THE TUCSON OFFICE MARKET
2011 OVERVIEW & 2012 FORECAST

Usually an historical context is provided when reporting on the state of the office market. Our reports over the last 25 years have done just that. Comparing this year to last year to the year before that and so on.

Reporting on vacancy rates, new construction, net absorption, rental rates, tenant improvement costs, market trends, sales prices, who is moving, who bought what, what did they pay for it and the like were all backed up with this chart and that graph comparing it to this quarter and perhaps where things were the year before and so on.

Many feel they need a rear view snapshot so they can figure out where things are possibly headed in the future. Perhaps having too much history is not as strong an asset as it used to be and can actually provide an immeasurable perspective that holds things in check rather than move them forward - treading water comes to mind.

The office market in Tucson is not that complicated, it is heavily influenced by the job market. Although the employment numbers have been improving, they are still too high to have anything but a negative impact on the demand for office space.

Once the employment numbers finally do stabilize, and we turn the corner and start creating jobs, people will need office space and that segment of the market will start to recover and see brighter days. The general economy coupled with the lack of job creation over the last four years has had a major impact on office markets across the country. Tucson is no exception.

The office market is also impacted by money and the ability to secure capital, or the lack thereof. Banks are not as eager as they once we're to loan money. It's a good thing too, because the demand for office-building financing is extremely low compared to year's past, despite the fact that interest rates are at an all time low.

The continued bad press has gone a long way to creating and maintaining this prolonged crisis in confidence. Perhaps the good news is that many feel that the office market is at or near the bottom. We would agree that things are starting to improve. However, sort of like a stone in a ranging river, we expect the Tucson office market will skip across the bottom for some time before we start to see any real upturn in the market. We don’t expect a major upward spike but rather the market recovery will be slow paced over a number of years. To most, the improvements to the office market over the short term will be minor and not overtly noticeable. Again, it is sort of like treading water.

Someone recently joked that due to the economy and ongoing budget cuts, the light at the end of the tunnel had been turned off. All of these factors, and many others that are out of our control, have obviously positioned most companies to be very cautious as they consider any expansion or hiring plans.

One interesting contributing factor to the office market over the past couple of years and one that continues today is the significant activity that occurred in the handful of years right before the economic downturn with smaller, under 10,000 square feet, owner-user buildings that were constructed and purchased.

Surely you remember the flood of office buildings that popped up all over town in new office parks that were designed for owner-user who wanted to be in a controlled "garden-style" development? The SBA financing was readily available for them and depending on whether it was new or existing construction they only needed to put down about 10% and then only had to occupy about 50% of the property. The thought was that the balance of the building was for the owner’s expansion, but most owners leased out this excess space on a short -term basis to other tenants.

Given the unprecedented economic crisis that we have faced for the last three plus years, many of these same owner-user buildings have lost their tenants. This is further compounded by the fact that the owners' need for space has also decreased.

For many is has gotten to the point where some owners are only using 25% of their building while the other 75% of unused space is not leased and has now become a drain on their business and perhaps survivability. To make matters worse, many do not have the funds to provide an allowance to refurbish the empty space for a new potential tenant should one happen to show up.

This situation is a different contrast to the great building boom that occurred from 1982 to 1986 when most of Tucson's class "A" multi-tenant office buildings were constructed. Obviously, most were pre 1986 tax reform act, which played a big role in this halt of most speculative construction projects.

Since then, the majority of the new office and medical office construction has been tailor-made, smaller owner-user buildings, in office parks. Those who didn't bite off too much "expansion space" are fairing better.

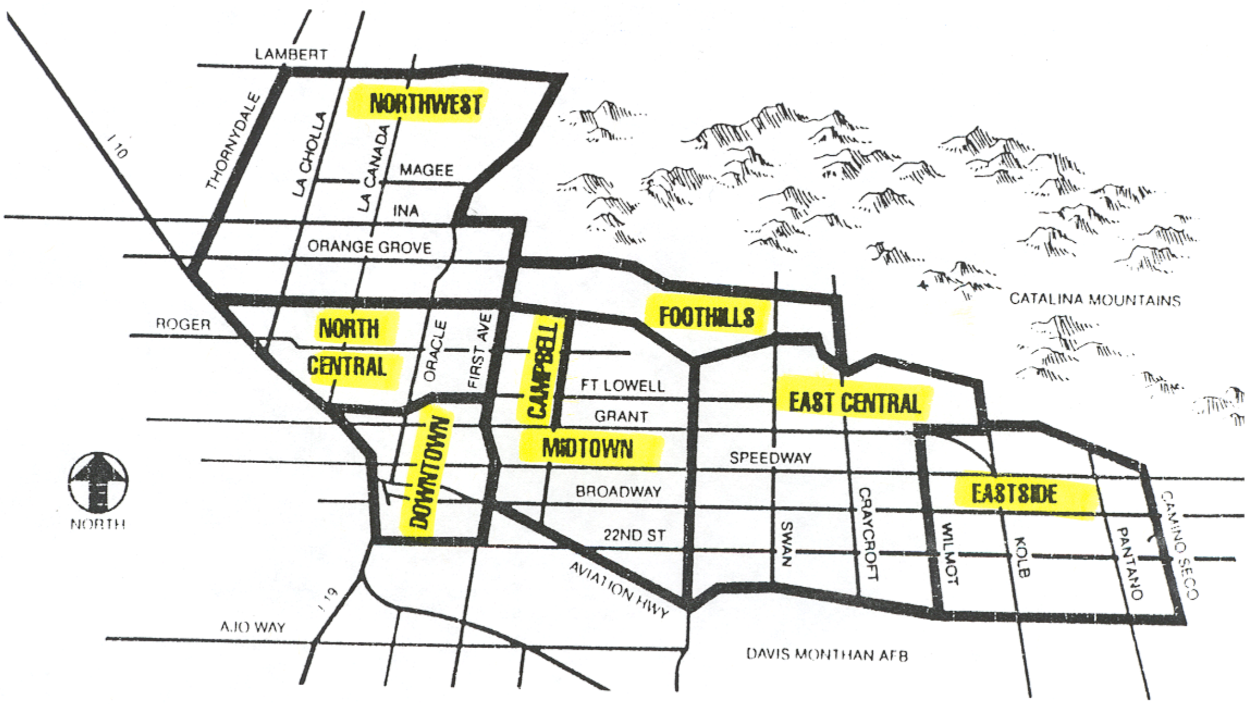
Changes are also occurring with how numerous tenants are using office space, with more electing to design open and collaborative spaces and less private offices. When there are private offices included they are typically smaller than in year's past.

Technology is allowing many companies to allow employees to work from home. Not just small "mom and pop" firms but large publicly traded firms too. Many have found it drives down their costs and in many cases increases their employee productivity and morale.

The "New Reality" is that many firms have returned to leasing rather than ownership, and even with this market shift leasing activity overall has been anemic to nominal activity at best. Exceptions always exist and some areas are seeing above average activity. Generally speaking, the Foothills, Upper Campbell Corridor and the Midtown submarkets are doing the best.

Reflected below is a map that defines the various sub-markets, which will be helpful as activity in each of the eight market areas are reviewed.

SUB-MARKET AREAS AND BOUNDARIES



Turning to the **Campbell Corridor submarket**, a number of leases occurred just off Campbell with Cox Media leasing about 7,000 square feet at Mesquite Corporate Park and KEPCO leasing about 6,500 square feet at Cambric Corporate Plaza. Other than these, most of the other transactions were less than 5,000 square feet. No significant sales occurred in this submarket area.

In the **Downtown submarket**, the new modern streetcar coupled with two new planned student housing projects will be a game changer.

Additionally, the UA Architecture Annex leasing the former Walgreens building, located at Stone and Pennington, that Pima County restored should bring more UA type uses to the downtown area. The new Unisource Energy building, and the incredible energy and influence of the ever-exuberant Fletcher McCusker and his company Providence are significant and will help in the Downtown recovery and also add to the energy and synergy on 4th Avenue too.

The Unisource building was a nice new addition to the downtown skyline and is approximately 170,000 square feet. Unisource more than quadrupled times two the amount of space they used to occupy at One South Church in a leased Class “A” building.

The “Reconstituted” Rio Nuevo Board has been too busy looking for $250M from past city controlled activities, and getting its financial house in order, to be any factor at all. In fact, as the Vice Chair for the board I must say I am dismayed we have not been able to be more proactive in 2011. Yes, we do have some culpability but hopefully with some of the ongoing mediation discussions between the District and the City of Tucson it is hoped that a resolution of the issues is forthcoming and that the parties will get on the same page concerning downtown redevelopment. Currently, both parties are more of a hindrance than an asset to downtown.

The **Eastside** and **East Central submarket** areas both have more than a few large blocks of empty space of office space that is available and candidly, it will take time to absorb this empty space. Most of the buildings have larger floor plate sizes and some are very difficult to demise into smaller spaces easily.

As just one example of the extensive “for lease” options in the **East** and the **East Central submarkets**, we just did a tour with a client seeking to lease approximately 15,000 square feet. We focused on opportunities from Alvernon on the west and extending east to Pantano, an area that encompasses both of these two contiguous submarkets. In just these two submarket areas, over 20 options existed. It used to be a struggle to find 10,000 square feet for lease anywhere in Tucson and most years it seems that less than 10 to 15 options existed in the marketplace.

The largest lease in this area was to the AFNI lease for roughly 50,000 SF at the Williams Centre Tech Park. Providence Service Corporation was next and they leased 23,000 square feet at El Dorado Plaza followed by La Frontera leasing 22,000 square feet at 4891 E. Grant and Breault Research Organization leasing 17,000 square feet at Courtyard Centre. Our firm represented Breault in that transaction.

From a medical standpoint Tucson Medical Center joined the medical uses that are expanding. They have broken ground on a new three-story 200,000 square foot surgical wing on the TMC campus. Tucson Orthopedic Institute leased the entire ground floor. Our firm represented them in this transaction.

In the **Foothills submarket**, no significant leases of any size were completed. However, two sales of newer buildings did occur with Tucson Eye Physicians purchase of the property at 1745 E. Skyline at approximately $171 a square foot. The property was just under 10,000 square feet. Another property sold to an investor at 4041 E. Sunrise for approximately $205 per square foot for a 6,200 square foot building.

In the **Midtown submarket**, no significant office building sales occurred and the only significant lease was to Pima Prevention Partnership who leased approximately 12,000 square feet of the former Long Realty office at Broadway and Country Club. Long stayed in the Midtown area and leased 6,000 square feet at 3777 East Broadway and were joined by Title Security Agency who leased 1,000 square feet. Our firm represented the landlord in these two transactions.

The **North Central submarket** saw quite a bit a lateral movement with tenants downsizing and improving the quality of their space. PSOMAS is an example of this and cut their space needs in half and leasing just under 13,000 square feet in 333 W. Wetmore. Our firm was involved in this transaction. The Department of Economic Security leased 26,000 square feet in the building at 800 E. Wetmore. This is the space that PSOMAS had vacated.

In the **Northwest submarket** about the only new construction were both with two of our clients. UMC expanded their medical office building on Orange Grove by approximately 14,000 SF.

Sundt built their new 47,000 square foot corporate headquarters building at River and La Cholla, on land we helped them purchase a few years earlier.

Sundt also vacated a number of office and flex style buildings they owned located near the TEP Plant close to Golf Links and Ajo.

We also helped Nova Home Loans take advantage of opportunities in the market with the purchase of a nicely improved 10,000 square foot building with Oracle Road frontage, which allowed them to consolidate two offices into one location.

The Northwest saw a number of sales occur and actually had the most activity of any of the submarkets, in terms of number of buildings sold. These included 6320 N. La Cholla (60,000 square feet) at $241 PSF, 3067 W. Ina ((21,000 square feet) at $116 PSF, 6893 N. Oracle (10,500 square feet) at $167 PSF and 3580 W. Ina (23,000 square feet) at $70 PSF. As you can see, prices were all over the board.

Overall there are about 2,400 office buildings of various sizes and classes throughout the greater Tucson market, which total over 23M square feet of space.

Breaking the data down further, there are just over 600 office buildings in Tucson of all classes that are 5,000 square feet or larger. They total roughly 16.5M square feet.

We focus our reporting data primarily on competitive “for lease” office building 10,000 square feet and larger. Currently we track just over 240 Class “A” and Class “B” for lease office buildings that are just over 9.5M square feet as our study area for reporting on vacancy rates, leasing activity and net absorption.

Figures on vacancy rates being reported are all across the board. A lot of this analysis and the figures they report depends totally on how a real estate brokerage firm looks at the market. Some report on all buildings while other reports, like ours, focus on the area in which they specialize.

Most brokerage firms have been reporting vacancy rates between 12 and 18%. Costar reflects the vacancy rate ended the year at 11.8%. In 2010 they reported them as 12.3%, then 11.2% in 2009, and then 10% in 2008, and finally 8.3% in 2007. Although the vacancy rates did improve last year they are still at least 4 percentage points greater that where they used to be five years ago.

Although we have touched on the new construction in the market it is important to note that all were for owner-users and had little, if any space, available to lease to outside tenants.

A few governmental buildings were constructed in business or industrial park settings and as such do not have an impact on the Class "A" and "B" office markets. The US government was active last year with the construction and leasing of two larger buildings including an 84,000 square foot building for the FBI and a 63,000 square foot build-to-suit for the DEA. Both will be completed in the first quarter of this year.

The Sundt and the Unisource buildings are two buildings that came on line in 2011 that are both LEEDS certified. Both are owner-user building with limited options for lease by others but do include some great space for the right tenant.

None of this construction reduced vacancy rates. In some cases, like the Unisource move, they actually increased the vacancy rate downtown by vacating “for lease” space and moving into owned facilities.

Another factor of the market are the sub-lease vacancies, which do not show up in the general market calculations concerning the vacancy rate. Most of the sub-lease space is in the East and East Central Sub-market including some larger 15,000 to 30,000 SF blocks of space.

Absorption rates, published by Costar , show that the market saw just over 280,000 SF of positive leasing activity. This compares with <40,000> square feet of negative activity in 2010, 21,000 SF of positive activity in 2009, <131,000> square feet of negative activity in 2008, and <34,000> square feet of negative absorption in 2007.

This basically means that the market saw less than 100,000 SF of positive net absorption over the last five years, or a pitiful 10,000 SF of absorption has occurred, on average, each of the last 5 years.

For comparison purposes, in 2006, just before the downturn, our firm reported that the Tucson office market was 92.3% occupied, and enjoyed 357,000 square feet of positive absorption. For those who enjoy the review mirror we reported a 92% occupancy rate with 256,000 square feet of absorption in 2005, an 89.4% occupancy rate with 211,000 square feet of absorption in 2004, and an 88.7% occupancy rate with 316,000 square feet of absorption in 2003. So, are these statistics really helpful?

For whatever it is worth, CBRE reported the 4th quarter had just shy of 65,000 SF of negative absorption and show that Tucson ended the year at a 17.9% vacancy rate. We have the market pegged at about 45,000 square feet of positive absorption and a year-end vacancy rate of 16.5%. Again, please note that our study reflects Class “A” and Class “B” buildings 10,000 square feet or larger, while the CBRE study reflects Class “C” buildings as well.

Overall sales volume, according to CoStar during 2011 was $74M. This compares to 49M in 2010, 46M in 2009, 68M in 2008 and 133M in 2007. Average sales prices continued to inch down and ended the year with the medium price of just under $100 PSF. This compares with $136 PSF for 2010, $183 PSF in 2009, $193 in 2008 and $175 PSF in 2007.

In conclusion, we feel that the office market has pretty much bottomed out and now will begin its slow turnaround. Sales activity and sales prices will remain fairly unchanged from 2011. Likewise, lease rates will remain stable and we expect landlord concessions to continue through the year.