



**Tucson Realty & Trust Co.
2010 Forecast
Executive Summary**

333 N. Wilmot Rd., Suite 340 • Tucson, Arizona 85711-2607 • 520/577-7000 • FAX 520/918-3031
www.tucsonrealty.com • e-mail: commercial@tucsonrealty.com

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INVESTMENT OVERVIEW

Howard Schwiebert
Investment Specialist
January 14, 2010

Commercial real estate investment in Tucson may have hit the bottom in the first half of 2009 and there may be cause for optimism in 2010, even if it is only from the viewpoint that there are more deals getting done. Total sales for improved properties declined 56 percent in the second half of 2009 compared to the second half of 2008 while total sales for land declined by only 13 percent. However, the first half of 2009 was extremely harsh with year-over-year declines in land and building sales of over 80 percent and so by comparison the most recent declines are more moderate. The sales data that might indicate that we have hit bottom is the comparison of the second half of 2009 with the first. Sales volume actually increased significantly in the second half of the year and while it's too soon to know, while we may have hit bottom as far as the volume of sales.... we probably haven't hit the bottom on prices.

Two important factors seem to be affecting sales. First, lender issues associated with maturing debt and deteriorating property performance did indeed result in the surge in defaults that we forecasted in 2009. Foreclosures are increasing and more properties are being resold into the market by the banks and loan advisory firms as well as those parties "that need to sell". This helped drive the increase in sales volume in the second half of the year yet the increase in sales volume is not likely a signal of a recovery. Because loan defaults continue to increase, we can expect the resale of bank-owned properties to continue in 2010. Although this obviously brings misfortune to distressed owners, it brings opportunities for investors and is a necessary part of the correction.

The second important factor is increasing investor returns (generally referred to as cap rates) associated with lower purchase prices. Cap rates have increased steadily across all property types from around 7.5 to 8 percent in 2008 to 9 percent and above in 2009. This is likely to have been the result of tenants having lower financial strength, an increase in distressed property sales as well as sellers adjusting to the reality of the market. Prices are starting to reflect the deteriorating performance of properties resulting from increasing vacancies and declining rents. Prices of individual properties are likely to continue to decline through 2010 even as sales volumes increase.

A related factor creating downward pressure on commercial real estate prices is the sales of notes backed by commercial property. Investors have been focused on purchasing these notes at deeply discounted prices. Investors employ various exit strategies including offering discounts to the original borrower if they can refinance, foreclosing on non-performing notes, and buying large packages of notes and then spinning off individual notes. This market is competing for capital that might have otherwise been invested directly into properties and has resulted in investor expectations of large price discounts.

What should we expect going forward? While we may have hit bottom, we can expect to move along that bottom for a time. Expect sales volume to begin to increase as more distressed properties are marketed even as prices decline. Look for cap rates to push past the 10 to 11 percent range. Defaults in commercial loans are expected to continue and bank lending is expected to remain tight, so the inability to refinance will result in ongoing inventory of bank-owned properties that investors will continue to focus on. Just as we saw numerous multi-family property foreclosures in 2009, look for significant retail and office foreclosures in 2010. On the positive side, liquidity may improve in 2010 as there are signs at the national level that the Commercial Mortgage Backed Securities market is re-opening and several REITs have successfully raised equity capital. This could shorten the correction cycle that some expected to extend through 2012 if more money begins to flow into refinancing.

2010 could be the year that much of the distressed property problem is dealt with. Beyond that, in 2011 and 2012, economic growth will likely stabilize deteriorating property performance and more liquidity will likely flow into the industry. This doesn't necessarily mean 2011 and 2012 will be great markets, but it may mean that 2010 is a year to make good deals if you're an investor. It may also be a good time for businesses that have weathered the storm to buy the buildings they are renting or move to a building they buy. 2010 will be the year to make deals.

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RETAIL MARKET OVERVIEW

David J. Houge
Retail/Investment Specialist
January 14, 2010

Most, if not all, business owners and consumers have dealt with many uncertainties in 2009. Among these uncertainties are job layoffs and store closures to name a few. All of these uncertainties in 2009 lead to the contribution to reduce discretionary spending, which affect retail tenants and shopping center owners. December 2009 comparable-store sales posted by a near-expected 2.8 percent gain compared with the same month of 2008, based on a tally of 33 retail-chain stores compiled by the International Council of Shopping Centers. The two-month (November-December) traditional holiday season recorded a gain of 1.8 percent compared with a record 5.6 percent drop in 2008. The 2009 holiday season pace was the strongest since 2006 (the last non-recession holiday season) when sales grew by 4.4 percent. We ended 2009 on a positive note with December Sales Up 2.8 percent--Season Up 1.8 percent, starting with September and October 2009 as the first months that we saw national sales increase after 13 months of declines.

Retail REIT Investment Returns Post 27.2 percent Gain in 2009; Regional Malls Up 63 percent, compared to the Dow which rose by 18.6 percent in 2009, following a steep 33.84 percent drop in 2008. *According to reports by International Council of Shopping Centers.*

Vacancy and Lease Rates

Shopping center vacancy rates are 12.1 percent, with some submarkets as low as 7.8 percent to some as high as 12 percent. Net absorption is negative for 2009 approximately -100,000 square feet.

Lease rates fluctuate from as low as \$11.00 per square foot, per year NNN to \$25.00 per square foot, per year NNN with the majority falling in the \$14.00-\$18.00 per square foot, per year range and the newer construction lease rate in the mid to low \$20.00 per square foot, per year.

Currently, lease rates are most likely as low as we shall see in this cycle with landlords actively contributing to retain current tenants and attract new tenants.

Significant lease deals in 2009 were: Ultimate Electronics, Staples, Big Lots, Burlington Coat Factory, REI, Cheesecake Factory, Goodwill, Old Pueblo Traders, Verizon (5855 E. Broadway), Twice as Nice, Aaron Rents and Sunstreet Mortgage.

Retail Investment

Limited amount of local retail investment transactions happened in 2009, which account for less than \$10 million in sales.

Nationally, investors and institutional investment companies are seeing 2010 as an ideal time to start increasing portfolios and rebuild assets. Many reorganized in the last 18 months and are geared up for acquisitions. Lenders and institutional investment firms will need to look hard at distressed commercial real estate mortgages and realize losses and dispose of these underperforming properties, before the national recovery can take place.

A noteworthy institutional transaction was by the U.S.'s biggest pension fund, California Public Employees' Retirement System, and their joint venture partner who agreed to buy back a shopping center portfolio, 86 centers in the U.S., which it sold in 2005 for approximately \$2.7 billion. The acquisition price of the portfolio was \$1.73 billion in second quarter 2009, about \$1 billion less than the 2005 sales price per *The Financial Times* in July 2009.

2010

2010 will be as challenging as the last 12 months have been, but it seems we have hit most of the lows and 2010 will trend up SLOWLY. Unfortunately, there likely will be some additional fallout with retailers and distressed properties going back to lenders' balance sheets. Retail real estate as a whole closely follows the financial and credit markets and could take 12 to 18 months before a full recovery. Remember that commercial real estate, retail especially, trails the major economic indicators. That said, given the psyche of today's consumers and their current

spending habits, we may not see the level of occupied retail space that we experienced in 2007 for quite a few years.

Distressed properties will be more in the forefront of the marketplace. Commercial notes will need to find new funding and traditional banks seem to want to reduce the number of real estate loans across the board. Life insurance companies will absorb some of the funding along with regional banks and credit unions that don't have any or very limited real estate assets on their balance sheets.

Funding projects will still be a major challenge for investors and developers. Most lending institutions have little or no appetite for any investment or new development, unless they are currently holding notes on stalled developments. New businesses and tenants that rely on credit to expand will be limited due to the number of active lenders, but don't forget the SBA programs. SBA is one of the very few ways that businesses can take advantage of the government incentives and the low interest rates to expand current and new businesses that qualify for the program.

Shopping center vacancy rates in Tucson metro for 2010 will be 9.5 percent overall, but high demand submarkets will be lower than other submarkets. Lease rates overall will remain stable and start to trend up in late 2010. We will continue to see landlords actively working with tenants throughout 2010 with competitive lease rates, incentives, and concessions. Limited new project activity and more stable retail sales with growing consumer confidence will help to stabilize rates and absorb vacancy.

Now is a great time to invest in retail properties with interest rates at or near record lows and most likely to go up in the near future. Property values are also at their lowest for the past decade. Financing projects and properties will take some creative twists, but capital is out there.

We should be on the road to recovery in 2010, which will be an interesting year to say the least.

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INDUSTRIAL OVERVIEW

Chuck Blacher
Industrial Specialist
January 14, 2010

The marquee should read “ BARGAIN PRICES “

Now is the time to consider buying industrial property. Not since 9/11 have prices fallen as fast and as far. Price reductions of 25 to 40 percent or more are not uncommon. The stage is set, the rehearsal is over, the coming months might be the final curtain call with the economy hopefully showing some sign of life. We are speaking about industrial warehouses, manufacturing facilities and contractor yards. Vacancy rates at the end of the fourth quarter have exceeded 11 percent in Tucson, but are leveling off. New building is non-existent with only one 15,000 square-foot building completed in the second half of 2009.

SBA loans are reasonable at 6 percent, but buyers are having difficulty coming up with the 10 percent down or qualify to make the payments. The after shocks of the credit crisis will be a significant drag on job creation during the economic recovery. Rental rates have fallen over the past 12 months with landlords granting rental concessions to keep tenants and lease extensions with no increases for some time. Rental rates are anywhere from \$.30 gross to \$.75 gross, depending on owner's economic viability, location and class of building. Sellers have been educated over the past year what they have to do to make a sale. Buyers that can write a check are in the front row.

With national unemployment slightly exceeding 10 percent at the end of 2009, there is minimal pressure for new housing in Tucson, which drives contractors demand for additional space. New retail space follows roof tops and new housing is driven by job creation which keeps the contractors busy: electrical, roofing, drywall, masonry, plumbing contractors, the list goes on.

Most businesses are running lean and mean to make a profit and survive today's lower demand for their product and services.

Our crystal ball presently is cloudy. Despite some flickering signs of economic recovery around the country, owners of troubled properties will find a final day of reckoning and, in some cases, lose their properties. Sale prices in Tucson in 2008 were in the \$112.00 per-square-foot range and presently prices have dropped to \$59.00 per square foot. Now is the time to snap up some great bargains. Make an offer; you might be surprised.

In the latter part of 2009 only one industrial building was completed totaling 15,000 square feet. There is no industrial space under construction at the end of 2009. The industrial market shows an ongoing weakness with vacancies up, absorption negative and construction at a standstill, the lowest levels in decades. This trend should continue well into 2010 until more signs of a sustainable recovery is evident.

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TUCSON OFFICE MARKET OVERVIEW

Michael A. Gross
Associate Broker
Office Leasing and Investment Specialist
January 14, 2010

I will say it again. This is the most interesting market and year I have ever seen in over 26 years in Tucson. We are experiencing a decent amount of activity, but not much gets finalized, although the office market is much stronger than the industrial, retail and land markets. The ones that do get finalized seem to be by proactive companies that are positioning themselves and taking advantage of the lower “effective market rates” to lower their overhead. They seem to understand that the peaks and valleys in Tucson are not as great as other more publicized cities, such as Phoenix, and decide to make the investment now when deals can be had. They also have a plan of marketing and going out and getting the business instead of waiting for the phone to ring. The ones that take this approach will most likely succeed in their goals. It is also called “getting back to basics” and doing what made us successful in years past. Although we continue to hear sour news about the national economy which affects a lot of people and companies and their decision making, Tucson still seems to be somewhat better poised for the future because we are a service-oriented tertiary city, again with a relatively good employment base, stable ground, good weather for most of the year, centrally located in the Southwest, a diverse population of both employment and people, a good retirement and visitor population, good foreign trade with Mexico, good medical resources and a strong medical industry, an increasing optics research environment, and a very strong secondary education system with two leading institutions in the University of Arizona and Pima Community College. We also have Davis-Monthan Air Force Base that seemingly continues to expand and Ft. Huachuca Army Base an hour to the southwest, which also continues to grow.

With that being said, I feel Tucson has hit the bottom and is slowly moving in the positive direction, as far as office leasing is concerned. The improvement will be gradual and 2010 will see some

movement of tenants and some relocations, if the deal makes sense or the tenant needs to grow and there is no expansion space where they are presently located. But, the relocations need to make economic sense. If you don't need expansion space and you are moving to take advantage of lower rates, it makes sense to try to get that from your present landlord along with some minimal improvements unless you are able to save \$3.00 - \$4.00 per square foot, per year. If you are looking at a \$1.00 - \$2.00 per-square-foot savings, a lot of that minimal savings will be eaten up in relocation costs, then you will have downtime for six months to one year, especially in this "skiddish" economy. So, making a lateral move for about the same rate per square foot when no additional space is needed and you can't get it at your existing location makes no sense whatsoever, unless you are looking to upgrade your space and/or location.

So what does a company do – Hire a professional that has your best interest in mind? Evaluate your situation and make an educated decision? In the past, a lot of decisions to move were made based on where the office was in proximity to where some of the principles of the company lived. Not in this economy. Today, smart decisions will be made based on rent, future operating expenses (which, in one to two years from now will have increased about 50 to 65 percent over five years ago in buildings that are not managed properly and professionally), ongoing improvements to the building creating future savings, good management, good parking, establishments such as restaurants and banks "in house" or in close proximity, strong ownership that cares about the building and it is just not an investment, and finally, a location in proximity to your clients. In today's market, there are a few EXISTING well-located Class "A" buildings out there which are offering the total package at \$20.00 versus \$24.00 - \$25.00 per square foot "Full Service", and a few EXISTING well-located Class "B" buildings out there which are offering the total package at \$18.00 - \$19.00 versus \$21.00 - \$22.00 per square foot "Full Service" and a BRAND NEW CLASS "A" BUILDING at approximately \$26.50 "Full Service" versus \$31.00 - \$34.00 offering everything mentioned above.

EXAMPLES OF EACH IN THE INVENTORY I HAVE ARE THE FOLLOWING:

- Class "A": NBA Plaza, 333-335 N. Wilmot Road; beginning rate \$19.50 - \$20.00
Class "B+": 4400 Broadway Building, 4400 East Broadway; beginning rate \$18.50 - \$19.00
Class "B": 6303 E. Tanque Verde; beginning rate \$17.75 - \$18.25

BRAND NEW CLASS "A" BUILDING BEING BUILT RIGHT NOW:

Monte V: 3501 E. Speedway Blvd., beginning rate \$26.50 with full "vanilla" tenant improvements. Out of approximately 40,000 square feet, about 20,000 square feet has already been leased.

2010 FORECAST

VACANCY

Office vacancy is approximately 16 percent and will continue to recede.

OFFICE DEVELOPMENT

The small owner-user developments will continue to be at a standstill due to over inflated land and construction costs, developer profits and the lack of financing at those prices per square foot.

CONCESSIONS

As mentioned in July, concessions will be available via free rent or a reduction in rates, but with this, the tenant improvements will also be reduced. During this period of time you can't have both. Tenants and landlords need to understand that this is an economy under mend (not due to the overbuilding we had seen in the recent past or like Phoenix currently and so many other parts of the country), but it is because of forces that have affected ALL of us and have brought our national and world economies to its knees. All of us are in this together, so don't be asking for too much on either side or you will find yourself without an office or without an office tenant.

CAP RATES

Cap rates will continue to increase for the most part, due to the economy, competition of other real estate investments, and tenants in these buildings not as strong financially as in past years. I think we will see cap rates increasing to about 9.5 to 10 percent to get a building sold. The battle will be to find affordable financing or to just find financing. If it is possible, sellers may want to consider an owner carry-back with an acceptable stop to get their price and properties sold.

RENTAL RATES

I believe what I projected six months ago is still going to continue to hold for 2010. We will continue to deal in terms of "Effective Rental Rates". "Effective Rental Rates" are the rates after you have calculated in the free rent or discounted rent. (Example: Rental Rate is \$20.00; one month free on a 12-month lease equals an Effective Rate of \$18.33). "Full Service" rental rates for existing "A" Class buildings should be \$20.00 – \$21.00; "B" Class buildings will be between \$18.00 - \$19.00 and the "C" Class buildings will be from \$16.00 - \$17.00 per square foot on an annual basis. These overall rates are also dependant on the term of the lease, the improvements and who the tenant is.

FINANCING

Financing is out there, but it is hard to find and only for the very strong. It will require a higher down payment from the owner, user and/or investor and there will be a lot more scrutiny/requirements by the lender. It appears that the commercial mortgage back securities market is beginning to show signs of life, which will help in terms of financing options available. I think we will also continue to see lenders going back to owners whose property values have decreased to where the loan-to-value ratio is a lot higher than it was when they bought or financed the property, and asking for an infusion of money (curtailment) to protect the lender's loan. So, again, don't be surprised if you get a call from your lender explaining they are sending out an appraiser to evaluate your property.

As recited six months ago, with regard to the future, Tucson is a big “little” city (1,000,000 area population and one of the fastest growing states in the country over the past decade). Because of that, we will see an increase in stronger local, national and regional developers/users come to our market down the road, although not necessarily this year. Because of this global recession, the survivors will be a tenant, tenant mix, quality of space and ownership, which is stronger and improved. The outlook for the Tucson Office Market is improvement, but as mentioned, much more methodical and slower than in the past recoveries.

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LAND OVERVIEW

Mick Cluck, CCIM
Land Specialist
January 14, 2010

2009 Recap

The Tucson residential land market continued its downward slide in 2009, although the second half was a little bit better than the first half. There were few sales and the land that exchanged hands was purchased at fire-sale prices. Like the previous year, finished lots were trading at infrastructure development costs or less depending on where the parcels were located. There really was not a market for platted lots or undeveloped land. Lack of sales and buyer motivation made it very hard to value land for analytical purposes. It was a great year for builders, investors and developers with cash who took advantage of the bleeding. Institutional lending for all practical purposes was not available. Most financing was limited to rolling options and owner carry-backs.

There were 63 sales between \$100,000 and \$1,000,000. The sales were comprised of an uneven distribution of undeveloped, platted and finished lots. I include this sale data of less than \$1,000,000 to illustrate the decline in activity and price point for land. There were 28 sales in excess of \$1,000,000 with a top sales price of \$8,200,000. This was a land-bank sale consisting of 664 finished lots in southeast Tucson. Another notable transaction in the same area was the sale of 463 finished lots for \$8,000,000. 2009 ended with D.R. Horton buying the remainder of Canoa Homes' inventory of 203 lots for \$5.8 million.

The majority of sales occurred in the northwest part of Pima County followed by sales in the southern part of Pima County. Finished lot prices were in the high teens to low twenties. There are currently 100 plus parcels on the market excluding for-sale-by-owner parcels. The actual number of building permits for 2009 in Pima County has not been calculated yet; however, it will come in around 2,000.

Commercial Land

Pima County had a scant 15 commercial land transactions in 2009. This is a 52 percent drop from 2008 and a 65 percent decline from 2007. The biggest sale was a parcel located downtown that sold for \$40.00 per foot, or \$6,500,000. This is the new site for Unisource Energy Corporation. There are currently 335 commercial parcels actively on the market.

2010 Forecast

I think the land market in 2010 will remain in an unsettled state, although we may be bumping along the bottom. Finished lots priced below replacement costs will continue to be absorbed by well-funded developers and investors. This absorption should increase finished lot prices marginally; however, the market for undeveloped and platted lots will continue to be flat. Growth has always been the engine that drives our land market and at this point, Pima County is at a standstill at best. When we begin to achieve near or total absorption of our finished lot inventory, I expect the herd mentality to kick in and increase the value of our platted lots rather quickly; however, this road to a balanced market will take several years. As always, when we do achieve parity, the “would’of’s” and “could’of’s” will be the topic of the day. I think our market will experience interest from outside investors this year as investors start to “kick in” because Tucson is still a wonderful place to live or raise a family and there will be some great prices on excellent real estate. The potential hurdle we are yet to face is the foreclosure market regarding prime mortgages. If Tucson experiences a significant spike, we will see another decline in the value of existing housing stock and a reduction in housing permits. There is talk that the national banks will begin to ramp-up their home foreclosures in 2010 as compared to 2009.

The other unknown will be long-term interest rates and how financial institutions will handle short sales. I think the number of housing permits will remain around 2,000 in 2010. Tucson always pulls out of its down cycles and we will survive this one. Hopefully, we will emerge from this cycle with a clear idea of what we want our community to look like in the future.

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