

Class A Cap Rates Compress to Prerecession Levels

Dallas/Fort Worth's office market will post moderate occupancy gains over the next year as new supply falls below historical norms and job creation accelerates. Performance, however, will vary significantly by asset quality and location, as most of the metro's net absorption can be attributed to large firms. As a result, Class A/B+ assets in desirable submarkets, such as Uptown and Quorum/Bent Tree in Dallas, along with Northwest Fort Worth, stand to outperform. Financial companies, such as American Home Mortgage and Wingspan, accounted for a sizable share of net absorption year to date, while a handful of major healthcare-related firms also signed large leases in recent quarters. The Class B-/C segment of the market, on the other hand, will lag. Many small businesses remain hesitant to hire amid uncertainty — both in terms of the U.S. economy and the potential for higher taxes and business costs stemming from healthcare reform. Mid- to lower-tier properties along I-635 between the North Central Expressway and Stemmons Freeway (I-35) will remain particularly weak due to road construction, which will span four-plus years.

Transaction velocity will accelerate in Dallas/Fort Worth as Class A listings rise alongside prices and investor demand. In the top-tier of the market, cap rates are quickly approaching previous lows, though investors and lenders place far more weight on tenant-credit quality and lease rolls than they did prior to the recession. As a result, Class A assets with institutional-grade tenants tend to trade at cap rates in the low-7 percent range, while properties occupied by lesser-credit tenants typically change hands between 7.5 and 7.8 percent. The Class B+ market has also seen increased interest. Cap rates in this sector tend to start in the low-8 percent range, but can push beyond 9 percent for assets in less-desirable locations or facing near-term lease rollovers. Investors interested in the Class C market, on the other hand, typically expect returns above 10 percent. Lower-tier assets, however, will prop up bank-owned inventories, as many property owners conclude that low rents and limited prospects for growth fail to justify needed repairs.

2012 Annual Office Forecast



Employment: Employment will rise 2.6 percent, or by 75,000 jobs, while office-using sectors grow 3.3 percent. The trade, transportation and utilities, education and health, and professional and business services sectors will lead, but strong energy markets will also boost job creation.



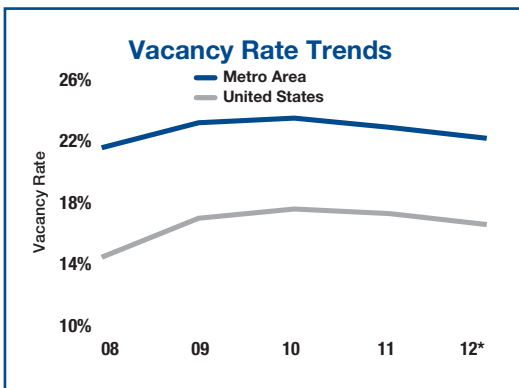
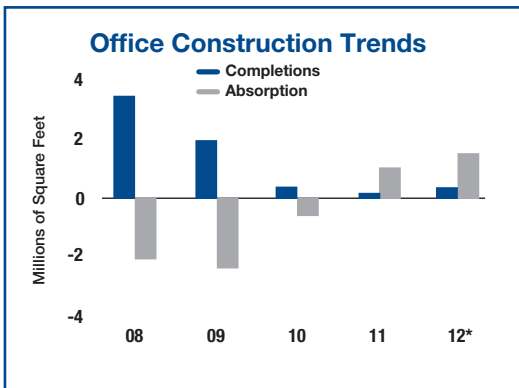
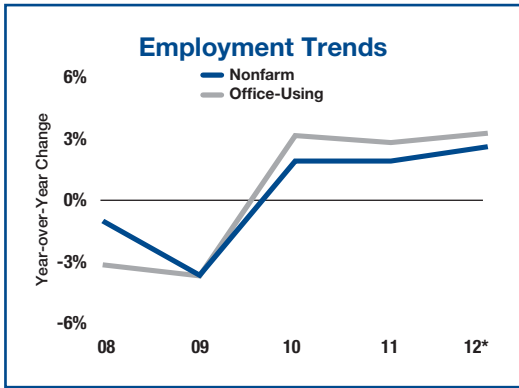
Construction: Approximately 350,000 square feet of traditional office space will come online in 2012. While this reflects an increase from 2011, when 161,000 square feet was delivered, this year's total represents a fraction of the new supply brought to market between 2007 and 2009.



Vacancy: Office vacancy will end 2012 at 22.2 percent, placing it 70 basis points below the year-earlier level. While Class A vacancy will likely hover around 20 percent by year end, the Class B sector will lag and continue to report vacancy around 25 percent.



Rents: In 2012, asking rents will rise 1.5 percent to \$19.73 per square foot, while effective rents gain 1.6 percent to \$15.38 per square foot. Overall, owners will likely need to wait for greater vacancy reductions to regain pricing power.



Economy

- Employment grew 1.9 percent over the past year with the addition of 54,200 jobs, including 21,000 posts in office-using sectors. This marks a deceleration from the prior 12-month period, when overall payrolls rose by 59,500 jobs.
- The most substantial growth in the first half occurred in the education and health services, and professional and business services sectors, which added a combined total of 24,000 jobs. While the former is not included in office-using employment aggregates, healthcare firms have become a strong source of new space demand.
- The hard-hit trade, transportation and utilities industry has recovered nearly two-thirds of the jobs lost in the recession. Construction maintains a greater shortfall, but renewed development is driving job creation in the sector. Government cut-backs, on the other hand, remain a drag on metrowide growth.
- **Outlook:** Employment will rise 2.8 percent with the addition of 82,000 jobs, while office-using sectors will grow 3.3 percent. The trade, transportation and utilities, education and health services and professional and business services sectors will lead, though strong energy markets will also boost job creation.

Construction

- Only 150,000 square feet of competitive office space has been delivered to the Dallas/Fort Worth metro over the past 12 months. This reflects an increase from the previous period, when completions were at a near standstill.
- The largest speculative project slated for delivery in 2012 is a 160,000-square foot building at Legacy Town Center in Plano. Three existing buildings at the business park, which boast combined occupancy of more than 90 percent, recently changed hands for an estimated \$113 million.
- As of midyear, more than 13 million square feet of traditional office space had been planned, and another 7 million square feet was proposed. While start dates have yet to be released for most of these projects, cranes will likely start to dot the skyline by 2013 or 2014.
- **Outlook:** Approximately 350,000 square feet of traditional office space will come online in 2012. While this reflects an increase from 2011, when 161,000 square feet was delivered, this year's total represents a fraction of the new supply brought to market between 2007 and 2009.

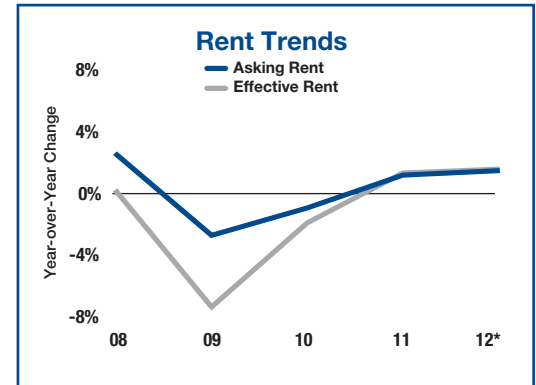
Vacancy

- Year over year, Metroplex office vacancy declined 30 basis point to 22.9 percent. A similar reduction was recorded during the previous 12-month period.
- Uptown Dallas, Preston Center and Southwest Fort Worth recorded vacancy reductions of 200 basis points or more over the past year. At the same time, a handful of submarkets, including Richardson and Northeast Fort Worth, softened.
- Class A vacancy retreated 20 basis points over the past year to 20.7 percent, while vacancy in the Class B/C sector declined 30 basis points to 25.8 percent.
- **Outlook:** Office vacancy will end 2012 at 22.2 percent, placing it 70 basis points below the year-earlier level. While Class A vacancy will hover around 20 percent by year end, the Class B sector will continue to report vacancy near 25 percent.

* Forecast

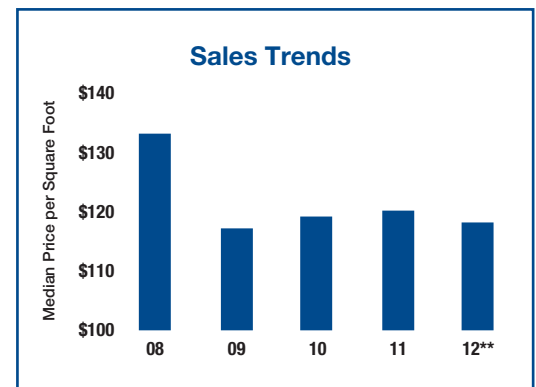
Rents

- Year over year, asking rents rose 1.3 percent to \$19.54 per foot, while effective rents increased 1.5 percent to \$15.22 per square foot. Asking rents fall just 2 percent shy of the previous peak level, though effective rents remain 8.5 percent lower.
- Class A asking rents advanced 1.2 percent over the past 12 months to \$22.22 per square foot. In the Dallas area, assets in the tight Preston Center submarket posted the strongest growth of 3.3 percent. In Fort Worth, the Southwest and CBD submarkets recorded the most sizable gains of 1.3 percent.
- Class B/C rents increased 1.5 percent over the past year to \$15.93 per square foot. In Dallas, the Las Colinas submarket posted the strongest uptick, while, in Fort Worth, the Northeast led growth.
- **Outlook:** In 2012, asking rents will rise 1.5 percent to \$19.73 per square foot, while effective rents gain 1.6 percent to \$15.38 per square foot. Overall, owners will likely need to wait for greater vacancy reductions to regain pricing power.



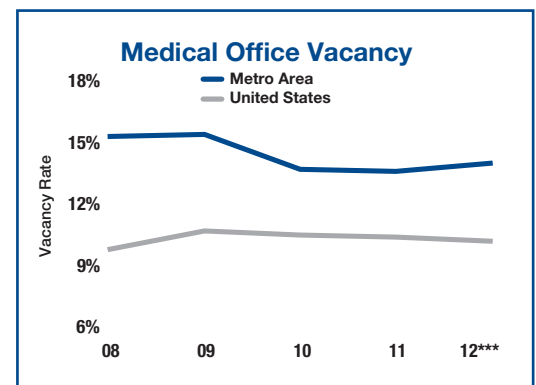
Sales Trends**

- Sales velocity increased 25 percent over the past 12 months, with some of the most notable gains occurring among properties/portfolios of 300,000-plus square feet.
- The market for Class B-/C buildings in the Metroplex remains somewhat weak, a trend likely to persist until small businesses ramp up hiring, which may not occur until after the November election or when U.S. economic growth intensifies.
- Prices vary dramatically, starting around \$50 per square foot for aging high-vacancy assets with significant deferred maintenance. Well-located performing Class A buildings, on the other hand, can trade at prices above \$175 per square foot, while single-tenant assets leased to high-credit tenants, such government agencies, can change hands for more than \$300 per square foot.
- **Outlook:** Class A properties will remain in high demand over the near term as deliveries fall well below historical levels and most of the metro's hiring occurs among large companies.



Medical Office

- During the past 12 months, developers delivered approximately 380,000 square feet of new medical office space to the Metroplex. Only a handful of properties will come online over the next year, though the pipeline of planned projects has grown to include approximately 1 million square feet.
- Local medical office properties continue to outperform traditional office assets. Over the past 12 months, medical office vacancy in the Metroplex declined 50 basis points to 14 percent.
- Rents for available medical office space in the averaged \$21.67 per square foot at midyear, nearly equivalent to the average 12 months earlier.
- Cap rates for on-campus, institutional-grade properties in the Metroplex can start in the low-6 percent range. Off-campus Class B assets, on the other hand, tend to sell at cap rates between 7 percent and 9 percent, depending on location, lease terms and asset and tenant-credit quality.



* Forecast
 ** Trailing 12-Month Period
 *** As of 2Q 2012
 Sources: Marcus & Millichap Research Services,
 CoStar Group, Inc., Real Capital Analytics

Marcus & Millichap

NATIONAL OFFICE AND INDUSTRIAL
PROPERTIES GROUP

Alan L. Pontius

Senior Vice President, Managing Director
National Office and Industrial Properties Group
Tel: (415) 963-3000
apontius@marcusmillichap.com

Marcus & Millichap

Real Estate Investment Services

Prepared and edited by

Erica Linn
Senior Analyst
Research Services

For information on national
office trends, contact

John Chang
Vice President, Research Services
Tel: (602) 687-6700
john.chang@marcusmillichap.com

Dallas Office:

Tim A. Speck
First Vice President, Regional Manager
tspeck@marcusmillichap.com
Centura Tower
14185 North Dallas Parkway
Suite 650
Dallas, Texas 75254

Tel: (972) 755-5200

Fax: (972) 755-5210

Fort Worth Office:

Bill Jordan
Regional Manager
bill.jordan@marcusmillichap.com
500 Throckmorton Street
Suite 325
Fort. Worth, Texas 76102

Tel: (817) 932-6100

Fax: (817) 932-6110

Price: \$150

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Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The FOMC announced after its August meeting that it would take no new steps to improve the economy before September. The Fed has pledged to maintain its lending rate near zero through at least late 2014 and has also amassed a portfolio of long-term U.S. Treasuries in an attempt to hold down long-term rates. In fact, the Fed expanded “Operation Twist” by \$267 million during June of this year.
- In general, lenders continue to be discriminating. Banks remain a source of relatively low-leverage financing for acquisitions of multi-tenant properties, and will also underwrite deals for three- and five-year terms. Life companies are focused on quality assets in primary markets, while conduit lenders are more apt to loan on lesser-quality properties in primary, secondary and, in some instances, tertiary markets. Additionally, smaller, owner-user purchases are often funded using SBA 7A and 504 loans.
- Ten-year loans are available at rates in the mid-4 percent range, or roughly 250 basis points to 300 basis points above the U.S. Treasury. The rate on the benchmark 10-year U.S. Treasury hovered in the mid- to high-1 percent range throughout the second quarter and into the summer. DSCs start at 1.25x, with repayment schedules of 25 years and LTVs of up to 70 percent available.

Submarket Vacancy Ranking

Rank	Submarket	Vacancy Rate	Y-0-Y Basis Point Change	Effective Rents	Y-0-Y % Change
1	Preston Center	8.1%	-330	\$22.71	3.5%
2	Southwest Fort Worth	11.0%	-290	\$13.32	0.6%
3	Fort Worth CBD	11.9%	30	\$18.80	1.0%
4	Northwest Fort Worth	13.2%	-190	\$15.82	1.2%
5	Southeast Fort Worth	15.2%	-40	\$13.78	1.1%
6	E. Dallas/Near North Central Expressway	15.8%	40	\$16.24	1.1%
7	North Dallas	20.1%	-60	\$12.74	1.2%
8	Uptown Dallas	20.1%	-470	\$22.69	1.7%
9	Far East Dallas	21.0%	-90	\$12.71	1.0%
10	Plano/Allen	21.1%	-100	\$15.48	2.3%
11	North Central Expy/Northeast Dallas	21.3%	-120	\$14.00	1.2%
12	Las Colinas	21.5%	-160	\$16.17	3.3%
13	South Dallas	21.9%	-10	\$13.13	0.8%
14	Flower Mound/Lewisville/Denton	22.4%	-240	\$13.65	-0.4%
15	Irving	23.0%	110	\$14.39	1.5%
16	Addison/Carrollton/Farmer's Branch	23.8%	90	\$14.32	1.8%
17	West LBJ Freeway	25.9%	-470	\$14.75	1.9%
18	Dallas CBD	27.3%	-20	\$15.51	0.5%
19	Northeast Fort Worth	27.3%	490	\$14.66	0.5%
20	Oaklawn	27.8%	640	\$16.86	2.1%
21	LBJ/North Central Expressway	28.5%	-120	\$13.52	1.6%
22	Richardson	28.6%	330	\$12.86	1.9%
23	Stemmons Freeway/Love Field	33.2%	-40	\$10.71	2.0%

Notes: Employment growth is calculated using seasonally adjusted quarterly averages. Construction, rent and vacancy figures exclude build-to-suit, flex space and medical office properties unless otherwise noted.

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