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Suburban Maryland Office Outlook Q1 2010

Quarter in review

While the Northern Virginia and Washington, DC markets continued to build on the occupancy gains they realized during the fourth quarter of 2009, move-outs and contractions softened the Suburban Maryland market during the first quarter of 2010. Weakness among financial, technology and life sciences companies weighed on demand in Suburban Maryland and produced the third consecutive quarter of negative net absorption.

Relocations by BAE Systems and Chevy Chase Bank drove occupancy lower and helped lift vacancy rates in Suburban Maryland to all-time highs. However, excluding those two movements, which had been expected for several quarters, net absorption in Suburban Maryland was nearly positive, suggesting a bottom to tenant demand in the market was probably not far away. Submarkets in Suburban Montgomery County, particularly along the I-270 Corridor, drove positive absorption. Conversely, markets inside the Beltway and Prince George's County accounted for most of the losses in occupancy.

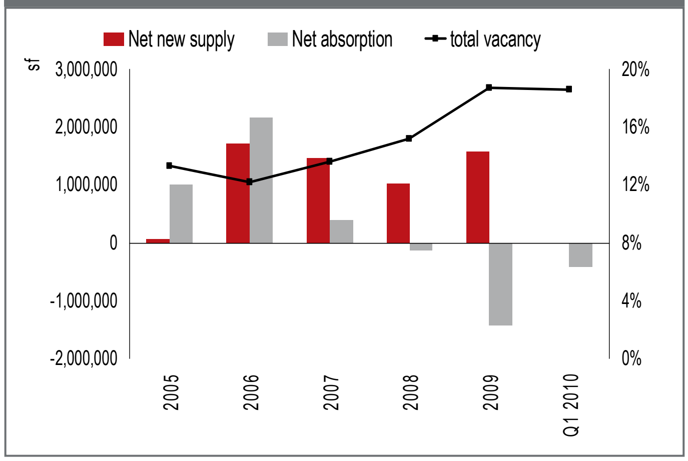
Billions of dollars of stimulus money earmarked for the life sciences and distributed as grants by the NIH have not produced a deluge of office and lab space leases in the private sector as some had predicted. The lack of venture capital funding to biotech companies presented a significant hurdle for private sector growth. However, government agencies in Suburban Maryland affiliated with the Department of Health and Human Services did continue to grow their footprint during the first quarter. The Food and Drug Administration signed a new 10-year, 55,000 square foot lease at 10001 New Hampshire Avenue in Silver Spring and the National Cancer Institute signed a 10-year lease with the JBG Cos. to commission a new headquarters at Johns Hopkins University's Montgomery County Campus. The new 575,000 square foot structure will consolidate and expand the National Cancer Institute's presence in Montgomery County.

Prince George's County continued to aggressively pursue federal tenants such as the Department of Health and Human Services and the Department of Homeland Security, with tax increment financing and other concessions to developers to accommodate these large agencies. Conversely, Montgomery County officials have been criticized for not doing enough to attract and retain large corporate tenants. Already, CoStar Group and Hanger Orthopedic have left the market for better tax treatment in other markets. While positive growth driven by the federal government seems likely given the democratic government and recently passed healthcare bill, rent growth is unlikely to resume until normalized demand returns to the private sector.

Key market indicators

	Key market indicators		12-month forecast
Supply	Supply	67,281,943 sf	↑
Supply	Direct vacancy rate	16.1%	→
Supply	Total vacancy rate	18.6%	→
Supply	Under construction (% preleased)	615,459 (43.7%)	↓
Demand	Leasing activity 12 mo. % change	-37.7%	→
Demand	YTD net absorption	-421,974 sf	→
Pricing	12-month overall rent % change	-5.8%	→
Pricing	Class A overall asking rent	$28. 64 psf	→
Pricing	Class B overall asking rent	$22.89 psf	→

Net new supply, net absorption and total vacancy



Class A vs. B overall asking rents

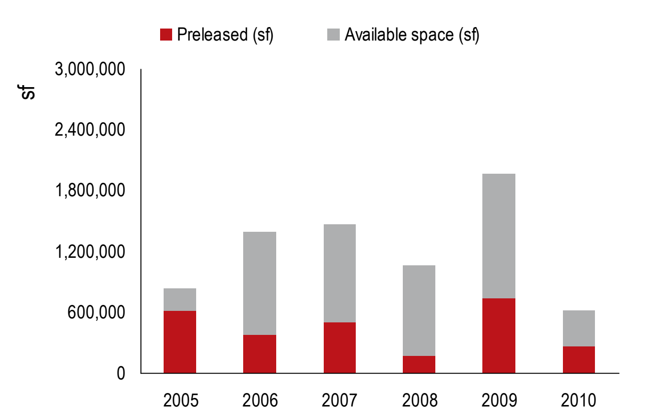
Development activity

No new buildings delivered or broke ground during the first quarter in Suburban Maryland. Nearly 2.0 million square feet of supply was added to the Suburban Maryland market during 2009. The additional space delivered just 37.8 percent preleased and remained just 49.6 percent leased at the end of the first quarter. The development pipeline in Suburban Maryland has thinned considerably from two years ago with ongoing projects limited to Prince George's and Frederick Counties.

Three notable exceptions to the cessation of new development activity are the M Square project in College Park, the Nuclear Regulatory Commission's build-to-suit project at the White Flint metro station in Rockville, and the National Cancer Institute's build-to-suit project at John's Hopkins University's Montgomery County Campus. The M Square site has targeted science-oriented tenants with an affiliation to the University of Maryland. Developer NAI Michael is clearing ground for a 153,750 square foot building that is currently without prelease commitments. The NRC signed a 15-year lease for developer LCOR to secure project financing and begin construction on the 358,440 square foot LEED Silver building. Construction on the NRC building is scheduled to begin during the second quarter of 2010 and the new NCI building is supposed to break ground during the third quarter of 2010. The buildings are scheduled to be completed during the third quarter of 2012 and the first quarter of 2013, respectively.

615,549 square feet of additional space is under construction. That pipeline includes the National Oceanic and Atmospheric Administration's 268,782 square foot build-to-suit project at M Square that is on hold due to developer Opus East's ongoing bankruptcy process. Excluding this project, there is a mere 346,787 square feet of speculative development underway, none of which is preleased.

Development pipeline



Demand

Overall leasing activity remained weak and consisted primarily of lease expiration-driven renewals and federal government transactions. The government remained Suburban Maryland's greatest driver of demand during the first quarter. However, with many large leases signed by the HHS, FDA, NRC, and NCI, there are fewer government tenants in the market than a year ago. One government agency, the National Institute of Allergies and Infectious Diseases, announced during the fourth quarter of 2009 that it would be seeking 419,000 square feet of space including 131,000 square feet that would be new growth to the market. During the first quarter, however, NIAID decided to reconsider its space needs, possibly without the expansion.

Defense contractor BAE systems reduced its footprint by approximately 125,000 square feet in Suburban Maryland by relocating out of its 262,923 square foot Class B building at 4115 Aspen Hill Road into the newly-developed 139,120 square foot Class A Redland Corporate Center III in the I-270 Rockville submarket. The relocation, which counts as negative absorption, affected market conditions but will not materially impact the competitive landscape because the vacated space is functionally obsolete. Owner Lee Development Group had not announced their plan for the building yet, but it will almost certainly require substantial renovation before returning to the market. While the move did not represent a major reduction in BAE's Suburban Maryland headcount due to increased space efficiency in the new building, it nevertheless hampered market fundamentals. Nearly all of the government contractor's metropolitan DC growth has gone to the Northern Virginia market over the past several years.

Rental rates

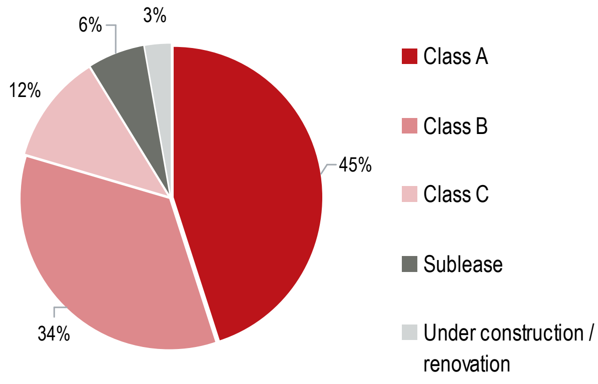
Rental rates remained level between the fourth quarter of 2009 and the first quarter of 2010 due primarily to the increased space available at 7501 Wisconsin Avenue, a trophy building with above-average rents. Landlords dropped asking rents 5.8 percent over the past 12 months in response to deteriorating market conditions and increased competition in the marketplace, and tenant improvement allowances and free rent remained elevated.

Looking ahead

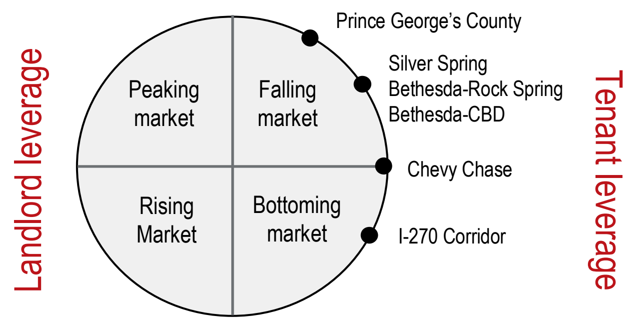
While market fundamentals for Class A space will stabilize over the next 12 months, it is unclear what will happen to Class B and C market dynamics as tenants transition out of older space into newly developed space at discounted rates. If such space is functionally obsolete it is likely that Class B and C owners will be forced to renovate in order to make their space competitive on the market.

The depletion of the development pipeline and a bottom to the recession mean that vacancy rates in Suburban Maryland are likely topping out. Still, the new development overhang and stagnant demand means rental rates are unlikely to rise during 2010 and may fall incrementally before a feeling of equilibrium is achieved. Government expansions due to healthcare reform may drive absorption in the future, but there are no specific requirements as of the end of the first quarter.

Vacant space breakdown



Property clock – current market conditions



Vacant space – existing buildings

Building	Submarket	Owner	RBA	sf
6720 Rockledge Drive (Piedmont Pointe II)	Bethesda-Rock Spring	Piedmont	230,714	230,714
530 Gaither Road	I-270 Rockville	Perseus Realty LLC	208,342	208,342
6400 Sherriff Boulevard	Prince George's County	PREI	192,000	192,000
6720 Rockledge Drive (Piedmont Pointe I)	Bethesda-Rock Spring	Piedmont	185,940	185,940
14200 Shady Grove Road	I-270 Rockville	BioMed Realty Trust	181,559	181,559

Completed lease transactions

Tenant	Address	Submarket	sf	Type
U.S. National Cancer Institute	JHU Montgomery County Campus	I-270 Rockville	575,000	BTS / Expansion
U.S. National Cancer Institute	Executive Plaza	Rockville Pike	331,253	Renewal
Hughes Network Systems	100 Lakeforest Boulevard	I-270 Gaithersburg	77,199	Renewal
U.S. Food and Drug Administration	10001 New Hampshire	Silver Spring	55,116	Expansion

Completed sale transactions

Address	Buyer / seller	sf	$ psf
9201, 9210, 9231 Corporate Boulevard	PS Business Parks / Black Rock realty	352,000	$170
1100 Wayne Avenue – Station Square	Urdang Capital JV Moore & Associates / Calpers	380,163	$196
4800 Hampden Lane	JBG Cos / Brookfield Properties	180,683	$392

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