folsom campus was the largest deal of the second quarter.

The largest deal of the quarter was DST's sale-leaseback of its roughly 220,000 square foot Folsom campus—however, as we survey both multi-tenant office space and owner occupied space, this transaction resulted in no change in our overall occupancy totals. The second largest deal of the second quarter was the Department of Corrections and Rehabilitation's lease of over 130,000 square feet in the Highway 50 submarket. This was tempered, however, by Ameriquest's return of 90,000 square feet to the marketplace when it abruptly closed its Rancho Cordova office at the beginning of this quarter.

Once the nation's largest sub-prime lender, Ameriquest's closure reflects the ongoing challenges faced by the sub-prime mortgage industry and marks the largest single hit that the Sacramento office market has experienced so far in terms of fallout from the residential housing slowdown. With the housing market not expected to rebound before next year, this trend may not be over.

But the news is not all bad. The return of the State of California to the marketplace remains the largest factor behind our optimism. We are aware of at least 1.2 million in remaining State of California requirements as well as another 1.3 million in requirements from the private sector currently in the marketplace. While timelines vary, we believe that most of these will result in signed deals within the next 18 months.

VACANCY AND ABSORPTION TRENDS

While vacancy trends in the Sacramento market are certainly impacted by overall macro-economic trends, it is important to note that following Washington DC, Sacramento is the second largest government town in the United States. In terms of commercial real estate, a strong governmental presence generally equates to market stability. While strong government markets often do not experience the types of robust growth that can occur when different industry types enter boom periods (Silicon Valley and the tech sector, for example), they are usually insulated during economic downturns.

For much of the past few years the public sector has been relatively inactive in the marketplace. Though the private sector has been active, aggressive development has far outpaced demand. The return of the State of California to the marketplace should begin to register a more significant impact on the market over the final half of 2007. Based upon deals already in the pipeline, we expect large increases in occupancy growth over the final half of the year. Unfortunately new deliveries will also be up significantly during that time. While the second quarter may ultimately be remembered as a pause in the action, we expect leasing and sales activity to pick up substantially over the final half of the year. Whether it will be able to keep pace with new development, however, is the million-dollar question. ▶

DEAL ACTIVITY

SELECT SALES ACTIVITY YTD

PROPERTY ADDRESS	SALES DATE	SALE PRICE	SIZE SF	PRICE/PSF	TYPE
300 Capitol Mall	6/14/07	130,000,000	383,000	$339.21	Class A
Parkshore Plaza	4/11/07	80,000,000	272,853	$293.20	Class A
California Center	4/19/07	29,000,000	166,881	$173.77	Class A
9815 Goethe Road	6/26/07	15,750,000	80,000	$196.88	Class B
1111 Howe Avenue	6/05/07	14,685,099	102,693	$143.00	Class C

SELECT LEASE ACTIVITY YTD

PROPERTY ADDRESS	OCCUPANCY	TENANT	SIZE SF	PRICE/PSF	TYPE
400 Capitol Mall	2/1/07	Wells Fargo	45,247	$2.76	Class A
10951 White Rock Road	2/1/07	Aerojet	35,000	$1.75	Class B
400 Q Street	4/18/07	CDCR	33,164	$2.80	Class A
4330 Auburn Boulevard	1/1/07	Strategies for Change	30,000	$1.60	Class C
2750 Gateway Oaks Drive	3/1/07	Sutter Health Sac Sierra Region	27,514	$1.80	Class A
3636 American River Drive	3/28/07	Matheny, Sears, Linkert & Long	22,407	$2.15	Class B
1808 14th Street	2/1/07	Union of CA State Workers	20,000	$1.67	Class C
1325 S Street	2/1/07	Union of CA State Workers	14,700	$1.67	Class C
1720 Prairie City Road	5/1/07	Meridian Project Systems	21,515	$1.44	Class B

OFFICE MARKET STATISTICS
Second Quarter 2007

		EXISTING PROPERTIES									ABSORPTION		CONSTRUCTION		RENTS
Class	Bldgs	Total Inventory SF	Direct Vacant SF	Direct Vacancy Rate	Sublease Vacant SF	Sublease Vacancy Rate	Total Vacant SF	Total Vacancy Rate	Vacancy Rate Prior Qtr	Current Occupied Space SF	Net Absorption Current Qtr SF	Net Absorption YTD SF	Completions Current Qtr SF	Under Construction SF	Avg Asking Rate
DOWNTOWN TOTAL															
A	24	7,211,286	481,501	6.7%	19,337	0.3%	500,838	6.9%	8.1%	6,710,448	82,421	228,095	-	799,791	$ 30.72
B	68	3,910,318	772,498	19.8%	37,111	0.9%	809,609	20.7%	19.0%	3,100,709	(67,721)	(200,513)	-	-	$ 23.16
C	163	3,132,735	347,172	11.1%	8,215	0.3%	355,387	11.3%	12.4%	2,777,348	32,459	75,752	-	-	$ 20.40
Total	**255**	**14,254,339**	**1,601,171**	**11.2%**	**64,663**	**0.5%**	**1,665,834**	**11.7%**	**12.0%**	**12,588,505**	**47,159**	**103,334**	**-**	**799,791**	**$ 26.50**
SUBURBAN SECTION:															
Roseville/Rocklin															
A	41	2,866,866	420,263	14.7%	54,740	1.9%	475,003	16.6%	15.5%	2,391,863	(32,070)	(37,124)	-	110,000	$ 28.80
B	217	5,032,341	745,133	14.8%	60,351	1.2%	805,484	16.0%	14.9%	4,226,857	(5,066)	63,652	61,460	1,008,204	$ 27.50
C	132	2,331,345	195,989	8.4%	9,900	0.4%	205,889	8.8%	6.8%	2,125,456	(48,786)	(6,599)	-	-	$ 21.36
Total	**390**	**10,230,552**	**1,361,385**	**13.3%**	**124,991**	**1.2%**	**1,486,376**	**14.5%**	**13.2%**	**8,744,176**	**(85,922)**	**19,929**	**61,460**	**1,118,204**	**$ 27.50**
Highway 50 Corridor															
A	39	3,784,450	282,209	7.5%	130,096	3.4%	412,305	10.9%	12.8%	3,372,145	71,721	62,644	-	-	$ 24.96
B	123	6,217,481	922,585	14.8%	41,578	0.7%	964,163	15.5%	14.7%	5,253,318	(48,547)	(13,366)	-	170,000	$ 21.84
C	157	3,589,088	605,530	16.9%	64,862	1.8%	670,392	18.7%	17.7%	2,918,696	(34,651)	(47,342)	-	7,225	$ 18.80
Total	**319**	**13,591,019**	**1,810,324**	**13.3%**	**236,536**	**1.7%**	**2,046,860**	**15.1%**	**15.0%**	**11,544,159**	**(11,477)**	**1,936**	**-**	**177,225**	**$ 21.36**
Folsom															
A	18	2,021,681	144,074	7.1%	18,029	0.9%	162,103	8.0%	2.5%	1,859,578	(111,087)	(80,983)	-	48,591	$ 27.12
B	81	1,612,333	243,002	15.1%	7,660	0.5%	250,662	15.5%	15.2%	1,361,671	34,957	162,740	75,891	21,295	$ 25.44
C	34	741,250	53,418	7.2%	-	0.0%	53,418	7.2%	6.7%	687,832	(4,015)	4,548	-	-	$ 22.10
Total	**133**	**4,375,264**	**440,494**	**10.1%**	**25,689**	**0.6%**	**466,183**	**10.7%**	**7.8%**	**3,909,081**	**(80,145)**	**86,305**	**75,891**	**69,886**	**$ 25.44**
Elk Grove															
A	2	68,108	5,222	7.7%	3,016	4.4%	8,238	12.1%	12.1%	59,870	-	3,087	-	-	$ 31.20
B	46	1,002,298	321,219	32.0%	9,649	1.0%	330,868	33.0%	18.7%	671,430	(27,339)	3,511	142,834	183,055	$ 29.88
C	12	200,107	17,264	8.6%	10,098	5.0%	27,362	13.7%	10.2%	172,745	(6,925)	(10,968)	-	-	$ 28.20
Total	**60**	**1,270,513**	**343,705**	**27.1%**	**22,763**	**1.8%**	**366,468**	**28.8%**	**16.8%**	**904,045**	**(34,264)**	**(4,370)**	**142,834**	**183,055**	**$ 29.88**
SUBURBAN TOTAL															
A	157	15,466,017	1,823,932	11.8%	284,921	1.8%	2,108,853	13.6%	13.2%	13,357,164	(68,646)	(6,476)	-	650,963	$ 26.52
B	864	26,039,076	3,882,234	14.9%	207,875	0.8%	4,090,109	15.7%	14.4%	21,948,967	4,750	240,137	415,349	1,603,868	$ 24.96
C	1,208	21,808,830	2,184,535	10.0%	127,457	0.6%	2,311,992	10.6%	10.5%	19,496,838	(32,379)	80,811	-	7,225	$ 19.60
Total	**2,229**	**63,313,923**	**7,890,701**	**12.5%**	**620,253**	**1.0%**	**8,510,954**	**13.4%**	**12.7%**	**54,802,969**	**(96,275)**	**314,472**	**415,349**	**2,262,056**	**$ 24.24**
MARKET TOTAL															
A	**181**	**22,677,303**	**2,305,433**	**10.2%**	**304,258**	**1.3%**	**2,609,691**	**11.5%**	**11.6%**	**20,067,612**	**13,775**	**221,619**	**-**	**1,450,754**	**$ 27.80**
B	**932**	**29,949,394**	**4,654,732**	**15.5%**	**244,986**	**0.8%**	**4,899,718**	**16.4%**	**15.0%**	**25,049,676**	**(62,971)**	**39,624**	**415,349**	**1,603,868**	**$ 24.80**
C	**1,371**	**24,941,565**	**2,531,707**	**10.2%**	**135,672**	**0.5%**	**2,667,379**	**10.7%**	**10.7%**	**22,274,186**	**80**	**156,563**	**-**	**7,225**	**$ 19.80**
Total	**2,484**	**77,568,262**	**9,491,872**	**12.2%**	**684,916**	**0.9%**	**10,176,788**	**13.1%**	**12.6%**	**67,391,474**	**(49,116)**	**417,806**	**415,349**	**3,061,847**	**$ 24.60**
QUARTERLY COMPARISON AND TOTALS															
Q2-07	**2,484**	**77,568,262**	**9,491,872**	**12.2%**	**684,916**	**0.9%**	**10,176,788**	**13.1%**	**12.6%**	**67,391,474**	**(49,116)**	**417,806**	**415,349**	**3,061,847**	**$ 24.60**
Q1-07	2,453	77,164,801	9,124,961	11.8%	606,883	0.8%	9,731,844	12.6%	12.9%	67,432,957	466,922	466,922	256,252	3,207,192	$ 24.20
Q4-06	2,441	76,908,549	9,316,871	12.1%	625,643	0.8%	9,942,514	12.9%	12.8%	66,966,035	250,911	610,338	344,363	2,770,647	$ 23.90
Q3-06	2,422	76,530,526	9,162,830	12.0%	652,572	0.9%	9,815,402	12.8%	12.5%	66,715,124	226,435	359,427	505,739	2,197,549	$ 23.30
Q2-06	2,406	76,016,731	8,964,247	11.8%	561,795	0.7%	9,526,042	12.5%	12.4%	66,490,689	193,728	132,992	349,091	2,511,937	$ 23.00

The information contained in this report was provided by sources deemed to be reliable, however, no guarantee is made as to the accuracy or reliability.
As new, corrected or updated information is obtained, it is incorporated into both current and historical data, which may invalidate comparison to previously issued reports.

It's been a busy year for Steven Schwarzman's Blackstone Group. After purchasing Equity Office Properties Trust for $36 billion, the then-private equity buyout firm chopped up and flipped the 580-building portfolio to various parties before launching the sixth largest IPO ever and then moving to acquire Hilton Hotels. In the Sacramento area this translated into the sale of 32 office properties to Hines Real Estate Investment Trust for a reported $760,000,000 or an estimated $312 per square foot.

CONSTRUCTION TRENDS

New deliveries outpaced net absorption throughout 2006, with the market recording over 1.5 million square feet of new product compared to roughly 610,000 square feet of occupancy growth. Unfortunately, this trend appears to be continuing in 2007. So far this year the market has added over 670,000 square feet of new product while absorbing just under 420,000 square feet of space.

While approximately 860,000 square feet of our ongoing construction total relates to build-to-suit projects that will be fully occupied upon completion—including a 400,000 square foot project for CalSTRS in West Sacramento as well as a 170,000 square foot office campus for EDFUND in the Highway 50 Corridor—the remaining 2.2 million square feet of space is all speculative development, of which only about 250,000 square feet have commitments in place.

New development remains aggressive throughout the region. For the first time since 1999, two high-rise office buildings are simultaneously under construction in Downtown Sacramento. David Taylor Interest's 25-story U.S. Bank Tower at 621 Capitol Mall will add over 366,000 square feet of space to the marketplace upon its delivery in late 2008. At the time of this report approximately one third of its space had been pre-leased. Meanwhile, Tsakopoulos Investments' 500 Capitol Mall will add over 430,000 square feet of competitive space to the marketplace upon its completion in the Fall of 2009. As this report went to press we knew of no pre-leasing agreements in place for this 25-story office tower. These two projects alone account for nearly 800,000 square feet of new office space or roughly 26% of all current construction.

Going forward there is no reason to believe that this trend will change. There is just over three million square feet of new office space currently under construction throughout the region—a level that we have not seen in years. By year's end we should top the two million square foot mark. While we expect occupancy growth to increase significantly over the final half of the year, current levels of new construction almost guarantee that the trend of increasing vacancy rates will also continue heading into 2008. Most significantly impacted by this trend will be the Roseville/Rocklin submarket—which accounts for nearly half of the suburban office construction currently underway. Yet, while this may sound like a doom and gloom forecast to developers, the fact is that there are some Sacramento submarkets where we believe new development may actually be overdue. With overall vacancy at just 10.8%, the Folsom submarket is prime for further office development. El Dorado Hills is another potential growth market where a lack of institutional quality office space and vacancy in the ten percent range may also prove to be the right formula for developers. And though vacancy is currently high in the Elk Grove submarket, this market's strong population growth and ongoing transition from being mainly a professional/medical office market could also offer opportunities.

TOO MUCH OF A GOOD THING?

The Roseville/Rocklin submarket has been the Sacramento region's premier suburban office market for the majority of the past decade. It has led the region both in terms of net absorption and new construction. Yet vacancy currently stands at 14.5% for all office product—up from 13.2% at the close of the first quarter. Just two years ago this number stood at 10.9%. It is imperative to note that we track both multi-tenant and owner occupied buildings. When we take owner occupied space out of the mix, vacancy shoots considerably higher. The current vacancy rate for multi-tenant office space in the Roseville/Rocklin market is 17.5%. Two years ago this number stood at 12.9%.

Since 2001, this submarket has accounted for roughly 40% of all office space built within the Sacramento region. It also has accounted for roughly 40% of all occupancy growth during that period and was the market leader in terms of rental rate growth. With over 1.1 million square feet of new space under construction, it continues to lead the market in terms of new office construction accounting for over 37% of all space in the development pipeline.

From 1999 to 2006, the Roseville submarket recorded over 3.9 million square feet of occupancy growth, or an average of over 120,000 square feet per quarter. However, since 2006 this market has cooled considerably in terms of occupancy growth. During the first three months of the year the Roseville submarket accounted for just under 20,000 square feet of occupancy growth—despite the fact that over 61,000 square feet of new product came online in the same period. Over the past 18 months, Roseville has averaged quarterly net absorption of approximately 54,000 square feet per quarter.

The Roseville/Rocklin submarket has historically led the way in terms of suburban office rental growth in the region. Despite current challenges, it still leads the market in terms of suburban rents, with a current average asking rate of $2.30 per square foot (based upon a monthly full service basis) for all classes of office space. ▶

This average has remained steady over the past nine months even as vacancy has continued to creep upward. This is not to say that this market is immune to pricing pressures.

We have seen considerable movement from landlords in terms of concessions with tenant improvement allowances increasing considerably—particularly for national credit tenants—as well as additional free rent. Whereas a national credit tenant may have expected one or two free months on a five-year deal in 2005, we are now seeing landlords offer the same caliber tenant as much as double that. Likewise, we have seen some recent leases offering tenant improvement allowances up to $50 per square foot, which is up by as much as 40% from just a year ago.

One event that may prove beneficial in terms of occupancy growth is the recent sale of Equity Office's portfolio. Equity's national portfolio sold in February to the Blackstone Group, who immediately split up the portfolio and flipped it. In Northern California, it sold these properties to Hines—including 11 major office buildings in the Sacramento market. Hines is known as the "market maker" and is expected to push rents up at least 10% on renewals. This will likely get at a few tenants moving around in the marketplace and we expect many of them to land in Roseville.

And while we expect the overall Sacramento market to record strong occupancy growth over the final half of this year, much of that will be generated by deals inked by various governmental entities. It is unclear how many—if any—of these deals could land in the Roseville/Rocklin submarket.

Current levels of new development all but ensure that vacancy will climb upward in the near future. As a result, we expect asking rents to register minor declines by next quarter. The good news, however, is that Roseville remains the region's premier suburban market in terms of tenant appeal. Even following the current wave of new development, this submarket remains within two solid years of market equilibrium. However, this is completely dependent upon the pace of speculative development slowing significantly.

LOOKING AHEAD

Look for occupancy gains to increase significantly in the second half of this year. Despite this, continued high levels of ongoing development will mean that vacancy levels will likely continue to increase. Vacancy will continue to increase in the Roseville/Rocklin market as projects currently under construction come to market.

We expect strong performances from the Folsom and Highway 50 submarkets. The Highway 50 submarket will likely be the greatest beneficiary of the State of California's current space requirements. Folsom is already positioned for a strong performance thanks to low vacancy, high prestige and continued tenant demand. North Natomas/Northgate and Elk Grove will continue to develop into major suburban submarkets, despite currently high levels of vacancy. In the case of Elk Grove, vacancy levels may actually increase in the short term as new projects come online, but the evolution of this area's office market will take a huge step forward with a shift away from professional office and flex space toward high-end institutional grade product. ■

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