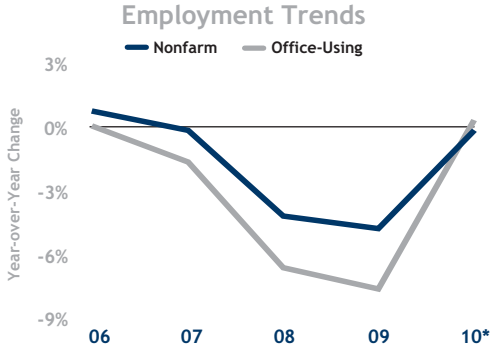
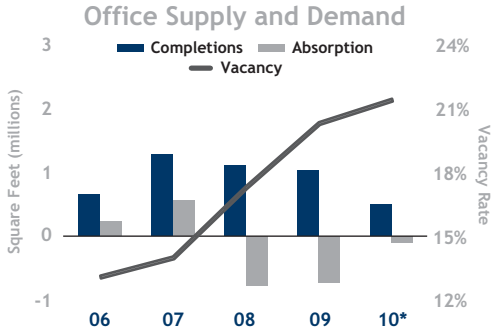
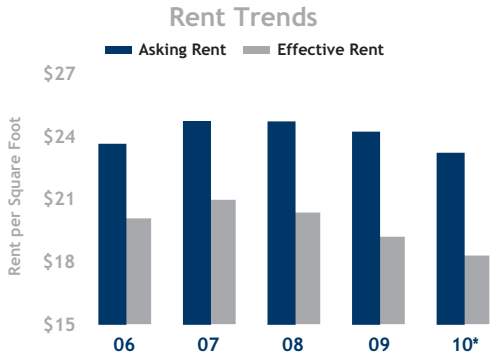
State Budget Challenges, High Vacancies Raise Investment Distress Opportunities

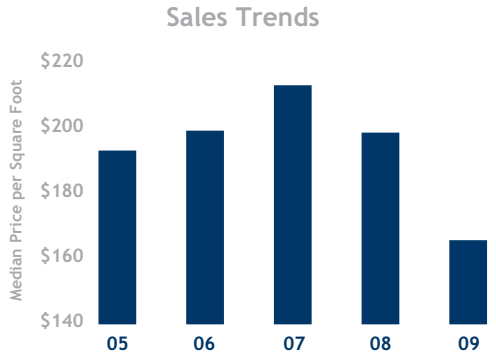
Sacramento will lag the nation in a recovery as a soft employment market stifles tenant demand for office space. Ongoing state budget shortfalls will cause employment in the government sector, which accounts for more than one in four metro jobs, to drop nearly 1 percent, following a 1.7 percent decline in 2009. Business formation will suffer as a result of continued weakness in the state government, and operators will have to trim rents when renewals arise in an attempt to retain tenants. Conditions in the Downtown/Midtown submarket will outperform the metro this year, however, with vacancy expected to hold steady at roughly 16 percent, as government tenants are unlikely to vacate large blocks of space. Outlying areas remain oversupplied due to a wave of speculative construction that came online in recent years, particularly in the Roseville/Rocklin submarket, where vacancy will push above 30 percent in 2010. High vacancy will pressure area effective rents, with decreases likely to significantly exceed the metrowide drop this year, after declining more than 10 percent in 2009.

Newer, high-vacancy assets will represent a large portion of metrowide investment activity in 2010, while owners of performing properties will likely hold off listing assets until market sentiment improves. Cap rates will average in the 9.5 percent to 10.0 percent range, although pricing volatility could intensify due to the impact of underperforming properties changing hands. While active buyers from more expensive Bay Area markets drove prices higher in recent years, investment activity in 2010 will likely be fueled by seasoned local buyers who will use existing tenant relationships to fill vacant space in value-add deals.









* Forecast

2010 Market Outlook

- **2010 NOPI Rank: 36, Up 3 Places.** Sacramento remained one of the bottom 10 markets in the ranking this year, despite a forecast for a continued drop-off of new construction.
- **Employment Forecast:** Employers are expected to trim payrolls by 0.1 percent in 2010, cutting 1,200 jobs. Office-using employment will expand by 0.3 percent following three consecutive years of decline.
- **Construction Forecast:** Developers will slow completions in response to soft tenant demand and 500,000 square feet of new space will come online this year, down from more than 1 million square feet in 2009.
- **Vacancy Forecast:** Despite moderating construction, vacancy will climb 110 basis points to 21.4 percent in 2010 on negative net absorption of nearly 100,000 square feet. Last year, vacancy spiked 300 basis points.
- **Rent Forecast:** Operators will cut rents in response to stalled tenant demand. Asking rents will contract 4.2 percent this year to $23.11 per square foot, while concessions will rise to more than 21 percent of asking rents as effective rents dip 4.7 percent to $18.22 per square foot.
- **Investment Forecast:** Investors will cautiously review properties with tenants that primarily provide services to the state. Budget cuts will likely weaken the viability and profitability of some of these firms, increasing risk to potential buyers and existing owners.

Market Forecast Employment: 0.1% ▼ Construction: 51% ▼ Vacancy: 110 bps ▲ Asking Rents: 4.2% ▼