

SITAR-RUTGERS REGIONAL REPORT

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Five Years: Retrospective and Prospective

Five years ago, James W. Hughes and Joseph J. Seneca together with William Sitar launched the Sitar-Rutgers Regional Report. This past January 2003, they met for a round-table discussion of major economic, demographic, and office market issues facing New Jersey. Participants included James W. Hughes and Joseph J. Seneca of Rutgers University, and William Sitar and John O'Hearn of Sitar Company - ONCOR International.

Hughes: We established this publication five years ago because we recognized that the economy was dramatically changing to a knowledge base. The new economic order is mainly housed in office buildings. Offices have become the factory floor of the new economy, where an increasing share of value-added is produced. Understanding current trends in each area is important to the understanding of the other.

Seneca: New Jersey is the poster child for so many important issues—land use, school financing, environmental quality, tax policies—and this quarterly report disseminates, in an accessible and succinct way, the current economic conditions and the implications not only for the office market but for public policies for New Jersey and beyond.

Hughes: Five years ago when we started this report, the state's economy was finally beginning to accelerate. What we tend to forget in today's perspective is that, following the 1989-1992 recession, it took a full five years to recover all the job losses, and it was not until 1997 that we got back to the job peak of 1989. It was also when the worst office development overhang in the state's history was just about over. In the 1997 to 2000 period, one of the strongest surges in jobs in the state's history took place; growth was 80 percent above the long-term trend, certainly spurring the office economy.

Sitar: In 1997 the office market was poised to go to record-low vacancy rates. Today there is a tremendous amount of sublease space in the market. New Jersey's telecom industry was hit very badly, as evidenced by the space vacated by AT&T, Lucent, and Avaya in particular. However, the New Jersey market compared to that of other states is very good because of its location between two major metropolitan centers, New York and Philadelphia, and its position as the most densely populated state.

Seneca: With apologies to Governor Kean, what a difference a business cycle makes! (*continued, p. 6*)

2003: The Year of Living Dangerously

James W. Hughes and Joseph J. Seneca

If the year 2000 had been an economic movie, as we suggested in an earlier *Sitar-Rutgers Regional Report*, it would have been entitled "It's a Wonderful Life." All of our economic stars were in full alignment. It was followed in 2001 by "From Here to Uncertainty," as the nation and New Jersey slipped into recession even before the tragic events of September 11. Now we can say with some conviction that 2002 should be entitled "Apocalypse Now." The stock markets posted their third straight year of declines, and

one-half of the ten largest corporate bankruptcies in history occurred during the year. In fact, the 2002 film short was "Dead Corporation Walking," while the new spectator sport was watching hand-cuffed executives escorted up the court house steps!

The 2003 economic movie, at least as of this writing, is destined to be "The Year of Living Dangerously." Pending war, global instability and geopolitical risks are adding new uncertainty to the economy, reinforcing risk-averse behavior already in place. (*continued, p. 2*)

New Jersey exited 2002 on a more positive growth trajectory.

Despite expansionary monetary and fiscal policies, true economic recovery depends on the willingness of businesses and investors to take risks. While heroic consumers have kept spending, we have grid-locked corporate investment decision making. Corporate America is plagued by uncertainty, plagued by the overcapacity stemming from the business capital investment binge of the second half of the 1990s, and plagued by the overexuberant decisions they made during the boom years, including massive office over-leasing. With global uncertainty added to the mix, they are now seemingly caught in a “deer in the headlights” paralysis, yielding risk averse gridlock. The potential of a strong economic expansion will only be realized when this gridlock is broken – probably when geopolitical instability eases. Until that happens, the shape of the recovery will probably be an elongated soup-dish: long and shallow. Its entirely possible that we won’t see a “Full-Metal Jacket” expansion until mid-decade.

End of Year Employment Accounts

Table A details the non-farm employment change in New Jersey and the United States for each of the past four years (1999 through 2002) as well as the quarterly data for 2002. In 1999 and 2000, New Jersey’s overall rate of job growth surpassed that of the United States; in 2001, the state’s rate of job loss was less than that of the nation. So, for three straight years, the economic

Table A
Nonfarm Employment Change
New Jersey vs. the U.S. 1998-2002
(Numbers in thousands)

	NJ		US	
	Number	Percent	Number	Percent
1999: December 1998 - December 1999	107.3	2.8%	2,752	2.2%
2000: December 1999 - December 2000	79.6	2.0%	2,002.0	1.5%
2001: December 2000 - December 2001	(1.3)	(0.0)	(1,070.0)	(0.8)
2002: December 2001 - December 2002	(13.9)	(0.3)	(181.0)	(0.1)
December 2001 - March 2002	(8.7)	(0.2)	(189.0)	(0.1)
March 2002 - June 2002	(10.2)	(0.3)	35.0	0.0
June 2002 - September 2002	(2.6)	(0.1)	93.0	0.1
September 2002 - December 2002	7.6	0.2	(120.0)	(0.1)

Source: New Jersey Department of Labor
 U.S. Department of Labor, Bureau of Labor Statistics

performance of New Jersey eclipsed that of the nation. But in 2002, New Jersey’s rate of employment decline was higher than that of the United States.

The 2002 comparative results did vary by quarter. New Jersey had higher rates of losses in the first two quarters, probably the result of financial firms moving back to New York City following the temporary New Jersey relocations after the terrorist attacks of September 11. But by the fourth quarter, the nation’s employment situation slipped considerably – reflecting what Alan Greenspan has termed a “soft patch” – while New Jersey’s employment situation improved substantially. Thus, New Jersey exited 2002 on a more positive growth trajectory. Obviously, fourth quarter growth was modest in the state, comprising only 7,600 jobs or 0.2 percent. But it was the only quarter of the year that was positive, hopefully setting the stage for the first quarter of 2003.

Table B
New Jersey's Employment Change
December 2001 - December 2002
(Numbers in thousands)

	Dec 2001	Dec 2002	Change: 2001-2002	
			Number	Percent
TOTAL	4,023.3	4,009.4	(13.9)	-0.3%
TOTAL PRIVATE SECTOR	3,418.3	3,400.2	(18.1)	-0.5
GOODS PRODUCING	602.6	583.6	(19.0)	-3.2
Mining	1.7	1.6	(0.1)	-5.9
Construction	162.9	162.9	0.0	0.0
Manufacturing	438.0	419.1	(18.9)	-4.3
SERVICE PRODUCING	2,815.7	2,816.6	0.9	0.0
Transportation/public utilities	265.4	258.7	(6.7)	-2.5
Wholesale trade	275.3	276.6	1.3	0.5
Retail trade	648.4	650.2	1.8	0.3
Finance/insurance/real estate	279.3	276.8	(2.5)	-0.9
Services	1,347.3	1,354.3	7.0	0.5
GOVERNMENT	605.0	609.2	4.2	0.7

Source: New Jersey Department of Labor

The detailed employment change by sector during 2002 (measured between December 2001 and December 2002) in New Jersey is presented in Table B. During the year, the state lost 13,900 jobs, a loss of 0.3 percent. As a point of reference, during the 1989-1992 downturn, New Jersey lost approximately 85,000 jobs per year. Thus, in pure statistical terms, the downturn in 2002 has to be classified as modest, notwithstanding the very real economic pain that was felt by many businesses and citizens in the state.

Manufacturing was once again the epicenter of New Jersey's employment decline (Table B), with a loss of 18,900 jobs during 2002, a total greater than the state's

overall employment losses (-13,900 jobs). During the state's first new economy downturn, it was the old economy stalwart - manufacturing - which overwhelmingly accounted for New Jersey's employment losses, a pattern similar to that of the nation as a whole. In addition, transportation and public utilities also showed job declines in the state, mirroring the nation. This was due to sustained post 9-11 airline problems, as well as the impact of public utilities deregulation. Moreover, the state also lost 2,500 jobs in finance, insurance, and real estate. As noted earlier, this was probably due to

relocations back to New York City during the year, and the general effects of the bear market on the industry. In contrast, the state added jobs in wholesale and retail trade as well as in services.

The bottom employment line for 2002 is that declines in actual "office-type" jobs were very minimal. Thus, the unprecedented scale of available office sublease space is a tribute to the scale of office over-leasing that took place during the late 1990s, a result of overexuberant forecasts of *growth* in office employment during the 2001-2003 period. Obviously, this growth has failed to materialize, and may not until corporate decision-making gridlock is broken. □

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Sublease Space Continues to Dominate Commercial Market

By Linda Tanaka

... the numbers reflect a continuing and increasingly lethargic office market over the past year.

2002 saw a continued sluggish economy with a deepening impact on the New Jersey office market. The sublease market expanded as the economy continued in low gear and more space became available. The lackluster economy created an environment in which tenants are hesitant to commit to space they may not need in the future and landlords are more agreeable to arrangements that continue the flow of cash. The lack of new construction was helpful and, with some tenant concessions, rents have remained relatively stable.

This phenomenon is likely to continue until the economy shows clear signs of a turnaround and geopolitical issues are resolved. So, while the market is little changed from the previous quarter, the numbers reflect a continuing and increasingly lethargic office market over the past year.

With limited new construction, the number of buildings remained at about the same level. The exceptions are Hudson and Monmouth counties where

construction added greater than 12 percent more buildings over the past year.

New building starts in Hudson County were driven primarily by continued interest and demand from New York City based financial firms. In Monmouth County, TYCO constructed over 200,000 square feet of Class A corporate office space, which they no longer need, adding to a commercial market that already had been hit hard by the "tech-wreck" of a few years ago.

These projects added 20 percent or nearly four million square feet of inventory to the Hudson County office market. While Monmouth County had a significant increase in the number of buildings, this was on a smaller scale, adding less than one million square feet of space. Somerset County on the other hand added nearly two million square feet of inventory from new buildings.

When examining Class A space, the growth in these select markets is even more significant. In Hudson County, Class A inventory increased by one quarter to

County	Buildings	Total Inventory	Available Space	Vacancy Rate	Sublet Available	Average Asking Rent	4th Qtr Net Absorption	2002 YTD Net Absorption
Bergen	542	28,872,598	3,199,003	11.08%	1,781,249	\$25.84	(43,246)	(455,197)
Essex	362	28,491,524	4,051,424	14.22%	838,934	\$24.07	205,485	42,557
Hudson	157	22,533,163	1,493,367	6.63%	1,957,133	\$25.35	111,723	2,194,509
Hunterdon	43	1,174,499	84,255	7.17%	13,988	\$18.31	(17,430)	(14,436)
Mercer	312	15,621,646	1,800,272	11.52%	825,486	\$23.56	33,378	171,769
Middlesex	388	23,844,631	3,319,983	13.92%	2,495,935	\$23.86	(57,043)	(523,057)
Monmouth	344	13,170,748	802,379	6.09%	685,798	\$23.10	131,542	175,746
Morris	379	25,364,402	3,459,405	13.64%	2,668,797	\$25.61	(43,267)	(372,506)
Passaic	136	5,656,481	570,552	10.09%	48,526	\$20.62	(8,259)	(74,774)
Somerset	241	17,659,124	3,321,746	18.81%	2,950,766	\$25.84	54,764	464,946
Union	282	10,309,360	1,292,654	12.54%	441,315	\$23.15	100,628	(60)
Total	3,186	192,698,176	23,395,040	12.1%	14,707,927	\$24.63	468,275	1,609,497
Central NJ	1,567	80,605,509	10,537,034	13.1%	7,399,300	\$24.19	263,269	289,344
Northern NJ	1,619	112,092,667	12,858,006	11.5%	7,308,627	\$24.91	205,006	1,320,153

* Includes all office buildings, 10,000 square feet and greater. Does not include owner-occupied facilities.

Northern and Central New Jersey Class "A" Office Market Fourth Quarter 2002									
County	Buildings	Total Inventory	Available Space	Vacancy Rate	Sublet Available	Average Asking Rent	4th Qtr Net Absorption	2002 Net Absorption	
Bergen	133	18,109,543	1,861,411	10.3%	1,434,487	\$26.93	13,539	(54,193)	
Essex	69	13,585,875	1,304,126	9.6%	587,922	\$26.11	176,307	260,113	
Hudson	52	18,145,408	947,184	5.2%	1,906,950	\$25.10	152,893	2,362,722	
Hunterdon	7	406,791	16,914	4.2%	-----	\$18.50	-----	1,488	
Mercer	70	7,107,873	951,210	13.4%	738,538	\$26.16	5,498	(188,840)	
Middlesex	102	14,593,261	2,288,617	15.7%	1,751,706	\$25.07	(45,965)	(549,837)	
Monmouth	46	5,553,776	242,361	4.4%	565,401	\$24.56	94,388	61,196	
Morris	147	18,354,106	2,849,633	15.5%	2,402,347	\$26.50	(47,491)	(363,259)	
Passaic	22	2,331,770	145,408	6.2%	48,526	\$23.62	(24,079)	(59,174)	
Somerset	103	13,626,830	2,764,900	20.3%	2,782,424	\$26.30	(10,877)	625,997	
Union	26	3,460,870	333,939	9.7%	426,354	\$26.86	86,030	110,014	
Total	777	115,276,103	13,705,703	11.9%	12,644,655	\$25.06	400,243	2,206,227	
Central NJ	347	44,342,610	6,581,027	14.8%	6,264,423	\$25.79	129,074	58,530	
Northern NJ	430	70,933,493	7,124,676	10.0%	6,380,232	\$24.46	271,169	2,147,697	

* Includes all office buildings, 10,000 square feet and greater. Does not include owner-occupied facilities.

Some significant changes in available space and vacancy rates occurred during the last quarter.

18,145,408 square feet. Class A inventory in Somerset County increased by nearly 1.6 million square feet or 13 percent. A similar rate of growth, although of a smaller magnitude, was seen in Union County. Here, Class A inventory jumped 14 percent to 3,460,870 square feet.

However, space in these buildings is becoming less occupied. In particular, direct available space increased meaningfully over the past 12 months. Overall availability for the region increased 9 percent from a year ago to 23,395,040 square feet. Middlesex (43.5%), Somerset (37.9%), and Union (12%) Counties in Central New Jersey as well as Hudson County (26.7%) in the northern part of the state are the primary drivers of these increases. Quality tenants for large blocks of space are few and far between in these commercial markets.

Middlesex and Somerset Counties each added about one million square feet of available space since the end of 2001. Although Union and Hudson Counties show a significant percentage increase in available space, the magnitude of the increase was

relatively small at 138,526 and 314,853 square feet respectively. This is a slight increase in available space from last quarter. On the other hand, Hunterdon County saw a significant 24 percent drop in available space, moving from 111,503 square feet in 2001 to 84,255 in 2002 due to pharmaceutical related companies signing several small leases in the area.

Some significant changes in available space and vacancy rates occurred during the last quarter. During this time, Mercer County added over 300,000 square feet or 20 percent of available space, pushing their vacancy rate to 11.5 percent. At the same time, Monmouth County's available space declined by nearly one quarter, bringing its overall vacancy rate down to a low 6.1 percent. However, when all the recent sublease space is added into the mix, corporate real estate directors have plenty to look at!

Total Class A space available directly increased significantly in Central New Jersey, increasing by 2.3 million square feet or 55 percent to 6,581,027 available square feet. Half of this became available in the last quarter due to expiration of *(continued, p. 6)*

6 Sublease, *continued*

Rents are still being paid and interest rates are low, making buildings a favorable investment.

existing leases, bankruptcies, and lease buy-outs. In addition, available Class A space in Hudson County more than doubled, increasing from 381,741 square feet to 947,184 square feet. This unfilled space is a result of many of the same issues facing Central New Jersey plus new construction.

The vacancy rate remains high, increasing slightly to 12.1 percent for the region over the past year. Central New Jersey showed an increase in vacancy from 11.2 to 13 percent, driven primarily by vacancy rate increases in Middlesex (up 50 percent to 13.9 percent) and Somerset (up 25 percent to 18.8 percent) Counties. This is a slight increase from the previous quarter. Monmouth (6.1%), Hudson (6.6%), and Hunterdon (7.2%) Counties defy the high vacancy rates seen elsewhere.

The vacancy rate among Class A properties in the region increased at an even faster pace over the same period, although in most counties it still remains below that of the overall market. The most notable exceptions are Somerset, Middlesex, and Morris Counties where Class A vacancies have reached 20.3, 15.7, and 15.5 percent respectively.

The real dilemma for landlords is the addition of so much sublease space to the market, which increased by more than half, to a high of 14,707,927 square feet. Factoring in available sublease space brings the vacancy rate to 17.6 percent for the region. In Somerset County the sublease vacancy rate jumped to 29.9 percent, while in Morris and Middlesex Counties it reached 21.9 and 20.9 percent respectively.

The vacancy rate for Class A space, incorporating sublease, is even greater at 19.5 percent. Here, Somerset has one in three (33.8%) Class A spaces available; Morris (26.0%) and Middlesex (23.5%) have one in four; and Mercer has one in five (22.3%).

Yet, amidst all this available space, rents have remained relatively unchanged since last year. Rents for the region averaged \$24.63 at the end of 2002 vs. \$24.65 the prior year. Concessions to tenants are making up the difference. Free rent periods and increased workletters have helped to keep rent numbers from plummeting.

However more decreases are apparent among Class A rents. The average Class A rent in the region decreased more than a dollar to \$25.06. Hunterdon and Hudson Counties showed the largest declines (about 25 percent) with Hudson County down to \$25.10 and Hunterdon County down to \$18.50. While net absorption for 2002 was positive at 1,609,497 square feet, it represents merely one quarter of the space absorbed for the year in 2001.

Although the economy and the office market are not enjoying the boom times of recent memory, things are not as dire as many have heralded. Rents are still being paid and interest rates are low, making buildings a favorable investment. For tenants, a similarly positive environment exists. Class A space is available at reasonable prices and/or terms so occupants can sit comfortably with the knowledge that they have a good deal. □

2003, *continued*

In five years New Jersey has gone from the strongest expansion to a period of fiscal difficulties. Despite the relative mildness of this current national recession, this is a severe fiscal depression for the state. It resulted from our dependence on the equity market boom that generated large tax revenues in capital gains, stock options, etc., increasing the state's income tax revenue ten to fifteen percent a year. It all disappeared in the current grizzly bear market, leaving the state – and most every other state across the country – in a very difficult fiscal condition. It is a challenge to the

governance of the state to be able to balance all of the public needs at this time of constrained resources. The economy is not generating the revenues, yet the state desperately needs to support our knowledge-based economy.

O'Hearn: The exuberance of the stock market investors as described by Greenspan a few years ago parallels that of the office market sector, especially the telecommunications and computer sectors. As the economy was booming, companies like Lucent and AT&T were growing, but they got carried away, taking

on more and more space. As everything imploded, investor confidence fell and the funds that fueled this growth disappeared. In trying to keep those returns and growth costs had to be cut. This is especially apparent in Somerset County, which currently has the highest vacancy rates. However, from the landlord's perspective, things are still the same as they were three years ago because they are still collecting the rents contracted during the boom. In the next two years, there will be some rate declines but not to the point that they declined ten years ago, when the economy had taken a downturn and the landlords had overbuilt. Speculative office buildings sat vacant while landlords lacked any rent rolls. There will not be much change unless something dramatic happens.

Seneca: That depends on where the economy is going and whether it will generate employment and the need for space. How will President Bush's proposals for major tax changes affect the economy of New Jersey - will it drive the national economy and create jobs? The tax policy proposals produce a conundrum. On the one hand the proposals are disproportionately favorable for the individual New Jersey taxpayer perspective - the elimination of dividend taxation and the acceleration of the tax cuts - because of the state's high wealth/high income profile. On the other hand, there is such fiscal distress, that we need more short-term stimulus for the economy than there is in the current proposal and we need block grants to the state governments to reduce the fiscal problems we now have.

Hughes: There was a great deal of disposable income generated in the second half of the 1990s from people who had invested in the stock market. This period is history. Because of the loss of faith in the market, people have been putting money into housing, and both housing and consumer spending have been the driving forces in the economy.

Seneca: The magnitude of job losses is less compared to the devastation of what was lost in 1989. This time, New Jersey lost only 32,500 jobs between June 2001 and September 2002 compared to 260,000 jobs lost in the 1989-1992 recession.

Hughes: There is also the psychological factor of corporate decision-makers who made overexuberant decisions in the late 1990s. They assumed that future job growth was going to continue as it did from 1997 to 2000. They over-leased space because they were afraid there would not be enough space, given the very disciplined construction market that emerged in the 1990s. Then their world fell apart in the last 24 months. They are plagued by uncertainty, and it is going to take a while for them to get their confidence back to make decisions again, so right now they are doing nothing. We need to go back to that famous New Jersey economist, Yogi Berra, who said: "They don't want to make the wrong mistake again." Until that changes, we are not going to see any extensive leasing of office space or any major expansion of jobs. It may take several years (absent any external shocks) to really get back to that robust, risk-taking mode of thinking that causes the economy to grow fast.

Seneca: There are several external stimulants and wild cards that could affect the economy: tax changes from Congress could stimulate the economy. A war with a crisp, concise beginning and end, or decreases in oil prices could have a positive effect on the economy. On the other hand, a long and costly war could have a negative effect on the economy. Interest rates could also be affected. This could be a complex situation, especially if the bear market continues as a result of uncertainty and the weak economy.

O'Hearn: Either way, there exists the danger of lease terms running out. During the boom, companies were not interested in leases with terms longer than five years because they feared outgrowing their space. We are coming to the point where over the next one and a half to two years those will be expiring. And this differs by sector; pharmaceutical and biomedical areas will continue to do well, as will professionals (lawyers, accountants, etc.). In Middlesex and Somerset counties and in areas around Route 287, there will be a very light market as telecommunication and IT-related companies quickly evaporate without new companies to absorb the space. (*continued, p. 8*)

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Sitar: Despite vacancies, real estate prices remain high. Demand for real estate is strong among both institutional and individual investors as they look to put funds into real estate investments rather than pour more money into the stock market. We have experienced an increase in calls from investors, both large and small, who want to invest in real estate, even in properties that need work, rather than invest in the stock market.

O'Hearn: Today's investor differs from those of a few years ago, when value-added institutional investors and developers would convert a relatively inexpensive Class B office building to a Class A and then reap the higher rents. Today that has dissipated. Investment is strong, but the strategy is to acquire trophy properties with a higher initial rate of return. This is seen as a safer tactic than holding onto paper stock.

Hughes: There is some talk about a fear of deflation. If we hit a deflationary period, noted by Greenspan and others, it could provide seeds of future office market problems. The specter of Japan's 10-year long recession is one of a major asset and price deflation. That is not a good prospect. Deflation is probably the worst scenario from a business and investment perspective.

Seneca: A short-term tax stimulus would be better, because it could give the economy a boost. Interest rates cannot be reduced anymore. The New Jersey economy is fundamentally sound, diverse, information-based, and has a strong knowledge-dependent services sector. The challenge to the public sector is how it will support the private sector. Older states have old infrastructures and high density; major issues confronting us include dealing with environment, immigration, transportation, schools, and keeping our quality of life attractive. We want to guarantee the success of the economy.

Sitar: Growth sectors in New Jersey include the health-care, biotech, and pharmaceutical industries. These

industries are a boon to New Jersey and should be supported and kept in the state. Horizon, for example, just leased 200,000 square feet in Monmouth County, where much of the growth will occur because employers have found a very good labor market there.

Hughes: We need to think modestly about our capacity to look five years out into the future. What will be the locomotives of growth? When we came out of the 1989-1992 recession, there was not one forecaster who could have foreseen that the telecommunications investment and the internet would be the engines of the prosperity of the late 1990s. We should heed those lessons – that is, that we really do not know what locomotives will be driving us five years from now. At times like these, it seems we are entering the economic dark ages because we do not really see what is pushing the economy forward. But the new economy lives. During this downturn, the world did not stop. We had corporate America furiously reinventing itself, becoming more productive, with new efficiencies, and the like. And so there is a potential already for larger innovation just as we had before. □

Sitar-Rutgers Regional Report is published by the Edward J. Bloustein School of Planning and Public Policy and Sitar Company•ONCOR International.

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