

Market Trends

	Change in Q1	Q2 Forecast
Lease Rates	↔	↔
Absorption	↓	↑
Direct Vacancy	↔	↔
Sublease Vacancy	↓	↓

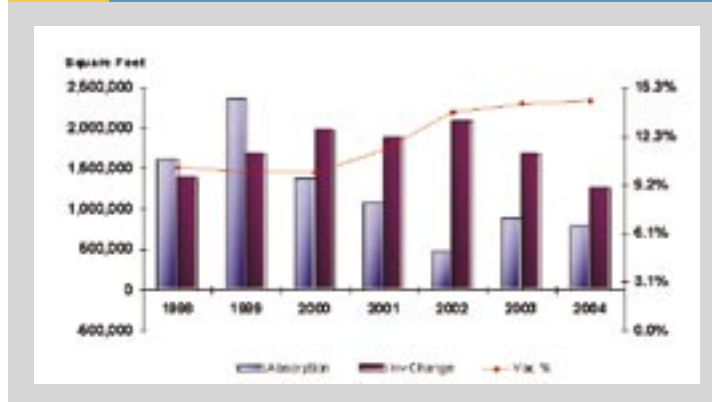
Market Stabilizes Over First Quarter

Overall vacancy within the Sacramento office market currently stands at 14.6%—the same level where it stood as of the close of 2004. The market absorbed nearly 250,000 square feet of product over the first quarter of the year. This marks a significant decrease from the 565,000 square feet of occupancy growth recorded in the final quarter of 2004, but the good news is that new development added just 280,000 square feet of product to the marketplace during the same time. Supply and demand essentially cancelled each other out over the first three months of 2005 with the market remaining in roughly the same place it was at the close of last quarter.

Leasing and Development Cool in First Quarter

Since 2000, the Sacramento office market has averaged quarterly occupancy growth of roughly 315,000 per quarter. While net absorption only reached 250,000 square feet during the first quarter, the good news is that this is not too much off the mark. Still, it paints a picture of a market that experienced a decrease in activity over the first three months of 2005. Gross absorption—or actual leasing volume—totaled roughly 1.3 million square feet during this same time—down significantly from the 1.7 million square feet that the market has averaged quarterly since 2000. It is important to note that while gross absorption measures all leasing activity, it does not take into account space that has been vacated. Net absorption, however, does take this into account and thus is a much more accurate measure of true economic growth.

FIGURE 1 Sacramento Office Market Change in Inventory, Absorption and Vacancy



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FIGURE
2

Sacramento Office Market
 Top Office Buildings Under Construction

Project Name	Submarket	Square Feet	Developer	Delivery
R Street Project	Downtown	550,000	CalPERS	2 nd Qtr
3741 Douglas Boulevard	Roseville/Rocklin	97,000	Granite Bay Ventures	2 nd Qtr
Folsom Professional Center	Folsom	70,000	Catlin Properties	2 nd Qtr
Summit at Douglas Ridge	Roseville/Rocklin	66,664	Equity Office	2 nd Qtr
Shea Center #9	Roseville/Rocklin	55,000	Shea Properties	2 nd Qtr
9355 Stockton Boulevard E.	South Sacramento	50,000	Treasure Homes	2 nd Qtr
California Center	Highway 50 Corridor	48,000	Panattoni	2 nd Qtr
Laguna East Business Park	South Sacramento	45,000	Jackson Properties	2 nd Qtr
8945 Cal Center Drive	Highway 50 Corridor	198,000	Opus West	3 rd Qtr
1375 Exposition Boulevard	Point West	54,551	Jackson Properties	3 rd Qtr
201 Creekside Ridge	Roseville/Rocklin	48,000	Evergreen Company	3 rd Qtr

But even while leasing activity was down during the first three months of 2005, so too was new development. New construction has outpaced net absorption in five of the past eight quarters. Development has played a major role in the increased vacancy rates that the market has experienced over the past two years with vacancy peaking in the third quarter of last year at 15.1%. New development added 280,000 square feet of space to the market over the first three months of the year—down significantly from the roughly 470,000 square feet of product that the market has averaged quarterly over the past five years.

As we reported in our last report, the big story of 2004 was that despite the fact that tenant interest and leasing activity were actually on the upswing, that vacancy had reached its highest levels since the recession of the early 1990s. The fact is that even though space users were returning to the marketplace after two sluggish years, so too were developers. Ultimately a surge in tenant demand could not keep pace with an even greater surge in new development. With both tenant demand and new construction having cooled off over the past

three months, the big question is how will this impact trends heading into 2005.

Construction Pipeline

Just over 1.5 million square feet of new development is currently in the construction pipeline, with most of that space slated for second and third quarter delivery. With only 280,000 square feet of space delivered during the first three months of 2005, it is almost a certainty that deliveries will increase substantially over the next two quarters. One might be tempted to assume that lower than average first quarter office deliveries may be the norm—thanks to Northern California’s winter rainy season. Yet, surprisingly, deliveries have been strongest during the first quarter in three out of the past five years.

Meanwhile, with over 1.5 million square feet of product currently in the construction pipeline, this actually marks a decrease from historical averages. Since 2000, the Sacramento office market has averaged over two million square feet of space in the construction pipeline at any given time. Despite a likely surge in deliveries over the next two quarters, development on the whole is on

the decline. Yet the same was true of last year when the market turned in just over 1.2 million square feet of new development compared to 2003’s total of nearly 1.7 million square feet.

What remains unclear is whether demand will keep up with current levels of new construction—even if those totals are down from previous years. What sticks out most is the fact that in ten of the last thirteen quarters new development has outpaced occupancy growth. This holds true whether looking at the market as a whole or just Sacramento’s suburban markets which have accounted for over 6.7 million square feet of new space since 2001 while recording only 3.7 million square feet of occupancy growth.

One might ask why new developers would continue to proceed at current levels, despite the fact that vacancy in the mid-teens almost guarantees flat (or worse) rental rates? The fact is that developers, hoping



Colliers International Sacramento Office Quarterly Report



Existing Properties											Absorption		New Supply		UC / Proposed		Avg Rent
Class	Bldgs	Total Inventory Sq. Ft.	Direct Vacant Sq. Ft.	Direct Vacancy Rate	Sublease Vacant Sq. Ft.	Sublease Vacancy Rate	Total Vacant Sq. Ft.	Occupied Space Sq. Ft.	Vacancy Rate Q1-05	Vacancy Rate Q4-04	Net Absorption Current Sq. Ft.	Net Absorption YTD-Sq. Ft.	Net New Supply Current Sq. Ft.	Net New Supply YTD Sq. Ft.	Under Construction Sq. Ft.	Proposed Sq. Ft.	Avg Rental Rate

DOWNTOWN

A	23	5,435,536	686,346	12.6%	48,164	0.9%	734,510	4,701,026	13.5%	13.5%	45	45	-	-	550,000	330,000	\$2.35
B	50	3,498,182	615,146	17.6%	7,622	0.2%	622,768	2,875,414	17.8%	16.4%	(49,456)	(49,456)	-	-	-	-	\$1.85
C	176	3,375,382	366,413	10.9%	18,500	0.5%	384,913	2,990,469	11.4%	12.0%	19,769	19,769	-	-	-	-	\$1.60
Total	249	12,309,100	1,667,905	13.6%	74,286	0.6%	1,742,191	10,566,909	14.2%	13.9%	(29,642)	(29,642)	-	-	550,000	330,000	\$2.00

SELECT SUBURBAN MARKETS

FOLSOM

A	19	1,238,006	137,190	11.1%	87,160	7.0%	224,350	1,013,656	18.1%	19.5%	17,493	17,493	-	-	-	655,628	\$2.10
B	57	1,898,553	170,058	9.0%	3,118	0.2%	173,176	1,725,377	9.1%	7.0%	(10,726)	(10,726)	32,592	32,592	85,000	257,239	\$2.00
C	32	712,989	186,205	26.1%	-	0.0%	186,205	526,784	26.1%	26.1%	184	184	-	-	-	-	\$1.70
Total	108	3,849,548	493,453	12.8%	90,278	2.3%	583,731	3,265,817	15.2%	14.6%	6,951	6,951	32,592	32,592	85,000	912,867	\$1.95

HIGHWAY 50

A	40	3,765,391	427,920	11.4%	125,216	3.3%	553,136	3,212,255	14.7%	14.5%	(7,687)	(7,687)	-	-	246,000	570,225	\$1.80
B	104	5,682,499	966,571	17.0%	77,492	1.4%	1,044,063	4,638,436	18.4%	21.5%	176,811	176,811	-	-	66,000	583,500	\$1.55
C	156	3,687,311	583,340	15.8%	19,100	0.5%	602,440	3,084,871	16.3%	15.8%	(18,416)	(18,416)	-	-	-	-	\$1.40
Total	300	13,135,201	1,977,831	15.1%	221,808	1.7%	2,199,639	10,935,562	16.7%	17.9%	150,708	150,708	-	-	312,000	1,153,725	\$1.55

NATOMAS/NORTHGATE

A	3	288,614	144,659	50.1%	16,230	5.6%	160,889	127,725	55.7%	56.0%	851	851	-	-	-	120,000	\$1.95
B	28	1,143,367	487,972	42.7%	38,971	3.4%	526,943	616,424	46.1%	48.1%	22,470	22,470	-	-	43,418	773,745	\$1.65
C	17	565,363	94,174	16.7%	-	0.0%	94,174	471,189	16.7%	16.9%	1,184	1,184	-	-	-	-	\$1.45
Total	48	1,997,344	726,805	36.4%	55,201	2.8%	782,006	1,215,338	39.2%	40.4%	24,505	24,505	-	-	43,418	893,745	\$1.65

ROSEVILLE/ROCKLIN

A	35	2,630,954	355,851	13.5%	97,113	3.7%	452,964	2,177,990	17.2%	18.0%	121,715	121,715	122,500	122,500	258,500	1,380,793	\$2.10
B	143	3,310,695	263,978	8.0%	24,095	0.7%	288,073	3,022,622	8.7%	11.1%	104,269	104,269	27,570	27,570	60,195	1,506,486	\$2.00
C	105	1,776,135	99,925	5.6%	18,855	1.1%	118,780	1,657,355	6.7%	6.9%	3,640	3,640	-	-	-	-	\$1.55
Total	283	7,717,784	719,754	9.3%	140,063	1.8%	859,817	6,857,967	11.1%	12.4%	229,624	229,624	150,070	150,070	318,695	2,887,279	\$2.00

SUBURBAN TOTAL

A	144	12,124,377	1,791,282	14.8%	357,696	3.0%	2,148,978	9,975,399	17.7%	17.7%	150,880	150,880	192,500	192,500	609,051	3,715,066	\$1.95
B	572	20,481,871	3,068,962	15.0%	212,504	1.0%	3,281,466	17,200,405	16.0%	16.6%	190,937	190,937	87,712	87,712	350,195	3,924,663	\$1.70
C	1,219	22,791,372	2,578,437	11.3%	118,432	0.5%	2,696,869	20,094,503	11.8%	11.5%	(66,082)	(66,082)	-	-	-	-	\$1.55
Total	1,935	55,397,620	7,438,681	13.4%	688,632	1.2%	8,127,313	47,270,307	14.7%	14.7%	275,735	275,735	280,212	280,212	959,246	7,639,729	\$1.75

GRAND TOTAL

A	167	17,559,913	2,477,628	14.1%	405,860	2.3%	2,883,488	14,676,425	16.4%	16.4%	150,925	150,925	192,500	192,500	1,159,051	4,045,066	\$2.05
B	622	23,980,053	3,684,108	15.4%	220,126	0.9%	3,904,234	20,075,819	16.3%	16.6%	141,481	141,481	87,712	87,712	350,195	3,924,663	\$1.70
C	1,395	26,166,754	2,944,850	11.3%	136,932	0.5%	3,081,782	23,084,972	11.8%	11.6%	(46,313)	(46,313)	-	-	-	-	\$1.50
Total	2,184	67,706,720	9,106,586	13.5%	762,918	1.1%	9,869,504	57,837,216	14.6%	14.6%	246,093	246,093	280,212	280,212	1,509,246	7,969,729	\$1.77

QUARTERLY COMPARISON AND TOTALS

Q4-04	2,169	67,426,508	9,114,302	13.5%	721,083	1.1%	9,835,385	57,591,123	14.6%	15.1%	565,298	565,298	266,971	1,279,746	1,729,735	7,866,245	\$1.77
Q3-04	2,155	67,153,767	9,342,324	13.9%	785,618	1.2%	10,127,942	57,025,825	15.1%	14.1%	-282,211	-282,211	469,229	1,012,775	1,501,456	8,423,226	\$1.77
Q2-04	2,133	66,684,538	8,478,890	12.7%	897,128	1.3%	9,376,018	57,308,520	14.1%	14.4%	509,220	509,220	301,845	543,546	1,595,777	8,744,663	\$1.75
Q1-04	2,114	66,382,693	8,664,464	13.1%	918,929	1.4%	9,583,393	56,799,300	14.4%	14.3%	-11,033	-11,033	241,701	241,701	1,644,307	9,120,555	\$1.75
Q4-03	2,106	66,255,790	8,734,606	13.2%	710,851	1.1%	9,445,457	56,810,333	14.3%	13.9%	88,214	88,214	380,626	1,684,152	1,144,451	9,315,000	\$1.74



to ride the next wave of the business cycle, moved aggressively in recent years to bring new product to the market in Sacramento. Remember that Sacramento was experiencing vacancy in the low teens at the height of the most recent downturn even while nearby markets such as San Francisco and San Jose struggled with vacancy nearing 30% or more. Even though occupancy growth has grown steadily in Sacramento since 2002, it has not been able to keep rate with current rates of development. An analysis of current vacancy based upon year built shows a trend that may give some developers pause. Given that it is normal for a speculative building to take anywhere from six to twelve months to lease up after completion, it would be normal for buildings built in the past year to have a higher than average rate of vacancy. Yet we see vacancy rates that are higher than the market average for all buildings built after 2001. Clearly new buildings are not leasing up as quickly as developers would like. This, combined with rapidly escalating construction costs, will likely result in development slowing by year's end—but the current amount of product in the construction pipeline will likely that we will not see this trend for at least six more months.

Market Strengths

The continuing imbalances between new development and occupancy growth have not impacted all of Sacramento's office submarkets in the same manner. The Roseville/Rocklin market, for example, remains the region's strongest trade area having recorded nearly 230,000 square feet of positive net absorption during the first quarter of this year as vacancy dipped from 12.4% at the close of 2004 to current levels of 11.1%. Likewise, the South Sacramento office market (which includes booming Elk Grove) currently boasts vacancy of 7.5%. The Highway 50 Corridor—despite current vacancy of 16.7%—also experienced positive growth over the first three months of the

year, recording over 150,000 square feet of occupancy growth. However, nearly all other Sacramento submarkets either remained flat during the first quarter or experienced minimal losses.

The good news for landlords is that most active brokers believe that declines in occupancy growth over the first quarter of the year are more a reflection of timing than of any long-term trend in declining demand. Following a fourth quarter performance in which over 565,000 square feet of space was absorbed (the highest level since the first quarter of 2003), many deals were simply not in the appropriate place in the pipeline to close before the end of the first quarter. We track tenant space requirements in the marketplace and are currently aware of over 1.9 million square feet of potential space needs. This total includes both tenants who are actively looking for space in the marketplace and space users who are facing pending lease expirations. This number is up substantially from the 1.3 million square feet in requirements we tracked exactly one year ago. Deals are in the pipeline and we expect absorption during the second and third quarters of this year to substantially surpass first quarter totals. Still, however, the big question is whether they will surpass levels of new delivery and begin to lower our overall vacancy rate.

More good news for landlords is the fact that rents on the whole continue to remain stable. This is despite the fact that vacancy has been at or above the 14% mark since late 2003. The overall average asking rate for office space in Sacramento currently stands in the \$1.70 to \$1.75 per square foot (on a monthly full service basis) range. This total includes all submarkets and classes of office buildings and is roughly the same rate recorded throughout 2003 and 2004. Class A asking rates currently stand at roughly \$2.05 per square foot (on a monthly full service basis) and have recorded slight increases over the past two years.

Investment Update

The big investment story of 2004 was the scarcity of office buildings available for sale. Quality office investments were few and far between and demand for those properties was so great that off-market sales became the norm. Yet, over the first three months of 2005 we have experienced a surge of institutional sales. We are aware of at least 13 buildings selling for \$5 million or more during the first three months of the year, including the Level I/Intel Buildings, Farmer's Market III, Summit at Douglas Ridge, the Kaiser Foundation and Delta Dental Buildings.

In light of continued interest rate hikes, this may be the new trend. In recent years the availability of "cheap money" has had a major impact on sales activity within the Sacramento office market as it has motivated many tenants to become owners, while also allowing investors to consider properties with net operating incomes that would be unprofitable were it not for extremely low debt service. This trend, along with an influx of investors fleeing an unstable stock market, have all led to demand far outpacing supply. This has only intensified over the past two years as the market has become largely picked over. Meanwhile, it has also sent prices upward at a steady clip.

Of course, now that interest rates have begun their gradual climb upwards one would expect this to register some impact on demand. But, this has yet to have taken place in Sacramento. Properties for sale are too scarce for recent minimal interest rates to have taken any bite out of demand and they are unlikely to be much of a factor anytime in the immediate future.



FIGURE
3

Sacramento Office Market
 1st Quarter 2005 Major Leases

Tenant	Address	Submarket	Square Feet
SBC Services	4111 Marconi Avenue	Watt Corridor	54,000
First Data	5140 Dudley Boulevard	Rio Linda/North Highlands	43,200
Confidential	Vision Service Plan	Highway 50	36,800
River Oak Children's Home	5030 El Camino Avenue	Carmichael/Fair Oaks	36,360
Confidential	Stanford Ranch II	Roseville/Rocklin	27,136
Confidential	Folsom Corporate Center V	Folsom	27,000
Panattoni Construction	8775 Folsom Boulevard	Highway 50	26,000
Confidential	Gold Pointe Corporate Center E	Highway 50	25,000
Confidential	Foothill Corporate Center I	El Dorado	24,884
Digital Insight	Howe Avenue Place	Howe/Fulton Corridor	21,980
Deacon Corporation	Oak Creek Village	Citrus Heights/Orangevale	16,000
Confidential	Mercy Building	Highway 50	15,047
T-Mobile	1755 Creekside Oaks Drive	South Natomas	14,950

If anything, this may be the time for owners to sell. Since 2000, the average sale price of office buildings in Sacramento has increased by over 40%. We recently surveyed all Sacramento office buildings that had sold at least twice since 2000. Excluding those properties that had undergone major improvements or upgrades, we found 74 properties of all classes throughout the metropolitan area. These buildings averaged a sales price of \$116.44 per square foot on their first sale transaction. By the time of the second sale, the average had reached \$154.53 per square foot. These select properties averaged price increases approaching 33% with an average rollover time of just 2.5 years.

While prices have soared, lease rates have remained flat. Rental growth since 2000 has amounted to roughly 10%. Average sale prices only increased slightly over the past

twelve months and all indications are that we are at or near the top of the cycle. Further increases in pricing seem even less likely in light of rising interest rates. Meanwhile, flat rental rates and growing interest rates may begin to negatively impact investment interest in the future. Now—while there is still demand in the marketplace—may be the time for owners who have been on the fence to re-consider selling.

The combination of interest rate hikes and price increases does pose some potential problems. In the past low interest rates have allowed buyers to still achieve required returns while still paying relatively high prices for their properties. This meant that landlords could still make a profit even in a soft market or with buildings experiencing higher than average vacancy. Vacancy for the Sacramento office currently stands at 14.6%

and with over two million square feet of product currently in the construction pipeline there is a strong possibility of further vacancy increases in the near future. With the price of buildings continuing to increase and with debt service becoming more expensive some landlords may feel the pinch. However, in the long run, these conditions may serve to help to reduce demand and bring it closer to equilibrium with supply cooling price growth.

Looking Ahead

We expect tenant demand to continue to increase heading into 2005. Look for the suburban office markets of Roseville, Elk Grove and Natomas to continue to draw



United States

- Akron, OH
- Allentown, PA
- Atlanta, GA
- Austin, TX
- Bakersfield, CA
- Baltimore, MD
- Beachwood, OH
- Bellevue, WA
- Boca Raton, FL
- Boise, ID
- Boston, MA
- Carlsbad, CA
- Charleston, SC
- Charlotte, NC
- Chicago, IL
- Cincinnati, OH
- Clearwater, FL
- Cleveland, OH
- Columbia, SC
- Dallas/Ft.Worth, TX
- Dayton, OH
- Denver, CO
- Detroit, MI
- Fairfield, CA
- Fort Myers, FL
- Fresno, CA
- Ft. Lauderdale, FL
- Gilroy, CA
- Greenville, SC
- Hartford, CT
- Honolulu, HI
- Houston, TX
- Indianapolis, IN
- Jacksonville, FL
- Kansas City, MO
- Las Vegas, NV
- Los Angeles, CA
- Louisville, KY
- Memphis, TN
- Miami, FL
- Milwaukee, WI
- Minneapolis, MN
- Nashville, TN
- New Haven, CT
- New Jersey, NJ
- New York, NY
- Oakland, CA
- Ogden, UT
- Orlando, FL
- Palo Alto, CA
- Park City, UT
- Philadelphia, PA
- Phoenix, AZ
- Pittsburgh, PA
- Pleasanton, CA
- Plymouth Meeting, PA
- Portland, OR
- Provo, UT
- Raleigh, NC
- Reno, NV
- Roseville, CA
- Sacramento, CA
- Salt Lake City, UT
- San Diego, CA
- San Francisco, CA
- San Jose, CA
- San Mateo, CA
- Scottsdale, AZ
- Seattle, WA
- St. Charles, MO
- St. George, UT
- St. Louis, MO
- St. Paul, MN
- Stamford, CT
- Stockton, CA
- Sun Valley, ID
- Tacoma, WA
- Tampa, FL
- Walnut Creek, CA
- Washington, DC
- Wilmington, DE

significant tenant interest. Downtown will likely remain flat as it remains in the shadow of the impact of State budget cuts and the ripple effect that they have had. Not only have buildings with significant government-tenancy been impacted, but those buildings with private sector tenants who provide goods or services to the State have also been impacted. Meanwhile, it is unlikely that

demand will significantly outpace new supply in the coming six months. Most likely, new development will continue to cancel out the positive impact of resurgent tenant demand in the immediate future. The possibility of increased vacancy is a real one, although it is more likely that any movement in vacancy levels will be minimal.

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