

METRO BOSTON OFFICE MARKET

Second Quarter 2001 Report

Bullish Signs on the Horizon?

After being shocked by negative net absorption of 3.5 million square feet during the first quarter, office building owners and lenders are generally "encouraged" to see negative net absorption tally only 777,000 square feet for the second quarter of 2001. That's a clear sign that most of the internet-related space givebacks have already materialized.

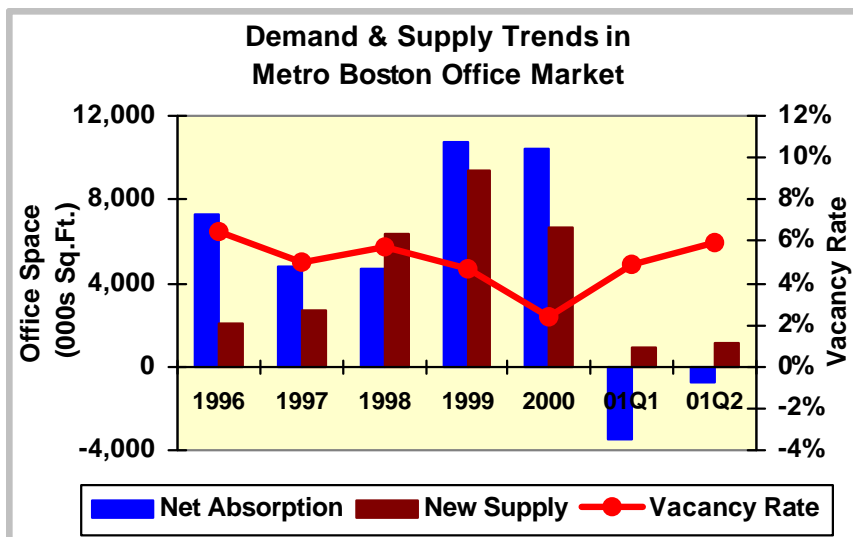
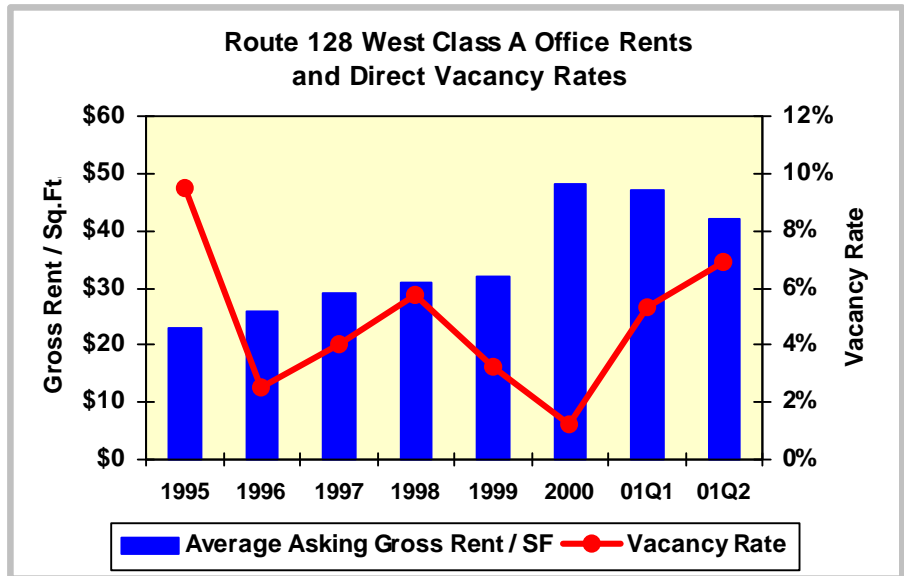
On the employment front, Metro Boston has managed a net gain of office space-using jobs of about 0.3% for the first five months of the year. That near standstill pace of growth is likely to continue for the rest of this year. New jobs in healthy sectors will continue to be largely offset by already announced job layoffs in the technology sector.

In the stock market such indicators of the bottom of the economic slump would be a bullish sign as previous negative news would already be reflected in current stock prices. To

some degree that's true of market values for trophy properties, as shown by the recent sale of One Federal Street in Boston for about \$350 per square foot. However, when it comes to market rents, these signs of a near-term bottom merely reinforce the need for suburban rents to be repriced at levels 10% to 15% below peak levels in 2000. This repricing has occurred so far only in the Route 128 West submarket.

Why is Route 128 West leading the correction in market rents? Route 128 West was the prime beneficiary of surging demand for space by venture capital-backed dot-com enterprises in recent years. Rents soared the most in this submarket, to levels that were clearly unsustainable. With sublease space in abundance and direct vacancy rates at the highest level in five years, owners are moving swiftly to re-establish market rent levels that will prompt credit-rated companies to pick up the pace of leasing in this popular submarket.

Market rents still need to adjust in most other suburban submarkets as well. To a large extent this is occurring behind the scenes with landlords seriously entertaining rent bids 10% below their stated asking rents. Low-ball rent proposals by tenants are largely being turned down flatly as most owners can patiently wait for better deals. Asking rents are starting to decline to reflect the underlying reality of demand and supply trends, but the "repricing" is occurring very gradually.



Financial District Remains Tight

Although sublease space availabilities now provide small and medium-size companies with numerous options in the Financial District, corporations requiring large blocks of space are often surprised to discover that there are still relatively few space alternatives available to them. Moreover, the increased concentration of institutional ownership of Boston's office skyscrapers means that a few office landlords control most of the available large blocks of space.

As a result, asking gross rents for Class A and Class B office space in the Financial District have remained firm this year. Deep-pocket owners with well-leased properties have little incentive to lower asking rents at present. It makes much more sense for them to continue to ride out the present temporary slowdown in demand rather than allow market rents to decline.

The Financial District also stands out from other submarkets in that there is very little new supply in the construction pipeline that hasn't already been leased. Congress Group Ven-

tures and Lend Lease Real Estate Investment's decision to proceed with development of 33 Arch Street is likely to turn out to be a very smart decision. It's doubtful that any other skyscrapers will be launched until next year at the earliest, providing 33 Arch Street with a timely window as the hot new space in the Financial District when it nears completion.

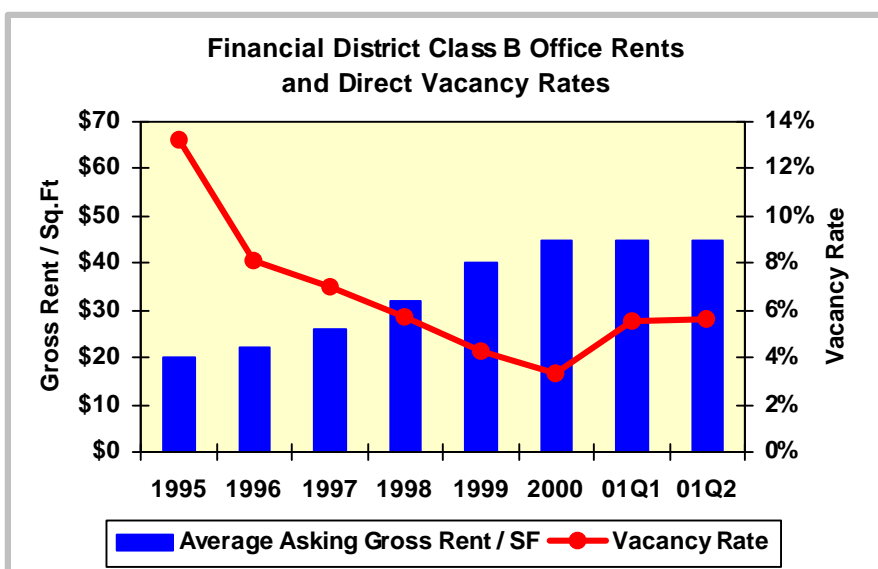
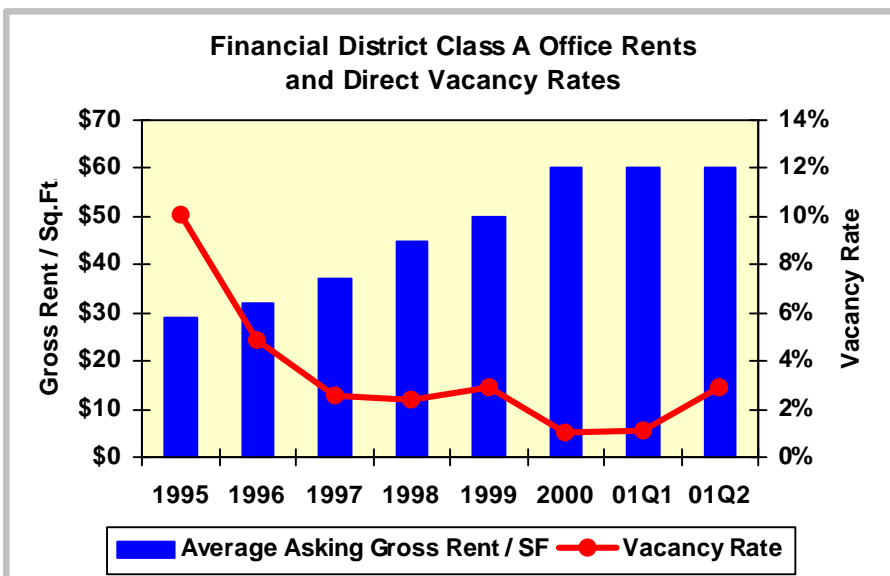
Speaking of hot new spaces, both 303 Congress Street and 470 Atlantic Avenue are receiving increased attention as work on their redevelopment nears completion later this year. Both of these properties are located on the

edge of the Financial District, along Fort Point Channel. This attractive water basin is slated to become a major cultural and entertainment venue with floating art displays.

As previously mentioned, sublease space availabilities offer some enticing "bargains" for small and medium-size firms in the Financial District. Not only are many of these workspaces well-equipped with telecommunications infrastructure, in some cases the furnishings and even computer systems hardware is available for purchase at a heavy discount from replacement cost.

Submarkets adjacent to the Financial District, such as North Station and South Station, have felt the impact of the dot-com sector shakeout more heavily than is the case in the Financial District itself. Asking gross rents for Class B space have declined about 10% from peak levels in 2000. In contrast, asking rents for Class A office space have remained at peak levels given the small supply and limited space availabilities.

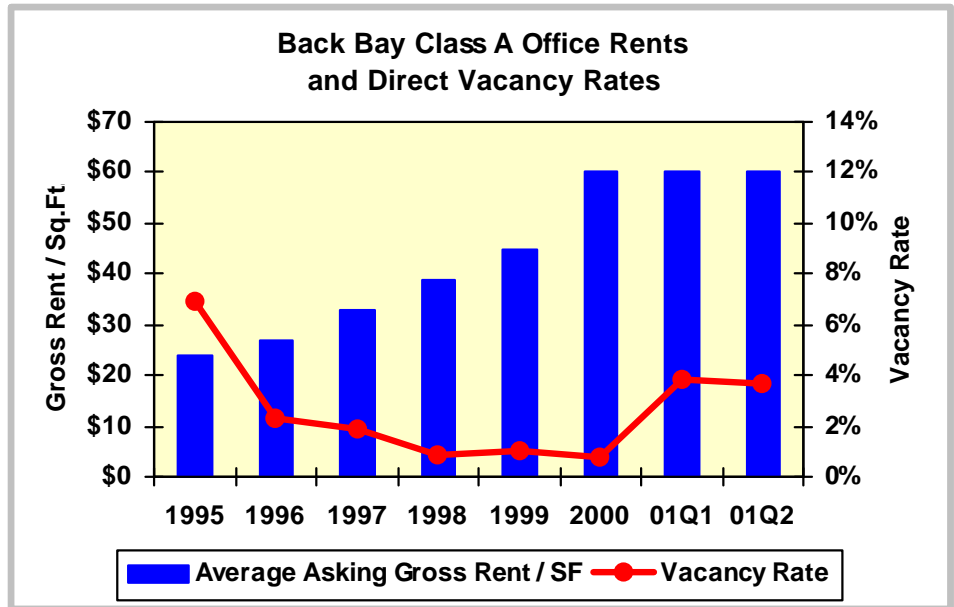
The outlook for the Financial District remains one of high rents and low vacancy rates. Little surprise then that property values have remained high in this core urban market.



Back Bay Thrives as Urban Oasis

Ever since the major insurance companies relocated to lower-cost space in the Back Bay, this sub-market has been gaining on the Financial District as the most desired office location in Boston. Proximity to Boston's historical Back Bay residential neighborhood is now complemented by proximity to the gentrified South End. Upscale Newbury Street continues to thrive as the premiere retail district in New England. And right in the heart of the office submarket is Copley Square, a refined urban oasis.

As the graph above illustrates, average asking gross rents for Class A office space in the Back Bay have remained at their 2000 peak level of \$60 per square foot. This is the same level as is found in the Financial District. Vacancy rates are very low in the Back Bay and not likely to increase all that much when 111 Huntington Avenue is completed at the Prudential Center later this year as this new skyscraper is already 75% pre-leased.



Further east, already completed 10 St. James Avenue is around 85% leased. This infill development blends in extremely well with its neighborhood and provides tenants with a strategic location just a few blocks from the Financial District as well as Copley Square.

High-rise residential development is also bolstering the strength and dynamism of the Back Bay sub-market, increasingly a true 24-hour urban district.



Newly-built 10 St. James Avenue brings 585,000 sq.ft. of highly sought after Class A office space to the Back Bay.

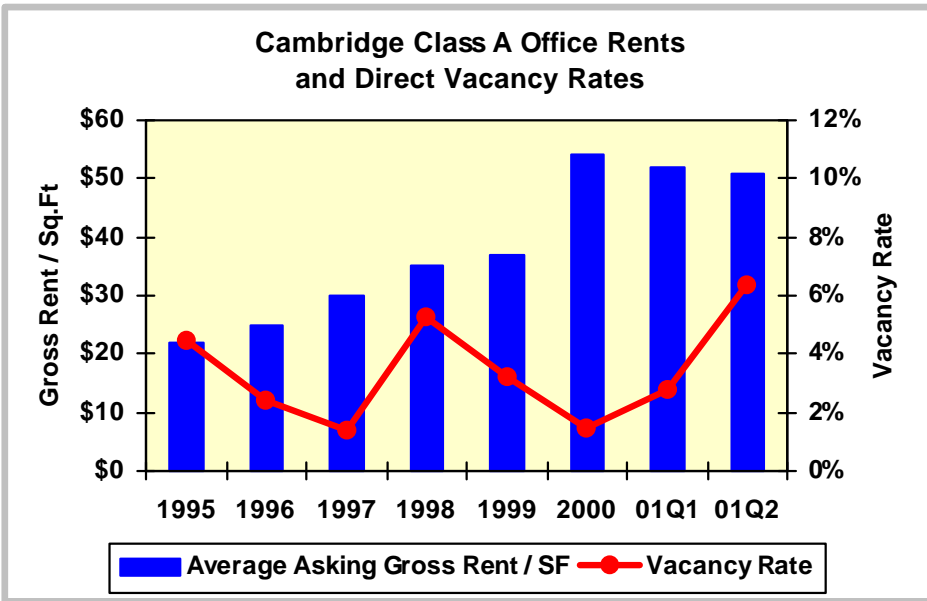
Refreshing Copley Square attracts more people than birds on warm, sunny days.



NAI HUNNEMAN COMMERCIAL

REAL ESTATE SERVICES, WORLDWIDE

70-80 Lincoln Street, Boston, MA 02111 (617) 457-3400 www.naihunneman.com



of Technology (M.I.T.) is literally adjacent to most of the Cambridge office submarket, making the location exceptionally attractive to biotech and pharmaceutical companies desiring to attract, retain, and/or team-up with many of the world's leading scientists and technicians in the life sciences.

M.I.T. recently purchased Technology Square, a 1960s-era urban office complex that is rapidly being renovated and expanded. Amgen's new office/lab building at neighboring One Kendall Square is nearing completion. Boston Properties' Cambridge Center continues to thrive as home to local offices of Fortune 500 firms and consulting firms, as well as biotech firms such as Biogen.

With demand from telecom firms all but dried up, a handful of buildings intended to house switches are now being redesigned to attract biotech firms. Whether or not these projects are successful will depend heavily on the fortunes of biotech firms in the stock market — stay tuned.

Soaring Cambridge Floats Back to Earth

If there is any submarket whose fortunes mirror those of tech sector stocks, it is Cambridge. Popular with both biotechnology and internet-related corporations, Cambridge has seen demand for office space surge when venture capital fundings, IPOs, and secondary stock offerings were in full bloom. Unfortunately, Cambridge has also seen vacant space flood the submarket as high burn rates and diminished investor interest caused dot-com enterprises to flame out.

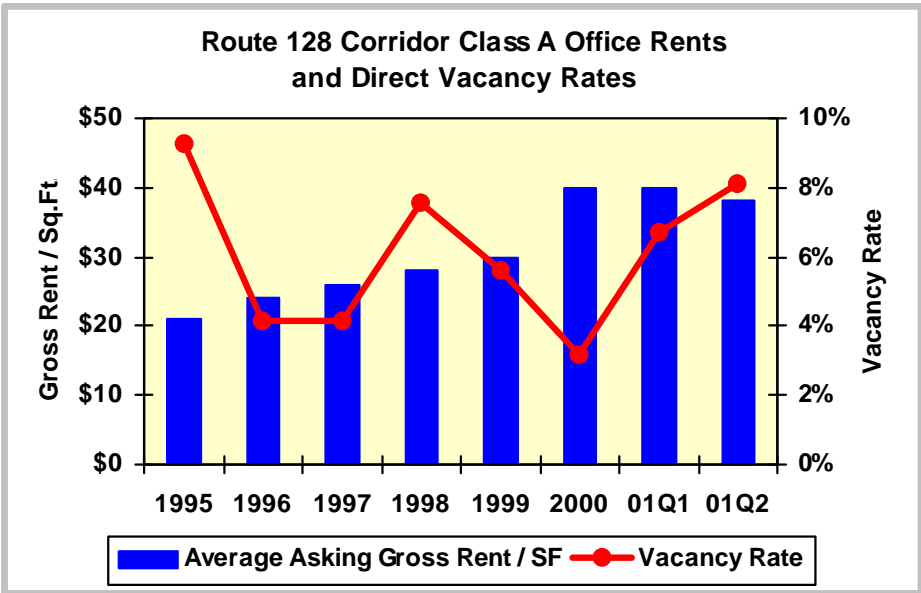
Direct vacancy rates are at a reasonably healthy 6.0% for the overall Cambridge office market, but factoring in sublease space availabilities pushes the combined direct & sublet vacancy rate well into double digits. Combined with the present lull in demand for space and with several office projects in the construction pipeline, asking rents are on the way down from peak levels. It's worth keeping in mind, though, that asking rents in Cambridge had soared to levels approaching those in Down-

town Boston, an amazingly high level for a non-CBD submarket.

The main reason that the long-term outlook for the Cambridge office market remains bright is that it has emerged as the number one urban biotechnology submarket in the world. The Massachusetts Institute



300 Technology Square is the newest building to be completed at Technology Square. Dyax Corporation, a biotechnology firm, has reportedly leased 60,000 square feet in the 175,000 sq.ft. building.



128 Northwest office market has experienced a more modest 9% decline in average asking gross rents for Class A space. Direct vacancy rates remain very low in that increasingly pivotal submarket which links the high-tech Route 3 Northwest Corridor with the Route 128 Corridor.

Office submarkets with the highest direct vacancy rates are the Route 128 Southwest and Route 128 South submarkets. After contending with very low vacancy rates in 1999, vacancy rates have been increasing ever since and now are 12.4% and 9.5%, respectively (for Class A & B space). Average asking gross rents remain the lowest along the Route 128 Corridor in these two submarkets.

Faring slightly better is the Route 128 North submarket, thanks largely to limited new supply in recent years. However, there is nearly 500,000 square feet of new space scheduled for delivery later this year which is leading to modest declines in asking gross rents here as well.

Route 128 Corridor Braces for Impact of New Supply

With 3.1 million square feet of new office space scheduled for completion later this year, owners in the Route 128 Corridor are already lowering asking rents in pursuit of scarce new tenants. Usually this amount of new supply would be readily absorbed in the same year of completion. However, in a market flooded with sublease space availabilities and with few new or growing tenants, owners are having to balance the desire to maintain high market rents with the need to lease-up vacant spaces sooner rather than later. Unless already largely pre-leased, new buildings face the greatest pressure to lower their original rent expectations.

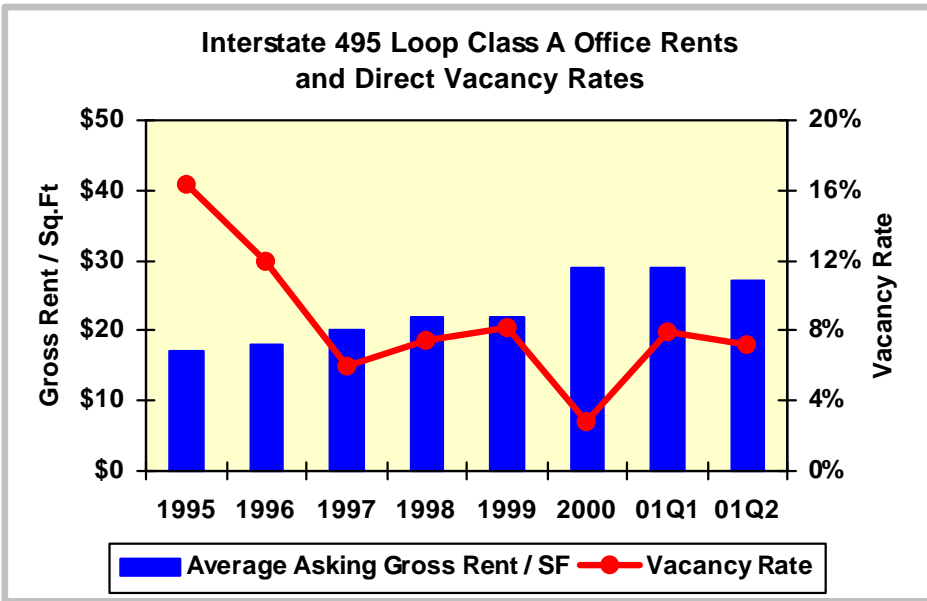
The centrally-located Route 128 West submarket, as discussed in the introduction to this report, is the submarket with the greatest exposure to the present unfavorable demand and supply balance. As a result, the average asking gross rent for Class A

office space in that submarket has already declined 12.5% during the first half of 2001. The average for Class B space has only declined 8.5%, but that reflects a less frothy peak level rather than stronger demand.

Showing great resilience, the Route



52 Second Avenue in Burlington illustrates another successful transformation of a former industrial building into attractive office/R&D space. This trend is likely to slowdown until the market rebounds.



able during the next few months. In the meantime, though, corporations looking for large blocks of space along the I-495 Loop are finding that their choices are more limited than expected. Asking rents have only softened slightly since current levels are reflective of replacement cost rents rather than IPO-spiked rents. The differential between rents along the I-495 Loop and in the Route 128 West and Route 128 Northwest submarkets is still considerable, making locations along the I-495 Loop attractive to cost-conscious corporations.

More important than office rents to many companies are lower housing prices. Locations along the I-495 Loop are in much closer proximity to affordable "American Dream" housing for highly-skilled engineers, scientists, technicians, and business professionals than are sites along Route 128. It is inevitable, even if delayed indefinitely, that firms such as Cisco Systems will eventually build state-of-the-art campuses along the I-495 Loop. As re: Cambridge, keep an eye on the stock market.

Interstate 495 Loop Faring Better This Time Around

As a point of reference, it's useful to keep in mind that the entire amount of Class A office space along the Interstate 495 Loop (12.3 million sq.ft.) is much smaller than the amount of Class A office space found in the Route 128 West submarket alone (16.2 million sq.ft.). Moreover, the amount of new Class A space added to the I-495 Loop after 1997 (3.8 million sq.ft.) is much less than that added to the Route 128 Corridor (8.7 million sq.ft.). In terms of new construction scheduled for delivery later this year, again the amount of Class A space slated for completion in the I-495 Loop is less than 1.0 million sq. ft., whereas the corresponding amount along the Route 128 Corridor is 2.5 million sq.ft.

What these comparisons reinforce is the somewhat surprising observation that, in general, the I-495 Loop office submarkets are in better shape than the Route 128 Corridor submarkets. With an overall Class A vacancy rate

of 7.3% and a Class B vacancy rate of 5.1%, the I-495 Loop looks a bit healthier than the Route 128 Corridor with vacancy rates of 8.1% and 7.2%.

This comparison could change depending on how much space high-tech firms such as 3Com make avail-



10 Technology Park Drive in Westford adds 150,000 sq.ft. of Class A space to the I-495 Northwest submarket, popular with high-technology firms as an alternative to the Route 3 Northwest Corridor.

Office Market Outlook

“Can it get any slower?” is a common lament of property managers and leasing agents attempting to fill vacant spaces. The low transaction velocity during the first half of 2001 stands in such stark contrast to the hyperactive velocity of deals last year that it seems like the world (of real estate) has come to a crashing end to many newcomers. Owners, lenders, facility managers, and service providers that worked their way through the last property market downcycle (or two (or three)) are grudgingly taking this slowdown in stride. Conditions aren’t nearly as bad as a decade ago and there are signs that the economy will start to pick up speed (albeit gradually) during the remainder of this year.



30 Corporate Park Drive in Burlington, a new 130,000 sq.ft. Class A office building in a pleasant campus setting with convenient access to Route 128, is about 27% leased of the end of the second quarter.

What is in store for office market rents and property values in the months to come? To a large extent, it depends on the degree to which an industry participant has already “marked down” rents and values in their perception of the current market. If you’ve already slashed your view of market rents by 10% to 15% from peak levels in 2000, you can see the market bottom being reached by the end of the third quarter, perhaps 5% lower. If you only watch asking rents, then it will be awhile longer until market rents hit their trough — perhaps not until the first quarter of 2002, at 15% to 20% below peak levels in 2000. Same destination, just a longer journey.

In terms of property values, the downward adjustments, in general, haven’t been as severe as values are usually heavily constrained by existing lease rents, with the extra

value of higher market rents deferred until leases expire. This kept values “reasonable” last year and most leased-up properties are holding their values well this year.

Office Submarkets	Capitalization Rates		
	Low	High	Average
Downtown Boston	8.0%	9.0%	8.5%
Route 128 West	8.5%	9.5%	9.0%
Other Suburban	9.0%	11.0%	10.0%

This report was researched and authored by Daniel P. Guenther, SrVP / Director of Research, in collaboration with NAI Hunneman Commercial Company office brokers, property managers, and project consultants as well as using property-level data provided by CoStar Realty Information Group. The views and opinions expressed are solely his own and are not necessarily those of NAI Hunneman Commercial Company nor its employees. For additional copies of this report, please call your NAI Hunneman office broker or Amy Szeto at (617) 457-3400. If you have questions regarding the data or analysis contained in this report, please call Dan Guenther at (617) 457-3369 or send an e-mail to dan_guenther@naihunneman.com.

Notice of Disclaimer: The information presented in this report is from sources deemed to be generally reliable, but no warranty is made as to the accuracy or completeness of the data, nor as to its usefulness for any particular purpose.

Copyright (c) 2001 by NAI Hunneman Commercial Company. All Rights Reserved.