The Wayne B. Swearingen Report®

Information Specific on Markets and Timing

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THE ECONOMY AND ITS EFFECT ON INVESTMENT OPPORTUNITIES AND THE FOUR YEAR TENANT PARADISE

(ENJOY WHILE IT LASTS)

WITH CONTRIBUTING GUEST ADVISORS
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FORWARD

As with the three previous reports, our goal is to interpret conditions and events as they affect the Dallas-Fort Worth office market, both from an investor viewpoint and from the tenant perspective, since we at Barclay work closely with both groups of clients. This report, as well as our September 2002, report, are now posted by link from our web site and we encourage the reader to pass it on as you wish. If you did not receive the September, 2002 report, you are advised to review it since we will refer to some previously defined factors and terms.

Barclay Commerical Group, Inc. continues to expand its professional services and capabilities, and will continue to team with the best professionals in our business. Two of these are guest advisors contributing to this report:

Jo Staffelbach Heinz, FIIDA, President and Principal in Charge
Staffelbach Design Associates Inc
Dallas, Texas

Jo is one of the most respected professionals in her business, having received numerous awards for her achievements. Her tireless and unselfish efforts to meet the Client's project needs combined with her Client commitment make her a team member with no equal. Please visit the Staffelbach web site at www.staffelbach.com.

Lewis T. Sweet, Jr.

Lewis T. Sweet, Jr. is a transactional lawyer who has emphasized real estate and real-estate finance in his practice. He chaired the real estate department of a major law firm for a number of years and is now in solo practice. He has been listed in *Who's Who in America, Who's Who in American Law,* and *Best Lawyers in America.*

THE ECONOMY

The main thrust of the war in Iraq is over but global unrest seems to be something we will have with us from now on. American business is going through an interesting phenomenon which may be a first for all of us. The economy is now growing at about 3.5% and the stock market recovery is under way. Mortgage rates of 5.2% are the lowest in history. This time, the glut of office space has not been caused by over-building to a speculative market. We over-built to an over-expanded business market, which continues its negative space correction**. We continue to shed excess employees, inventories, and space.**

For two years businesses have been laying off non essential people, combining duties, and eliminating middle management. Excess inventories, where possible, have been slowly absorbed as manufacturing was curtailed. The result of all of this has produced a tremendous overhang (or hangover) of business space on the market. In Dallas, true vacancy ranges from 27% to 35% in our major business sectors. **Ghost space**, that not being occupied, and sublease vacancy adds to the total. **The opportunities for tenants are at an all time high and will continue through 2004. These opportunities will be discussed later in this report.**

THERE ARE TWO HUGE NEW FACTORS

JOBLESS RECOVERY

AND

LESS SPACE PER WORKER

Jobless Recovery - This is a catchy buzzword, not particularly relished by my friends in the staffing business. It simply refers to the fact that duties were doubled up and employee productivity greatly improved as a result of the three years of employee layoffs. As business starts to expand again, it will expand with the current people for a while before the largest overhead item (people) is again increased. Many people who are currently jobless will find other careers or start new businesses. This always happens after a recession. But, for a while, unemployment will stay relatively high at about 6%.

LESS SPACE PER WORKER
Jo Staffelbach Heinz, FIIDA

> **As companies continue to look for ways to decrease costs and increase efficiency they have developed business strategies with dramatic real estate implications. Among these strategies are:**

- **Transferring business functions away from their main offices**
- **Relocating some processing/divisional groups to less expensive real estate in the "suburbs"**
- **Outsourcing business functions**
- **Allocating space in a more standard method providing more generic, smaller and more open workspace to accommodate unique and varied work styles**

After staffing, office space is typically an organization's largest expense and these trends have allowed organizations to focus on reducing their office space and the square footage per occupant in their facilities, thereby reducing costs.

In 1997, the International Facility Management Association (IFMA), published its BENCHMARKS III research report. IFMA surveyed the leading corporations and firms in various types of industries and published that the average square footage per occupant in facilities at that time ranged from 284 - 495 usable square feet per occupant.

Since 1997, the real estate industry has seen dramatic CHANGE. Mergers, acquisitions, decentralized markets, technological developments, economic conditions, alternative work strategies and outsourcing have all reduced the amount of square footage per occupant. Companies are changing their organizational structures to be more flexible while still meeting the functional needs of their employees. For most workers, bigger is not necessarily better. Workers today are focused on the right tools and the best equipment to get the job done.

Today's workspace standards have shifted from status and hierarchical needs to functional needs and have become more simplified to satisfy the needs of more staff levels. Successful firms are focused on increasing productivity and profitability through innovation in the workspace.

In the most successful companies, facilities are created through the implementation of strategies flexible enough to support the changing requirements of today while considering potential future changes.

The usable square footage per occupant in 2003 now stands at approximately 178 - 273 usable square feet; representing reductions of anywhere from 35 – 80% .

The configuration of workspaces has changed with fewer offices, increased open office and more "convertible" space. Companies are finding assurance in designing and planning space that can be easily reconfigured to adapt to the high rate of change required in today's challenging economic climate.

As an example, Law Firms, historically classified as high space consumers with some of the highest space utilization rates, have significantly reduced the size of partner offices, placed senior partners and partners in the same office size, reduced associates' offices, moved paralegals to open interior workspaces and promoted the sharing of offices by retired Partners. Whereas previously, a law firm would have never considered utilizing open offices, firms now are leading the space reduction charge by using open office systems workspace concepts for attorneys.

The keys for making this reduced office space per occupant work are based on advanced technology and its benefits for the office worker. With increased technology, paper storage can be reduced, workers are less "tied" to their desks, can operate with remote and wireless connections and their adjacencies can be achieved electronically versus in real time.

It is most likely this direction of reduced real estate per office occupant will continue as technology continues to make space less important than the tools that are provided each worker. And as companies face tougher competition and an ever increasing rate of change, the strategic advantages of greater cost reduction will be the key to increased profitability and success.

SALES OF INVESTMENT GRADE OFFICE BUILDINGS

For the first five months of 2003, over 30 major office properties have been sold in the Dallas-Fort Worth market. The price per square foot ranged from $30 to $160, with the main sales in the $60 to $80 range. The trophy sales of 2002 at near $200 per square foot are now history, and could prove not to be wise investments. Product hungry investment funds justified purchase prices based on leases well above today's market, and rents are not going up any time soon in most sectors.

Our firm, along with King Laughlin Company and Fobare Commercial, represented the purchaser, Skyrise Properties, in the acquisition of the largest project sold during this period. Western Place in the western sector of Fort Worth consists of 423,000 square feet in two towers built in 1978 and 1982. The sale price was at approximately one third of replacement cost, and the towers are over 75% leased, with a growing tenant base. (Remember the M Factor from our September, 2002 Report)

BUY BY THE POUND This is the rule to follow, whether the building is currently leased or empty. Those investors who think they have bought good income streams, and ignore replacement cost and current market rents, may get burned within the next five years.

If you are holding a building off the market and plan to sell soon, take your lumps and sell now. We now have the lowest interest rates of our lifetime, but re-financing may be a temporary "fix", like a cortisone shot. You could get caught when the rates start up and many properties hit the market at one time.

CORPORATE DECISIONS; SAME OLD MISTAKES Here again, if excess space is owned by a corporation, it should be marketed by the pound. Take the write-down now.
If the excess space is on a long term lease, and no buyout is available, consider subleasing the space. Large corporations often hire their tenant rep brokers to market the

space, opening the possibilities of conflicts. An alternative could be to hire a space marketing firm which specializes in just that.

The next section of this report will deal with **SUBLEASING AND THE SUBLEASE MARKET FROM A TENANT PERSPECTIVE**.

THE FOUR YEAR TENANT PARADISE
(ENJOY WHILE IT LASTS)

Last year, Jack Griffin joined Barclay Commerical Group, Inc. as President of our **BUSINESS ADVISORY SERVICES**, a name we prefer over tenant rep or corporate services. Jack brings 32 years of heavy real estate experience to the company. He headed Trammell Crow's suburban development for years, where he became skilled at development, management, and leasing of office properties in North Texas. (See Jack's bio on our web site.) We have found that only with experience from both sides of the table can we bring the complete professional service to our tenant clients. This has been proven recently with several cases-in-point.

I was representing a new company which wanted to take advantage of the sublease overhang in the market. I will call this Company A, needing about 6,000 square feet in a hurry. Jack was representing Company B requiring about 17,000 square feet, also wanting a super sublease deal.

I was successful in subleasing an entire space for my client for the remaining four year term of the original lease. We met a tight schedule, with motivated parties and a cooperative landlord. Jack was not as lucky. He hit snag after snag, trying to fit his 17,000 foot user into long term 120,000 foot lease space. The marketing of the sublease space was being handled by a large tenant rep firm. Moving this space was not high on their agenda. The building landlord was not at all cooperative and had no motivation. The deal cratered and a direct lease was made elsewhere.

The point is this. **SUBLEASING IS NOT EASY**. Most brokers stay away from these assignments because of experiences similar to Jack's. <u>So, is the sublease space really having the great effect on the market?</u> Are there really six to eight million feet on the market that can be used? In negotiating one of these complicated transactions for a client, what are the pitfalls that dilute the advantages?

This next section is authored **by Lewis T. Sweet, Jr.** who has had many years of experience in real estate legal matters.

> **By statute in Texas, a tenant has no right to sublease without the landlord's consent, which may be arbitrarily refused. Most often, if a lease does permit subleasing it is only with the landlord's prior written consent, "which will not be unreasonably withheld," and is conditioned upon the tenant's not being in**

default under the lease. A subtenant has no right to further sublease the premises without the consent of the sublandlord.

If subleasing is permitted, the Subtenant will be subject to the provisions of the base lease (the "Lease") and the rights of the Landlord (the fee owner). Therefore, it is essential for the Subtenant to examine the Lease. Particularly if the Subtenant is going to spend a substantial amount of funds in connection with the sublease, it would be desirable for the Landlord to join in the execution of the sublease to evidence consent to the sublease and agree that if the Sublandlord defaults under the Lease, the Landlord will allow the Subtenant to remain in possession under the terms of the sublease. This is not likely to happen unless the sublease is in some way advantageous to the Landlord. <u>Without such an agreement, however, the Subtenant has no contractual relationship with the Landlord.</u>

If such an agreement is not available, the Subtenant can seek an estoppel letter from the Landlord, with a copy of the Lease attached, acknowledging the existence of the sublease and stating that the attached Lease is the entire agreement between Landlord and the Sublandlord and that the Sublandlord is not in default under the Lease. Again, this may be obtainable only if the Landlord perceives that its position is improved by the sublease.

As a minimum, the Subtenant should get the warranty and representation of the Sublandlord that the Lease is the complete agreement, is in force, and that neither the Landlord nor the Sublandlord is in default. The sublease should also provide that the Sublandlord will not agree to an early termination of the Lease or an amendment to the Lease which would adversely affect the rights of the Subtenant. But if the Sublandlord violates this covenant and agrees with the Landlord to terminate or amend the Lease, in the absence of an agreement directly with the Landlord, the Subtenant has no cause of action against the Landlord for termination of the Lease and no right to continue in possession. If the Lease has renewal or expansion options, the Subtenant will not be able to exercise those options without a contract with the Landlord.

The Subtenant must be sure that its intended use of the premises is permitted by the Lease, and the sublease should also provide that the Sublandlord will cause to be made available to the Subtenant the services the Subtenant will need such as utilities, janitorial services, listing on the building directory, office signage, and parking, because, in the absence of an agreement with the Landlord, the Subtenant will have no right to require those services from the Landlord.

The Subtenant must obviously be concerned about the obligations of the Sublandlord under the Lease. If the Lease is terminated because of the Sublandlord's default, the sublease is also terminated. The sublease should

require the Sublandlord to give Subtenant a copy of any notice of default given to the Sublandlord by the Landlord and give the Subtenant the right, but not the obligation to cure such default; but without a contract between the Landlord and the Subtenant, the Landlord may refuse to accept performance by the Subtenant.

Assuming, as is most often the case, that the Lease is subordinate to the mortgage, the Subtenant is vulnerable to a default by the Landlord under a mortgage of the fee interest in the property (or a default by the Sublandlord under a leasehold mortgage on its leasehold estate) because a foreclosure of the mortgage could cause a termination of the Lease and sublease. The leases could be ratified and continued if the purchaser at the foreclosure does not terminate the leases and accepts rent from the Sublandlord or Subtenant.

A discussion of bankruptcy is beyond the scope of this report, but if the Sublandlord should go into bankruptcy and the Lease is not terminated by either the Landlord or the Sublandlord, the Subtenant can stay in possession under the sublease so long as the Subtenant is not in default. If the Sublandlord rejects the unexpired portion of the sublease, the Sublandlord is not required to provide any services to the Subtenant. If the Landlord should go into bankruptcy, the Sublandlord can continue in possession so long as it is not in default, and the Subtenant may continue in possession under the Sublandlord, but if the Landlord rejects the unexpired portion of the Lease, the Landlord is not required to provide any services to the Sublandlord (and, thus, the Subtenant may not receive those services). In a single-tenant building, or a building in which there are very few tenants, it may be feasible for the tenants (or subtenants) to arrange for services on their own, but as a practical matter, in multi-tenant buildings the practical effect is that when a landlord stops providing services, the tenants (and subtenants) will move elsewhere.

MISCONCEPTIONS VS. REALITY BYTES AND OBSERVATIONS

- **Job layoffs have slowed, but they continue, just at a slower pace.**
- **Middle management continues to be permanently eliminated, and those folks used office space.**
- **Sales people are being hired, as usual, and many will use NO office space.**
- **All buildings are not vacant. Some are full with waiting lists. Our market needs to be considered Sector by Sector.**
- **Tenants in the Uptown and Preston Center Sectors need to ignore the vacancy articles. In those two Sectors, rates are increasing, and the tenant is not "king".**

- **Investors considering the long picture should buy now. The economic upturn has started and will be followed by some job growth in late 2004 and 2005. Then it will be too late to buy.**
- **"Change in use" will be seen more now. In our industry we call that *ECONOMICS OF ALTERNATES*. Examples are seen weekly….telecom buildings taken over by insurance companies and banks.**
- **The new TI plant, announced at UT Dallas, projects a direct and ripple effect of 74,000 new jobs. Groundbreaking is set for 2005. <u>Watch this area for opportunities</u>.**
- **Lockheed is still fueling West Fort Worth. (See our Sept. 2002 Report)**
- **The Dallas CBD continues its steady comeback, not as we knew it, but with a young residential base. The services for these folks are following, along with much entertainment. DART plays a major role.**
- **During the recent recession, construction continued at DFW Airport with the new International Terminal and the "state of the art people mover". The American Airlines changes are a loss to St. Louis and a gain for the mid-cities job markets.**
- **The baby boomers had 2 kids per family. The "echo boomers" are having 2.2 kids per family, and they are spending more time with these kids. The kid entertainment business continues to grow.**
- **The first new business spending will be in "information technologies". WATCH FOR IT.**

WE THOUGHT YOU WOULD BE INTERESTED IN SOME COMMENTS FROM CLIENTS REGARDING THE WAYNE B. SWEARINGEN REPORTS

"I found the report very informative and thought provoking"
Kevin Brands – CMD Realty Investors, Inc.

"I have never read a report like yours. It was like listening to ESPN when they have ex-players giving insights into how the sport is played and what the real picture is"
John W. Knapp - AVEX Group

"Thanks for sending me your latest report. I get so many reports, but thoroughly enjoy reading yours. For some reason I think you might know a little more than the vast majority of real estate *professionals* out there. I enjoy your style; it is fun to read."

Stephen L. Bryan – Catellus Development Corp.

"I like your straight-to-the-point style and I tend to agree with your assessment of the *Mega-Markets*."

Mark Cypert – Thomas Properties Group, L.L.C.

"I like the upbeat spirit of your Report and relate with your approach."

Hal Barry – Barry Real Estate Companies, Inc.

"I applaud your comments, particularly in regard to large, often bloated companies. We look forward to getting further Reports in the future."

Harvey Rudy – Barry Real Estate Companies, Inc.