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Commercial Real Estate Outlook for 2004

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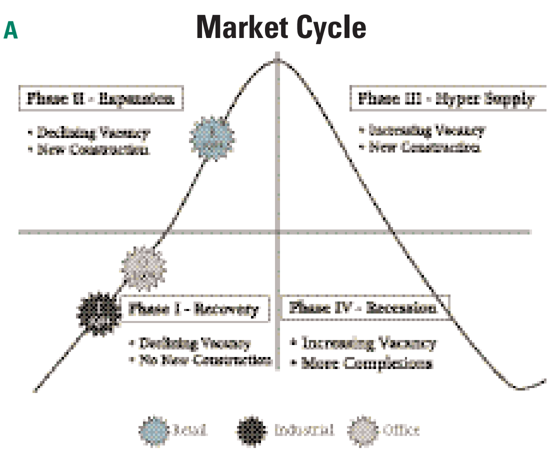
Experts agree we are on the road to recovery nationally, but how is West Michigan's real estate market faring? In 2003, the Midwest saw manufacturing continue to downsize, causing still more increases in vacancy and unemployment. West Michigan was no exception; unemployment rates surpassed 8 percent, the highest in a decade. The industrial market, which had until recently been the strongest in the area, is now taking a back seat to the retail market. Although the area is starting to show signs of economic improvement, the industrial market may take several years to recover. The office market has remained rather stagnant with little or no increases in significant leasing. Optimism remains the key for 2004.

In the last ten years, the MSA (Metropolitan Statistical Area), which includes Grand Rapids, Grand Haven, Holland, and Muskegon, has literally exploded in growth. With this strong MSA (1.11 million people), an above-average median income, low cost of living, and young population, Grand Rapids remains a hot-bed for national retailers who appeal to the area for development opportunities, and that trend looks to continue into 2004.

Figure A



As with most economic forces, real estate is cyclical in nature. The cycle, however, is compounded by the lagging relationships between supply and demand for existing space. This lag may explain why, at this point, the economy appears to have begun its resurgence, but the real estate recovery is still in its infancy. By using the real estate market cycle, (Figure A) we can determine the current market phase — Recovery, Expansion, Hyper-Supply or Recession — and where we expect each property type to gain strength or decline.

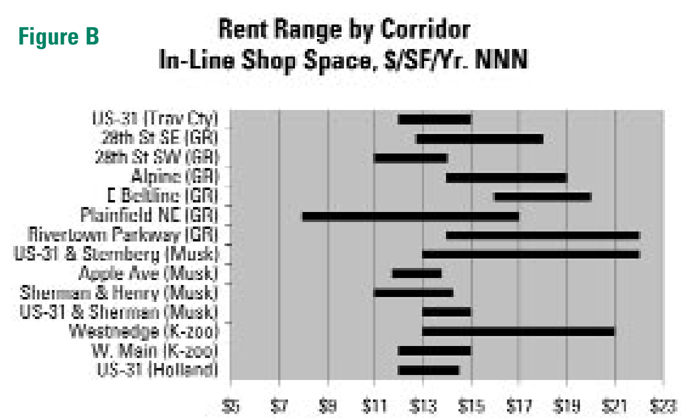
The retail market is currently in Phase II, just as it was in 2002. This Expansion Stage is likely to continue during 2004. New and expanding retail projects totaled over 1.8 million square feet in 2003, and an astounding 2.5 million square feet is expected in 2004–2005.

The five primary retail corridors (Alpine, 28th Street, and Rivertown in the Grand Rapids area, US-31 in Holland, and Sternberg Road in Muskegon) all have vacancy rates of less than 5%. The newest regional mall in Grand Rapids (Rivertown) is reportedly seeing average sales in excess of $400 per square foot. Major restaurants throughout the MSA, are also reporting very strong sales. The 28th Street SE corridor remains the strongest retail area, and several new national tenants will be added in 2004 including Old Navy, DSW, and Costco. Woodland Mall is considering expansion plans and Centerpointe Mall is nearly 100 percent occupied. Waterfall Shoppes at I-96 will add several tenants unique to the area. With the recent addition of Celebration Cinema, Meijer, and two stand-alone restaurants (Johnny Carino's and Chili's), the East Beltline corridor continues to expand. As the new South Beltline (M-6) nears completion, developers are showing high levels of interest in sites. Further west, on M-6, a grocery-anchored center is planned at Byron Center Avenue across from Metropolitan Hospital's future 170-acre health complex. Numerous retail projects are under way south of Grand Rapids into Kalamazoo. Two additional Wal-Mart stores are planned, with several other recently completed projects totaling 842,000 square-feet.

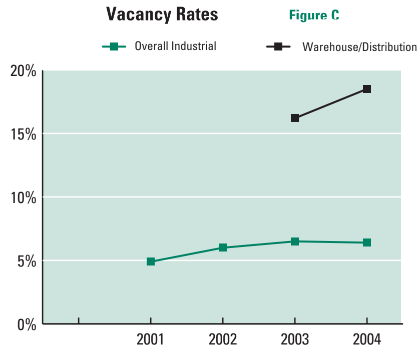
Currently, retail rental rates are expected to remain steady in most areas, except for the 28th Street SE and Rivertown Parkway corridors where there will be slight increases. See the graph for a range of lease rates throughout West Michigan (Figure B).

The industrial market is in Phase I of the Market Cycle – Recovery. As a national leader in manufacturing, Grand Rapids has been particularly hit by this recession, especially in larger

Figure B



warehouse/distribution facilities and manufacturing plants. West Michigan's historically low vacancy rates have risen to 6.54%; however, a closer look reveals some distinct trends. The majority of the average vacancy increase can be attributed to a rise in warehouse/distribution vacancy to 16.2% (Figure C) and a number of 500,000 square feet and larger manufacturing facilities becoming vacant.



The impact on the market allows large space users to negotiate very aggressive rates and lease terms on space over 50,000 square feet, whether warehouse or heavy manufacturing facilities. Tenants will continue to negotiate aggressively, as it will take up to three years to absorb this excess capacity. Contrasting that of larger properties, users of facilities less than 50,000 square feet are finding strong competition and a very limited supply of facilities from which to choose. Identifying facilities for sale is especially difficult, and, in fact, many achieve near record selling rates. This is the largest segment of the market and is most affected by the "owner-user" mentality of our West Michigan manufacturers. Speculative construction for these users will remain sparse while build-to-suit opportunities will begin to increase in the next 12 to 18 months.

A "silver-lining" benefit of the current market may be the unemployment rate. In past years where the West Michigan unemployment rate was not more than 3%, manufacturers were reluctant to move their operations to the area, due to a deficit of highly skilled workers. Now, however, manufacturers will consider this area as a potential site for growth and expansion.

The office market mirrors much of what we see in the industrial market. Currently, it is in Phase I – Recovery. However, the office market has shown signs of slight recovery and is, therefore, ahead of Industrial.

Figure D **Office Market Rental Rates**

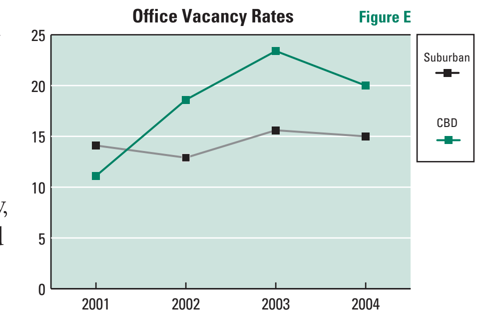
	CBD	Suburban	Total
Class A	$20.99	$19.10	$20.36
Class B	$15.02	$16.66	$16.01

* Square feet in thousands; excludes owner-occupied office/medical and government
** Weighted average asking rent/SF/year, Full Service Source: Grubb & Ellis|Paramount

In 2003, net effective lease rates in all classes of buildings dropped throughout downtown. Although asking rates remain constant (Figure D), motivated landlords have offered tenants heavy discounts in an effort to renew existing leases or acquire new tenants. The continued momentum in institutional investment, including the new Convention Center and Art Museum, helped create market opportunities for nearly a dozen new restaurants in the Central Business District (CBD). Some of these restaurants will occupy first floor spaces in older office buildings, helping to alleviate office vacancies.

After a decade-long trend of losing large office tenants to the suburbs, Grand Rapids CBD is gaining Blue Cross/Blue Shield of Michigan. It will occupy the former Steketee's Building following renovation. This is one of the largest office lease transactions in the past five years. Without substantial incentives from the City of Grand Rapids, however, the transaction might never have been realized. With Renaissance Zone benefits and parking incentives, this relocation is advantageous for both the landlord and Blue Cross.

Suburban office vacancies range from 8 to 28[1] percent (Figure E), depending on the particular office sector. The most stable markets continue to be East Paris and East Beltline. These landlords have had the highest success in retaining existing tenants and attracting new ones to their buildings. Other sectors like Centennial Park have been under ever-increasing pressure. Many buildings have offered the option of an "office condominium" to satisfy heavy demand for acquiring real estate ownership. Generally, suburban tenants did not receive the same generous renewal concessions as their downtown counterparts. In 2004, tenants in Class B and C buildings will be offered generous concessions on lease renewals. Buyers will continue to search for existing office buildings to purchase vacant land on which to construct new offices.



The investment market encompasses all of the markets including hospitality and multi-housing. High levels of interest and strong demand for investment property, but a limited supply of inventory in Grand Rapids and West Michigan, mirror the problems experienced in other areas of the Midwest. Low interest rates make it significantly less expensive to own properties than to lease them, and demand from owner-users has increased market pressures by removing properties from the investment pool. The supply and demand issue contributed to historically low cap rates in investment properties of all types.

In 2003, as in the previous year, strong demand in metropolitan areas encouraged national and international investors to consider secondary markets like Grand Rapids. Chicago-area investors, in particular, appreciate the proximity of West Michigan and are actively seeking investment opportunities.

Low interest rates motivated commercial real estate investors and drove existing multi-family tenants to pursue home ownership. This has contributed to significantly higher vacancy rates in Class A and B multi-housing, typically the "renter by choice" market. Landlords are granting rental concessions and other incentives to retain existing residents and attract new tenants. Despite higher apartment vacancy rates, West Michigan experienced strong demand for multi-housing properties.

1 Source: 2004 Real Estate Forecast – Great Lakes