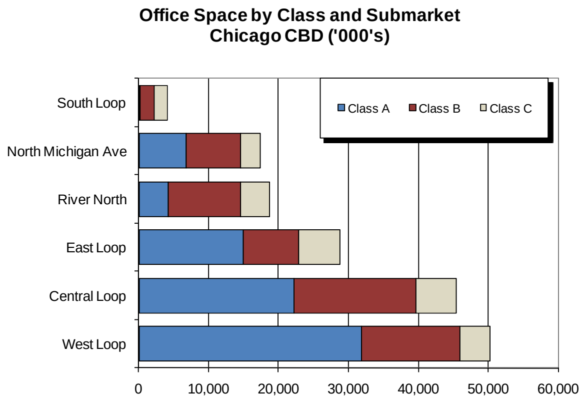
OFFICE MARKET ANALYSIS – CITY OF CHICAGO

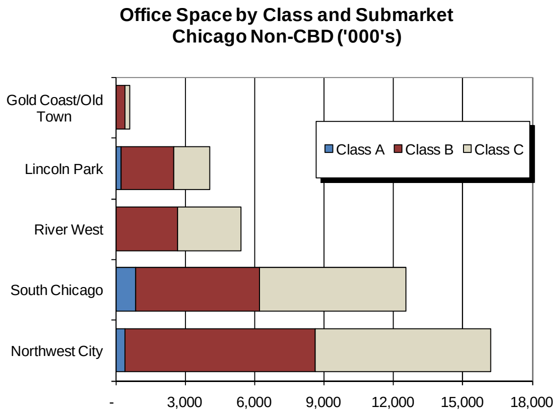
Market Composition & Distribution

According to Costar Property, the City of Chicago office market is distributed as follows:

Office Submarket Distribution - City of Chicago

	Class A		Class B		Class C		
Submarket	Square Feet	Percent Submarket	Square Feet	Percent Submarket	Square Feet	Percent Submarket	Total
CBD							
West Loop	31,864,896	63%	14,075,077	28%	4,288,751	9%	50,228,724
Central Loop	22,227,247	49%	17,430,403	38%	5,723,892	13%	45,381,542
East Loop	14,953,165	52%	7,891,595	27%	5,915,825	21%	28,760,585
River North	4,281,655	23%	10,289,021	55%	4,114,110	22%	18,684,786
North Michigan Ave	6,742,869	39%	7,828,186	45%	2,836,427	16%	17,407,482
South Loop	244,960	6%	1,953,225	47%	1,932,465	47%	4,130,650
Subtotals	80,314,792	49%	59,467,507	36%	24,811,470	15%	164,593,769
Non-CBD							
Northwest City	415,748	3%	8,191,024	50%	7,615,622	47%	16,222,394
South Chicago	864,622	7%	5,342,867	43%	6,335,920	51%	12,543,409
River West	-	0%	2,666,039	49%	2,750,205	51%	5,416,244
Lincoln Park	251,955	6%	2,265,800	56%	1,542,543	38%	4,060,298
Gold Coast/Old Town		0%	409,573	69%	183,061	31%	592,634
Subtotals	1,532,325	4%	18,875,303	49%	18,427,351	47%	38,834,979
Total City	81,847,117	40%	78,342,810	39%	43,238,821	21%	203,428,748



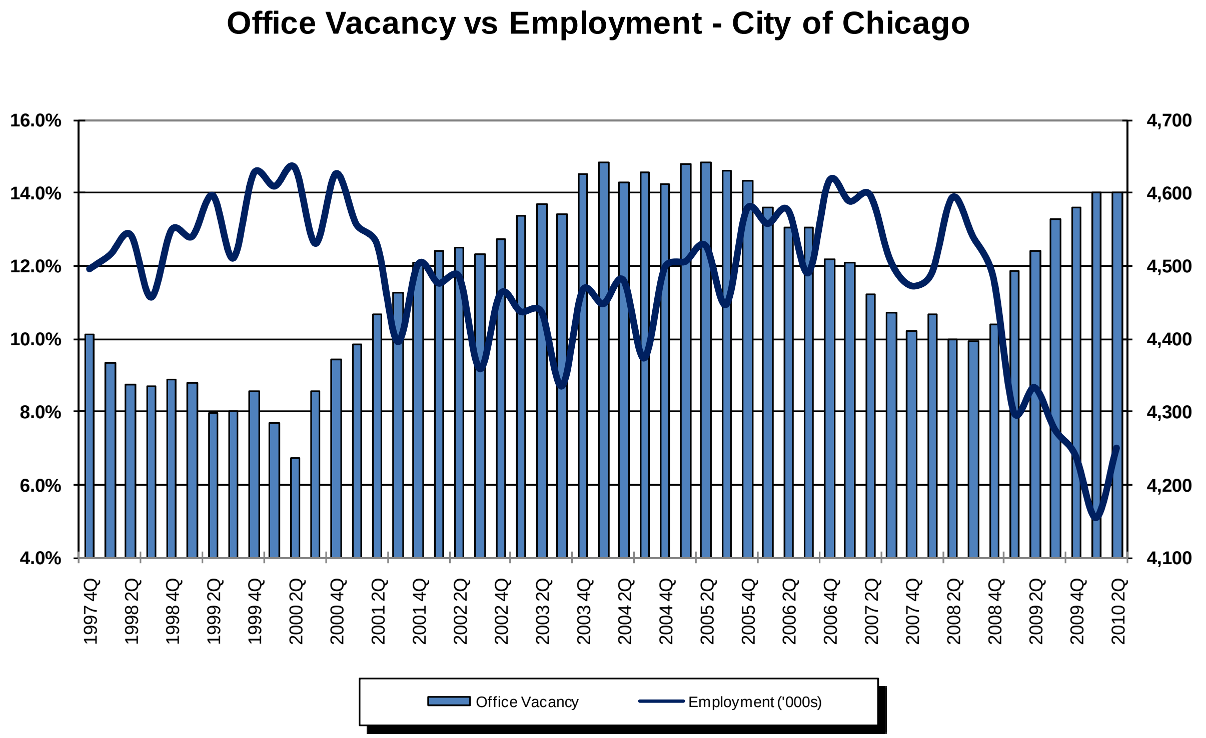


In the CBD, the West Loop is the largest submarket and contains 40 percent of the Class A space downtown. With its proximity to the train stations, most of the new development has occurred in the West Loop. The Central and East Loop submarkets follow in size with roughly 50 percent of the space in these submarkets being Class A. Many of the Class C buildings in the East Loop, and to a smaller degree in the Central Loop, have been converted from office use to an alternative use in the last few years. These redevelopments, which have mostly been for residential condominiums, have helped the vacancy rates. Less than 20 percent of the office market is located outside the CBD with space dominated by Class B and C buildings.

Vacancy

Vacancy is a function of employment – which translates into office workers. Vacancy hit a low point in the MSA in the late 1990s/2000, reaching levels below 8 percent, and then increased as the economy went into a recession. After peaking in roughly 2004/2005, vacancy declined as employment strengthened. The lag in response time for vacancy to the rise in employment is due to corporations filling vacant committed space prior to expanding.

Vacancy rates had declined significantly since 2005, which was due to the employment growth that started in 2003. However, this trend has clearly reversed with the recession that began in December 2007. The following chart illustrates how employment growth is a precursor to net absorption and lower vacancy levels.

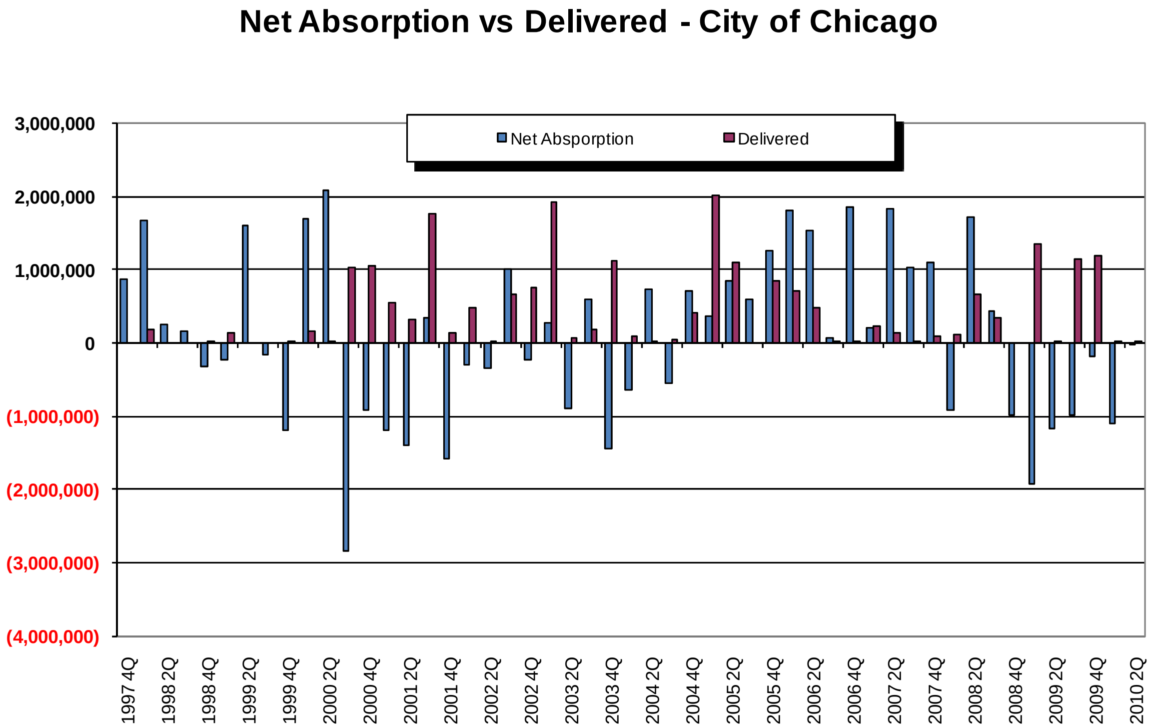


Source: Costar Property

Vacancy rates spiked quickly since mid 2008 as employers have slashed payrolls. We believe that vacancy rates have stabilized and job growth is starting to occur, albeit at a slow pace. While job growth is occurring, vacancy rates are not expected to improve substantially for some time due to the anemic job growth.

Absorption & Deliveries

Job growth in the late 1990s/2000 led to positive absorption of space. The recessionary climate which began in 2000 and continuing through 2003 resulted in an extended period of negative absorption in the market. Absorption began picking up in early 2004 when the employment market started to turn positive. The level of absorption however has been on the decline since early 2007. With the weakening employment market and deliveries of three CBD office buildings, we expect negative absorption into 2010.



Source: Costar Property

Because of the time lag for new development including site acquisition, zoning approval, design and ultimately construction, deliveries lag changes in demand. Projects that were financed based on growth seen in the late 1990s delivered in late 2000 through 2003 after the market had turned downward. These factors contributed to the high vacancies previously illustrated during the period 2002-2005. While there have been few deliveries over the last couple of years, this changed in 2009 with three large CBD buildings adding about 4.6 million square feet to the market.

The table on the following page summarizes the buildings that were added to the CBD area over the most recent building cycle.

CBD Office Recent Completions

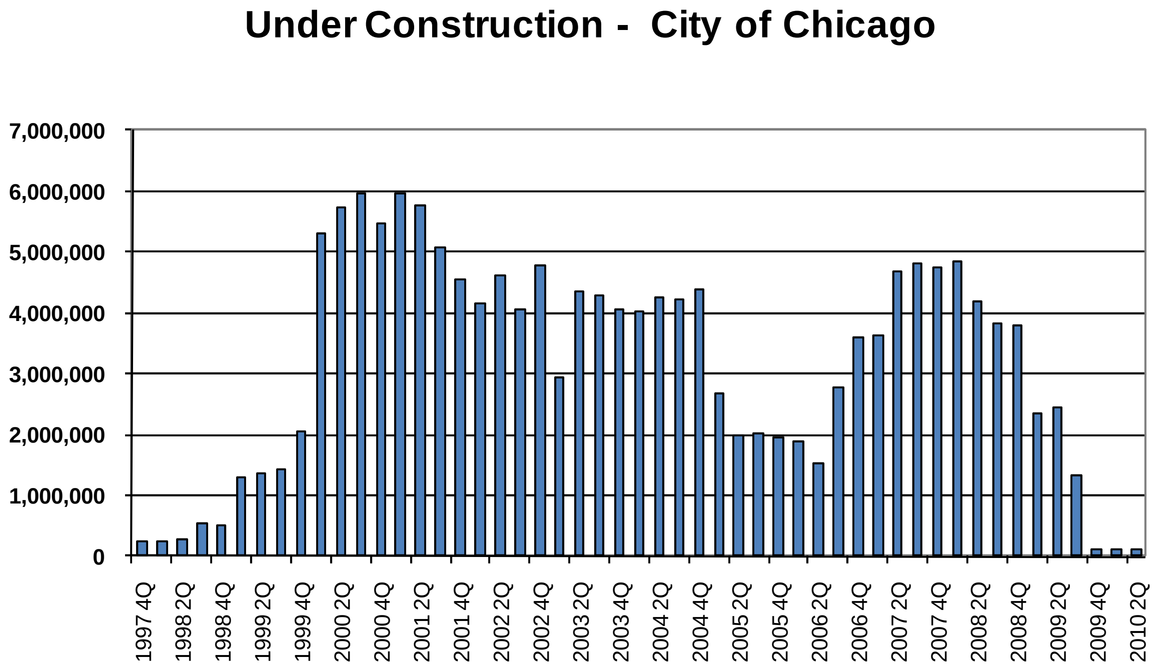
Location	Name	Sub-Market	Developer	Delivery Date	# of Stories	Total Rentable SF
353 N. Clark		River North	Mesirow Financial	2009	45	1,173,643
155 N. Wacker		West Loop	The John Buck Co.	2009	46	1,123,330
300 N. LaSalle		River North	Hines Interests	2009	60	1,350,000
111 W. Illinois		River North	The Alter Group	2008	10	227,604
550 W. Adams	USG Building	West Loop	Fifield Co.	2006	18	479,000
1 S. Dearborn		Central Loop	Hines Interests	2005	40	841,498
111 S. Wacker		West Loop	The John Buck Co.	2005	51	1,027,683
71 S. Wacker	Hyatt Center	West Loop	Higgins Development	2004	47	1,472,460
131 S. Dearborn	Citadel Center	Central Loop	The Prime Group	2003	37	1,504,364
540 W. Madison		West Loop	Hines Interests	2003	31	1,300,000
555 W. Monroe	Pepsico Chicago HQ	West Loop	Fifield Co.	2002	18	420,000
191 N. Wacker		West Loop	Hines Interests	2002	37	732,000
1 N. Wacker	UBS Tower	West Loop	The John Buck Co.	2001	50	134,000
550 W. Jackson		West Loop	Mark Goodman Assoc.	2001	18	405,968
525 W. Van Buren		West Loop	Development Resources	2000	16	522,000
550 W. Washington		West Loop	Fifield Co.	2000	16	372,000

The preceding buildings have done well in lease-up and are all at or near stabilized operations. The market has shown strong demand for buildings that offer new, functional space with the latest available technology.

As demonstrated by the table, the West Loop has been the submarket of choice for new construction. This is largely due to the proximity to the primary commuter train stations of Union Station and Ogilvie Transportation Center. The West Loop has pushed the historical western boundary of the CBD from the Chicago River to the Kennedy Expressway, as six of the 13 buildings completed this decade have been west of the river.

New Construction

Because of the lag in supply matching market demand, new construction continued through the beginning of the 2000-2003 recession. Construction slowed notably after 2000 and leveled off until late 2006 when volume picked up. We do note however that the current cycle has not produced the same level of additions to supply that occurred leading up to and through the last recession.



Source: Costar Property

The graph above illustrates the decline in the under construction square footage from 4Q08 to 1Q10, which was due to the delivery of 300 N. LaSalle, 155 N. Wacker, and 353 N. Clark.

While much of the new construction space was pre-leased, there are now holes created in the downtown market due to vacating of previously occupied space. There has been limited new demand for space from corporations outside the downtown market. Rather, companies are relocating from older, obsolete space to more efficient, new space in the market.

With the limited availability of financing for new projects, we expect few, if any, new construction starts over the next couple of years.

The following summarizes the buildings that are currently being proposed:

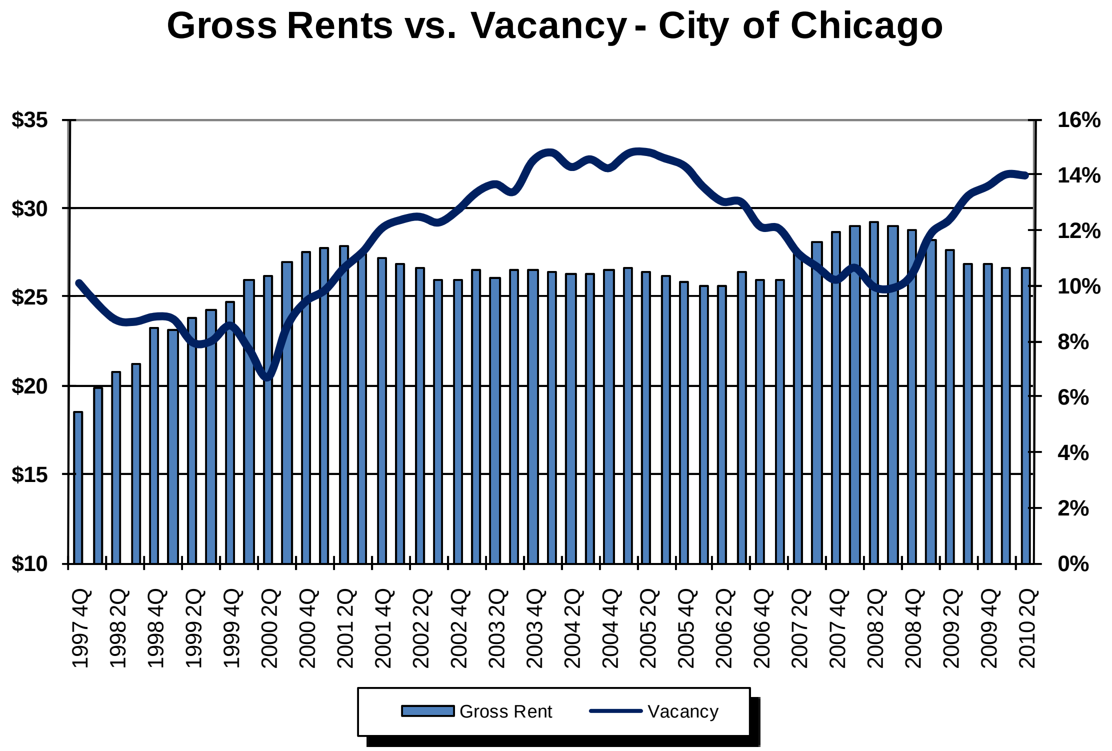
CBD Office Buildings Proposed

Location	Sub-Market	Developer	Total Rentable SF
401 S. Wacker	West Loop	Development Resources	885,304
210 S. Canal (Union Station)	West Loop	Jones Lang LaSalle	1,500,000
444 W. Lake Street (River Point)	West Loop	Hines	1,100,000
199 W. Monroe	Central Loop	Lincoln Property	695,800
222 W. Randolph	West Loop	The John Buck Co.	815,411
400 W. Randolph	West Loop	The Prime Group	1,200,000
601-25 W. Monroe	West Loop	Fifield Development	1,182,948
433 W. Van Buren (Old Post Office)	West Loop	GlenStar Properties	1,167,000
Total			8,546,463

While there are several buildings on the proposed list, each of these will have to wait for the next building cycle, which could be several years out. No financing is available for new construction at this time, not to mention the lack of demand from tenants.

Rent Trends

The correlation between rent and vacancy is illustrated below.



Source: Costar Property

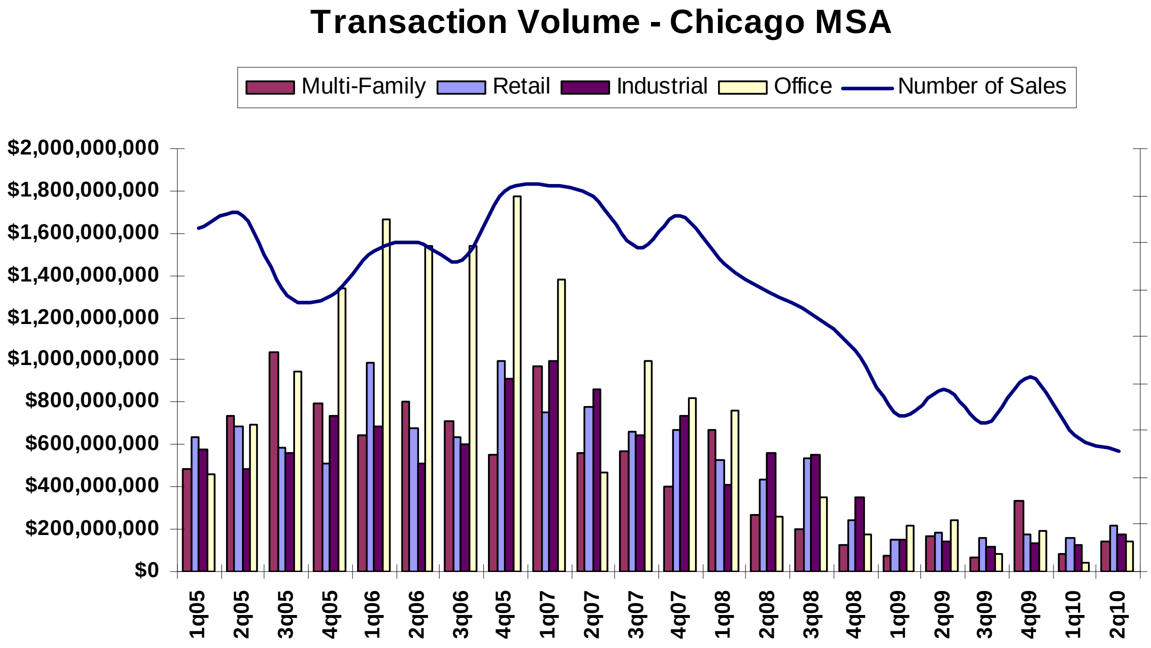
Vacancy rose through the 2000-2003 recessionary period and rents flattened out through mid 2005. Owners began reducing rents until vacancy went below 14 percent and then rents spiked through late 2007. More recently, with the weakening employment situation, vacancy has increased and rents are on the decline.

Transaction Market

A substantial run up in transaction volume across all property types occurred from 2004 through 2006 due in large part to very favorable loan terms (high leverage/low rates) and the expectation of increases in net income due to expected growth in demand. Weaknesses in the overall economy became apparent in early to mid 2007. The housing market was cooling in part due to the subprime mortgage market and a general over building in many markets. The collapse of numerous financial services firms led to a virtual shut down of the markets as noted below:

Bear Sterns acquired by JP Morgan Chase	March 2008
IndyMac taken over by FDIC	July 2008
Lehman Brothers filed for Bankruptcy	September 2008
Merrill Lynch acquired by Bank of America	September 2008
AIG Bailout by US Treasury	September 2008
Washington Mutual, Inc seized by OTS	September 2008
Fannie Mae acquired by US Treasury	September 2008
Freddie Mac acquired by US Treasury	September 2008
Wachovia acquired by Wells Fargo	October 2008

The ability to obtain financing for real estate was diminishing as banks began to stockpile cash for reserves. As financing became more costly with lower loan to values and higher debt coverage ratio requirements, equity investors were requiring higher rates of return resulting in a double hit to returns.



Source: Costar Property

Few transactions have occurred since late 2008 for two primary reasons. First, there remains a significant buy/sell price gap for most property types that has not yet been bridged. Sellers remain focused on pricing attained at the peak of the last cycle and buyers are unable to make the numbers work with lower loan to values and higher equity return requirements for their investors. Many sellers have debt that exceeds current market value. Second, while many buyers believe the market is at or near the bottom, they cannot obtain financing at leverage levels that make the deals work.

With the volume of refinancing activity coming due over the next few years, there is a belief by many that the current financial system simply cannot deliver enough credit to keep the market functioning. Many properties are underwater with debt exceeding the value of the asset requiring substantial equity infusion to stay afloat. Should the government not come up with a workable solution, many market participants believe a wave of foreclosures will result, flooding the market with distressed assets. For the most part, the only sellers in the market today are those that are under pressure to sell.

Overall we do not expect to see transaction volume increase over at least the next six months as there does not appear to be a solution at this point to the lack of liquidity in the market.