

The Wayne B. Swearingen Report

Information Specific on Markets and Timing

September, 2002

2003 OFFICE MARKET INVESTMENT OPPORTUNITIES

WITH CONTRIBUTING GUEST ADVISORS

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This is one of a series of reports dealing with changes occurring in our market. The report is the property of Wayne B. Swearingen and Barclay Commercial Group, Inc. There is no affiliation with any other business entity or market study.

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FOREWORD

The focus of this report is to probe more deeply into the “cause and effect” of the current Investment Real Estate Market. **Where are the new Economic Opportunities and Why? How does an investor get positioned to benefit? How do we identify and measure the risks?**

Clients, friends, readers, and helpful critics have encouraged me to delve more deeply into the dynamic forces shaping the DFW investment real estate market today. **With the elongation of deflationary market pressures, it has become clear that old investment assumptions and theories no longer apply.**

Upon entering the real estate business in August, 1962, my forte was leasing office space and thus my first company grew around that specialty. I started Barclay Commercial Group in 1990 and it has evolved into an **Investment Advisory** company as well as a **Business Advisory** firm. This report has become a guide to the type of analysis we provide with 40 years of successfully interpreting the Dallas-Fort Worth market.

SPECIAL 40TH ANNIVERSARY THE WAYNE B. SWEARINGEN REPORT

This report compliments other recently published reports:

A REAL ESTATE SERVICE REVOLUTION

January 2001

INVESTMENT BROKERAGE REINVENTED

February 2002

CONTRIBUTING GUEST ADVISORS

This report could not have been completed without the input and critique of an esteemed group of highly respected professional friends to whom I am eternally grateful. These contributing guest advisors are:

Jerry D. Fults

Jerry and I have worked together and consulted with one another for years. He is the founder of Fults Companies, a trend setting and dominating firm which he headed from 1981 until he sold his company in 1990.

C. King Laughlin

King and I have also worked together for many past years and we are currently involved together with numerous active assignments. He is president of King Laughlin Company, Inc.

Rosanna Stanley

Rosanna owns her own company, Stanley Corporate Coaching, which assists executives in taking their companies to the next level. She was a principal with Fults Companies, and was a founding team member when I started The Swearingen Company in 1972. Together, we completed the first Dallas Office Survey at Henry S. Miller Company in 1971.

PURPOSE

The report is sent to a select list of more than 100 investment clients with the purpose of unveiling a true picture of the Dallas-Fort Worth office market. At times I touch on other investment products, but the main focus remains office buildings and related opportunities. Current investors' questions include:

- What is the current condition of the office market?
- What market conditions impact the leasing market, and why?
- Which DFW office buildings will be impacted and to what degree?
- What are the risk factors in buying, selling, or holding?
- How will returns and values change and why?
- What future changes can be expected?

Do businesses in 2002 have a “NEW FORMULA” for leasing office space? YES!

MEGA-SECTORS AND FACTORS

The balance of this report will include some newly coined terms, briefly defined as follows:

Mega-Sector

This term refers to a redefined area which may include one or more of the original office sectors used in surveys. A Mega-Sector is an area being influenced as opposed to a sector of choice defined by tenants' desires. The colors are simply to identify the Mega-Sectors on the attached map at the end of the report.

A Factor

A Factor (Alternative Officing)

C Factor

C Factor (Corporate Consolidation)

D Factor

D Factor (Dallas Area Rapid Transit) refers to the entire mass transit system, including the “T” in Fort Worth and the Trinity Express which connects Dallas to Fort Worth.

M Factor

M Factor (Military)

N Factor

N Factor (Neighborhood)

T Factor

T Factor (Tech and Telecom) refers to office space consolidation caused by the huge drop in technology and telecommunications businesses and associated layoffs.

THE ECONOMY AT A GLANCE –SEPTEMBER 2002

Office space usage and thus leasing always lags the general economy. Restating profits or losses is the order of the day. Our confidence in corporate America has been shaken and it has taken its toll on the stock market. Fortunes have disappeared and savings have dwindled. Profits have declined or disappeared. We have experienced massive layoffs and there will be more of the same in 2003.

Free market business always cycles. The younger workers who graduated and entered the workforce in the early 90s have never seen a down market or a recession. I have witnessed and experienced six booms and the subsequent recessions, five during my real estate career. In three of these, '72, '83, and '92, there were real buying opportunities where investor clients entered the market early. **We are entering another of those periods.**

OFFICE SURVEYS

(What they show and what they don't show.)

The typical survey, as shown below, will divide the market into sectors and sub-sectors, usually following the major freeways. When we did the first survey in Dallas in 1971, there were 7 sectors. Currently there are 17. I want to discuss only the largest and most significant of these in this report. Later, I will discuss the Mega-Sectors, applying the factors, and creating new and larger boundaries. A typical survey today shows:

Dallas CBD	19 Class A & AA Bldgs.	19.6% Vacancy	rates of \$20.62
Richardson/Plano	30	25.9%	\$20.31
Far North Dallas	71	24.6%	\$23.32
Las Colinas	55	22.4%	\$24.58

In each case, the vacancy fails to accurately incorporate the sublease space which changes daily. There is also the leased but unoccupied space, which will soon become available. The effective vacancy may be as high as 30% to 37% by the end of 2002. When the economy picks up, vacancy will start down again well before new construction starts. Effective rental rates on leases and renewals being signed are from \$4.00 to \$8.00 below what is shown in the surveys. Surveys show quoted rates. We track real deals being made in the market.

MEGA-SECTORS

Original sectors were defined as areas which were classified within boundaries based on tenants' desires.

Example: I want to office north of the CBD, south of LBJ Freeway, and within three blocks on either side of North Central Expressway. That became Sector 2 in the first survey. Other sectors were added accordingly. That is why leasing companies did the first surveys which were much more useful and accurate than those done today by "statistical companies".

Using the new term, Mega-Sector, I will redefine five significant areas of the Dallas-Fort Worth market for purposes of analysis for investment opportunities. This is not meant for use in locating office space for tenants.

Red Mega-Sector This area encompasses all of the CBD, Uptown, Oak Lawn, and Preston Center Sectors. Interestingly enough, the Uptown area developed as a northern move out of the CBD. Now, some of the Uptown tenants are moving back to the CBD to take advantage of the very low rental rates. The two sectors seem to be blending across Woodall Rodgers Freeway. Uptown and Preston Center also exchange tenants. Those two sectors have the most stable tenancy with both the highest and lowest rental rates in the market. They defy the economy. Land costs are the highest and in shortest supply in the sectors surrounding the affluent Park Cities, whose older (more mature) office users do not want long commutes. The red Mega-Sector has the highest N Factor and the lowest C and T Factors.

Purple Mega-Sector I see **great opportunity for investors** with deep pockets and **tenants seeking good value**. This area starts just north of LBJ Freeway and extends to Parker Road on the north, and east and west of North Central Expressway. It also extends east and west along President George Bush Turnpike (Hwy. 190) to Preston Road on the west and the City of Garland on the east. It includes the telecom area of Richardson, but also parts of Garland and Plano. This Mega-Sector is the most depressed by the T Factor. The same thing happened in 1972 but the market came back quickly. Telecom and high tech is not going away; it is here to stay. Too much capacity is a temporary thing. DART now serves the area with light rail all the way to Hwy. 190, causing a high D Factor.

Green Mega-Sector Tenants can make bargain deals here, but investors should be cautious and **buy only the premium products** at this time. This area is generally referred to as Far North Dallas but also includes Addison and Frisco. It is a popular office area, close to homes, shopping, and golf courses. It is also the most overbuilt, and there is still land available. The C Factor comes into play here as corporate businesses are downsizing.

Yellow Mega-Sector **Unless a building is highly discounted, do not buy here.**

This area encompasses the LBJ sector, Las Colinas, Mercer Crossing, Freeport, Solana, and all sub-sectors therein. Large and small corporate users have migrated to this area, drawn by access to DFW International Airport and good freeways which are now often congested. This area is the most affected by the C Factor and corporate downsizing will continue well into 2003. Tenants will find bargains but investors will not see rising rents for some time.

Orange Mega-Sector I am advising clients to **look hard at this area for all types of investments**. Positive job growth has already begun here. Now it is again time to look to the west; not just Fort Worth, but West Fort Worth. The M Factor refers to military. This area includes I-30 from the downtown area to Loop 820. The magnet is Lockheed Martin and its long-term contract to produce the next two supersonic stealth fighters and fighter-bombers that will serve the nations of the free world for the next four decades. More details on the effect of the F-22 and F-35 design and production impact on that area will be covered later in this report. Sub-contractors are already taking space in the few buildings which have available space.

A FACTOR

A Factor stands for alternative officing or “**We don’t office the way we did 20 years ago**”, and we may never again.

Think of the times when you visit a company and find no receptionist at the reception desk, no one in the conference room, and half of the massive offices covered with diplomas and family pictures. These are luxuries of the past, along with private secretaries, administrative assistants, and private lavatories. Big corporations had better take heed because stockholders are looking down their throats now. Arco once had four executives and four secretaries on one entire floor in the Arco tower in downtown Dallas. Big banks were just as palatial. Not now. **Not at \$25 per square foot.**

I have operated without a secretary or assistant for six years. My office space must be small because I want everything within reach. I operate my own computer and my cell phone never leaves my side. I am much more productive and in better hands-on control of the quality of my work. Instead of worrying about my people and their problems and training my future competition, I spend all of my energy on solving my clients’ problems. **And when they call, I answer the phone.**

Now, multiply this A Factor throughout businesses, large and small. The net effect is tremendous, and it applies to all of the sectors to some extent and to the Yellow Mega-Sector to a great extent.

C FACTOR

The C Factor is an all inclusive conglomeration of the effect of “corporate implosions” due to business downsizing, bankruptcies, and/or layoffs. Whether caused by fraud, greed, poor management, incompetence, or all or none of the above, the effect is the same. **Business downsizing causes space vacancy.**

Those of us who have dealt with large corporate bureaucracies in the past know that incompetence is not new. A case in point is my own experience, wherein I made the decision in 1990 to remove my firm from the growing list of “corporate service” groups that now crowd the real estate market. I had started Barclay Commercial Group, Inc. with its main thrust in investment brokerage. Several brokers asked to join me and concentrate on corporate work, which they did. While attending a meeting in New York, I heard a presentation by a real estate executive with IBM outline how IBM was going to “outsource” all of its real estate functions. The downsized IBM staff would simply oversee the work of those lucky firms chosen in “beauty contests”. IBM would dictate fees and commission policy. I thought WOW, here is a big company which almost went under recently and they are going to dictate how we brokers will do business. I left the meeting with the decision to leave the corporate work to others and limit my tenant work to entrepreneurial private firms. This has proven more rewarding and fulfilling. I would no longer have to attend those national meetings, enter beauty contests (which I cannot win anyway), and constantly entertain corporate executives in order to get business. The large real estate shops now look, feel, and act like their corporate clients with salaried employees. Life is too short. **This is not brokerage.**

Now, I was not smart enough to have predicted the corporate implosion, and the resulting stock market plunge. I did see lack of responsibility, lack of business ethics, and terrible judgments lead to big corporate real estate mistakes. So, now we have the C Factor. **In areas such as the Yellow Mega-Sector the C Factor is so high that office space absorption will continue to be negative for some time to come.**

D FACTOR

The D Factor stands for DART and all other forms of mass transit. In spite of lingering negative articles and commentaries, DART **works**. This is one of the brightest features of our maturing *Metroplex*. Yes, Dart is needed. We have sprawled too far. Mass transit, in the form of rail and light rail is expensive, but it is cheaper to build now than it will be in 10, 20, or 30 years. DART narrowly passed in Dallas after a bitter campaign. In Houston it failed and they lost 25 years. Now they are starting it up again, far behind Dallas.

Fort Worth has the T (Bus mass transit), and partnering with Dallas, they have opened the Trinity Express. Using frequently scheduled diesel trains and standard rail, the CBD's of Fort Worth and Dallas are now just a pleasant 50 minutes apart. The D Factor will fuel the continued resurgence of both CBD's. **Residential and retail development will continue to surround main mass transit stations, offering investment and development opportunities.**

In the early development years ('60s and '70s) companies started the move to the suburbs because of cheap land and new freeways. The "campus" was in vogue. I call this "**campus isolation**". Isolate the employees; subsidize the lunchroom; park cars on the cheap acres of concrete or asphalt. Employees can shop at the company store. Some of these moves still continue, but recent trends show a reversal. Employees want to mix with other people in a more normal setting. I predict that businesses will seek sectors and buildings with a high D Factor in the future.

M FACTOR

M stands for military. New contracts are fueling job growth in the Orange Mega-Sector while all others are still laying off. Projections call for over 23,000 jobs to be created during the design, engineering, and production phases of new weapons. **We are advising our clients that there is opportunity in West Fort Worth.**

My interest was peaked in the mid '90s when I did work in that area for Lockheed. I then started reading about the future Joint Strike Fighter (JSF) program, led by the U. S. government. In the late '50s I spent my military career as a pilot in B-47s, the six jet engine forerunner to the B-52 which is still in service. Perhaps that is a reason for my interest. In the '90s, hot competition was started between Boeing and Lockheed Martin to become the prime contractor for a futuristic military plane with unbelievable criteria to be met by designers. Example:

The JSF must be stealth, cruise at supersonic speeds,
be lighter than the F-16, and must carry more lethal ordinance.
Then, by the way, the Marine version must be able to take off and
land vertically. All of the services will use it. Now, go for it.
They did. They designed it. Lockheed Martin won the competition, and West Fort Worth will
benefit for the next 40 years. Checks are coming in from many of the free world nations, even
though the aircraft will not be available for export until 2012.

The F-16 Fighting Falcon fighter bomber had been and still is the finest fighting machine ever created, with the final assembly line at Carswell AFB (now the Joint Reserve Base). Orders are still arriving for F-16s while the F-22 Raptor and the XF-35 (JSF) are being designed and built.

N FACTOR

The N Factor stands for neighborhood of stability due to the non-effect of the C Factor (Corporate), T Factor (Tech.), and A Factor (Alternative Officing). The N Factor is very high near neighborhoods of “old wealth”. These smaller office users do not tend to expand and contract with the economy. The Turtle Creek and Preston Center markets as well as the Class A buildings in the CBD have a high N Factor. The N Factor may be high in the Uptown Area with high rents or high in the CBD with low rents.

Within the Red Mega-Sector, Uptown and Preston Center Class A rates are the highest (\$24 to \$32), vacancy is the lowest, and values are high. This explains sales in the \$200 per foot range and steady land prices from \$45 to \$75 per square foot. Recessions seem to have only an indirect effect.

T FACTOR

The Richardson *Telecom Corridor* and the rest of the Purple Mega-Sector is a mini-version of the once booming Silicon Valley between San Francisco and San Jose, California. I worked on an assignment in that area during 1999 and 2000, seeking hotel sites for a client. On my numerous trips I noted interesting phenomena. The Silicon Valley had become the home of three of the 10 most valuable firms in the world. Startups in that area had taken in nearly half of the \$69 billion invested by venture capital firms in 2000. I saw land selling for over \$40 per square foot for two story build-to-suits housing tech firms. Landlords were taking stock in lieu of rent. This was not real estate investment, it was gross speculation. Office vacancy was less than 1%. Now, the Valley has lost 8% of its jobs (1 in 13). Vacancy there has hit 21.6% officially, and the true number may be closer to 40%. In Texas, the tech industry has lost only one job in 36. It may go to two in 36. That is only high if it is **your job**.

The over-expansion of tech and telecom and the fallout, (the T Factor) has had a great effect on the Purple Mega-Sector, but the area will recover much faster than California. Other businesses will back-fill, taking advantage of the infrastructure, high quality fiber, DART rail (D Factor) completion to Hwy. 190, and attractive rental rates. Travelers Property Casualty Corp. recently signed a 106,000-square-foot long-term lease, moving 550 insurance employees over from the North Dallas Tollway corridor. The Mega-Sector still shows a 26% vacancy in class A space, with the true number possibly closer to 34%.

I would bet on a quick rebound in this area, ahead of the other depressed sectors. **High tech is not going away.** All of the elements are in place. We just need to look for the “corporate recovery”.

STATE OF THE INVESTMENT MARKET
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Interest rates are the lowest they have been in decades. These low rates have allowed owners to refinance (Example – Libor+250 basis points) resulting in product shortage. There is no panic selling, yet. There is no wholesale discounting.

The stock market meltdown has created a new attitude by the institutional buyer community. Eight or nine percent returns don't look so bad.

A large amount of cash is waiting on the sidelines as the stock market baffles investors. Some investors are looking harder at the 100% leased “trophy properties” thinking that they will withstand the volatile rental market that now exists.

The magnitude of corporate layoffs has made the “corporate designed buildings” less attractive, especially if they are vacant.

New speculative construction has come to a complete halt in DFW and most other markets. Most new construction will be done with pre-leasing, a concept slow to reach our area with such a large stable of well financed developers.

Large sums of money are chasing a relatively small number of high quality, well leased properties at low cap rates. **LOW RISK** seems to be the word of the day. Investors with money in T-bills certainly want higher returns, but not if the risk is too high.

Investors with deep pockets, willing to buy properties with “opportunity”, have the chance to create value by instigating a new business plan for the property by using a matrix using knowledge of the factors discussed in this report. **Buy by the pound; then sell with a yield.**

Numerous properties are being “auctioned to the world” by sellers who think they can get the highest price this way. Most astute buyers, however, are reluctant to invest the time in this process, since their due diligence time can be entirely wasted. Who wants to buy an over-shopped piece of merchandise? Nothing replaces the ability of a true professional and knowledgeable investor broker who can seek out, identify, and negotiate a purchase, fair to both parties.

Now for the good news. Historically, when our market area found itself with unusually high office vacancy, corporate America perceived that it is a good time to look here for relocation or expansion. Corporations may not be expanding now, but they are sure looking for cost-cutting and low rent. Relocating employees get an automatic raise due to low living and housing costs along with no state income tax. Moves have also been quietly used for job cutting. **Dallas-Fort Worth, with its central location, is poised to capitalize as we arise from these troubled times, creating a new 21st century Metroplex that will remain the corporate and distribution destination of choice in mid-America and the Sunbelt .**