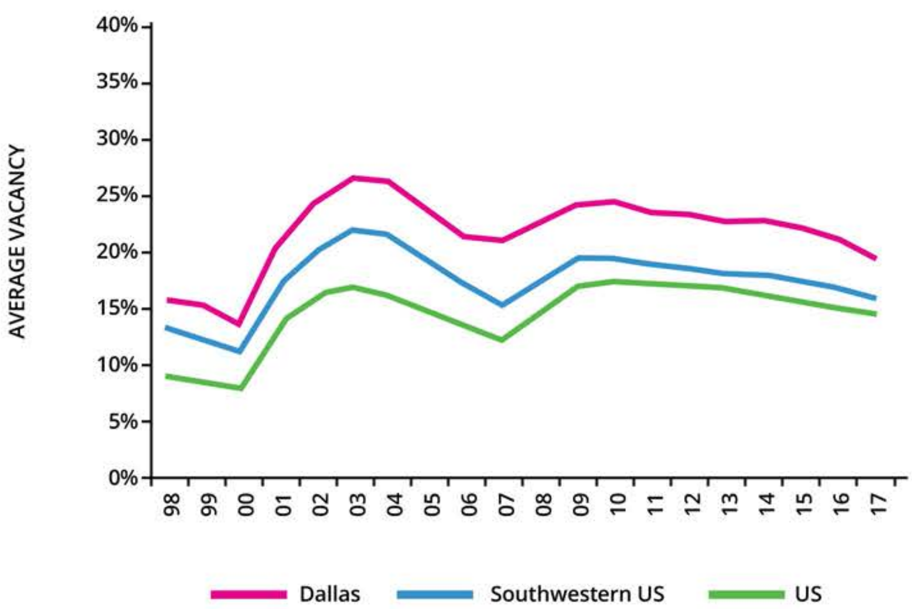
Q2 2013 MARKET TRENDS: DALLAS - OFFICE

The Dallas market shows many of the hallmarks of robust expansion. Creation of office-using jobs has been very strong, corporate expansion and relocation across a broad industry base fuels demand, net absorption numbers are the highest seen here since before the recession, and speculative development, following a period of quiet, has returned. Rates of rent growth, while unspectacular, are firmly positive and have been rising as the pendulum swings in favor of the landlord. Closer analysis, though, reveals a less than even playing field. Submarkets such as Uptown along with areas in the suburban north including greater Plano-Richardson thrive with strong demand while others, downtown Dallas in particular, remain weak or sluggish. In addition, overall vacancy remains high, an effect of earlier zealous development. In an item of particular note, meanwhile, State Farm Insurance has chosen Richardson as the site of a massive corporate campus, the development of which is now under way. Robust investment activity is indicated.

Note. This report addresses the office market on the Dallas side of the Dallas-Fort Worth Metroplex (the MSA). The Fort Worth market is tracked in a separate Reis Observer. Running at 154.3 million square feet, the Dallas-side market accounts for fully 85.9% of total existing Metroplex office space inventory as of mid-year and plays host to its most dynamic submarkets.

Occupancy

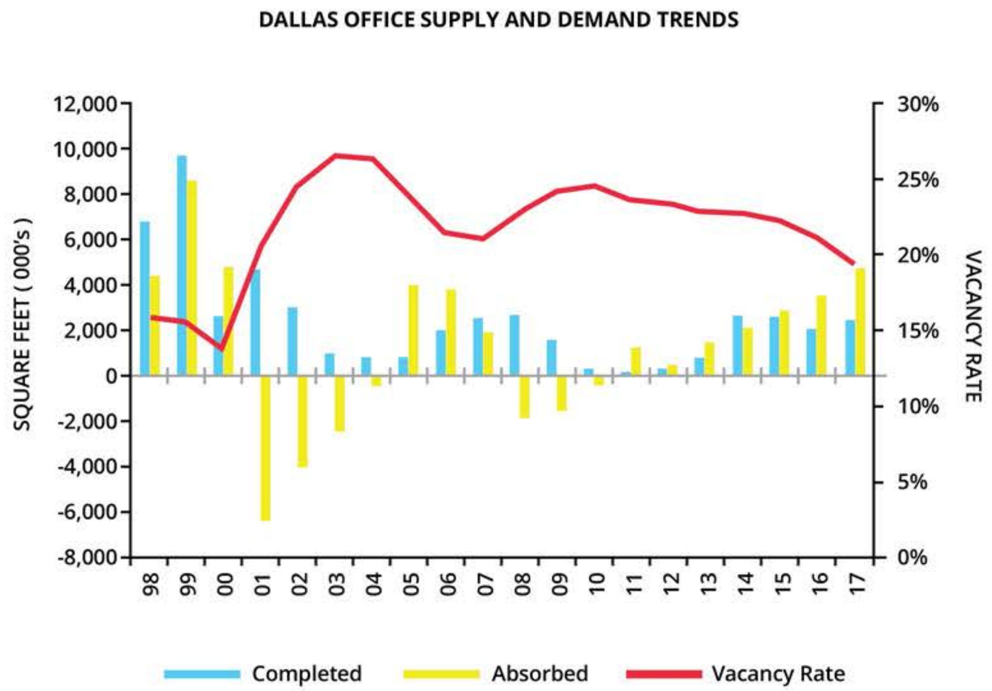
OFFICE VACANCY TRENDS



Dallas area general purpose, multi-tenant office market occupancy is a complicated issue. For one thing, the market is generally understood as strong despite a notably high vacancy rate profile. "With the exception of West Plano, Frisco and Uptown, tenants still have a wide range of options to consider in most submarkets," explains Studley, Inc. It is the strength of those submarkets, however, that provide the overall market with much of its evident vigor. Along these lines, Jones Lang LaSalle notes a "limited supply of available space in Far North Dallas, Uptown and Preston Center [north of Uptown and Oaklawn]." Reis put the second quarter overall metro-wide vacancy rate at 23.1%, down 20 basis points from a quarter earlier, down 50 basis points year-over-year and onerously high by the standards of office market vacancy generally. Indeed, the current rate is only 150 basis points below the post-recession peak reached in the third quarter of 2010. This sluggish pace of descent is due in large measure to the large size of the market. (Notably, rates rose to nearly 27.0% during the early 2000s, an effect of the dotcom-telecom bust.)

As is common among markets with high vacancy profiles, "flight to quality" has emerged in the Dallas area as rental concessions and tenant improvement allowances (see Special Real Estate Factors) in upper-tier spaces attract some number of lower Class A or Class B tenants. Reis put second quarter Class A vacancy at 20.6%, a decline of 50 basis points for the period, a loss of 90 year-over-year. At the daunting rate of 26.6%, the quarter-end Class B/C rate, on the other hand, was up 20 basis points from the quarter before and was identical to the rate reported for the second quarter of 2012. Delivery of new Class A supply over the latest four-quarter span, strong demand notwithstanding, slowed what would otherwise have been a more rapid descent in Class A vacancy.

Supply and Demand



Three years of negative net absorption totals were followed by positive sums in 2011, 2012 and 2013 to date. The latter year, meanwhile, shows promise of being the strongest yet post-recession. Reis put net absorption for the first half of the year at 951,000 square feet, well in excess of the 546,000 square feet of new competitive general-purpose supply delivered during the period (two build-to-suit projects with a combined total of 462,500 square feet also completed during the year's first half—see Submarkets.) Meanwhile, demand, supported by the strength of the local economy and metro Dallas's relatively affordable occupancy costs and low costs of doing business, arises from both local business expansion and corporate relocation. Recent relocations across a broad industry base and from a variety of locales as cited by Studley, Inc. include retailer Kohl's, from Wisconsin; Alco Stores, from Kansas; aeronautics giant Raytheon, from El Segundo, Calif.; and IT services provider NTT Data, from Boston. Not all Dallas area submarkets benefit equally, however. As indicated, "Tenants continue to focus on West Plano and Frisco within the Richardson Telecom Corridor and on Uptown [Dallas]." Law firms specializing in real estate also are focusing on Dallas, this source reports.

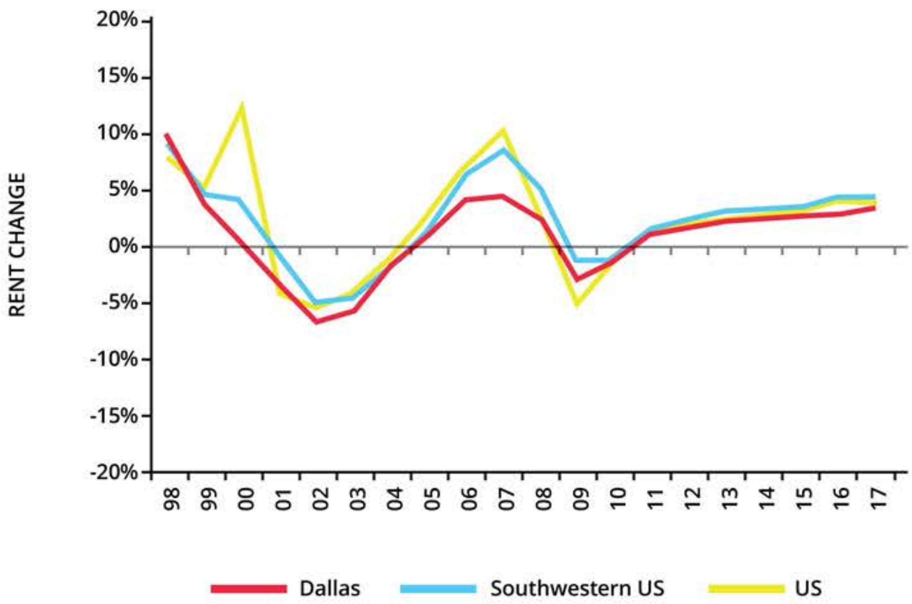
According to Jones Lang LaSalle, vacancy needn't be low by the norms of oversupply for new construction to arise in Dallas: rates below "the historic norm and solid job growth" are sufficient. "[S]everal developers have recently started projects with some additional developments expected to begin later this year," states this source. "The current pipeline, however, remains well below the average with 1.9 million square feet currently underway, of which about 70.0% are pre-leased or built-to-suit." Reis's numbers are slightly higher. According to the firm, 2.4 million square feet of general-purpose space were under construction per the date of this report, a small portion of which is scheduled to deliver this year. Not included in this total is the massive 1.5-million-square-foot headquarters complex for State farm Insurance underway in Richardson along with a smaller single-tenant corporate expansion for Internet services firm Ericsson Inc. in Plano. Development, meanwhile, is dominated by the Plano/Allen submarket, where about half of metro Dallas's competitive office projects are underway.

Not long ago, the market made news with the return of speculative development in the form of a 164,000-square-foot project at, fittingly, Legacy Town Center in Plano. The project completed in May (see Submarkets). Other spec endeavors are now apparent—some underway, some announced some in the greater Plano area, some elsewhere. Included, among others, is the 304,500-square-foot fourth phase of the Granite Park complex in Frisco. "Spec projects are expected for Uptown, Preston Center and Las Colinas," states Jones Lang LaSalle.

Rents

As with demand and leasing, the performance of rents has been uneven in the metro Dallas market. In the market's hotter areas—Richardson/Plano, Far North Dallas, Uptown, Preston Center and Las Colinas, as listed by Jones Lang LaSalle—conditions in these submarkets have "shifted from neutral to landlord-favorable," a trend expected to prevail until the next wave of construction deliveries alters the dynamics of these markets in late 2014 or early 2015. The uneven playing field notwithstanding, rent growth has been positive overall for metro area averages. Reis put second quarter market-wide average asking and effective lease rates at $20.20 psf and $15.62 psf, respectively, up 0.6% each for the period following first quarter's similar gains—and quite low by the norms of major U.S. office markets. The respective gains of 2.5% and 2.7% reported for 2012 all told should be essentially duplicated in 2013, the firm expects.

OFFICE RENT TRENDS



At $22.85 psf, the second quarter average Class A asking price, low by national norms for the product type, was up 0.6% for the quarter following a smaller increase the quarter before. The Class A gain for all of 2012 was 2.7%. At $16.52 psf, the mean asking rate for Class B/C space was up 0.5% for the quarter following first quarter's 0.7% increase. A gain of 2.3% is reported for 2012.