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**PPR Releases 2Q 2006 Forecasts**

**Vacancy Rates Continue to Fall**

Vacancy rates declined in the second quarter for all property types except warehouse, where vacancies were flat at 8.8%. The tightening remains the strongest in the apartment and office markets, which each witnessed a 0.2-percentage-point decline in the vacancy rate, while retail economic vacancies declined by 0.1 percentage point.

Over the past year, vacancies have fallen the most in the apartment market, from 6.8% at mid-year 2005 to 5.8% currently. This is due to both strong demand, fueled by the growing economy, and low levels (negative in some markets) of net completions as condo converters took apartment units out of the rental inventory. Office and retail vacancies both dropped by 0.9 percentage points over the past year, and vacancies are currently sitting at 16.2% and 9.4%, respectively.

Office will be the standout performer, in the short term and in the long term. It is the only property type expected to have vacancy rates solidly lower at the end of 2010 than they are today. Over the next 12 months, office vacancies for the PPR54 are expected to decline by 50 basis points, versus a 30-basis-point decline for apartments, a 10-basis-point decline for retail, and a 30-basis-point increase for warehouse. The markets with the largest vacancy drop over the past year and the over the next 12 months are shown below.

Markets With Largest Vacancy Drop Past Quarter				Markets With Largest Vacancy Drop Next Year			
Metro	Property Type	Vacancy Rate (%)		Metro	Property Type	Vacancy Rate (%)	
		2006Q1	2006Q2			2006Q2	2007Q2
New Orleans	Office	30.2	29.1	New Orleans	Office	29.1	22.5
Miami	Apartment	3.7	2.7	San Jose	Office	20.9	18.4
Palm Beach County	Apartment	4.7	3.7	Phoenix	Apartment	6.3	3.9
Nashville	Warehouse	9.0	8.3	East Bay	Warehouse	7.8	6.1
Honolulu	Retail	4.1	3.4	New Orleans	Warehouse	7.8	6.1
San Francisco	Retail	6.0	5.3	Boston	Office	20.3	18.7
Phoenix	Apartment	7.0	6.3	Portland	Retail	6.6	5.2
Washington - NoVA - MD	Apartment	6.9	6.2	Raleigh	Office	15.8	14.4
Salt Lake City	Apartment	6.2	5.5	Raleigh	Apartment	10.6	9.2
East Bay	Retail	2.7	2.0	San Jose	Warehouse	8.9	7.6

Source: PPR

**Demand Has Peaked**

Net absorption remained sturdy in the second quarter but dropped from first quarter levels in all property types except apartment.

The office market, which had net absorption of 27.1 million SF in the second quarter, saw a very modest decline from the first quarter. But with a tight labor market and a slowing housing market (which will impact office-using housing-related jobs, such as mortgage brokers) to blame, net absorption is expected to fall to 25 million SF in the third quarter and 24.1 million SF in the fourth quarter and continue to moderate in 2007.

The cooling housing market is stimulating apartment demand, which increased 6% in the second quarter. Still, although Echo Boomers continue to enter the work force, apartment demand will cool slightly over the next year as the post-recession bounce in employment, which fueled a lot of demand over the past year, moderates.

Slower growth in retail sales in recent months can also be partly attributed to the moderating housing market and has caused a slowdown in retail demand. Retail demand, coming off near-record highs, fell further than demand in any other property type from the first to the second quarter. It will continue to do so given high and rising energy costs and the slowing housing market. Warehouse demand peaked in 2005 and has been moderating ever since, down 1% quarter-over-quarter and 18.5% year-over-year.

### Supply Is Rising!

Have rising construction costs got you down? Well, they aren't keeping everyone down! Construction completions in the second quarter were up across the board. Warehouse, with 33.7 million SF completing, saw the largest increase since the first quarter (up 13.4%), followed by retail (up 11.6%, to 34.4 million SF), and office (up 9.2%, to 20.5 million SF). And since condo conversions have slowed from last year, even apartment saw an increase in net completions, from 6,100 units in the first quarter to 6,400 units in the second quarter. Over the next 12 months, warehouse will see the greatest relative increase in supply, with inventory growing by 2.4%, and retail will have a similar 2.2% increase in inventory. While converters have curtailed their acquisitions significantly this year, the apartment market will still be impacted by condo conversions in the near term. It will see only a modest 0.5% increase in inventory over the next 12 months, while office inventory will grow by 1.2%. The markets with the highest supply growth over the next 12 months are shown below.

Markets With Highest Supply Growth Next 12 Months		
Metro	Property Type	Inventory Change
Inland Empire	Office	8.3%
Austin	Retail	8.0%
Columbus	Warehouse	7.3%
Norfolk	Warehouse	6.0%
Las Vegas	Office	5.0%
Phoenix	Retail	4.8%
San Antonio	Retail	4.4%
Inland Empire	Warehouse	4.4%
Chicago	Warehouse	4.2%
Raleigh	Retail	4.2%

Source: PPR

### Landlords Are Smiling Because Rents Are Growing

Rents are rising at a healthy pace in all property types. The apartment market, where vacancies are plummeting due to condo conversions, is having the strongest gains over the past year, 3.7%. Office properties saw the weakest rent growth over the past year but they will have the strongest growth of any

property type over the next 12 months (4.4% growth is expected nationally). Warehouse is the only property type where rent growth has peaked, and growth over the upcoming 12 months will be below that of the previous year, as new supply will bite into rent growth.

### **Office Continues to Have the Strongest Outlook for Total Returns**

Driven by strong rent and income gains, the office market will continue to lead other major property types for total returns over the next five years, with an expected annual return of 8.1% through the end of 2010. Despite new construction, warehouse will take second place with a 7.2% forecast annual return, followed by retail with 6%. Apartment will take last place with a 5.3% expected return due to rock-bottom cap rates that will be most affected by rising interest rates and the cooling condo market.

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