



## INVESTMENT OVERVIEW

**Howard Schwiebert**  
**Investment Specialist**  
**January 12, 2011**

The Real Estate investment market in Tucson is improving but challenges remain. In 2010 one of the most important questions for real estate investors was “Have we hit the bottom?” Looking back over the past five years of the real estate cycle shows that 2009 was the low point and 2010 showed an increase in investment as we had predicted (See Exhibit A). Because the economy is improving and there is abundant investor cash, this improvement will likely continue in 2011. However, the bad debt problem will continue to be a drag on prices.

There appears to be general consensus among real estate professionals that leasing fundamentals are stabilizing. Vacancies appear to have peaked, and rents have bottomed out, which further indicates that the worst is behind us. Additionally, credit markets are improving, interest rates remain low, and there is growth in the domestic and global economies. This makes investing more predictable and this should entice more buyers into the market and put upward pressure on prices. This could also bring more balance to the market if investor attention shifts away from distressed assets. Thanks to a lack of construction financing since 2007, the Tucson market is not overbuilt like the Phoenix market. This will help demand catch up to supply quicker in Tucson.

Challenges remain however. Performance of properties purchased at the market peak will be challenged because rents have stabilized at lower levels than the market peak. Consequently, leases will rollover at lower rents resulting in lower operating income going forward. At the same time many of these properties are overleveraged. According to Foresight Analytics, an estimated \$1.4 trillion in commercial real estate debt in the US is set to come due between 2010 and 2014. Because most loans are five years in length, much of the debt incurred during the market peak in 2007-2008 will mature in 2012-2013. The peak year for maturities is expected to

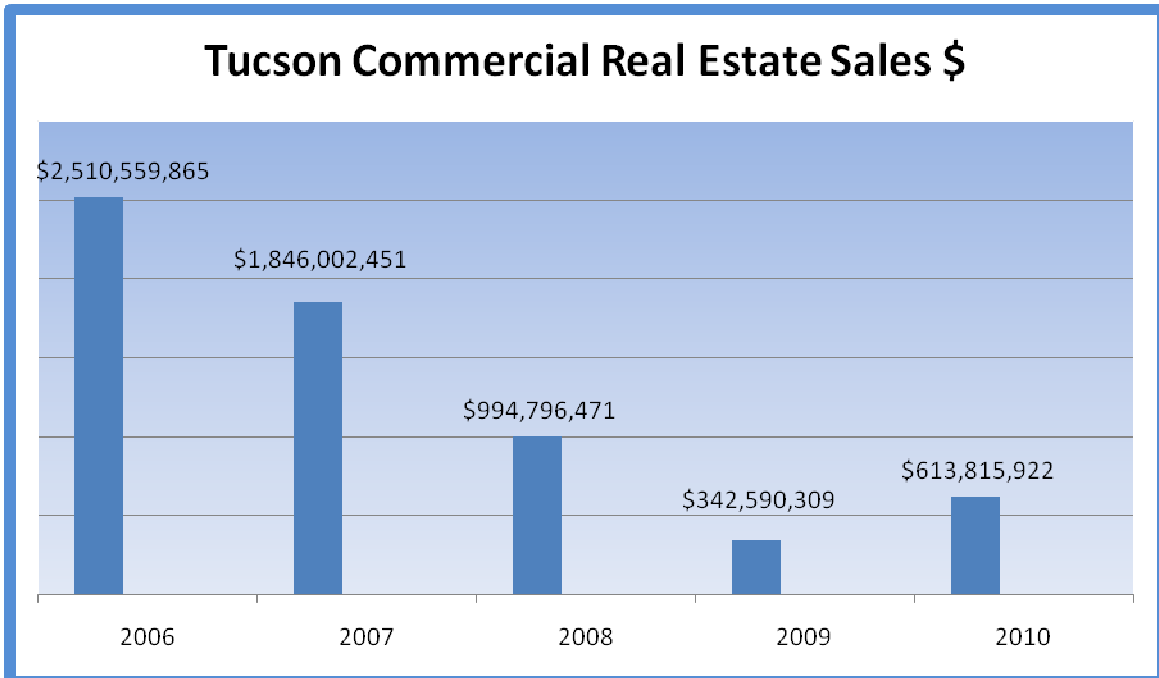
be 2013, when \$311.8 billion will come due. Although the improving economy will provide lenders with new lending opportunities, they will need to rid their portfolios of bad assets before they can reinvest or lend anew. This means distressed assets will likely hit the market throughout 2011 and beyond.

We grow out of down cycles as the economy grows and jobs are added but we could be faced with high unemployment for some time to come. Furthermore, housing historically leads the way into and out of recession. This time housing led the way in, but it continues to decline. Modest GDP growth, subdued consumer spending, volatile employment, and a weak housing sector, indicate a robust short-term recovery is unlikely. So it will take some time to get out of this cycle by growth alone. This cycle was caused more by overleveraging than by overbuilding. Although loan default rates are stabilizing, significant amounts of bad debt remain to be dealt with. So while an improving economy has a positive effect on real estate, deleveraging will continue to have a negative effect.

What can we expect going forward? We can expect real estate investment to increase again in 2011 but it will likely be a long and gradual climb out of this cycle. It appears the economy will be neither a major threat nor a major catalyst in the short term. Signals indicate the worst is over and that it may be a good time for investors to enter the market. The key will be to have strategies based on realistic expectations of modest and gradual growth. Deleveraging will need to continue and so distressed assets will continue to be an opportunity for buyers and this will keep downward pressure on prices. Although unfortunate, this is a necessary process for the market to return to normal.

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Exhibit A. (Source: Costar)





## RETAIL MARKET OVERVIEW

**David J. Houge, CCIM**  
**Retail Specialist**  
**January 12, 2011**

2010 is behind us and many are relieved that we made it through one of the worst real estate cycles in modern history. 2010 was full of various challenges including ups in the first quarters of the year and downs most of the rest of the year. The exception was the last portion of the fourth quarter which finished the year in the black. The 2010 holiday shopping season was the strongest since 2006 (the last non-recession holiday season) when sales grew by 4.4 percent. We ended 2010 on a positive note with same store sales growth November/December at approximately 3.1 percent and total sales over \$520 billion, per International Council of Shopping Centers (ICSC).

REIT Investment stocks had a 27 percent Gain, compared to the Dow which rose by 11 percent and Standard & Poor's 500 index which was up 12.8 percent at the end of December 2010, per *Dow Jones* and the *Wall Street Journal*.

### **Vacancy and Lease Rates**

Tucson's retail overall vacancy rate is 8.4 percent. Some submarkets vacancy rates are as low as 5.3 percent to other submarkets as high as 12.5 percent. Net absorption is positive for 2010 approximately 125,000 square feet, per CoStar

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 \$15.00-\$18.00 per square foot, per year range. Newer construction lease rates are in the mid to low \$20.00 per square foot, per year range.

Currently, lease rates are most likely as low as we shall see in this cycle with landlords still offering lease concessions to retain current tenants and attract new tenants, but we are seeing less concessions as conditions are improving in the local marketplace. We have bottomed out with lease rates in 2010.

Significant lease deals in 2010 were: Beaudry RV, Ross, Goodwill, Dollar Tree, Party City, Big Lots, BJ's Restaurant, Five Guys, Panda Express, Beyond Bread, Tavolino's relocation, Pet Club, and Vantage West CU to name a few.

## **2011**

2011 will still be challenging and similar to the last 12 months, but we have hit bottom and 2011 will trend in the upward direction. Unfortunately, there likely will be some store closings as retailers still adjust to the new rules of the consumers. Going forward, many retailers are looking at expansion plans for 2011/2012 and beyond as the economy improves and retailers lock in low rates and favorable terms now. Store openings will improve and most likely out pace any store closings.

Retailers will continue to view Tucson as a stable market (Tucson unemployment rate is 8.8% compared to Phoenix area at 8.9% and national unemployment at 9.8%) and expand their current presence or establish a presence in our local market. Project funding will still be a challenge for retailers and developers, 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.

Retail overall vacancy rates in Tucson metro for 2011 will be 8.1 percent, but high demand submarkets will be lower than other submarkets. Lease rates overall will remain stable and have started to trend up and will continue to do so 2011. We will continue to see landlords actively working with tenants throughout 2011 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.

We are on the road to recovery in 2011, which will still have challenges, but the worst is behind us and now history.

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## INDUSTRIAL OVERVIEW

**Terry Lavery**  
**Industrial Specialist**  
**January 12, 2011**

The Tucson industrial market in 2010 faced a number of mis-directions from the local and national economy. New job growth and business opportunities were not in the forefront as the financial overhaul and tax break uncertainty contributed to slow real estate sales. Lease rates remained relatively in the same range as the prior year with landlords passing the burden of tenant improvement to the users who demanded short-term leases due to the weak economy. Lease rental rates per month for triple net transactions were as low as \$.30 per-square-foot for large distribution space and \$.60 per-square-foot for flex space. Large transactions of 25,000 square feet or greater were less than a five total... in a 43 million square foot industrial marketplace.

The New Year brings an improved optimism as the major shock of the two-year recession appears to be receding. Consumer confidence and low industrial inventory have jump started shopping with the added incentive of low prices and a slack labor marketplace. Real estate as an asset type is still a 'big ticket' purchase and must face financing underwriting which pulls recent comparable sales from a shallow transaction pool. Fortunately, the banks with cash appear willing to lend to credit worth users with improving cash flows. The Tucson market has not been burdened with speculative development for industrial space with less than 130,000 square feet delivered in the past two years. Strong recent additions such as of the Target Distribution Center, Sanofi-Aventis, and Alliance Beverage contributed over a 1.2 million square feet of new and improved user development activity.

The 2011 forecasted trend is a stabilized industrial market for Tucson. This trend is the opposite of the Phoenix industrial market place with the current vacant inventory equal to the entire

Tucson industrial market. With an improved lending and cash flow, values should be stable if not a bright spot. With the voter revolt nationally and regionally, more cash rich companies will seek low price inventory and labor to further improve shareholders returns. Arizona could be the beneficiary of California's woes. Vacancy rates should be well off the current 19.59% which is still less than 2004 (19.90%) by a least one full percentage point.

In conclusion, the Tucson industrial market is forecasted to bounce off the bottom with positive absorption and improved property values based on an improving national and state economy. With the new government in California and the state in a dire budget crisis, more burden will be on businesses with increased taxes and labor cost. If this California revenue crunch becomes a reality, Tucson is one publicly traded industrial user relocation away from a banner 2011.

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## **TUCSON OFFICE MARKET OVERVIEW**

**Michael A. Gross**  
**Associate Broker**  
**Office Leasing and Investment Specialist**  
**January 12, 2011**

Though the Tucson office market is getting healthier, it will continue to be defined by other larger markets. That is the cost of being a tertiary market meaning there will be more of an emphasis to strengthen “Big Brother” before “Little Brother” will be given new shoes. But Tucson is growing from the grassroots, which means our business base has always been relatively sound. Though we have our inherent problems and terrible headlines, one of which reared its ugly head a few days ago, we Tucsonans seem to continue on with shallower valleys due in part again to our grassroots and strong desire to continue to make Tucson a better and stronger place to live and conduct business. Though we are constantly compared to Phoenix, recently I have seen a methodical resistance to what that “norm” was in the past and the change we are now experiencing when it comes to price, rate and terms. That is because Tucson is not 20 – 30 percent vacant! We do not see a \$250 per-square-foot newly constructed “A” Class building being given away for \$60 - \$70 per-square-foot with \$9 per-square-foot triple net lease rates. It is because we are healthier than that as a whole!

That does not mean we will not see some buildings reducing their rates to keep a tenant. There is a reason for that. They were too high to begin with and did not offer the same amenities as the “competition”. The wise tenant will recognize this and stick with proven performance and will be rewarded with a reduction in their rate. The other will get what they pay for. All the above are perfect examples of what I have seen in the past year. In the last example, I saw two tenants in the same building, one a national and the other a local, make completely opposite decisions. The national’s decision was made strictly looking at the bottom line. They went with the large rate reduction. The other relocated. They will end up paying less than they were per-square-foot, get

the expansion and improvements they needed to grow their business, but they will also have security for their employees as the building both tenants were located in had serious security issues. **All that glitters is not gold! Do your homework and have a good broker to help you make the best decision for you.**

The same can be said for the best built, newest building on the block or an existing one that has retrofitted its infra-structure to save operating costs in the future. They may not have the lowest rates, but both will definitely save you money in the future due to lower operating costs and most likely have the security you and your employees want.

In today's market, there are few EXISTING well-located Class "A" buildings out there which are offering the total package at \$20.00 versus \$24.00 - \$25.00/square foot "Full Service". A few EXISTING well-located Class "B" buildings out there which are offering the total package at \$18.50 - \$19.50 versus \$22.00 - \$23.00/square foot "Full Service" and a BRAND NEW, CLASS "A" BUILDING at approximately \$26.50 "Full Service" versus \$31.00 - \$34.00/square foot.

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

Class "A": NBA Plaza, 333-335 N. Wilmot Road; beginning rate \$19.50/square foot

Class "B+": 4400 Broadway Building, 4400 East Broadway; beginning rate \$19.50/square foot

Class "B": 6303 E. Tanque Verde; beginning rate \$17.75 - \$18.25/square foot

**BRAND NEW CLASS "A" BUILDING:**

Monte V: 3501 E. Speedway Blvd., beginning rate \$26.50/square foot with full "vanilla" tenant improvements with available space from 2,200 – 13,000 square feet on the 1<sup>st</sup> floor.

## **2011 FORECAST**

### **VACANCY**

Currently, office vacancy is at 16.3% and will drop below 16%. It will continue to gradually 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 these prices on a per-square-foot basis.

### **CONCESSIONS**

As mentioned in June, concessions will be available via free rent or a reduction in rates, but with this, the tenant improvements will also be reduced.

### **CAP RATES**

Cap rates 9 – 11% for typical investment property, although as low as 8 – 8.5% for a good exchange property. The battle will be to find affordable financing or to just find financing and an appraiser that totally understands the market and what is being sold!!! 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**

Overall, rental rates are stabilizing, especially for A & B Class properties. Below average properties, rates may continue to slide. 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/square foot; one month free in the first year of the lease equals an Effective Rate of \$18.33/square foot). “Full Service” rental rates for existing “A” Class buildings

should be \$20.00 - \$21.00/square foot; “B” Class buildings will be between \$18.00 - \$19.00/square foot and the “C” Class buildings will be from \$16.00 - \$17.00/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 strong. It will require a higher down payment from the owner and there will be a lot more scrutiny/requirements by the lender. It appears that the commercial mortgage back securities market is coming back, which will help in terms of financing options available. However, having the property appraised, even if it is for the agreed upon sales price has been difficult in many cases. 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.

I recently coined the phrase “Every day is a full moon” meaning that it is a strange market out there and all kinds of crazy things are happening. That said, the outlook for the Tucson office market is improving, but as mentioned, much more methodical and slower than in the past recoveries.

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## LAND OVERVIEW

**Mick Cluck**  
**Land Specialist**  
**January 12, 2011**

### **Residential Land**

The land market in Tucson continued on a downhill slide in 2010; however, unlike 2009 there were twice as many sales in the first six months of 2010 as there were in the second half. I attribute this difference in part to investor/builder caution, seller profit taking and capitulation to market conditions. There was a spot of activity in second quarter 2010 as builders believed the market was improving and wanted to purchase finished lots so as not to be caught short handed. However, that came to a standstill in the beginning of the third quarter when residential sales came to a stop as the tax-credit program was terminated. I do not expect to see a significant change in buyer/seller motivation and activity in 2011. Like the previous two years, finished lots are trading at infrastructure development costs or less depending on the size and where the parcels are located. The market for platted lots is very thin and the sale of undeveloped parcels is almost non-existent. Like the previous three years, valuing land is very difficult due to lack of sales and the uncertainty of a timeframe for the financial recovery of the national, state and local economies. Lending institutions appear to be willing to take their thumping now and have been selling their inventory; however, I think 2011 will bring another round of foreclosures. There are going to be some phenomenal opportunities on the table in the upcoming year and if you have the cash, it is going to be a great year to bank some land for future development; however, it may take a while for profit realization. Financing is still difficult to obtain and in many situations it is not available at a workable number or not at all.

There were 29 sales between \$1,000,000 and \$5,000,000 with a high sales price of \$4,350,000. The highest sales price in this group is half of 2009's biggest sale. These sales were comprised

of an uneven distribution of finished, platted and undeveloped parcels. Aside from a much lower dollar volume, the land activity was a mirror image of 2009. The big sale in Pima County was the 3,500 acre parcel that was purchased by the mining company Freeport-McMoran for \$24,000,000 in May 2010. There were approximately 730 finished lots that sold in 2010 per Costar Comps with prices ranging from \$30,000 – \$117,000 per lot. The majority of these sales were in northwest Tucson and the next most active area was southeast Tucson. The remaining land sales were scattered throughout the Tucson area at large with only one sale in central Tucson. There are currently 186 parcels, excluding properties not represented by real estate brokers, for sale in the Tucson area priced between \$1,000,000 and \$30,000,000 and 165 of these parcels are priced between \$1,000,000 and \$5,000,000. This is a 50 percent inventory increase from last year.

The Tucson Metro area currently has about 6,000 available finished lots with about 70 percent owned by builders and the remainder owned by investors. Northwest Tucson has about 2,700 lots and the southwest, far south area and the southeast parts of town each have about 1,100. There were 1,761 housing permits issued for the first eleven months of 2010 and I think the total for the year will be 1,825. This would be about 15% less than 2009. In the last few months, permits have been down significantly with an annual low of 62 in October. On the whole, simple arithmetic indicates that Tucson has at least a three-year supply of lots and if the resale market experiences further decline, it could easily make it a four-year supply. Yet, if taken at the sub-market level, 1,000 to 2,000 lots is not a lot of inventory should the market pick up quickly. The Tucson area has about 22 production and small builders with approximately 95 communities. This averages out to 1.5 sales per month, per community. Not easy to pay the bills on a sales count this low. Unfortunately, I believe Tucson home prices will decline an additional 10% in 2011 with a leveling off at years' end or in the first part of 2012.

## **Commercial Land**

There were 12 sales of commercial property between \$1,000,000 and \$10,000,000 in 2010. This number is slightly less than 2009; however, the dollar volume is higher. Currently there are 185 parcels on the market above \$1,000,000 and 303 under \$1,000,000 with 6 in a pending status. Commercial land sales in 2011 will be user driven or bargains picked up by cash heavy investors and there will be some great deals available.

## **2011 Forecast**

The land market in 2011 will continue to move forward at a snail's pace with finished lot absorption at a rate equivalent to 2010. This is due to the continuously weakened residential home market as foreclosures continue to mount and sales are down. I think lot prices will remain at the 2010 level; however, premium properties will sell at a slightly higher rate than 2010. Great property almost always has a buyer and I think some investors are finally seeing an end to this very difficult economic period. Others are looking at sub-markets and the relatively low number of finished lots available. Platted and raw land deals will be nominal and purchased by the true believer who will not need his cash in the near future. I think this segment of the market will take years to recover, so an investment in this area takes a significant leap of faith in the recovery of the land market. The resale inventory at the end of the year was near an annual high and this coupled with increased interest rates does not get the market off to a good start in 2011; however, interest rates are still very affordable and if they remain in the low fives, Tucson's resale inventory will decline at a moderate pace. All of Tucson's homeowners have experienced a significant plunge in their real estate values; however, this new price level makes our community affordable for young people and transplants which creates a better business climate for many Tucsonans. The Tucson area is a great place to live, work and raise a family and the long term future for our community is still promising.