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TRENDS IN WASHINGTON COMMERCIAL REAL ESTATE

[Succeeding in a Competitive Market]

SUCCEEDING IN A COMPETITIVE MARKET

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A Collaborative Publication of Delta Associates,
Partners in Excellence with Transwestern.

Foreword

February 2013

To our friends, clients and colleagues:

We are pleased to provide you this 16th annual edition of ***TrendLines: Trends in Washington Commercial Real Estate.*** This is a collaborative publication of Delta Associates and Transwestern. Our purposes are to distill the trends of 2012 and to shed light on pivotal forces and issues that we believe will affect the region's economy and commercial real estate in 2013 and beyond.

A year ago in this space we spoke of the uncertainty that affected decision-making in 2011, negatively impacting an expanding market, one that had shown its typical resilience in 2010. In 2012, that uncertainty grew as major deadlines drew closer – a fiscal cliff that had the nation on edge but which could have a greater impact on our region than any other. By December, the prevailing sentiment among government contractors – who may have been most acutely impacted by the Federal spending cuts known as "sequestration" – was "let's get this over already." Decision-makers at major office tenants across the region were thirsting for resolution – they can respond to Federal budget cuts, but they are paralyzed by the kick-the-can approach that the government is using with sequestration, which will be debated again in March 2013. Our region realized – perhaps for the first time – that it is vulnerable to downsizing within its primary core industry: the Federal government.

Despite the frustration the local business community has been feeling for the past two years, our local economy and commercial market has demonstrated its resiliency once again:

- The unemployment rate is down to 5.0% as of November 2012, the lowest among major metro areas and a decline of 30 basis points compared with 12 months earlier;
- The regional economy has generated 34,300 net new payroll jobs in the 12 months ending in November 2012, only slightly below our long-term average despite political headwinds;
- The region's proficiency at attracting corporate headquarters facilities has never been better;
- Local retail and industrial markets are in full-fledged expansion mode; and
- Regional commercial real estate remains a global leader in attracting investors' capital.

Notwithstanding these positive indicators, the marketplace is simply more competitive than it has been in the past. So, it is the job of the savvy investor to find opportunity in this new, more competitive market. This report is our effort to help you sift through opportunities and take advantage of the best ones 2013 has to offer.

We know that those who invest in Washington from afar are prone to be caught up by negative press – we saw evidence of this as foreign capital faded late in 2012 as the fiscal cliff neared. This is an advantage for local investors and developers who know this market best. The first half of 2013 in particular is likely to be filled with dour political news as the February debt ceiling, the March sequestration deadline, and the annual budget fights dominate headlines. Local investors who are better able to micro-target demand for various product types and who know a superior location when they see it have a chance to put out capital ahead of their competitors.

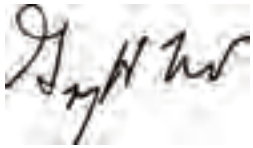
Where are the opportunities in 2013? Our apartment market will see steady demand but will be fighting through the new supply that is scheduled to deliver. The housing market will continue its rebound, with condominiums leading the charge. The retail market, supported by nation-pacing household incomes, will continue to flourish. Flex/industrial product will benefit from the growth of online retailers in need of large warehouses and the demand for data centers. Finally, we expect gradually rebounding demand for office space, though we will have to wait for 2014-15 to see material rent growth.

Ultimately, success will go to those with deep pockets, a sensible capital structure, and best-in-class designs, management, and marketing at superior locations. Place-making at mixed-use projects and accommodating the modern office tenant as its needs change also will be requirements for success in the period ahead.

We offer more specifics about these opportunities in Section One of this report (Succeeding in a Competitive Market) and throughout the book. Overall, we expect to find more opportunities in our industry in 2013 than we found in 2012. For the thoughtful investor and developer the concerns blaring from the bold-type headlines are opportunities to be exploited.

Thank you for your interest in our research and other services, including brokerage, property management, investment sales, and development. We look forward to helping you interpret everything you see in the market and to being your service partner in the period ahead. Best wishes for a successful 2013.

Eric Mockler
President, Mid-Atlantic Region
TRANSWESTERN®
The Performance Advantage in Real Estate



Gregory H. Leisch, CRE
Chief Executive
DELTA ASSOCIATES
A Transwestern Company

BAKER TILLY

Accountants and Advisors

To Our Clients and Business Associates:

As a leader in the DC business community for almost 40 years, Baker Tilly is once again proud to support TrendLines®.

Baker Tilly continues to be recognized for service and quality in the delivery of tax, assurance, and consulting services to the Washington, DC marketplace. Our breadth and depth of resources focused on the real estate industry allows us to serve the leading real estate companies and institutions investing in the Washington area.

The looming battle over spending cuts, an increase in the debt ceiling and potential for additional increased tax revenues will again create uncertainty not dissimilar to what we experienced as we ushered in 2013.

On the positive side, this year promises to be an exciting time for people living in the metro Washington area; street cars are expected to be on line in the District before the end of year as well as the arrival of Metro's Silver Line in Virginia leading many to hope that gridlock will only relate to our Federal Government and not our traffic. These transportation improvements are expected to shape future real estate development for many years to come.

Baker Tilly looks forward to continue advising the businesses and entrepreneurs who are the foundation of the Metro Washington real estate industry, and helping them maximize the opportunities created by an ever changing world.

Sincerely,

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PNC REAL ESTATE

Dear TrendLines® Participant,

PNC Real Estate is proud to sponsor the TrendLines® Report once again in 2013, which is widely regarded as a premier resource for our region's commercial real estate professionals.

In today's rapidly evolving real estate environment, having access to timely market knowledge is critical to running your business. For years, the TrendLines® Report has been such a source, delivering a valuable overview of the Washington, D.C. real estate market.

Equally critical is having confidence in your lender, an institution that has experienced varied economic cycles and has always been available to its customers. PNC Real Estate is one of those lenders.

PNC Real Estate continues to deliver one of the industry's broadest platforms of products and services. Our comprehensive array of capabilities includes acquisition, construction and permanent financing for public and private developers and investors; agency financing for multifamily and seniors housing properties; debt and equity capital for the affordable housing industry; access to the capital markets and treasury management services. In addition, through Midland Loan Services, we provide third-party loan servicing, asset management, and technology solutions.

PNC is one of the nation's top banks by deposits, with $301 billion in assets and over 2,900 branches as of September 30, 2012. Our strength lies not only in our size, but in the innovative ways in which we deliver products and solutions to help you achieve your business goals.

To learn how we can bring ideas, insight and solutions to you, call us or visit www.pnc.com/realestate.

Sincerely,

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TRENDS IN WASHINGTON COMMERCIAL REAL ESTATE

SUCCEEDING IN A COMPETITIVE MARKET

Acknowledgments: The editor, Gregory H. Leisch, CRE, wishes to acknowledge and thank this project's research team at Delta Associates: Alexander (Sandy) Paul, CRE, President of the Transwestern Support Group and National Research Director; and Elizabeth Norton, Senior Vice President and Mid-Atlantic Research Director. The creative design team at Transwestern, led by Ji Chang, and the staff at Delta have our gratitude. Most of all, our appreciation is hereby expressed to the dozens of industry leaders who spent their valuable time responding to questions about the future of our industry here in the Washington area.

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Succeeding in a COMPETITIVE MARKET

1

Succeeding in a COMPETITIVE MARKET

The purpose of ***TrendLines***® is to distill the trends of 2012 and shed light on pivotal issues that shape our commercial real estate opportunities in the Washington marketplace in 2013 and beyond.

Last year in ***TrendLines*** we stated that 2012 would be filled with both opportunities and potential pitfalls. Indeed it was. Our region faced the threat of sequestration – significant Federal budget cuts – only to see a decision on those cuts deferred until March 2013. All of this uncertainty – our theme of ***TrendLines*** last year – led to stasis: executives across the region paused hiring and investment until the Federal government acted. While Congress and the President did strike a deal on income tax rates as the calendar turned to 2013, the coming debt ceiling debate, sequestration decision, and annual budget negotiations are much bigger concerns for Washington's business community and commercial real estate market.

And yet, despite these ongoing frustrations, the Washington economy remains sturdy, with continued job creation, including in the sectors that drive office demand, such as professional and business services. Still, our office market retreated in 2012, with negative net absorption for the first time since we began keeping records – a function of both GSA's pullback and the densification of office space, with tenants trying to reduce occupancy costs by squeezing more people into less space. This is a major factor affecting future demand, and one we explore further in this section of the report.

As jobs continue to be created, demand for apartments – particularly Class A units – remains consistent. However, we advised a year ago that there was still opportunity in apartment development in underserved submarkets and for projects with special features. You – *many of you* – took our advice, and the apartment pipeline reached levels that are likely to create downward pressure on rents in 2013. Still, the longer-term outlook for multifamily product remains bright, with a large cohort of young potential renters ready to "de-nest" from their parents' houses and "uncouple" from roommate situations as soon as their finances allow.

In sum, 2012 brought a more competitive market, one we think is here for the foreseeable future. What can investors and developers do to succeed in a competitive market like the one we face? In the balance of this section – and throughout the remainder of this report – we share our thoughts on how to tackle the challenges ahead.

In sum, 2012 brought a more competitive market, one we think is here for the foreseeable future. What can investors and developers do to succeed in a competitive market like the one we face? In the balance of this section – and throughout the remainder of the report – we share our thoughts on how to tackle the challenges ahead.

We think the opportunities ahead are shaped by six main themes or "megatrends":

1. The Washington region realized for the first time that its economy is vulnerable to a major change in Federal budget policy.

2. Notwithstanding that vulnerability, the region's private sector is expanding due to extraordinary regional strengths.

3. With the right-sizing of the Federal establishment and other lifestyle and demographic trends, like the "densification" of office space – fewer SF leased per worker – there will be less demand in the future for commercial real estate than we are accustomed to.

4. Lower barriers to entry for our market – namely, a reduction in red tape by public officials who are actively recruiting new businesses, including those already in this region – mean a more competitive landscape for veteran Washington investors. Our market is experiencing a structural change.

5. With reduced demand, plus lower barriers to entry, we face a more competitive landscape which is here to stay. And this will result in higher vacancy rates, lower rent growth rates, and a continuing flight to quality.

6. Success will go to those with deep pockets, a sensible capital structure, and best-in-class design, management, and marketing at superior locations. The champions of the future are those who best resolve the current mismatch between old designs or existing product and new tenant requirements – and who do it well at superior locations.

The balance of this report drills down to each property type to get more specific about trends and opportunities for each asset type.

Let's start with a brief discussion of how our commercial real estate community finally came to realize that despite the longstanding strength and consistent expansion of our biggest core industry – the Federal government – we truly are vulnerable to a major change in budget policy.

1. Washington realized vulnerability during 2012.

The Washington metropolitan area economy has historically outperformed the national economy. This performance is due largely to the combination of and symbiotic relationship between:

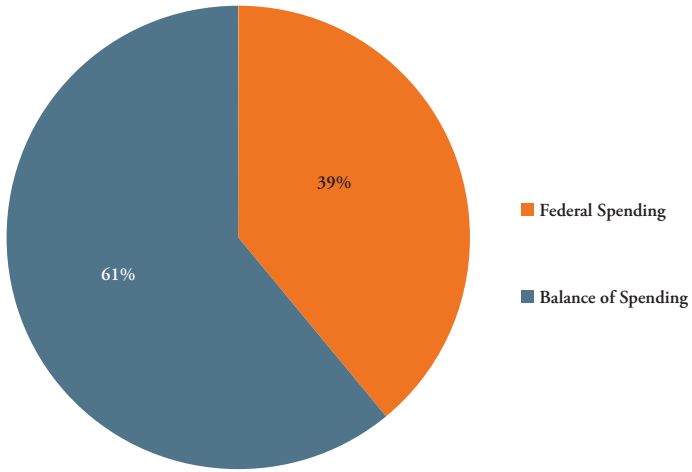
1. The Federal government, which accounts for more than one-third of the gross regional product (GRP), but just 12% of the metro area's workforce; and

2. A private sector led by contractors providing services to the government but also stand-alone Professional and Business Services and Information Technology Services firms with a regional, national, and worldwide business base.

The Federal government sector has provided a steady, moderate growth pace year-in and year-out while the private sector has provided bursts of rapid growth during expansion cycles. This combination has made the region recession-resistant and well above average in job growth.

As a result, the Washington area economy has proven to be more resilient than the nation during economic downturns. Not recession-proof, but recession-resistant, the metro area has consistently enjoyed lower unemployment rates and higher job growth rates than the nation as a whole. During the past 20 years, the Washington metro area grew new payroll jobs at an annual average rate of 1.6%, compared to the national rate of 1.0%. For example, the local unemployment rate during the past 20 years averaged 4.0%, below the national average of 6.0%.

Share of Gross Regional Product
Washington Metro Area | 2012



Source: GMU CRA, Delta Associates; January 2013.

But years of deficit spending caught up with politicians by 2010 when a new wave of budget-conscious representatives was elected to the 112th Congress. This group seems bent on controlling expenses even at the cost of national economic growth. So the mood for the foreseeable future seems to be to rein in spending – and with it, Federal dollars spent in the Washington region. No better is that seen than in procurement spending in the Washington area. Since 1980, when records were first kept, procurement spending was $4.2 billion. It grew every subsequent year to $82.4 billion in 2010. It declined for the first time in history to $79.6 billion in 2011. This decline alone accounts for the loss of some 19,600 jobs in the private sector. In addition, over the past 12 months, the Federal government shed 4,200 payroll jobs.

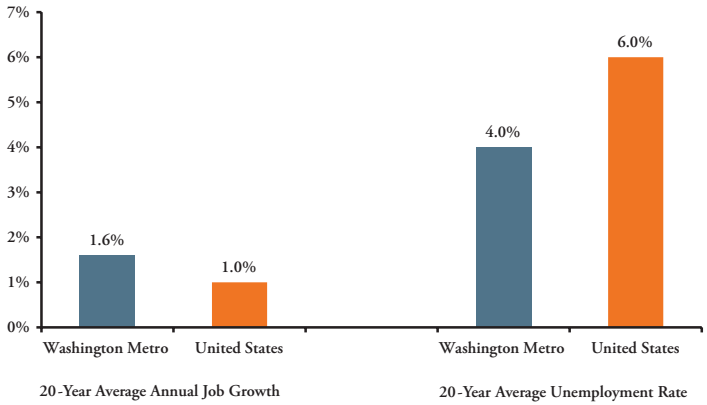
These losses hit home – the region is vulnerable. And this is before sequestration, or its reincarnation after negotiations in March, affects the region.

With the pullback in Federal spending and job losses, overall regional job and GRP growth were lackluster compared to historical norms. The Washington metro area grew 34,300 new positions during the 12 months ending November 2012, which is below the 20-year annual average of 39,800. This rate is modest compared to past recovery cycles which averaged 60,000 to 80,000. On a percentage basis, the Washington metro area grew jobs by 1.1% during the 12 months ending November 2012. Comparatively, national employment grew at a faster pace, at 1.4%, as other metro areas experienced greater gains in payroll jobs.

The Washington metro area GRP growth rate weakened in 2012; the 2.4% growth rate was below the 10-year average of 3.0%.

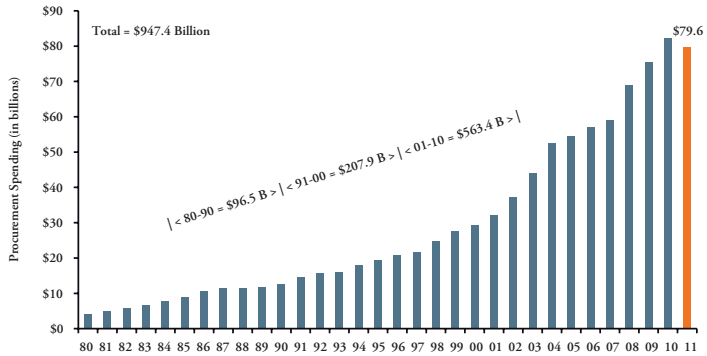
As economic vulnerability increased in the Washington metro area beginning in 2011, corporate leaders became less optimistic about future conditions. At the end of each year Delta Associates surveys commercial real estate "market makers" in the Washington metro area. As part of the survey, we ask respondents about expected business conditions over the next 12 months. Our most recent survey at year-end 2012 shows a decline in respondents expecting improving local economic conditions over the next 12 months. By contrast, there was an expectation of improvement in 2009 and 2010. During 2011 these expectations faltered – as respondents were more pessimistic about what the next 12 months would bring due to the prospect of sequestration. These concerns accelerated in 2012, as our survey shows 25% of respondents expecting improving conditions over the next 12 months, a decline from 31% of respondents at year-end 2011.

Economic Metrics
Washington Metro Area vs. United States



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

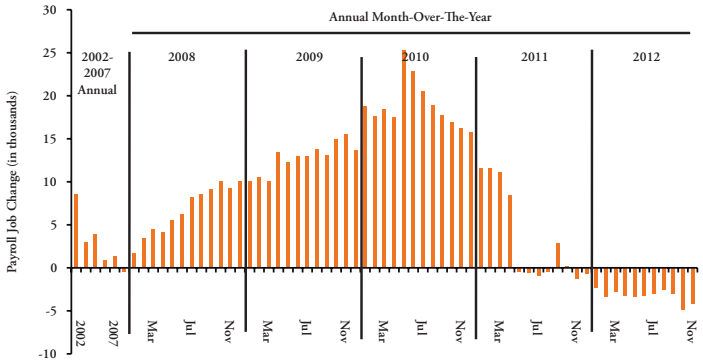
Federal Procurement Spending
Washington Metro Area



Source: GMU CRA, Delta Associates; January 2013.

Federal Government Payroll Job Change

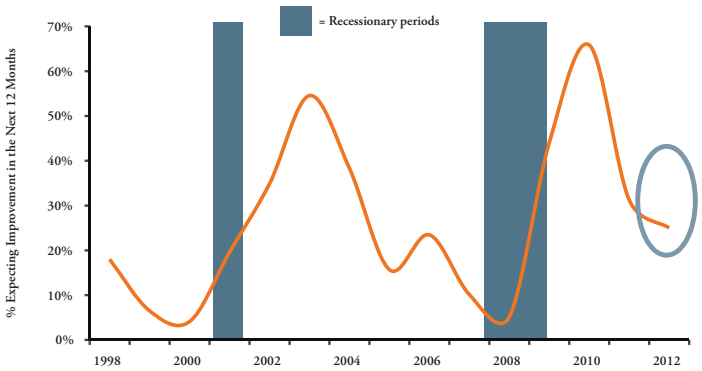
Washington Metro Area



Source: GMU CRA, BLS, Delta Associates; January 2013.

Delta Associates' Business Confidence Index

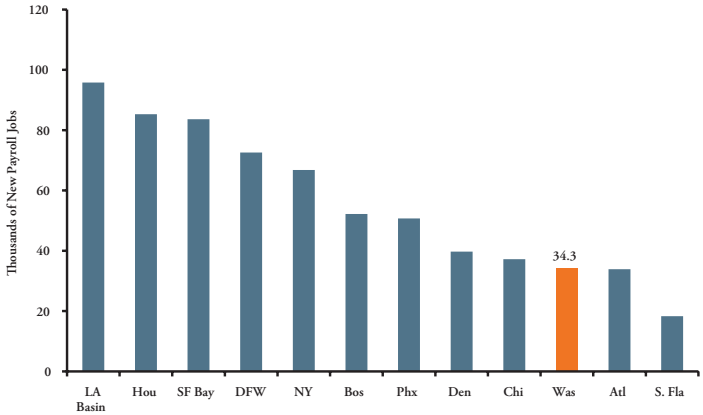
Washington Metro Area



Source: Delta Associates' Market Maker Survey; January 2013.

Payroll Job Growth

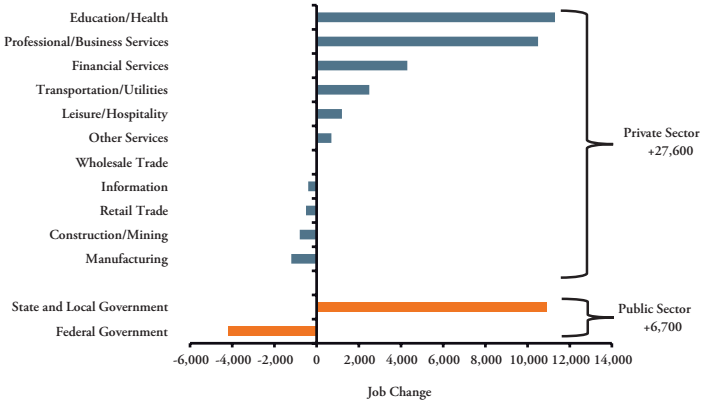
Large Metro Areas | 12 Months Ending November 2012



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Payroll Job Growth

Washington Metro Area | 12 Months Ending November 2012



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

2. Despite vulnerability, the private sector made gains during 2012 due to extraordinary regional strengths.

Despite vulnerability, the private sector continued to create jobs in the Washington metro area during 2012. During the 12 months ending November 2012, the private sector in the Washington metro area grew 27,600 new jobs – with Education/Health and Professional/Business Services as leaders. This growth is above the 10-year annual average of 17,000 new private sector jobs. Public sector job growth retreated during this period, growing 6,700 new jobs. The State and Local Government sector was the leader, backfilling positions that had been left vacant during the 2009-11 budget crunch. This contrasts with the Federal government, which shed jobs due to budget austerity measures. Overall, public sector job growth is below its 10-year annual average of 10,700 new positions per year.

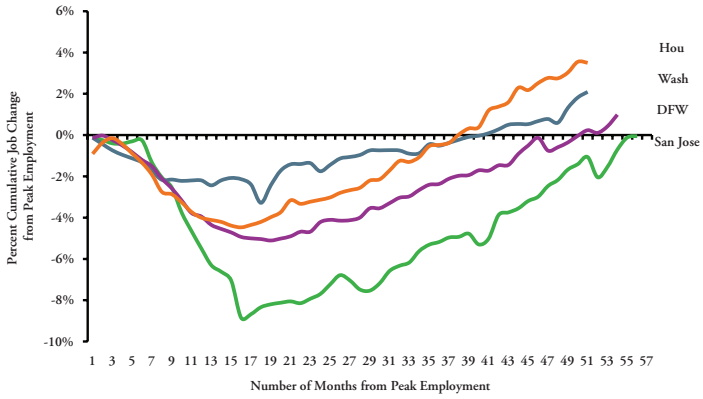
Even with the drag of the public sector, the Washington metro area has recovered the jobs lost during the downturn. Only three other major metros can claim that – Houston, Dallas/Ft. Worth, and San Jose (part of the San Francisco Bay Area).

What distinguishes these metro areas as winners? More specifically, what makes the Washington metro area a winner?

Houston: Since the end of the recession, Houston has added 187,500 new jobs, a 7% increase. Growth in the Health/Education and Trade/Transportation sectors contributed notably to job creation during this period. The oil/gas industry is a major player in the local economy, which has also contributed to economic gains. Any gain in energy jobs has a multiplier effect on the local economy as this is a high-income industry. According to the Bureau of Labor Statistics (BLS), every 100 jobs created in oil/gas exploration create an additional 480 jobs elsewhere in the metro area, and for every 100 new jobs in oil field service an additional 210 jobs are created.

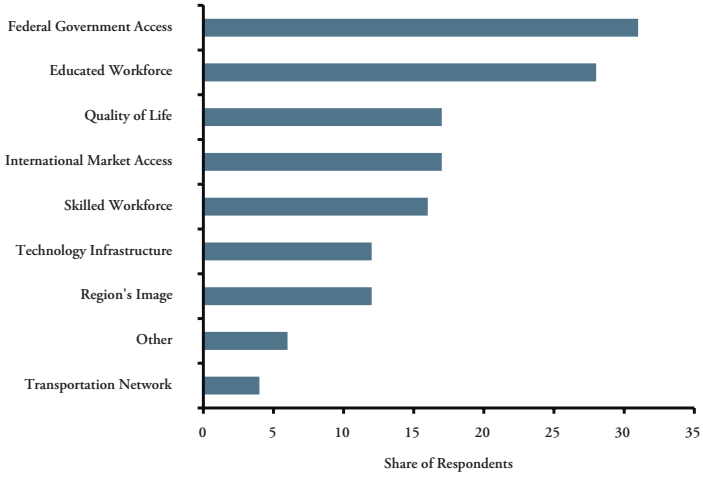
Dallas/Ft. Worth: Since the end of the recession, Dallas/Ft. Worth has added 114,500 new jobs, a 6% rise. The job growth was driven by the Professional/Business Services and Health/Education sectors during this period. Dallas/Ft. Worth has positioned itself as a strong industrial and financial economy. The location of large oil/gas companies in Dallas, such as ExxonMobil, also plays a notable role in economic stability. Given this stability and low cost of living, the Metroplex's population has grown to be the fourth-largest in the United States at 6.6 million, which helps fuel the metro area's economy.

Cumulative Job Loss After Peak of Current Business Cycle
Select Metro Areas



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Primary Reasons Companies Relocate to Area
Washington Metro Area



Note: Multiple responses were permitted.
Source: MWCOG, Delta Associates; January 2013.

San Jose: San Jose is part of the San Francisco Bay Area. Since the end of the recession this area has added 64,800 jobs, an 8% increase. The job growth was driven by healthy gains in the tech and education sectors, as these sectors are major local industries. San Jose serves as the capital of Silicon Valley, as a large concentration of high-tech engineering, computer, and microprocessor companies are located here. Given the rising demand for technology, these companies have driven the local economy.

Washington: Since the end of the recession, the Washington metro area has added 92,900 new jobs, a 3% increase. The job growth during this period was driven by the Professional/Business Services and Health/Education sectors. Despite budget austerity measures, it has been the private sector that has driven the economy lately and will continue to drive the economy in the near-term, as the Federal government recedes.

The Washington metro area has experienced an increase in companies relocating to the area to be closer to the Federal government. According to the Metropolitan Washington Council of Governments, the primary reason companies relocate to Washington is access to the Federal government – likely either because the government is a client or for lobbying purposes, or both. The second most important reason for relocation is the educated workforce, as the Washington metro area has the highest percentage of bachelor's or advanced degrees (at 47%) among large metro areas. According to the Greater Washington Board of Trade, the region has recently captured a third of all major corporate headquarters relocations in the country.

Corporate headquarters relocation to the Washington metro area has ramped up over the past few years. For example, Northrop Grumman, Hilton, and Siemens have relocated headquarters to the area. A handful of recent decisions will help fuel the economy going forward. For example:

- Maryland recently passed a law expanding gambling, which is attracting casino operators to the state;
- Inova Health plans to spend over $1 billion on expanding its Fairfax and Loudoun operations; and
- Capital One recently grew after acquiring the online bank ING Direct and the majority of HSBC's credit card business.

Through 2017, we expect private sector growth to pick up momentum, adding just over 291,000 new jobs during this five-year period. We expect the Government sector to pull back – eliminating just over 10,000 jobs. Within the private sector, the Professional/Business Services segment is projected to be a major player – far exceeding the other sectors in job creation with over 143,000 jobs added during this period. We expect most of these positions to be created in the Management, Scientific, and Technical Consulting Services and Computer Systems Design and Related Services sectors. In addition, new jobs will be added to this sector as companies continue to relocate to the metro area. We believe this trend will continue despite the slowdown in Federal spending. As discussed later in this section, the region's economic development authorities will be fighting over these new jobs.

3. Demand for commercial real estate will be less than we are used to.

Economic uncertainty, demographic shifts, and the rise in technology have impacted the Washington metro area commercial real estate market. These effects have changed the way businesses and consumers spend money – impacting all property types. Although economic uncertainty may decline in the years ahead, demographic shifts and the rise in technology will have a continuing impact on the demand for all types of commercial real estate.

Office: Densification and GSA's pullback restrict demand.

According to our records, which date back to 1970, 2012 was the first year the Washington metro area experienced negative net absorption of office space. Economic uncertainty, coupled with tenant densification (taking less space per worker), has reduced the moving 10-year annual average to 4.4 million SF at year-end 2012, a decline from 7.1 million SF at year-end 2000, and 10.3 million SF at year-end 1990. Although tenant densification is not a new trend, it has ramped up recently as companies implement alternative work programs to save on occupancy costs.

In the period ahead, we believe the following trends will impact office demand, keeping the annual average hovering around 4.5 to 5.5 million SF per year.

- ***GSA pullback:*** GSA accounted for approximately 65% of total Washington area leasing activity during 2010; its appetite declined to 45% in 2011 and 12% in 2012. Given continuing budget battles, we expect GSA leasing activity to remain around 10% to 15% of office market demand in the near future.

- ***Densification:*** Tenants (both private and public) are changing the way they utilize space. Changes in the nature of work and how tenants use office space are driving the reduction in the amount tenants lease. In 2000, the average SF leased per worker was approximately 197 SF. This average declined to approximately 190 SF by 2010. It is expected to decline to approximately 182 SF by 2015. Tenants are increasingly consolidating offices, leasing less space per worker due to hotel and telework programs, and right-sizing office space due to staff reorganization and technological changes in the work place.

The Professional and Business Services sector (the region's primary user of office space) will help pick up some of the slack in demand, as this sector is projected to add over 143,800 new jobs to the economy through 2017, according to Dr. Stephen Fuller. Although we expect private sector leasing activity to rise during this period, it should be restrained somewhat as companies will utilize shadow space before inking new deals.

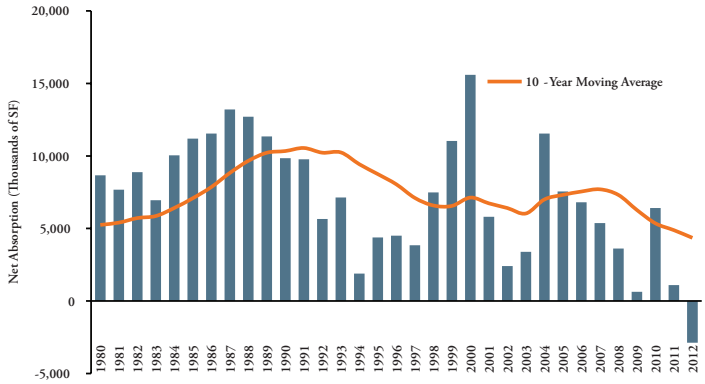
Multifamily: A shift from owner to renter due to demographic changes.

A notable demographic shift occurred in the Washington metro area from 2006 to 2011. During the downturn, the Washington metro area continued to grow jobs as the national economy weakened. During this period, the relocation of 25- to 34-year-olds to the Washington metro area, many in search of a job, intensified. While the region lost 5% of its 25- to 34-year-olds from 2000 to 2006, it gained 21% in that cohort from 2006 to 2011.

In addition, living with parents during the economic downturn became an option (or necessity) for many in the Generation-Y age bracket. Nationally, approximately 5.5 million people moved back in with parents or doubled up with others to save money. As the economy continues to recover, those currently living with parents or doubling up, coupled with the influx of younger folks to the Washington metro area, represents a huge pool of likely future renters, which will power a healthy apartment market over the next five years. This younger age bracket prefers to rent versus own, given financial standing and the recent retrenchment of the housing market.

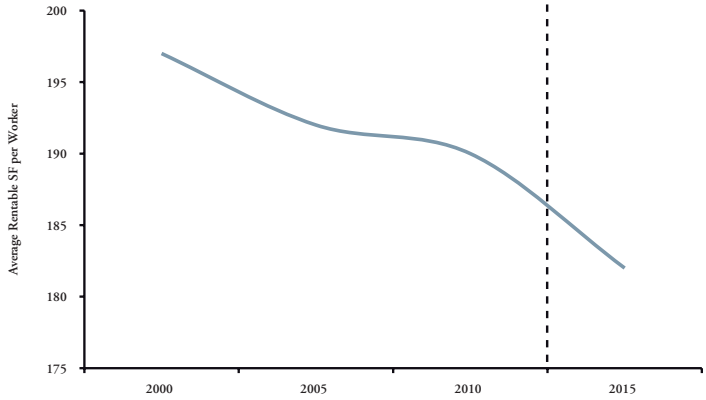
Prospective renters in the younger age brackets – an estimated 9.1 million nationally from 2011-15 – will continue to join the workforce over the coming decade and demand the flexible housing arrangements that apartments provide. Those in the younger cohort currently doubling up or living with parents will eventually "age out" (or be nudged out) and look for their own places, further enhancing demand over the long term. This bodes extremely well for the apartment industry. But the apartment

Office Net Absorption
Washington Metro Area



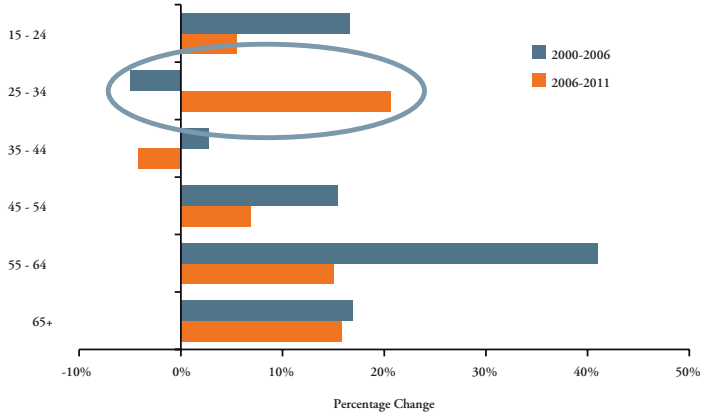
Source: Delta Associates; January 2013.

Average Office Square Feet Per Worker
Washington Metro Area



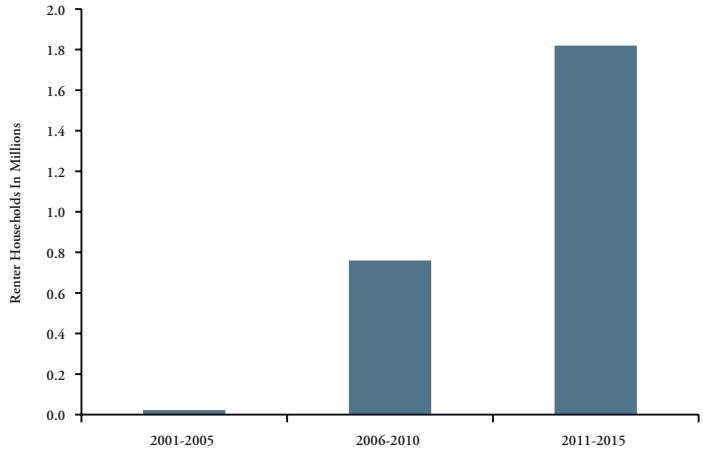
Source: Delta Associates; January 2013.

Population Change By Age Group
Washington Metro Area



Source: U.S. Census, GMU CRA, Delta Associates; January 2013.

Annual Change in Total Renter Households
United States



Source: U.S. Census Bureau, John Burns Real Estate Consulting, Delta Associates; January 2013.

of the past decade may not suffice – putting pressure on the industry to invent new product and repurpose existing product with significant renovation dollars in order to compete.

Retail: Structural shifts benefit some formats but not others.

E-commerce is projected to grow at an 8.5% annual rate from 2010 through 2016, according to Nielsen. It should be no surprise that e-commerce is projected to experience a faster growth rate than other retail sectors, as advancement in technology continues to make shopping online easier. Major retailers, seeing the rise in e-commerce, have jumped on the bandwagon, offering both online shopping in addition to a brick-and-mortar store. This diversification has allowed retailers multiple ways to make contact with each consumer. However, at the other end of the spectrum, gains in technology have also provided consumers the ability to price-compare, putting pressure on the retailer to compete. Overall, retailers with the money to invest in a multi-channel strategy will in the long run outperform companies unable to diversify. As inadaptable companies fade away, a rise in vacated physical space will add to the vacancy rate.

In addition to e-commerce, other retail categories are likely to grow more rapidly in the period ahead, including pet stores, big-box club stores, drug stores, and grocery stores. Herein are the opportunities in the period ahead for commercial real estate development.

The rise in technology will put pressure on retailers to perform. However, retail real estate has, for at least a decade, been under-produced in the metro area, yielding nation-pacing occupancy rates. We believe the demand for retail real estate in the Washington metro area will continue to outpace supply, making for solid performance metrics.

The Washington metro area has 27.5 SF of shopping center space per capita as of year-end 2012, compared to the national average of 23.7 SF. Although Northern Virginia and Suburban Maryland are above the national and Washington metro averages, the District remains underserved at just 8.0 SF of shopping center retail space per capita, as population growth outpaces retail development – an opportunity for retail developers and retailers alike. We believe demand for retail space in the metro area will remain steady in the long run, as the population continues to grow.

Industrial: Advancements in technology fuel demand.

We believe a "boomlet" is occurring for flex/industrial product in the Washington metro area. Two drivers are contributing to this:

- ***The cloud:*** This refers to data centers that support technological changes as to how we compute, access, and store information. As more people and companies utilize the internet, the infrastructure that supports the internet needs to increase. This in turn increases the demand for data centers. We expect this trend to continue – with particular impact on Northern Virginia.
- ***Retailing:*** More retailers are incorporating online selling into their business models. These retailers are storing merchandise in warehouse space. In addition, strictly online retailers, like Amazon, are growing and demanding more distribution space. Other retailers with an online presence also deliver their goods via industrial/distribution space.

Notably, flex/industrial product has maintained its attractiveness to investors in the Washington metro area, according to our annual Market Maker survey. Flex/Industrial assets scored a 6.3 for investment worthiness in 2012, above the investment-worthy threshold of 5.0, according to our survey. We expect this trend to continue in the long run, as technology continues to advance, coupled with a rising population.

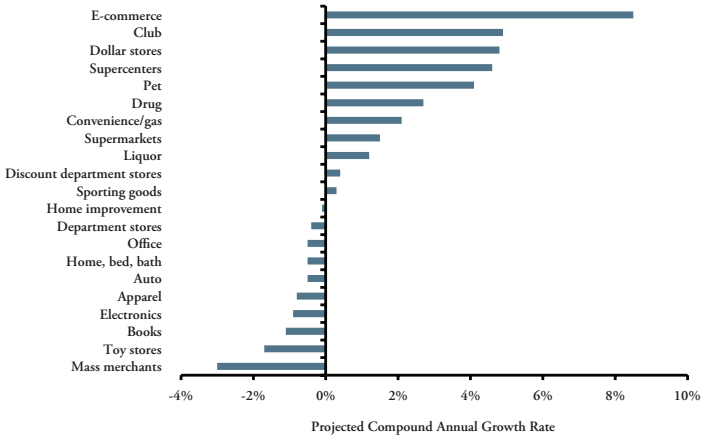
4. Barriers to entry for developers – and other businesses – are easing, adding to competition.

Combined with reduced demand for space, something that has been building for several years, local competition among economic development authorities (EDAs) has been heating up. Take a look:

"Venture capital in this region in medical innovation all goes to the other side of the river [to Montgomery County]. There's not that culture of investment here." – *Gerald Gordon, Fairfax County EDA, Washington Business Journal, 4/17/12*

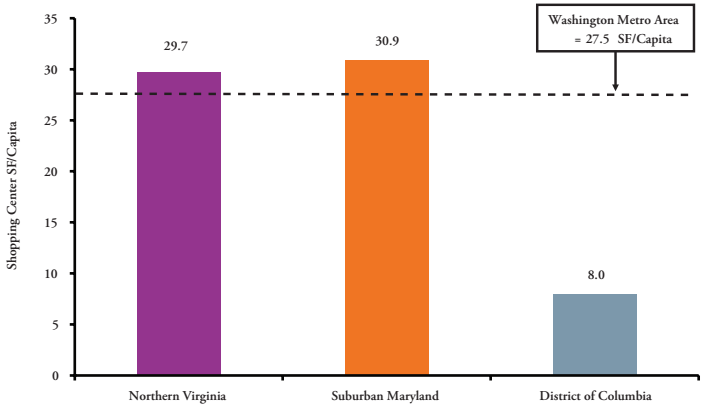
Loudoun County business leaders are considering whether the county should form an economic development authority. . . .The discussions come after the Fairfax County Economic Development Authority said last month it added more than 9,000 jobs in 2011. – *Washington Business Journal, 2/17/12*

Projected Retail Channel Annual Growth Rate
United States | 2010 - 2016



Source: Nielsen TDLinx & Nielsen Analytics, Delta Associates; January 2013.

Shopping Center Space Per Capita
Washington Metro Area | Year-End 2012



Source: CoStar, ICSC, Census, Delta Associates; January 2013.

Investment Worthiness Index – Flex/Industrial
Washington Metro Area

Source: Delta Associates' Market Maker Survey; January 2013.

Changes in Economic Development Agency Budgets
Selected Major Jurisdictions in the Washington Metro Area
Fiscal Years 2006 - 2011

Jurisdiction	2006 Budget	2011 Budget	Change
Fairfax County	$6.4	$7.0	9%
Montgomery County	$10.3	$8.3	-19%
Arlington County	$2.6	$3.1	19%
Prince William County	$1.9	$2.0	5%
City of Alexandria	$0.7	$1.4	100%

Note: In millions of dollars.
Source: County and city agencies, *Washington Business Journal,* Delta Associates; January 2013.

Prince George's County's permitting process is undergoing a major reorganization. . . . "Compare our permit process to other jurisdictions nationwide and we get an A-plus for being the most complicated. . . .Even if you're a veteran and know the process inside and out, it takes a long time." – *Haitham Hijazi, Director of Prince George's County's Department of Public Works and Transportation, The Business Monthly, 11/6/12*

"We created a new position in our county government, the Small Business Navigator, to help our business get the answers they need from our County and the Small Business Assistance program to help small businesses during times of redevelopment. We also need to be less enamored with 'the Montgomery County Way' and more open to new ideas, and the newly created position of Chief Innovation Officer should help infuse our county with fresh approaches." – *Roger Berliner, Montgomery County Council, 12/4/12*

Bechtel Corp. will receive $6.5 million from Virginia in return for moving 625 jobs from Frederick, Md., to Reston Town Center and investing $18 million in the state, Gov. Bob McDonnell announced Monday. – *Washington Business Journal, 11/7/11*

[Steven] Silverman [of Montgomery County] said he expects Virginia to try to poach [Sodexo], perhaps by offering subsidies. "The state [of Maryland] and the county will work together to work against Gov. McDonnell, because that's where the money comes from," he said. – *WashingtonPost.com, 5/27/12*

* * * * *

In a time of broad-based budget cutting, public officials know that they must broaden their tax bases in order to be able to continue providing the level of service that residents demand. This means making their jurisdictions more appealing to firms that are creating jobs. It also means reducing red tape to help the real estate community create new, desirable places – striking a balance between protecting the residential character of communities and inviting new development that will bring jobs, tax revenue, and amenities.

A symbol of this movement in public support of private development (and its often contentious citizen reception) came in 2012 when Alexandria passed the developer-friendly Waterfront Plan over the objection of much of the more conservative elements of this residential community.

Support of these EDAs means investing more resources into fighting for new jobs and projects. As shown in the adjacent table, most major economic development agencies in the region experienced budget increases during the 2006-11 period despite the intervening recession that forced budget cuts in most other discretionary departments.

Partly as a result of this increased competition, our pipelines for office and apartment development are proving troublesome. The most recent peak in the Washington metro office pipeline was in 2007, with 20.6 million SF under construction. By comparison, the pipeline peaked in the prior cycle, in 2000, at 21.3 million SF, a comparable figure. The difference is that in 2000 office absorption totaled 15.6 million SF and we were typically running at approximately 7-9 million SF per year of demand. By 2007, demand was just 5.4 million SF and had been declining for three years.

A similar story developed in the local apartment market more recently. The most recent peak in the Washington metro apartment pipeline is now, with 35,767 units under construction or planned with likely delivery in 36 months. By comparison, the pipeline peaked in the prior cycle, in 2007, at 36,952 units, a comparable figure. The difference is that in 2007 apartment absorption totaled 3,264 units and we were typically running at approximately 5,400 units per year of absorption. By 2012, absorption was just 360 units and had been declining for two years.

The combination of. . .

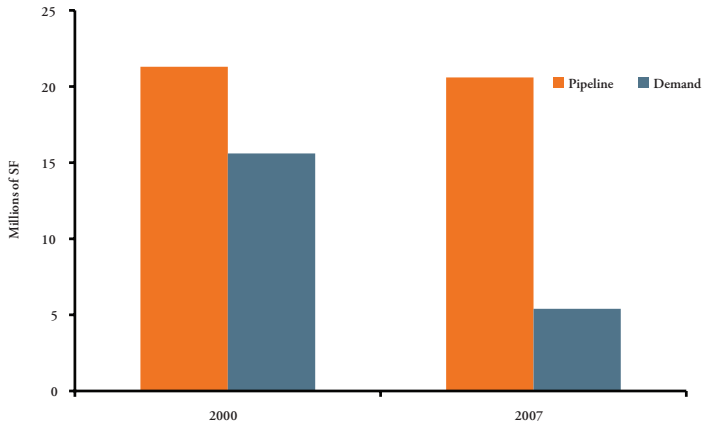
- Modest private sector demand;
- Reduced Federal spending;
- More development;
- An easier permitting process; and
- Greater economic development battles among jurisdictions within our region

. . .means the more competitive environment is not going away for the foreseeable future.

5. **These trends portend a foreseeable future that is more competitive – and will result in higher vacancy rates, lower rent growth rates, and a continuing flight to quality.**

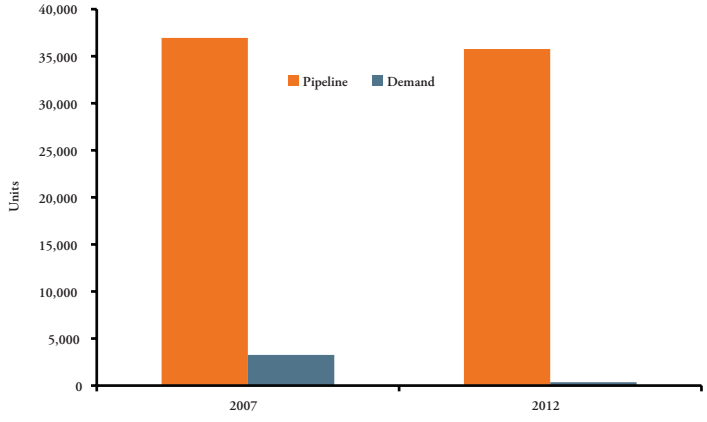
With a rising pipeline and easing of demand, what will this mean for vacancy rates and rent growth in the years ahead?

Office Pipeline vs. Demand at Cyclical Peaks
Washington Metro Area | 2000 vs. 2007



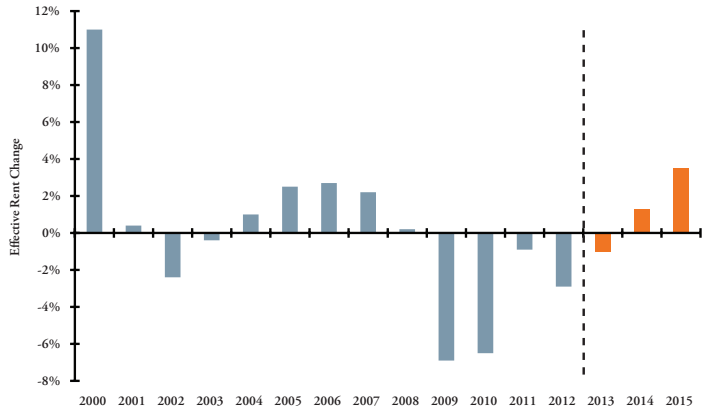
Source: Delta Associates' analysis of CoStar data; January 2013.

Apartment Pipeline vs. Demand at Cyclical Peaks
Washington Metro Area | 2007 vs. 2012



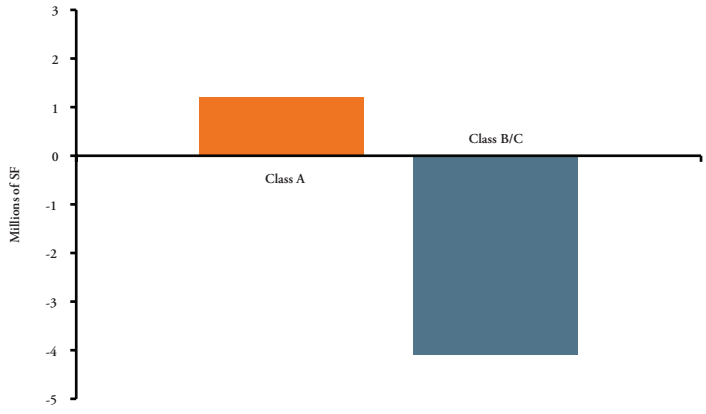
Source: Delta Associates; January 2013.

Office Effective Rent Change
Washington Metro Area



Source: Delta Associates; January 2013.

Office Demand by Class of Space
Washington Metro Area | 2012



Source: Delta Associates; January 2013.

The reset balance between supply and demand is likely to raise vacancy rates and suppress rent growth in the period ahead. While there will be variability and volatility across submarkets, let's look first at the office market:

- We expect **effective rents** to decline approximately 1% in 2013 before gaining traction and rising 1-2% in 2014. By 2015, we expect the office market to have returned to landlord conditions and rent growth of 3-4%.
- However, we do not foresee office **rent spikes** in this cycle; the confluence of factors noted earlier is not likely to allow for that.
- We do, however, expect Class A office space to remain in demand. As we saw in 2012, the recent reductions in Class A rents have encouraged a **flight to quality,** as tenants look to move into better space at limited or no additional cost compared with their prior leases. Class A net absorption across the metro area totaled positive 1.2 million SF in 2012, while net absorption for Class B and C space combined totaled negative 4.1 million SF.

For multifamily:

- 2013 is likely to see Class A apartment effective **rent change** of, on average, negative 2%, as vacancy rises. In 2014 we expect rents to edge up, with growth of positive 0.25%. By 2015, the Class A apartment market is likely to experience 1-2% rent growth. We expect to wait until 2016 before the market returns to rent growth of 4-5% – in line with the long-term average, but still less than the robust growth rate of 7.8% in 2010 that encouraged so much new supply.
- As with the office market, a **flight to quality** has occurred in the apartment market. In 2012, Class A apartment absorption totaled positive 5,073 units. The Class B apartment market, on the other hand, experienced negative net absorption of 4,713 units. We expect this pattern to continue in the period ahead as new Class A product delivers to the market and owners reduce rents to fill units.

Despite the tough competition, apartment developers still have reason to be optimistic. While the low barriers to entry have invited more new supply, the firms that relocate to the Washington metro area are creating jobs and thus demand for rental units. For example, from 2009-11, the Washington area was the top metro in the U.S. for in-migration of young adults, with over 10,000 new residents age 25-34.

Given these trends, what is the optimal strategy for achieving success in the period ahead?

6. **Success will go to those with deep pockets, a sensible capital structure, and best-in-class design, management, and marketing at superior locations.**

The champions of the future are those who best resolve the current mismatch between old designs or existing product and new tenant requirements – and who do it well at superior locations.

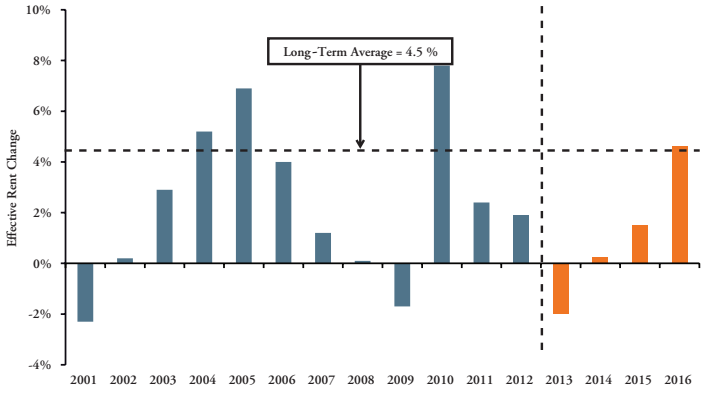
Yes, these ingredients have long added up to success – but in a more competitive market, they will be not just *helpful* but *required*. The best way to distinguish a project in the period ahead will be by connecting the design to the needs of the targeted user; this principle applies to all product types, but especially to office and apartment development – the two product types where competition will be fiercest.

The champions of the future are those who best resolve the current mismatch between old designs or existing product and new tenant requirements – and who do it well at superior locations.

Think about the changing needs of **office** tenants, which is a component of the densification trend discussed earlier. The modern tenant needs space that is built out with fewer private offices, a more efficient floor plan, flexible design, accommodations for technology, more space for collaboration, higher levels of finish to help retain staff, and other design elements that allow for fitting more people into less space than before. From parking structures to the size and speed of elevators to the neighborhood amenities, tenants will be choosier because they both can afford to be (in a competitive market) and because they must be (to reduce occupancy costs, compete with peer firms, and retain talent). Smart developers and investors will design and target projects that meet the needs of the modern tenant.

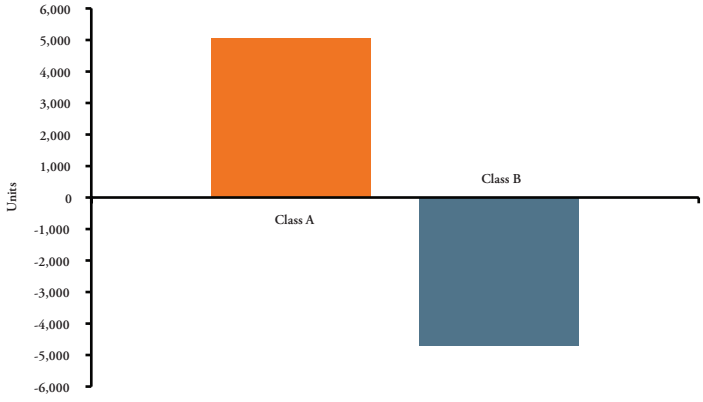
How about for **multifamily** projects? The Generation-Y cohort may be eager to exit their parents' basements, but they will be tight on funds when they do. Smaller units are most likely to appeal to the renters of the future, but amenities that they can share with their friends – from high-tech common areas to outdoor living spaces – will make up for the small units. Creative place-making will yield success. However, do not lose sight of the empty-nesters who will be renting in great numbers in the decade ahead – their needs are quite different from those of the Generation-Y cohort.

Annual Class A Apartment Rent Growth
Washington Metro Area



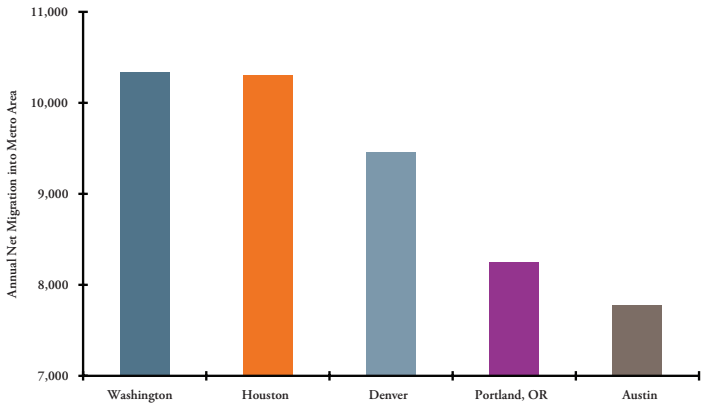
Source: Delta Associates; January 2013.

Apartment Demand by Class of Space
Washington Metro Area | 2012



Source: Delta Associates; January 2013.

Annual Net Migration of Persons Age 25-34
United States | 2009 - 2011



Note: Includes top five ranked metro areas with population over one million.
Source: Brookings Institution, Census Bureau, *Washington Post*, Delta Associates; January 2013.

These trends bode well for the **condominium** market – a less expensive form of ownership at higher-density/lifestyle locations that appeal to the 25- to 34-year-old and empty-nester cohorts – and which has a record-low pipeline.

Winners also keep an open mind:

- The Washington area's **retail** market is among the best-performing in the nation, as discussed in Section Eight, and is driven by the highest household incomes in the United States. This segment of the market was underdeveloped over the past decade, especially in certain emerging markets in the District.
- **Industrial** product, as noted in Section Five, has also been a strong performer and should not be neglected – particularly the well-located warehouse product that can serve as distribution centers for the exploding online retail market. We also need more data centers to facilitate our unquenchable thirst for downloading on our many devices. Investors should go beyond their old routines in seeking out opportunity.

Ultimately, there is demand in the Washington area for all kinds of product because of the current mismatch between existing product and new tenant requirements. Commodity product will not win the future; development that satisfies a specific need will rule the day. Success will go to those with:

- Deep pockets;
- A sensible capital structure; and
- Best-in-class design, management, and marketing at superior locations.

Ultimately, there is demand in the Washington area for all kinds of product because of the current mismatch between existing product and new tenant requirements. Commodity product will not win the future; development that satisfies a specific need will rule the day.

* * * * *

We hope the information in this report assists you in making informed decisions to meet your particular business objectives in 2013 and beyond. The balance of this report provides detailed information to support our recommendations and to enable you to be prepared for whichever approach you choose. Best wishes for success in the period ahead.

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2

The NATIONAL ECONOMY

2

The NATIONAL ECONOMY

Recovery Continues Despite Political Headwinds

Last year in ***TrendLines*** we noted "uncertainty created a pullback in consumer spending, business investment, tenant leasing, and decision-making in general, which slowed national economic growth." Although we have anticipated a slow growth recovery for three years now, we expected the sequestration decision, Bush tax cuts and debt ceiling issues would be finalized before year-end 2012, thus lifting the uncertainty that has been plaguing consumers and businesses, and allowing for more momentum going into 2013. But, that was not to be. So, uncertainty continues to prevail, affecting consumers and businesses and the national economic recovery.

Uncertainty has created a lack of momentum needed to drive the economy into a more robust recovery.

Uncertainty has created a lack of momentum needed to drive the economy into a more robust recovery. In comparison to the past three recessions, the current recovery remains sub-par. Consumers and businesses remain wary of the economy. Automatic across-the-board cuts, totaling $1.2 trillion over ten years (known as sequestration), are slated to go into effect in March 2013, as the New Year's fiscal cliff agreement merely kicked the can down the road with regard to spending cuts. This dagger has been looming over the heads of businesses and consumers since November 2011, hampering economic growth due to uncertainty.

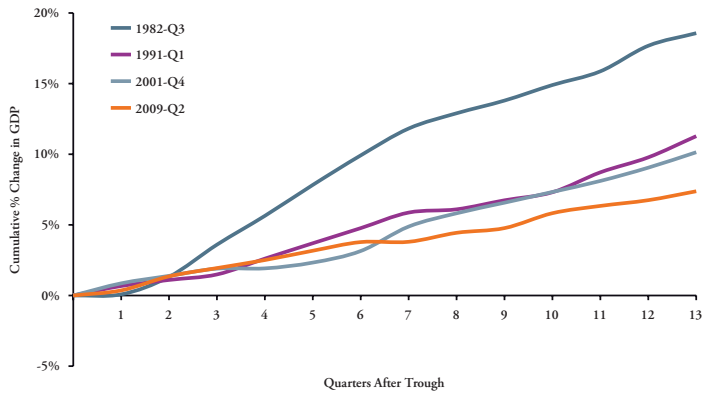
In early January 2013 Congress took action on tax cuts, but delayed making a decision on sequestration. The fiscal cliff deal will, in addition to other items:

- Keep the Bush administration's tax cuts for individuals earning less than $400,000 per year and couples earning less than $450,000.
- Raise tax rates, to the Clinton administration level, on individuals earning more than $400,000 per year and couples earning more than $450,000.
- Delay the sequestration decision for two months – until March 2013.
- Not address the debt-ceiling – which is upcoming at the time of this writing.

Sequestration refers to $1.2 trillion in spending cuts - 50% from defense and 50% from domestic programs - that are mandated by the Budget Control Act of 2011 and set to take effect in March 2013. With this decision still looming, businesses and consumers remain cautious about spending, which continues to hamper economic growth. Although the projected Federal deficit will be reduced if sequestration goes into effect, this will come at a severe cost to an already sluggish economy.

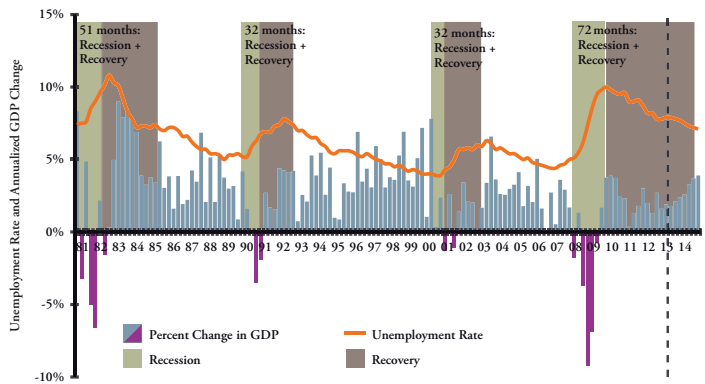
Economic conditions point to a sluggish economy, not a stalled economy. Sluggish economic growth is likely the new normal for periods of economic "expansion" in the period ahead. So, business success could be measured by how commerce adapts to this new slower-growth economic environment.

GDP Recovery Patterns After the Past Four Recessions
United States



Source: Bureau of Economic Analysis, Center for Regional Analysis, Delta Associates; January 2013.

Economic Trends and Forecast
United States



Source: BLS, BEA, Center for Regional Analysis, Global Insight, Delta Associates; January 2013.

And so also for those in the commercial real estate business – adapting to slower growth and lower levels of demand. Combine these lower levels of demand with shifts in the type of real estate in demand brought about by lifestyle and demographic changes, and therein lies the challenges and opportunities we see in the period ahead. These shifts are creating rapid obsolescence and therefore demand for replacement real estate. They include:

- Smaller household sizes – making our existing housing stock and on-the-shelf designs less attractive to the "new" tenant and buyer.
- Bifurcated age demographics – an increase in age cohorts 25 to 34 and those over 55 – making for robust retailing opportunities and housing challenges.
- Densification of office space – making for less demand for office space.
- Growth of jobs that do not require as much traditional office space – making for weaker office markets but stronger retail and industrial space and at-home office space.
- Growth in on-line commerce, making for greater demand for industrial space.
- Continued influence of the Millennials (Generation Y) – with less dependence on/support of the automobile, kitchen, and traditional suburb.
- Aging of the Boomers – and their increasing need for retirement living and aging services including medical care.

These are the economic and business challenges and opportunities we see in the period ahead.

Now, for a look at the components that make up our economy:

Payroll Jobs

The national economy added approximately 1.8 million new jobs during the 12 months ending December 2012, with the private sector adding over 1.9 million new jobs compared to the public sector shedding 68,000 positions. Month-to-month gains have surpassed economists' expectations, as 155,000 jobs were added to the economy during the month of December. However, job gains have been disappointing compared to past economic recoveries. Approximately 125,000 jobs must be created per month just to keep the unemployment rate steady. Although the economy continues to move forward, it does so at a sub-par pace. This sub-par pace will encourage businesses and consumers to alter spending patterns to adjust to limited growth. We expect muted job growth in the near-term. We expect approximately 1.9 million new jobs will be created in 2013, assuming our politicians do not derail the economy and compromise on two key items during the first half of 2013:

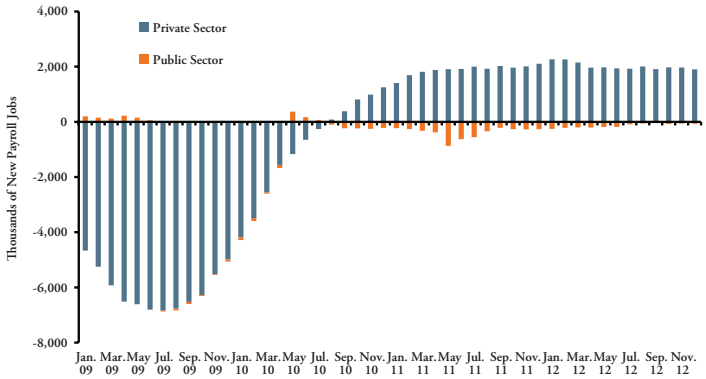
- Sequestration – $1.2 trillion of mandated budget cuts
- The debt ceiling

Companies remain cautious in hiring, as they take a wait-and-see approach. Furthermore, many companies do not need to hire back laid-off employees, as productivity gains have eliminated many jobs.

During the 12 months ending December 2012, the top three sectors in job gains were Professional/Business Services, Education/Health, and Leisure/Hospitality – adding a total of 1.2 million new jobs. The Federal government shed the most workers over the past year – cutting 42,000 positions. The State and Local Government workforce followed with 26,000 positions cuts over the 12 months ending in December.

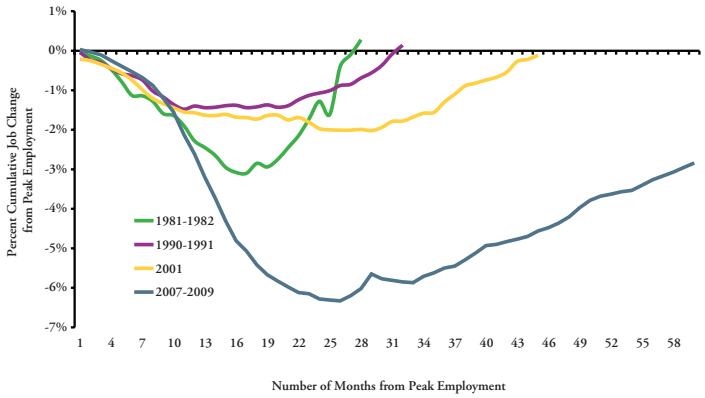
The Bureau of Labor Statistics projects that the economy will add 19.7 million nonfarm payroll jobs through 2020, for an average annual growth rate of 1.4%. This growth rate compares to a 1.0% annual average over the past 20 years. Education/Health is projected to be the leader in job growth through 2020, adding 6.5 million jobs. Professional/Business Services follows, adding 3.8 million positions. Although the Construction sector ranks third for the number of jobs added, this sector suffered severe job loss during the 2008 downturn and likely will remain below its pre-recession employment level in 2020.

Payroll Job Growth
United States | Year-Over-Year



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

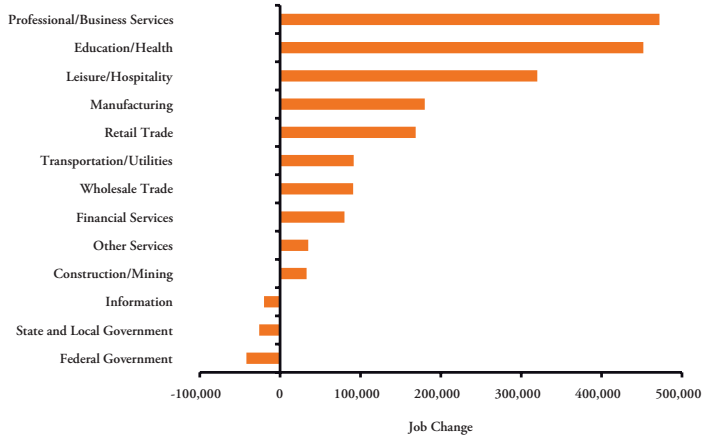
Cumulative Job Loss After Peak
A Look at Past Recessions | United States



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Payroll Job Growth

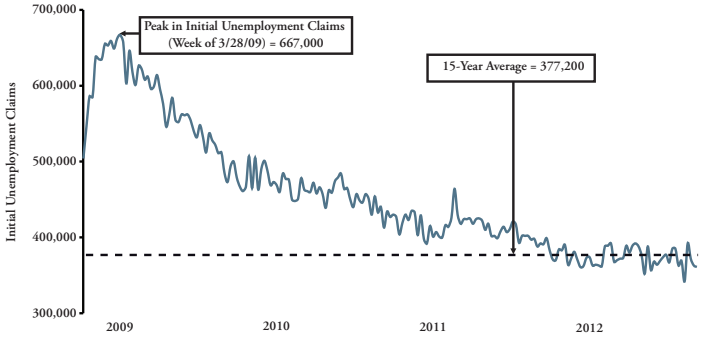
United States | 12 Months Ending December 2012



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Initial Unemployment Claims

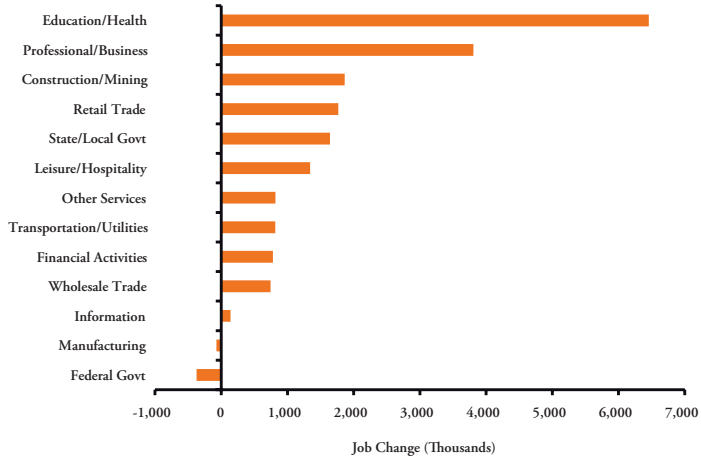
United States | Four-Week Moving Average



Note: Data are seasonally adjusted.
Source: Department of Labor, Delta Associates; January 2013.

Projected Payroll Job Growth

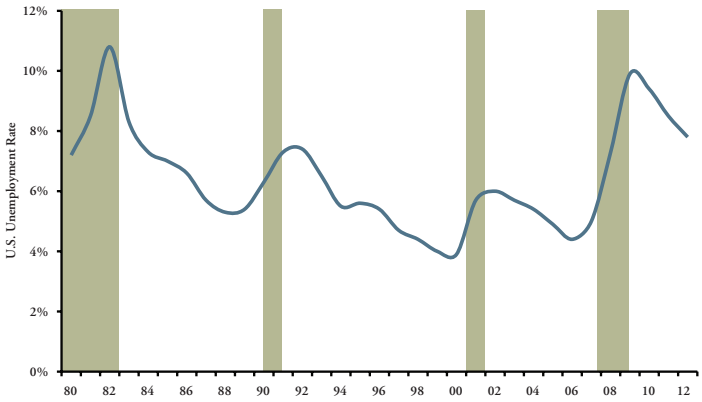
United States | December 2010 - December 2020



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Unemployment Rate

United States



Note: Through December 2012; seasonally adjusted; shaded bars represent recessions.
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

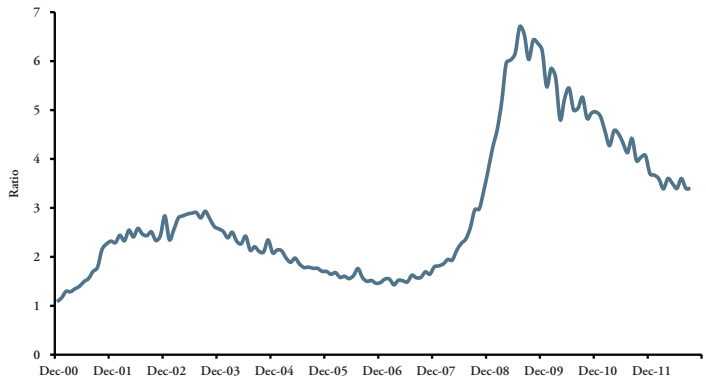
Initial unemployment claims have bounced around the 15-year average since the start of 2012. At the end of December initial claims fell to 360,000 based on a 4-week moving average. This compares to the 15-year average of 377,000. We expect claims to hover at the current level into 2013.

The **unemployment rate** has ticked down to 7.8% as of December 2012 from 8.5% one year ago. Although this decline provides optimism for the economy, it should be viewed cautiously, as the decline was due in part to people giving up looking for work and dropping out of the workforce. We anticipate that the unemployment rate will stay in the 7.5% to 8.0% range during 2013 assuming agreement to avoid the sequestration and debt ceiling fiscal cliff is reached in the first few months of 2013. We do not expect that the unemployment rate will edge down materially in the short run, as formerly discouraged job applicants will start the application process again.

Job Seekers Ratio: A telling barometer of the economy is the ratio of job seekers (applicants) to job openings. This ratio peaked during the recession (in July 2009) at 6.7 applicants for every job opening. As of September 2012, for every job opening there were 3.4 applicants. This is still above the 10-year average of 3.1, but considerable progress from the depths of the recession.

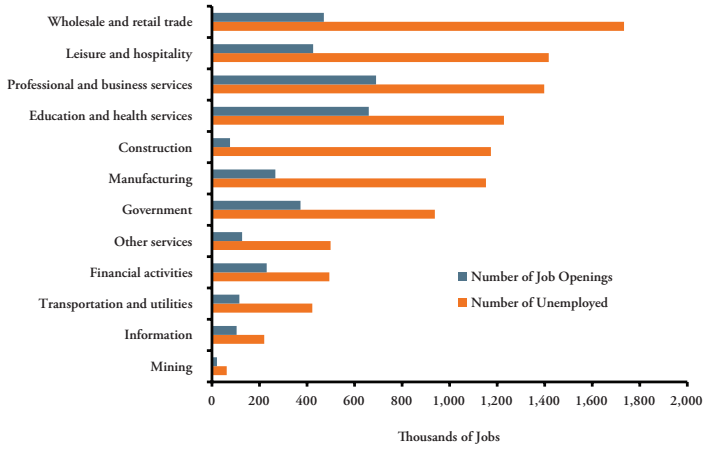
Drilling down to job sectors, there are too many potential applicants for too few jobs within each sector. This gap is most apparent in the construction sector, where for every job opening, there are 15.5 potential applicants. Although BLS projects that the Construction sector will add over 1.8 million jobs from 2010 through 2020, this sector suffered severe job losses during the downturn, and it will still be below its pre-recession employment level in 2020. This will force many unemployed construction workers to revamp their skill sets in order to be hirable by another sector. In comparison, the Education and Health Services sector has just 1.9 applicants per job opening.

Job-Seekers Ratio
United States



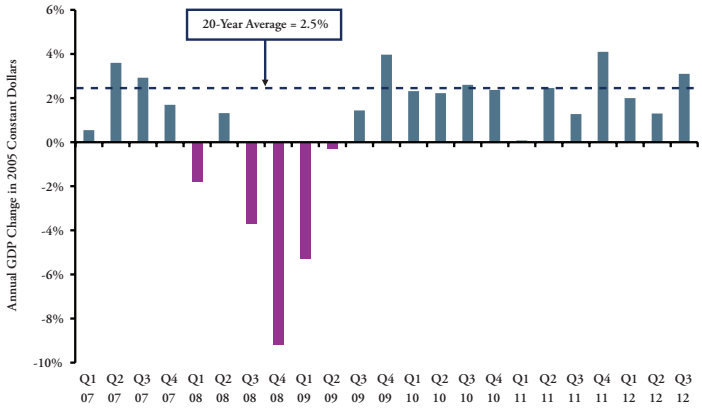
Note: Through September 2012.
Source: Bureau of Labor Statistics, Economic Policy Institute, Delta Associates; January 2013.

Number of Unemployed vs. Job Openings
12-Month Average Ending September 2012



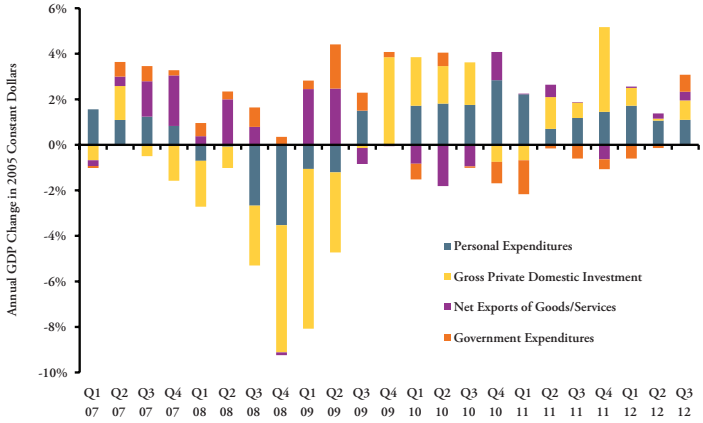
Source: Bureau of Labor Statistics, Economic Policy Institute, Delta Associates; January 2013.

GDP Percent Change
United States



Note: Annualized.
Source: Bureau of Economic Analysis, Delta Associates; January 2013.

Contributions to U.S. GDP Percent Change
United States



Note: Annualized.
Source: Bureau of Economic Analysis, Delta Associates; January 2013.

Gross Domestic Product (GDP) and Consumption

GDP increased at a 3.1% annualized rate during the 3rd quarter of 2012, compared to rising 1.3% during the 2nd quarter. The 20-year annual average growth rate is 2.5%. The rise in GDP during the 3rd quarter is the 13th consecutive quarter that the economy has expanded. Although the economy continues to make gains, the growth rate remains volatile. We anticipate GDP growth in 2012 will total around 2.2% when the data is finalized, which is above the increase of 1.8% achieved during 2011, but below the pace needed to significantly lower the unemployment rate and improve the national standard of living.

GDP growth during the 3rd quarter was due to personal expenditures and private domestic investment. The Government and exports contributed to growth during the 3rd quarter, a turnaround from earlier in the year. Although growth has benefited from gains in consumer spending and equipment investment, these fundamentals have improved at a pace below the average of prior recoveries.

Households are currently under stress, as the unemployment rate remains elevated, prices are on the rise, and home values remain depressed, despite a modest rebound. According to the household stress index, which accounts for the rate of inflation, unemployment, and real estate values, households experienced a rise in stress during 2011.

The index peaked at 26 during 2008, as home values experienced a steep decline and unemployment was elevated. Although the index declined during 2009 as home values and unemployment stabilized, it climbed again in late 2010 and into 2011, as prices on consumer goods increased and housing values took another hit – although not as drastic as in 2008.

Consumer stress declined below the long-term average in 2012 and should decline further during 2013 and 2014, as economic conditions improve. This bodes well for consumer spending and a boost to GDP.

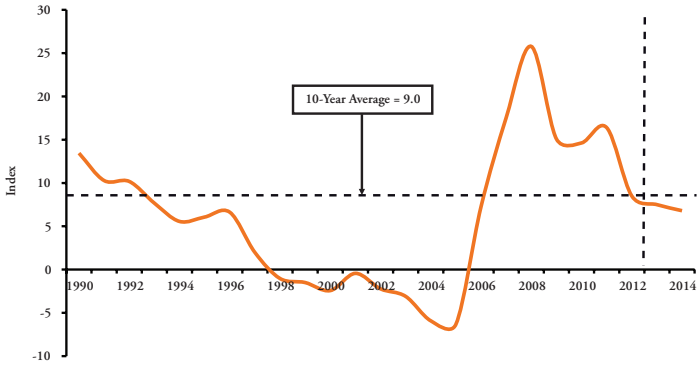
Compared to past recoveries, consumer spending will not be a strong economic driver during this recovery period. With consumer spending responsible for 70% of U.S. GDP, growth in consumer spending is essential for a more robust domestic recovery.

Although **consumer spending** is helping to boost GDP, spending has been restrained due to below average consumer confidence. The University of Michigan Consumer Sentiment Index tallied 74.5 as of December 2012, below the 20-year average of 88.2. Consumer sentiment edged down in December, likely due to concern about the possibility of higher taxes in 2013 as fiscal cliff negotiations continued. Weak consumer sentiment continues to hamper spending, as consumer expenditures rose 1.8% on a year-over-year basis during the 3rd quarter of 2012, excluding auto and gas purchases. This rate is below the 15-year average of 2.9%.

Consumer spending remains below average due in part to the decline in personal net worth during the recession. And the recovery in net worth since then has been lumpy. Households lost over $17 trillion in **personal wealth** from the 4th quarter of 2007 to the 1st quarter of 2009. Although households have regained some of the assets lost, gains have been uneven and it will take several years to recoup the total amount. Household net worth increased $1.7 trillion during the 3rd quarter of 2012, after declining $157 billion during the 2nd quarter. Americans continue to struggle to recover what was lost during the downturn, as median net worth dropped 40%, from $126,400/person in 2007 to $77,300/person in 2010, according to the Federal Reserve. This decline in net worth puts downward pressure on spending, as Americans remain cautious until a broader recovery and rebuilding of net worth is achieved.

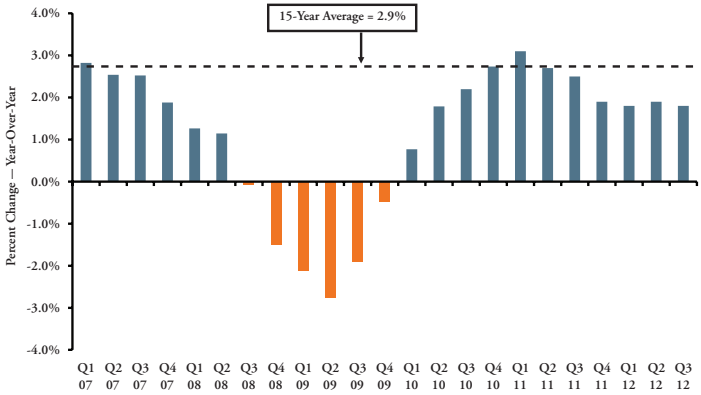
U.S. companies are sitting on piles of cash, waiting for clear signals that the economy is on a consistent recovery path. Corporate profits rose 7.5% during the 12 months ending during the 3rd quarter of 2012 and are estimated to total $1.97 trillion for the year. Companies have the resources to hire but remain wary about future demand for their products and services. In addition, with sluggish consumer demand, companies have enough labor to keep pace.

Household Stress Index
United States



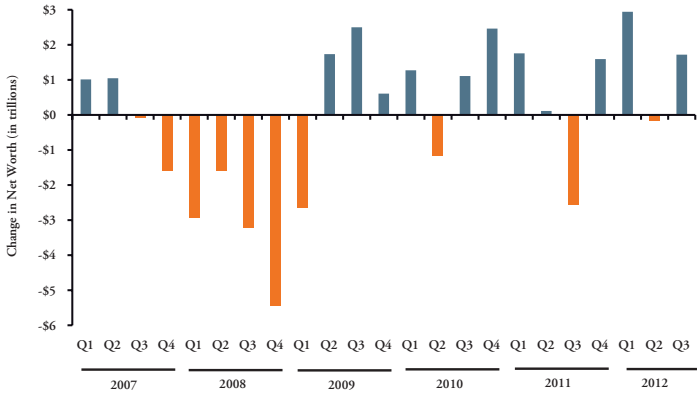
Note: 2012 - 2014 figures are estimates/projections
Source: Bureau of Labor Statistics, Case/Shiller, PNC, Delta Associates; January 2013.

U.S. Personal Consumption Expenditures
Constant Dollars



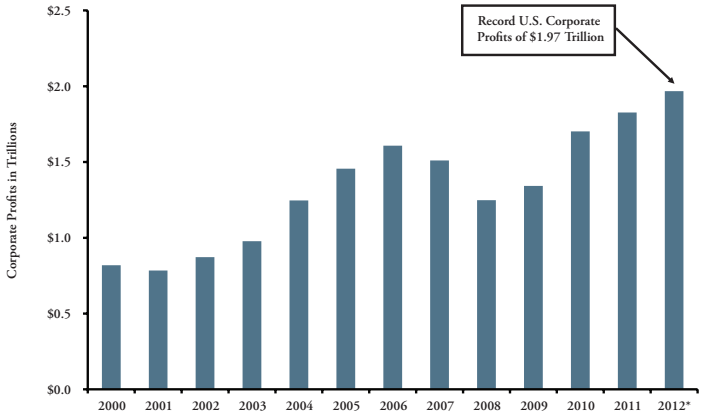
Note: Excludes auto/auto parts and gasoline.
Source: Bureau of Economic Analysis, Delta Associates; January 2013.

Change in Household Net Worth
United States



Source: Federal Reserve, Delta Associates; January 2013.

Corporate Profits
United States



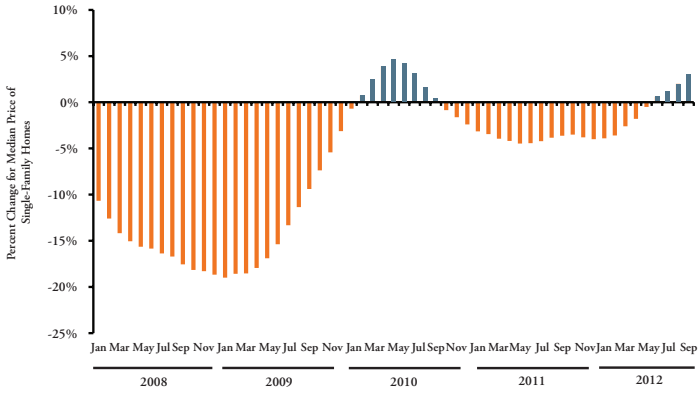
* Through Q3 2012; seasonally adjusted at annual rates.
Source: Bureau of Economic Analysis, Delta Associates; January 2013.

Housing Market

Home prices in the 20 major metro areas increased 3.0% during the 12 months ending September 2012, the most recent data available, according to S&P/Case-Shiller. The housing market is gradually gaining traction after years of sub-par performance. We expect home prices to continue to edge higher in 2013, though year-over-year gains may be muted by continuing uncertainty in the economy and sluggish employment growth.

The number of U.S. home sales increased to 5.0 million (on an annualized basis) during November 2012, compared to 4.3 million during 2011. However, the number of sales is well below the level achieved at the peak of the market. The U.S. sales price averaged $229,500 during November 2012, up 9.1% from one year earlier, according to the National Association of Realtors. Prices have risen on existing home sales, as inventory has declined from 7.1 months of supply in November 2011 to 4.8 months at November 2012. This low level is more a reflection of homeowners not putting their house on the market given the value of their home has not increased enough to justify the sale. In many cases, homeowners have negative equity, meaning their home is worth less than the remaining balance on the mortgage. However, on balance, national housing conditions are markedly improved.

Annual Change in Existing Home Sale Prices
United States



Source: S&P/Case-Shiller, Delta Associates; January 2013.

Federal Intervention and Inflation

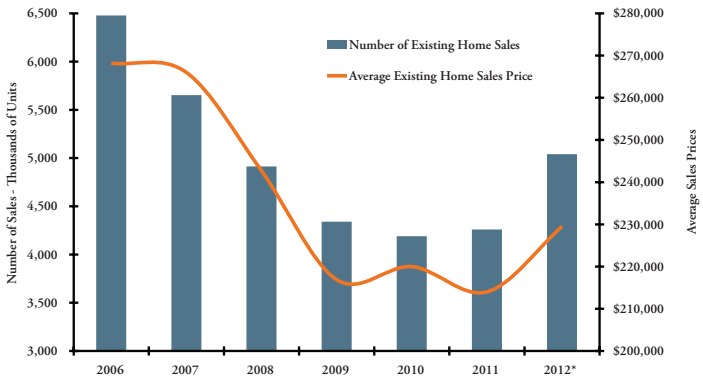
Notwithstanding the debate over the Federal budget, the Federal government continues to implement programs to sustain the national economy, vowing to do what it takes to keep the economy on track.

The Federal Reserve has kept the Federal Funds Rate at its current low level, as some business sectors continue to shed jobs. Given the economy continues to grow at a slow pace, the Fed plans to keep short-term rates at its current range of 0% to 0.25% until the unemployment rate drops to 6.5% or inflation is an issue. Between little pressure in the economy and the Fed's commitment, we see a low probability of a meaningful increase in short-term interest rates until mid-decade. However, long-term interest rates are exposed to different factors. Long-term rates could increase if our foreign bond holders trade out of U.S. debt at an unexpected rate. In turn, that could be related to the coming debt ceiling debate. That would be a very costly consequence of a dysfunctional Federal government display in February when this issue comes to a head.

Regarding inflation, prices increased 1.8% during the 12 months ending November 2012. The main driver of this low inflation rate is a notable decline in gas prices since the spring. Overall, we expect inflation to be contained in the near-term due to elevated unemployment and limited income growth, which will continue to cause lackluster consumer spending. Given this, coupled with appropriate monetary measures, inflation should remain controlled around 2.3% during 2013. If employment growth and consumer spending accelerate in 2013 inflation may accelerate in turn. Many observers believe that the current Fed policy will lead to inflation by the end of the decade. But in the short run we appear insulated from the pressures.

Existing Home Sales vs. Sales Price

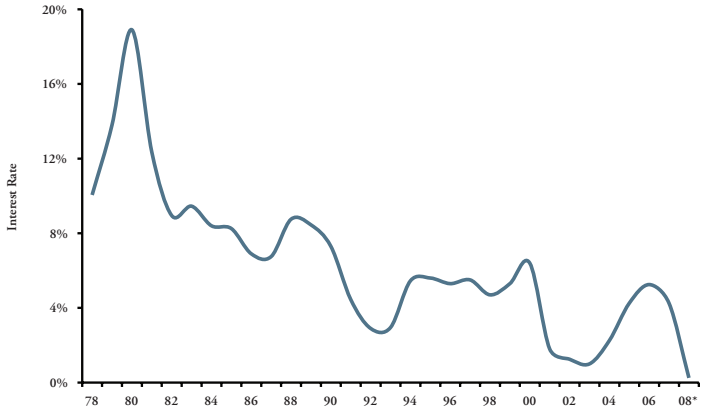
United States



* Annualized sales rate at November 2012.
Source: National Association of Realtors, Delta Associates; January 2013.

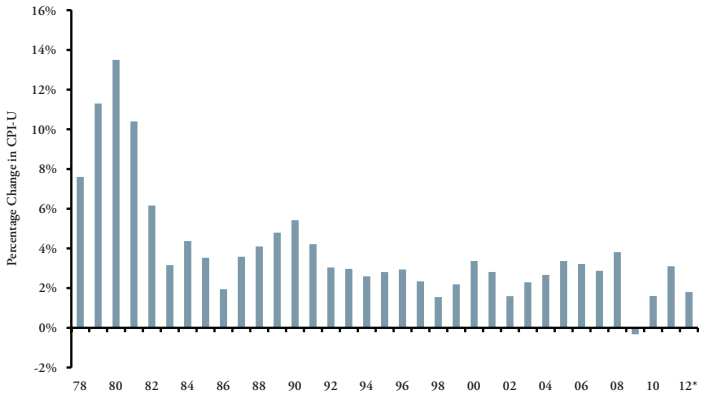
Federal Funds Rate

United States



* Unchanged since December 16, 2008.
Source: Federal Reserve Board, Delta Associates; January 2013.

Inflation
United States



* 12-month percentage change through October 2012.
Note: Data is seasonally adjusted.
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

U.S. Payroll Job Growth

Year	Job Change	% Change
2012*	1,835,000	1.4%
2011	1,503,000	1.2%
2010	-931,000	-0.7%
2009	-6,008,000	-4.4%
2008	-800,000	-0.6%
2007	1,504,000	1.1%
2006	2,397,000	1.8%
2005	2,275,000	1.7%
2004	1,423,000	1.1%
2003	-344,000	-0.3%
2002	-1,489,000	-1.1%

* Change for 12 months ending in December 2012; others are comparisons of annual averages. Note that BLS has rebenchmarked figures since their initial publication; the figures presented above are the most recent estimates.

National Economic Outlook

We believe the national economy will continue to experience a steady but slow recovery over the next several years, if politicians do not get in the way.

Specifically, we believe the economic outlook is as follows:

- GDP growth: 2.0% to 2.2% in 2013.
- Payroll jobs: 1.6 to 2.0 million added in 2013.
- Unemployment rate: hovering in the 7.5% to 8.0% range throughout 2013.
- Federal Funds Rate: 0% to 0.25% through year-end 2015.
- Long-term interest rates: steady to slightly rising in 2013.
- Inflation rate: 2.3% during 2013; edging higher in 2014 as consumer demand strengthens.

National Payroll Job Growth Summary

The U.S. economy gained 1.8 million payroll jobs over the 12 months ending December 2012. This represents an increase of 1.4%. This compares to the 25-year annual average of 1.3 million jobs at a 1.1% average growth rate.

12-Month Payroll Employment Change Through November 2012

Metro Area	Job Change #	Job Change %
LA Basin		
Los Angeles/Long Beach/Glendale	68,100	1.8%
Orange County (Santa Ana/Anaheim/Irvine)	16,700	1.2%
Riverside/San Bernardino/Ontario	11,000	1.0%
Subtotal LA Basin	95,800	1.5%
Houston	85,300	3.2%
San Francisco Bay Area		
San Jose/Sunnyvale/Santa Clara	32,600	3.7%
San Francisco/San Mateo/Redwood City	32,400	3.4%
Oakland/Fremont/Hayward	18,600	1.9%
Subtotal Bay Area	83,600	3.0%
Dallas/Ft. Worth	72,600	2.5%
New York	66,800	0.8%
Boston (Metropolitan NECTA)	52,200	2.1%
Phoenix	50,700	2.9%
Seattle	46,400	2.7%
Denver-Boulder	39,700	0.9%
Chicago	37,200	0.9%
Austin	35,300	4.4%
Washington, DC	34,300	1.1%
Atlanta	33,900	1.5%
Minneapolis-St. Paul	29,900	1.7%
San Diego	24,600	2.0%
Cincinnati	23,700	2.4%
Philadelphi	23,700	0.9%
Tampa-St. Pete	22,900	2.0%

Metro Area	Job Change #	Job Change %
Charlotte	22,900	2.7%
Orlando	21,400	2.1%
San Antonio	21,000	2.5%
Columbus (OH)	19,800	2.1%
Oklahoma City	18,100	3.1%
Salt Lake City	17,700	2.8%
Raleigh-Durham	15,400	1.9%
Portland (OR)	15,300	1.5%
St. Louis	14,600	1.1%
South Florida		
West Palm Beach/Boca Raton	5,700	1.1%
Fort Lauderdale	5,300	0.7%
Miami/Miami Beach/Kendall	1,600	0.2%
Subtotal South Florida	12,600	0.6%
Detroit (Detroit/Warren/Livonia)	12,200	0.7%
Cleveland	10,700	1.1%
Pittsburgh	8,500	0.7%
Indianapolis	8,100	0.9%
Baltimore	6,700	0.5%
Las Vegas	6,300	0.8%
Sacramento	6,000	0.7%
Jacksonville	5,400	0.9%
Nashville	3,700	0.5%
Kansas City	2,400	0.2%
Memphis	(400)	-0.1%
New Orleans	(800)	-0.2%

Source: Bureau of Labor Statistics, Delta Associates; January 2013.


MAN

3

The Washington Area
ECONOMY

3

The Washington Area ECONOMY

Regional Economy Hesitates Until More of Fiscal Cliff Resolved

Last year in ***TrendLines*** we stated that "uncertainty pervades the region as to the impact of proposed cuts in the Federal budget." This continues to impact the local economy, as consumers and businesses delayed major decisions until the future is clearer. Yet, the private sector made some impressive gains in spite of the Federal government being on pause.

Consumers and businesses remain wary of the Washington metro area economy. Automatic across-the-board cuts, totaling $1.2 trillion over ten years, are slated to go into effect in March 2013, as the New Year's fiscal cliff agreement merely kicked the can down the road with regard to spending cuts. This dagger has been looming over the heads of businesses and consumers since November 2011, hampering economic growth due to uncertainty. As of now, half the cuts will come from the Defense budget and half from the Domestic budget. We expect growth in the Washington region to remain sluggish during the 1st half of 2013, with the economy generating greater momentum during the 2nd half of 2013.

For an expansion cycle, the Washington metro area experienced slow growth during 2012. Payroll employment increased 34,300 during the 12 months ending November 2012, compared to job growth associated with prior expansion cycles of 60,000 to 80,000 jobs per annum. As a result, this expansion feels anemic by comparison. But 34,300 job growth is capable of sustaining a commercial real estate market of considerable scale. Just not the scale we have been used to in prior recoveries.

At November 2012 the unemployment rate remains the lowest in the nation among major metros, at 5.0%. And some employers are reporting difficulty in filling positions in cyber-security and health care – two rapidly growing industry sectors. The good news in all of this is the Washington metro area has been shifting away from its dependence on the Federal government, and we believe the long-term outlook for the Washington metro area is strong – particularly for the Professional/Business Services sector which will drive the economy in the period ahead. The Washington area will experience long-term growth due its strengths such as a highly educated work force, a diversified economy (as compared to the dependence of the region on the Federal establishment in the 1970s), growing tech and health care industries, a high quality of life, a strong housing market with sustained values, and as a destination for corporate and association headquarters moves. These are the things that are sustaining the region now and will sustain its growth in the period ahead.

Payroll Jobs

With 3.1 million payroll jobs, the Washington metro area ranks the fourth-largest job market among metro areas, behind New York, the LA Basin and Chicago. The Washington metro area economy added 34,300 new positions during the 12 months ending November 2012. This number is just below the 20-year annual average of 39,800 but is modest compared to past recovery cycles which averaged 60,000 to 80,000 jobs per annum.

Although the Washington metro area added 34,300 new jobs during the past 12 months, other metro areas continue to outpace it in job gains. LA Basin, Houston, and SF Bay top the list job growth, spurred by growth in Professional/Business Services and Health/Education. Although LA Basin and SF Bay continue to play catch-up, adding back jobs lost during the downturn, Houston's job growth is being fueled by the Energy and Trade/Transportation sectors.

Economic Highlights

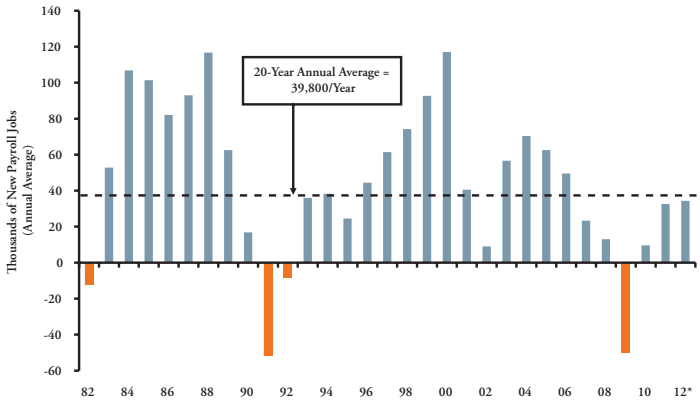
Washington Metro Area | Year-End 2012

Payroll Employment: 3.1 million at November 2012.
Job Change: grew 34,300 during the 12 months ending November 2012. Compares to 39,800/annum long-term average.
Unemployment Rate: 5.0% at November 2012, down from 5.3% one year ago and lowest among the nation's largest metro areas.
Inflation: prices increased 2.1% during the 12 months ending November 2012.
Housing Prices: increased 3.2% during the 12 months ending September 2012.

Source: Bureau of Labor Statistics, S&P/Case Shiller, Delta Associates; January 2013.

Payroll Job Growth

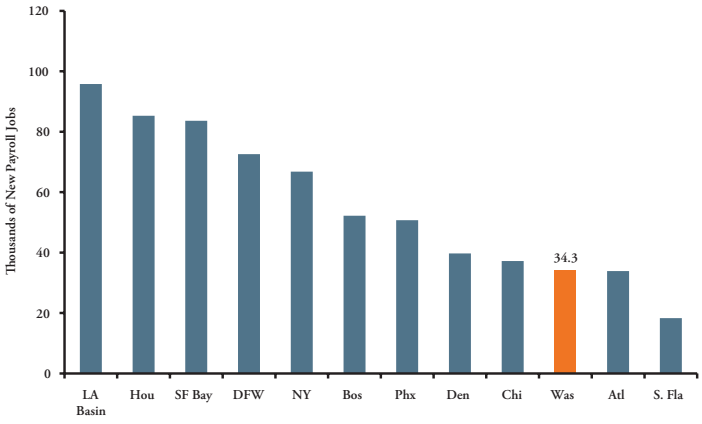
Washington Metro Area



* 12 months ending in November 2012.
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Payroll Job Growth

Large Metro Areas | 12 Months Ending November 2012



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Payroll Jobs by Sector

The Professional/Business Services and Government sectors drive the Washington Metro Area, as these sectors each represent 23% of the total payroll jobs. This compares to the national economy, with the Professional/Business Services and Government sectors representing 13% and 17% of the total workforce, respectively.

There are important differences in job growth by sector occurring in the Washington metro area. The service-providing industries are made up of such industries as Professional/Business Services and Financial Activities. They created 36,300 new positions during the 12 months ending November 2012. This compares to the goods-producing sectors, made up of such industries as Construction and Manufacturing, which cut 2,000 positions.

The top three sectors leading job growth are Education/Health, State/Local Government, and Professional/Business Services – with a total of 32,700 new jobs added to the economy in these three sectors alone.

The **Education/Health** sector gained 11,300 jobs in the previous 12 months, which is above the 20-year annual average of 8,300 new positions. Almost half of these positions were created in the District of Columbia, primarily within the health sector.

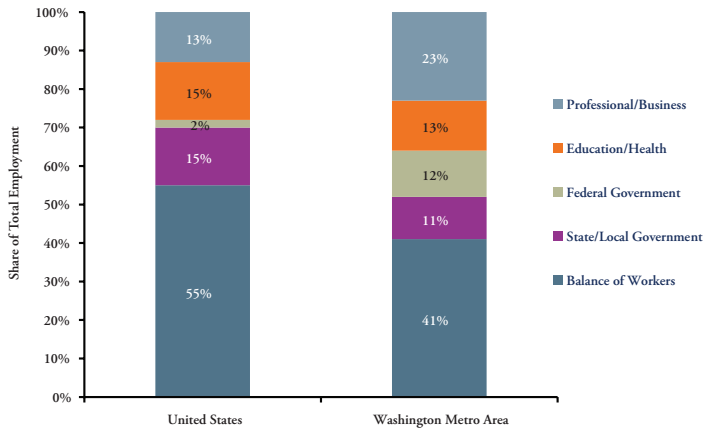
The **State/Local Government** sector gained 10,900 jobs during the 12 months ending November 2012, which is well above the 20-year annual average of 3,600 new positions. The bulk of positions were added to the local government in Northern Virginia, as 8,600 positions were added during the past year. This sector is currently adding back jobs that were lost during the downturn.

The **Professional/Business Services** sector gained 10,500 jobs during the last 12 months, which is below the 20-year annual average of 16,300 new positions. The Professional, Scientific, and Technical Services subsector added 8,500 of these jobs. Although this sector is making gains, it remains subpar compared to past recovery cycles.

Notably, the **Federal Government** sector lost 4,200 jobs during the 12 months ending November 2012, as agencies tighten spending due to Federal austerity measures. Just over half of these job cuts occurred in the District of Columbia. The Federal government is not laying off workers; rather, a hiring freeze has prevented hiring for vacated positions due to retirement or workers leaving for other positions outside the Federal government.

Employment Base

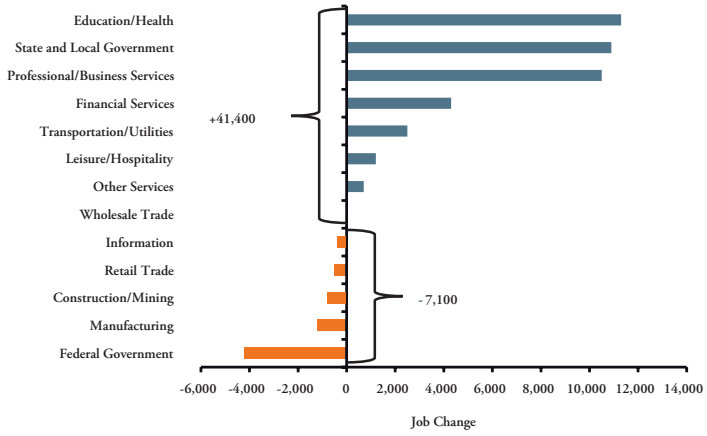
United States vs. Washington Metro Area | At November 2012



Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Payroll Job Growth

Washington Metro Area | 12 Months Ending November 2012



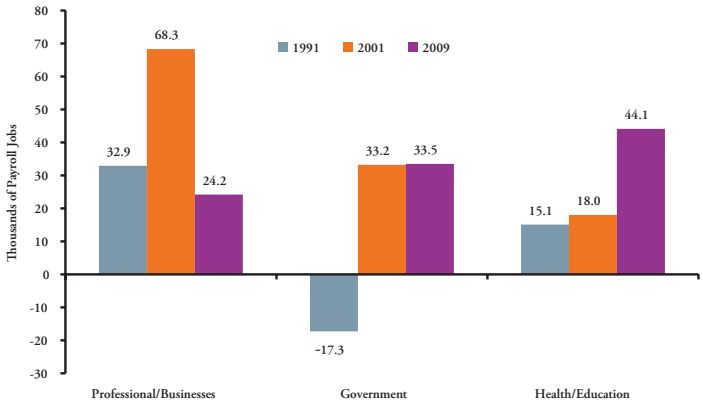
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Trends in Employment by Major Sector
Washington Metro Area

	November 2012	12-Month Change	20-Year Annual Average
Prof/Business	701.6	10.5	8.3
Edu/Health	390.3	11.3	16.3
Federal Gov't	378.8	(4.2)	3.6
St./Local Gov't	328.4	10.9	0.6
Leisure/Hosp.	270.5	1.2	1.5
Retail Trade	260.1	(0.5)	(0.1)
Other	183.7	0.7	3.6
Financial	151.6	4.3	4.5
Construction	145.5	(0.8)	(0.1)
Information	79.9	(0.4)	1.1
Wholesale	63.2	0.0	(0.9)
Trans/Utilities	62.6	2.5	0.0
Manufacturing	48.6	(1.2)	1.4
Total	**3064.8**	**34.3**	**39.8**

Note: In thousands of payroll jobs.
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Payroll Job Growth by Select Sectors
Washington Metro Area | Comparison to Past Recoveries



Note: Job growth total for 41 months after trough.
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

The largest sectors within the Washington metro area are Professional/Business Services, Government, and Education/Health. The adjacent graph explores job growth within each of these sectors during the 41 months following the trough of recent recessions.

- Compared to past recovery cycles, job growth in the **Professional/Business Services** sector is lackluster. This sector added 24,200 jobs since the trough of the 2009 recession. This compares to 68,300 jobs added after the trough of the 2001 recession, and 32,900 jobs added after the trough of the 1991 recession.
- Although job gains in the **Government** sector since the trough of the 2009 recession mirrors the gains made since the trough of the 2001 recession, the current gains were made early in the recovery cycle and job growth in this sector is now waning as austerity measures continue to be implemented.
- Growth in the **Health/Education** sector has outpaced growth experienced after the 2001 and 1991 recessions. This sector added 44,100 jobs since the trough of the 2009 recession. This compares to 18,000 jobs added after the trough of the 2001 recession, and 15,100 jobs added after the trough of the 1991 recession.

Although the Professional/Business Services sector is currently experiencing lackluster growth, we expect this sector to significantly pick up steam in the near-term. Through 2017, we expect the Professional/Business Services sector to far exceed the other sectors in job creation with over 143,000 jobs added during this period. We expect most of these positions to be created in the Management, Scientific, and Technical Consulting Services and Computer Systems Design and Related Services sectors. As the Federal sector sheds 22,000 jobs during this period, another sector has to pick up steam in order to keep the local economy churning. Also, helping to churn the economy will be the Construction sector, adding 55,400 jobs during this period as housing demand ramps up and the Education/Health sectors with 38,800 new jobs.

Unemployment Rate

The Washington area unemployment rate was 5.0% at November 2012, down from 5.3% one year ago. This compares to the national rate of 7.8% in November and December 2012. The Washington metro area has the lowest unemployment rate among the nation's largest metro areas. The Washington metro area unemployment rate peaked in January 2010, at 7.0%, and has since declined, albeit unevenly.

Housing Prices

House prices increased 3.2% in the Washington metro area during the 12 months ending September 2012, according to the S&P/Case-Shiller Home Price Index. This compares to a rise of 3.0% in the 20 MSA Composite Index.

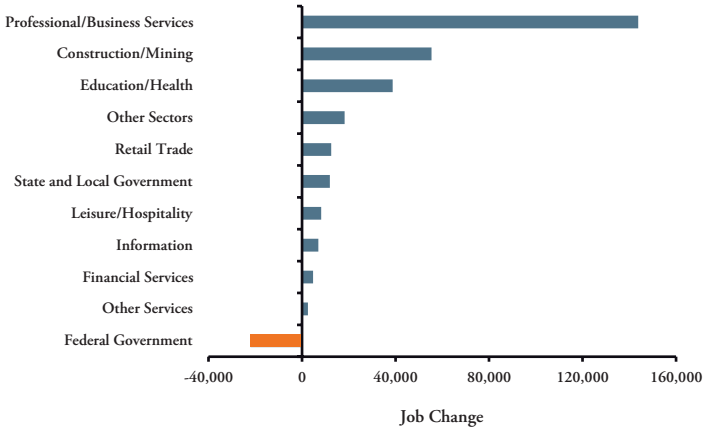
The Washington metro median home price was 3.2 times the median household income as of the 3rd quarter of 2012, above the U.S. ratio of 2.8. Nationally, home price growth outpaced income growth from 2000 to 2006. Prices started to decline in 2007 due to the Credit Crunch. The national recession further impacted home prices, as the credit markets froze and job losses increased foreclosures. The recession brought about a much-needed correction in housing affordability. Nationally, housing is more affordable now than at any time in the past 30 years. The New York metro area is the least affordable with a ratio of 6.7 as of the 3rd quarter of 2012.

We believe the Washington area housing market is in the recovery phase of the cycle. We expect that a combination of the following will bring gains to the Washington for-sale housing market during 2013.

- A slowly recovering national economy.
- Mortgage interest rates that remain near all-time lows, with small, measured increases in 2013.
- An expanding local labor market, notwithstanding possible Federal austerity measures.
- An end to the local structural shift away from home ownership and toward rentals.

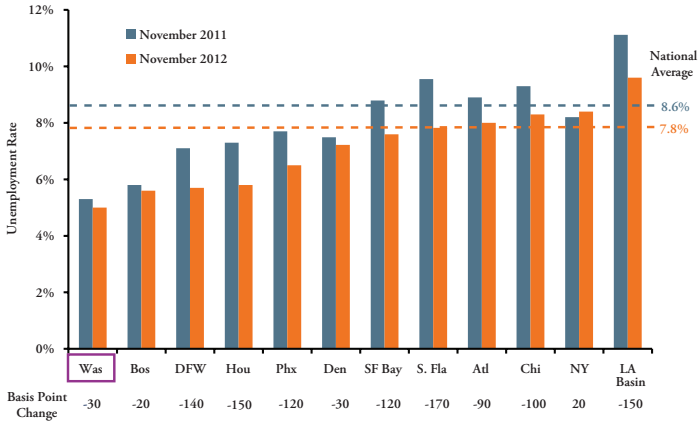
The pace of the recovery may remain volatile, however. We expect that rising demand will yield modest yearly housing price gains with likely percentage price increases in the mid-single-digits.

Projected Payroll Job Growth
Washington Metro Area | 2012 - 2017



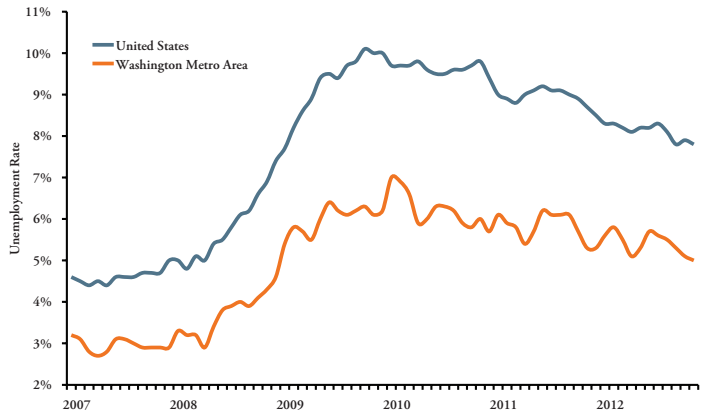
Note: Other sectors include manufacturing, wholesale trade and transportation/utilities.
Source: Dr. Stephen Fuller, Delta Associates; January 2013.

Unemployment Rate
Large Metro Areas | November 2011 vs. November 2012



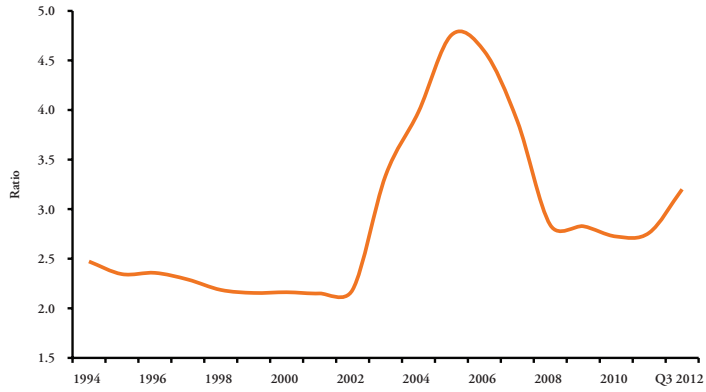
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Unemployment Rate
Washington Metro Area vs. United States



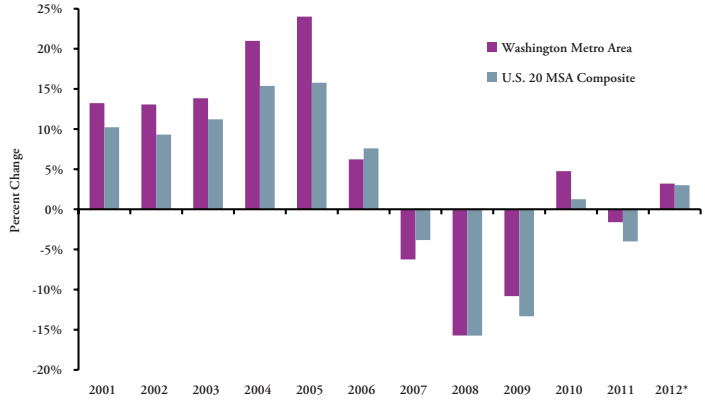
Note: Not seasonally adjusted.
Source: Bureau of Labor Statistics, Delta Associates; January 2013.

Ratio of Median Price to Median Household Income
Washington Metro Area



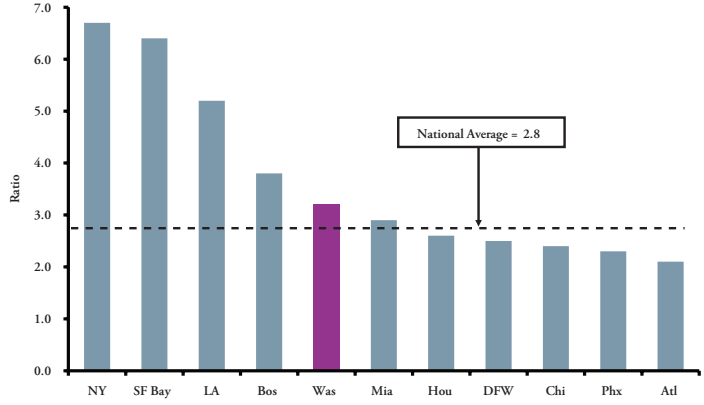
Source: NAHB/Wells Fargo Opportunity Index, Delta Associates; January 2013.

Percent Change in House Prices
Washington Metro Area vs. U.S. 20 MSA Composite



Note: Seasonally adjusted.
* 12 months ending September 2012.
Source: S&P/Case-Shiller, Delta Associates; January 2013.

Ratio of Median Price to Median Household Income
Select Metro Areas | Third Quarter 2012



Source: NAHB/Wells Fargo Opportunity Index, Delta Associates; January 2013.

Region's Core Industries

The Federal government is the largest component of the Washington area economy, accounting for more than one-third of the Gross Regional Product (GRP), as its spending touches every job sector.

The most important element of Federal spending in the metro area economy is procurement – the government's purchase of goods and services from the private sector. Procurement spending declined 3.5% in 2011, to $79.6 billion. We expect procurement spending to decline by around 2.7% during 2012 once the numbers are finalized, as the Federal government continues to implement budget austerity measures.

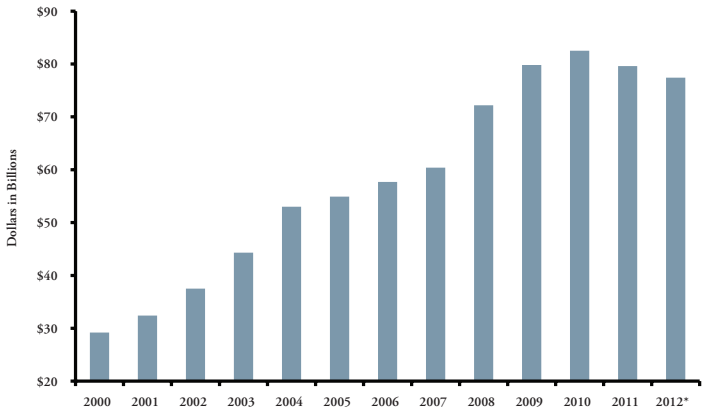
Although procurement spending is set to decline further during 2012, we expect other sectors to stimulate GRP growth in the metro area in the period ahead – specifically the Professional/Business Services sector as this sector is projected to add 143,800 jobs through 2017. When breaking down GRP share by job sector, the Professional/Business Services sector is a standout, accounting for 24.8% of the GRP during 2012. By 2017, this share is expected to grow to 29.5% of the GRP. The Federal government, accounting for 13.9% of the GRP during 2012 is expected to decline to 11.3% during 2017.

Washington Area Economic Outlook

We expect the Washington metro area economy to progress during 2013, with sluggish growth during the 1st half of year followed by stronger progress during the 2nd half. Automatic across-the-board cuts, totaling $1.2 trillion over ten years, are slated to go into effect in March 2013, as the New Year's fiscal cliff agreement merely kicked the can down the road with regard to spending cuts. This dagger has been looming over the heads of businesses and consumers since November 2011, hampering economic growth due to uncertainty. We expect economic conditions in the Washington region to improve as the outcome of the Federal budget is better established.

Although we believe the local economy is in the expansion phase of the economic cycle and showing recent signs of acceleration, we expect the speed to be slower than seen in previous expansion cycles. During this period we expect the Federal government to reduce spending. However, we expect other sectors to pick up the slack to help stimulate the Washington metro economy through 2017 – specifically the Professional/Business Services sector.

Federal Procurement Spending
Washington Metro Area



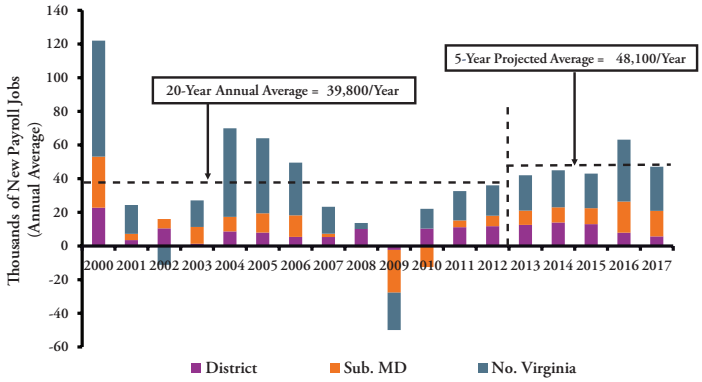
* Estimate.
Source: Dr. Stephen Fuller, Delta Associates; January 2013.

Change in Share of GRP per Sector
Washington Metro Area

	2012	2017	% Point Change
Prof/Business	24.8%	29.5%	4.7%
Financial	21.5%	20.3%	-1.2%
Federal Gov't	13.9%	11.3%	-2.6%
Information	7.5%	9.3%	1.8%
Other Sectors	6.9%	6.6%	-0.9%
Edu/Health	6.0%	5.5%	-0.5%
St./Local Gov't	5.0%	4.2%	-0.8%
Retail Trade	4.1%	3.9%	-0.2%
Construction	3.8%	3.8%	0.0%
Other Services	3.4%	2.9%	-0.5%
Leisure/Hosp.	3.1%	2.7%	-0.4%

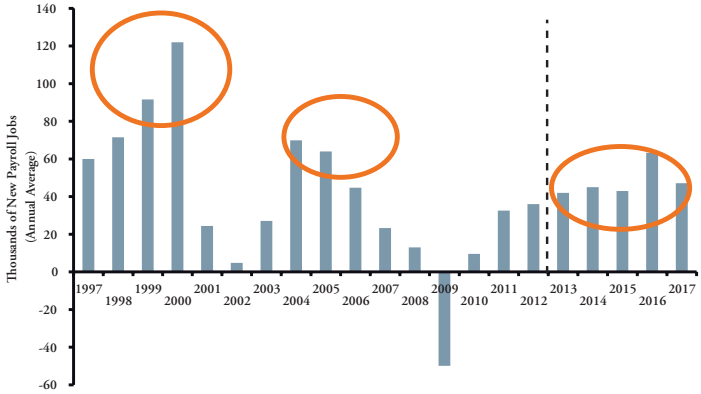
Note: Other sectors includes Manufacturing, Wholesale, and Trans/Utilities.
Source: Dr. Stephen Fuller, Delta Associates; January 2013.

Payroll Job Growth
Washington Metro Area



Source: Bureau of Labor Statistics, Dr. Stephen Fuller, Delta Associates; January 2013.

Payroll Job Growth – Comparing Past Cycles
Washington Metro Area



Source: Bureau of Labor Statistics, Dr. Stephen Fuller, Delta Associates; January 2013.

In consultation with Dr. Stephen Fuller of George Mason University, we estimate that 36,000 payroll jobs were added to the Washington metro area economy during 2012 once the numbers are finalized. We expect the Northern Virginia substate area to be the leader in job growth with 18,000 new jobs in 2012. The Suburban Maryland and District substate areas should produce 6,200 and 11,800 new jobs, respectively. We expect job growth in the Washington metro area to gain traction during 2013, as 42,000 new jobs will be added to the economy. Private sector firms relocating operations to the Washington area will bolster local employment in the period ahead.

We project job growth will average 48,100 jobs per annum during this expansion cycle through 2017, compared to 60,000 in the last expansion cycle and 100,000 in the cycle before that.

We project job growth will average 48,100 jobs per annum during this expansion cycle through 2017, compared to 60,000 in the last expansion cycle and 100,000 in the cycle before that. Although 48,100 jobs per annum is low compared to prior expansion cycles, it is sufficient to support a healthy commercial real estate market if the industry re-calibrates its demand expectations.

4

The Washington Area
OFFICE MARKET

4

The Washington Area
OFFICE MARKET

Investment Sales Still Strong, Yet Annual Absorption Negative for First Time in History Due to GSA Pullback, Tenant Hesitancy, BRAC-Related Move-Outs and "Densification"

Last year in ***TrendLines,*** we noted a slower recovery, with 1.1 million SF of net absorption during 2011, coming off a robust expansion year in 2010. This compares to a long term average of 5.7 million SF of absorption. And more like 8.0 million SF during expansion periods.

In 2012, we experienced negative net absorption for the first time since records have been kept (Delta's records go back to 1970). What happened?

- Tenant uncertainty – spurred by Federal budget battles
- Pullback in GSA leasing
- Densification of office space
- BRAC-related move-outs of private space

The Washington metro area office market ended the year on weak footing:

- Net absorption was negative
- The overall vacancy rate increased 130 basis
- Concession packages remain elevated
- We see shorter lease terms
- Effective rents declined 2.9%

Yet, better buildings in stronger submarkets are outperforming this metro-wide trend.

Notwithstanding these more competitive conditions, developers started construction on 3.7 million SF of office space during 2012, concentrated in Northern Virginia around the Orange and Silver Line Metro stations. Those that have not broken ground are starting to queue office development projects, particularly renovations of older product, for delivery in 2015 when they expect the market will be stronger. We believe performance fundamentals will be slow to progress during 2013. We expect soft conditions during the 1st half of 2013, with conditions improving during the 2nd half of the year, as the market figures out densification of office space and uncertainty over the Federal budget lessens. However, vacancy will be kept from declining in the future if construction starts continue to rise at the current pace without notable pre-leasing in place or net absorption to follow.

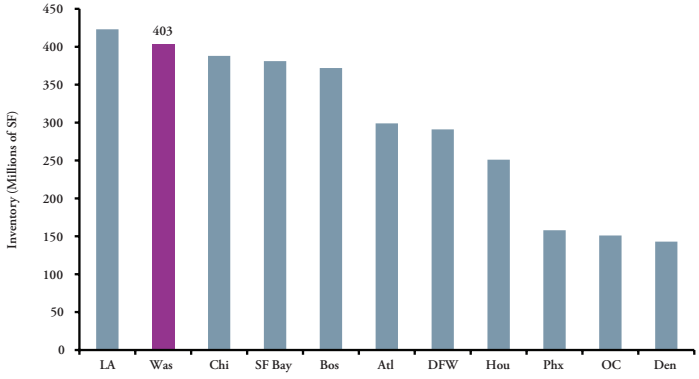
With these structural shifts in place, such as densification of the use of space by tenants and GSA pullback, we do not see meaningful market momentum and improvement until mid-decade for this asset type except in isolated submarkets and for trophy assets.

National Context

At 403 million SF of private office space, the Washington metro area is the 3rd largest office market in the nation, behind New York and Los Angeles.

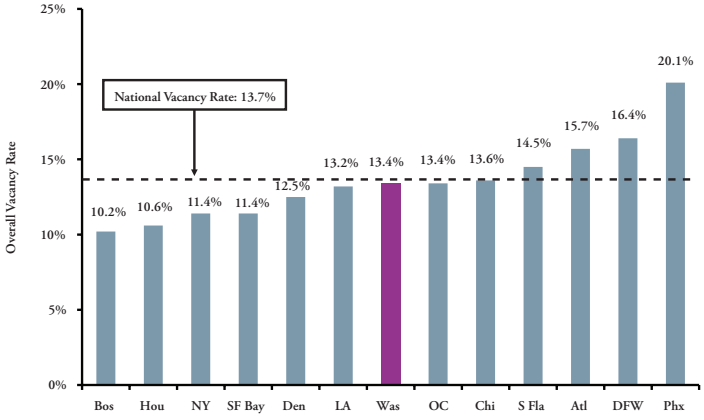
Net absorption of office space in the Washington metro area totaled negative 2.9 million SF during 2012. This is the first time that the Washington metro area experienced negative annual net absorption. As the Washington area market took a step back, other markets such as SF Bay and Houston took the lead.

Largest Office Markets
Selected Metro Areas | 2012



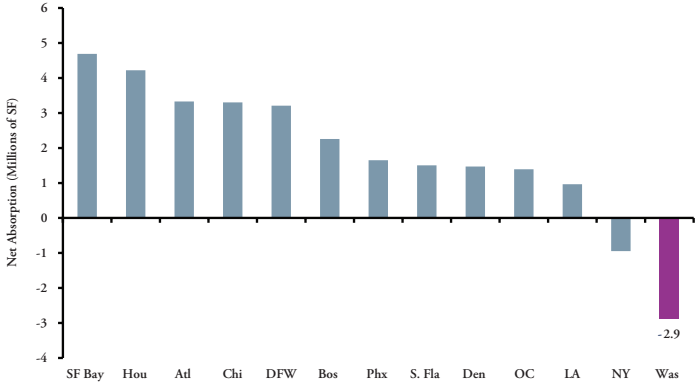
Note: Excludes New York at 1.0 billion SF.
Source: CoStar, Delta Associates; January 2013.

Office Vacancy Rates
Selected Metro Areas | Year-End 2012



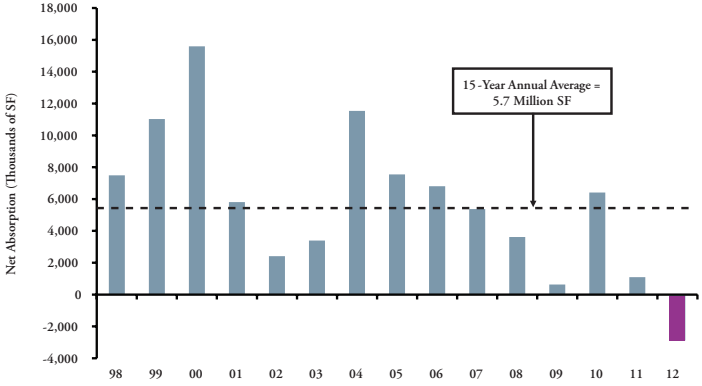
Source: CoStar, Delta Associates; January 2013.

Office Net Absorption
Selected Metro Areas | 2012



Source: Delta Associates; January 2013.

Office Net Absorption
Washington Metro Area



Source: Delta Associates; January 2013.

Office Market Highlights

Washington Metro Area | Year-End 2012

Net absorption: Negative 2.9 million SF during 2012, compared to positive 1.1 million SF during 2011.
Sublease space: Increased by 9,000 SF during 2012. Sublease space represents 1.0% of the standing inventory.
Overall vacancy rate: 13.4%, up from 12.1% one year ago. Seventh-lowest rate in the nation among major metro areas.
Direct vacancy rate: 12.4%, up from 11.1% one year ago.
Direct stabilized vacancy rate: 11.0%.
Pipeline (U/C and U/R): 8.0 million SF, up from 7.0 million SF one year ago.
Pipeline pre-lease rate: 51%, compared to 52% one year ago.
Effective rents: Down 2.9% during 2012, compared to a decline of 0.9% in 2011.
Investment sales: $6.7 billion ($355/SF) during 2012, compared to $6.9 billion ($373/SF) during 2011.

Source: Bureau of Labor Statistics, S&P/Case Shiller, Delta Associates; January 2013.

The Washington area's overall vacancy rate is 13.4% at year-end 2012, a rise from 12.1% one year ago. The Washington metro has the seventh-lowest overall vacancy rate among large metro areas in the United States. The Boston and Houston metro areas have the lowest vacancy rates at 10.2% and 10.6%, respectively.

With these structural shifts in place, such as densification of the use of space by tenants and GSA pullback, we do not see meaningful market momentum and improvement until mid-decade for this asset type except in isolated submarkets and for trophy assets.

Net Absorption

Net absorption of office space in the Washington metro area totaled negative 2.9 million SF during 2012, compared to positive 1.1 million SF during 2011. This compares to the 15-year average annual absorption of 5.7 million SF.

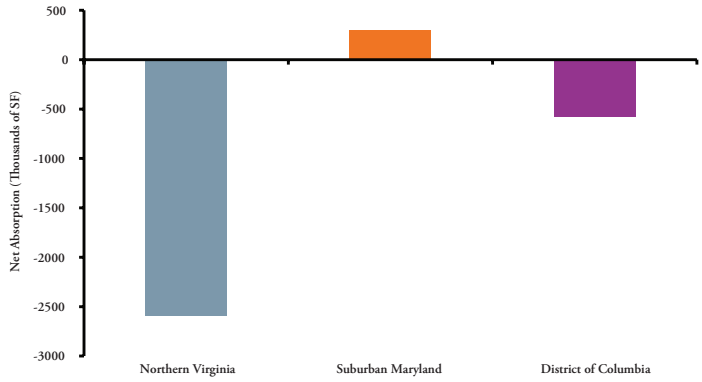
Net absorption weakened in Northern Virginia in 2012, primarily due to BRAC-related move-outs. For example:

- GSA vacated 290,000 SF at 251 18th Street S and 330,000 SF at 2511 Jefferson Davis Highway in Crystal/Pentagon City.
- Booz Allen vacated 258,000 SF at 8281 Greensboro Drive and 30,000 SF at 7950 Jones Branch Drive.
- GSA vacated 239,000 SF at 400 Army-Navy Drive in Crystal/Pentagon City.
- Fannie Mae vacated 230,000 SF at 12900 Worldgate Drive in Reston/Herndon.
- Department of Defense vacated 195,000 SF at 4040 N. Fairfax Drive in RCB Corridor.

In the District of Columbia, demand remains lackluster from both the public and private sectors as tenants take a breather from committing to new space. The drag in net absorption occurred primarily from tenants vacating large blocks of space. This was the first time since 1994 that the District of Columbia experienced annual negative net absorption. For example, in 2012:

- KPMG vacated 169,000 SF at 2001 M Street, NW in the CBD.
- Dewey & LeBoeuf vacated 140,000 SF at 1101 New York Avenue, NW in the East End.

Office Net Absorption
Washington Metro Areas | 2012



Source: Delta Associates; January 2013.

Net Absorption of Office Space and Change in Sublease Space
Washington Metro Area | 2011 vs. 2012 | (Thousands of SF)

	Direct Space Net Absorption		Sublease Space Absorbed or (Returned)	
Market	**2011**	**2012**	**2011**	**2012**
NOVA	520	(2594)	(467)	(123)
Sub MD	(343)	297	164	(3)
District	918	(581)	348	117
Total	**1,095**	**(2,878)**	**45**	**(9)**

Source: Delta Associates; January 2013.

- IRS Criminal Investigation Division vacated 103,000 SF at 1750 Pennsylvania Avenue, NW in the CBD.
- The District of Columbia Government vacated over 200,000 SF at 64 New York Avenue, NE in NoMa.

Suburban Maryland experienced positive net absorption during 2012, due in part to Bethesda Center North delivering 358,000 SF fully leased to the U.S. Nuclear Regulatory Commission. Tenants chose to remain quiet and renew in Suburban Maryland during the past year, which helped to balance the limited demand with limited move-outs.

Sublease space increased 9,000 SF in the Washington metro area during 2012, compared to decreasing 45,000 SF during 2011. Sublease space currently represents just 1.0% of standing inventory at December 2012. This compares to a level of 1.4% at the end of 2009. The limited amount of sublease space on the market will help promote a rebound, though shadow space (excess leased space that is not being marketed) remains a concern.

Net absorption of Class A space totaled positive 1.2 million SF during 2012, compared to 4.3 million SF during 2011. We expect Class A office space to remain in demand. As we saw in 2012, the recent reductions in Class A rents have encouraged a flight to quality, as tenants look to move into better space at limited or no additional cost compared with their prior leases. We currently face a more competitive landscape, which is here to stay. This will result in elevated vacancy rates, lower rent growth rates, and a continuing flight to quality.

Vacancy Rate

The Washington area's overall vacancy rate is 13.4% at year-end 2012, a rise from 12.1% one year ago. The Washington metro has the seventh-lowest overall vacancy rate among large metro areas in the United States. The Boston and Houston metro areas have the lowest vacancy rates at 10.2% and 10.6%, respectively. The Washington metro area's direct vacancy rate was 12.4% at December 2012, up 11.1% one year ago.

The Washington area overall Class A vacancy rate is 12.5% at year-end 2012, compared to 11.9% one year ago. The Washington area direct Class A vacancy rate is 10.9%, up from 10.4% one year ago.

The direct stabilized vacancy rate is 11.0% at December 2012. The stabilized vacancy rate excludes buildings constructed between 2008 – 2012 that have not reached 90% occupancy during initial lease-up.

The District of Columbia holds the lowest direct vacancy rate in the Washington metro area at 8.7%. The direct vacancy rate in Suburban Maryland is 13.9%, lower than in Northern Virginia at 14.4%. When unstabilized properties are removed from the inventory the vacancy rate declines in each substate. The most notable decline is in Northern Virginia where the stabilized vacancy rate is 12.8%.

Construction

There is 8.0 million SF of office space under construction or renovation in the Washington metro area at December 2012, up from 7.0 million SF one year ago. 51% of the space under construction is pre-leased at December 2012, compared to 52% one year ago. This compares to the 10-year average pre-lease rate of 44%.

Developers started construction on 3.7 million SF during the past year, compared to 4.0 million SF during 2011. Developers pushed forward on pre-leased projects or used their own resources to start spec projects – banking on improved conditions upon delivery. Groundbreakings have risen in Northern Virginia, as developers are starting to break ground around the new Metro line.

Notably, Macerich started 524,000 SF at 7900 Tysons One Place in Tysons Corner during the year, which snagged Intelsat as a tenant during the 4th quarter. This is the first phase of a mixed-use development, which will include office, residential, and a hotel upon full build-out.

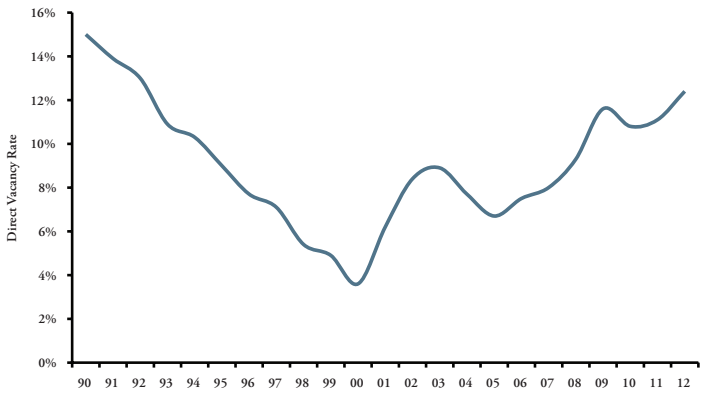
We anticipate several projects will break ground in Tysons Corner over the next 12 months, as developers prepare to deliver new product to the submarket by the time Metro arrives. For example, MRP Realty is rumored to have secured LMI to a 150,000 SF deal at an undeveloped parcel in Tysons Corner where a 335,000 SF office building is planned. Reston/Herndon appears to be following in Tysons' footsteps, banking on delivering new product at the time Metro arrives. For example, the Fairfax County Planning Commission recently approved the site plan for a 23-story, 419,000 SF office project at 1760 Reston Parkway. Upon build-out, this project will be the tallest building in Reston.

Vacancy Rates and Vacant Space (All Classes)
Washington Metro Area | December 2011 vs. December 2012

	December 2011	December 2012
	Vacancy Rate	
Direct	11.1%	12.4%
Sublet	1.0%	1.0%
	Vacant Space (Millions of SF)	
District	44.6	49.9
Sublet	4.0	4.0

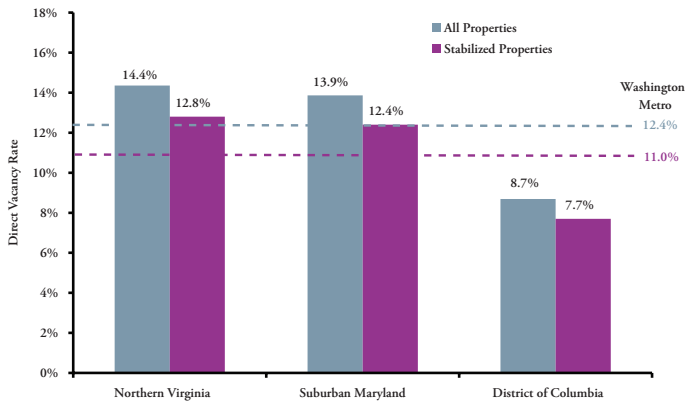
Source: CoStar, Delta Associates; January 2013.

Office Vacancy Rate
Washington Metro Area



Source: CoStar, Delta Associates; January 2013.

Office Vacancy Rate
Washington Metro Area | December 2012



Source: CoStar, Delta Associates; January 2013.

Office Space Under Construction
Washington Metro Area | (Millions of SF)

Substate Area	December 2010	December 2011	December 2012
NOVA	1.3	1.9	3.5
Sub MD	1.4	2.2	1.8
District	2.2	2.8	2.6
Total	**5.0***	**7.0***	**8.0***

* Does not total due to rounding.
Source: CoStar, Delta Associates; January 2013.

Also notable, Carr Properties started construction on 220,000 SF at 4500 East West Highway in the Bethesda/Chevy Chase submarket during the 4th quarter. This project started with no tenants in place. The company was able to acquire a loan from Wells Fargo to cover just over $100 million of the construction cost, or 55%, according to the Washington Post. Although considered risky given current conditions, the Bethesda/Chevy Chase submarket has very little available Class A space, with a 2.9% direct vacancy rate as of December 2012. Given this, we believe this asset will likely find tenants. The company plans to deliver the project by Spring 2014.

With tenant demand focused on Class A assets, property owners are focusing on efforts to renovate Class B space to compete with the Class A market. We expect renovations on older product to ramp up, particularly in the CBD and East End, over the next 24 months, with delivery plans in 2014/2015 when the market transitions to landlord favor. For instance:

- Mitsui Fudosan America and Akridge plan to build a new 170,000 SF office building at the former National Restaurant Association headquarters at 1200 17th Street, NW in the CBD. Demolition is underway with a planned delivery by 2014. Pillsbury Winthrop Shaw Pittman is rumored to be taking 120,000 SF and leaving 2300 N Street, NW.
- Boston Properties is slated to start demolition of 211,000 SF at 635 Massachusetts Avenue, NW in the East End after NPR vacates for its newly constructed space in NoMa. Boston Properties plans to build a larger building of 478,000 SF on the parcel. Arnold & Porter is rumored to be taking up to 400,000 SF of this space, leaving its current location at 555 12th Street, NW.

In Suburban Maryland, a handful of projects are in the development queue, planning to break ground with delivery around the time the market transitions back to landlord favor. Notably, Federal Realty Investment Trust is preparing for development of the first phase of Pike and Rose of the Mid-Pike Plaza in N. Bethesda. The first phase will include 120,000 SF of retail, 80,000 SF of office, and 500 residential units. Upon full build-out, the mixed-use project will include 1.1 million SF of office, 450,000 SF of retail, 90,000 SF hotel, and 1.7 million SF of residential. This major project will play a role in the transformation of North Bethesda, which will ultimately help link this submarket to Bethesda/Chevy Chase – creating the Wisconsin Avenue Corridor.

We expect renovations to buildings vacated due to BRAC could continue to pick up. For instance, Lowe Enterprises started renovations during the 2nd quarter of 2012 at 1400 Crystal Drive in order to upgrade this property to Class A – advancing this building to competitive stock. Federal Capital Partners and RESI Management plan to fully renovate 4040 N. Fairfax Drive in the RCB Corridor once the Department of Defense vacates space by year-end. In addition, now that DARPA has vacated 175,000 SF at 3701 N. Fairfax Drive in the RBC Corridor, the Cafritz Company plans to renovate the space. As tenants vacate older space under the BRAC decision, landlords will look to renovations, as tenants in the market are seeking newer office space.

Developers delivered 2.8 million SF office space in the Washington metro area during 2012. These projects came online at 67% leased. Notably, during the 4th quarter, LCOR, Inc. delivered 358,000 SF at Bethesda Center North. This project delivered fully leased to the U.S. Nuclear Regulatory Commission. Also notable, Skanska delivered 1776 Wilson Boulevard in the RCB Corridor, a 139,000 SF office building during the 4th quarter. This project delivered 43% pre-leased.

A total of 2.6 million SF of office space, including renovations, delivered in the Washington metro area during 2011. Projects that came online during 2011 delivered at 61% pre-leased. This compares to the 10-year annual average of 7.2 million SF at 50% leased upon delivery.

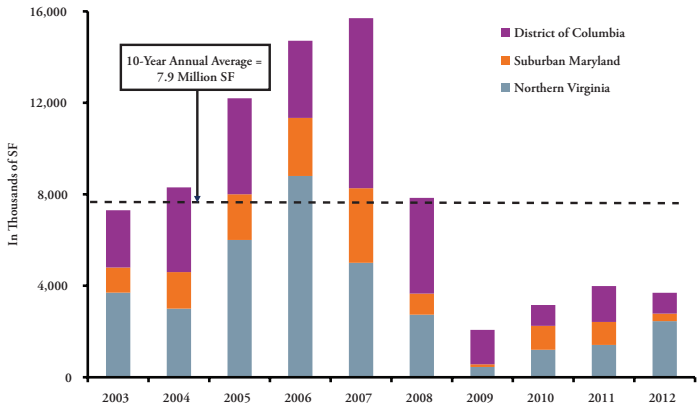
We project the metro-wide overall vacancy rate will edge down from 13.4% today to 12.8% at December 2014.

Projected Supply vs. Demand

We project the metro-wide overall vacancy rate will edge down from 13.4% today to 12.8% at December 2014. Although we expect demand to gradually pick up pace over the next two years, we do not believe this demand will be robust enough to significantly lower the vacancy rate metro-wide, as other tenants consolidate or vacate space and new product delivers. Much of the demand will be generated by pre-leased deliveries arriving to the market over the next two years.

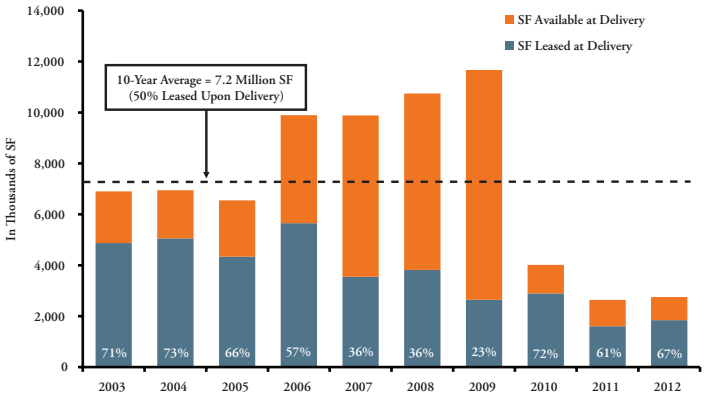
- We project the overall Northern Virginia vacancy rate will decline, from 15.7% today to 14.9% by December 2014, as this substate captures at least half of the job growth in the metro area.

Office Construction Starts
Washington Metro Area



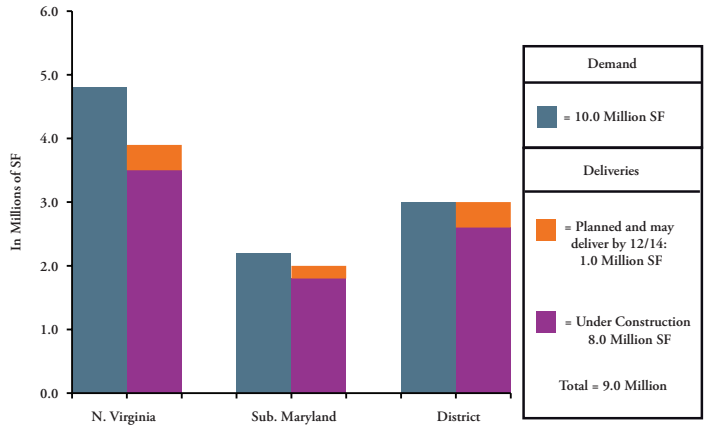
Source: CoStar, Delta Associates; January 2013.

Office Construction Deliveries
Washington Metro Area



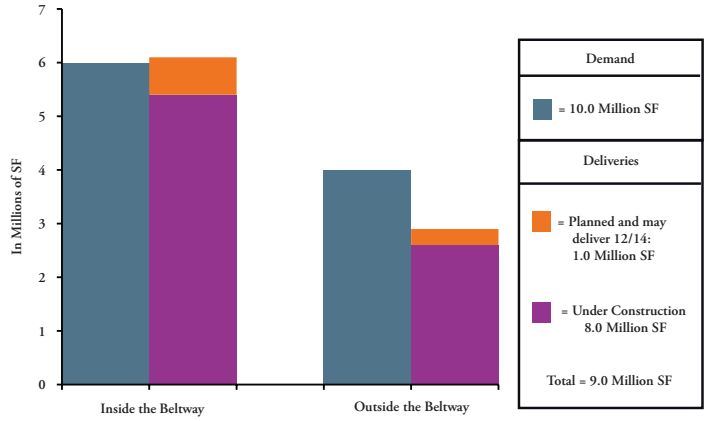
Source: CoStar, Delta Associates; January 2013.

Office Demand and Deliveries
Washington Metro Area | 24 Months Ending December 2014



Source: Delta Associates; January 2013.

Office Demand and Deliveries
Washington Metro Area | 24 Months Ending December 2014



Source: Delta Associates; January 2013.

- We project the overall office vacancy rate in Suburban Maryland will edge down from 14.7% today to 14.2% by December 2014.
- We project the overall vacancy rate will edge down in the District from 9.3% today to 9.1% by December 2014.

We believe the vacancy rate will decline only modestly over the next two years, as leasing activity remains muted. With GSA taking a breather from leasing space due to budget austerity measures, coupled with the private sector being too timid to lease space until Federal budget cuts are resolved, leasing levels will be muted. The hesitancy to lease space arrives at a time when tenants will be vacating second-generation space – relocating to newer space signed for during 2011 and 2012. We look to 2015 for the market to transition to stronger conditions.

We expect overall vacancy outside the Beltway to edge down to 14.6% over the next 24 months, from 15.5% today. We project the overall vacancy rate inside the Beltway to edge down to 11.4% by December 2014, from 11.7% today. We believe vacancy will be slow to decline, as a handful of spec projects are underway and could impede a reduction in the vacancy rate if tenants are not secured by delivery. In addition, a healthy amount of second-generation space is due to come online over the next few quarters – particularly in the District of Columbia and Northern Virginia due to BRAC-related move-outs.

Effective Rents

The average effective office rent declined 2.9% during 2012, compared to declining 0.9% during 2011. We expect concession packages to remain elevated during 2013, as tenants remain hesitant to lease space, coupled with older second-generation space coming on the market. Overall, the market remains in tenant favor. We believe the window of opportunity to secure lowered rents on quality Class A space in the closer-to-the-core submarkets will be closing in the next 24 months in submarkets with better supply/demand balance.

We believe average metro-wide effective rents will likely edge down by 0.5% to 1.5% during 2013, as vacancy remains elevated. As the vacancy rate gets closer to the rent equilibrium zone, a zone where rents tend to neither rise nor fall, landlords will start to push rents and limit concessions. We expect it will not be until 2014 when the Washington metro area experiences modest gains in rent. Better buildings in stronger submarkets will see rent growth sooner.

Investment Sales

Investment sales volume totaled $6.7 billion in the Washington metro area during 2012, compared to $6.9 billion during 2011. Sales prices averaged $355/SF during 2012, compared to $373/SF during 2011. The most notable deal of the year was MetLife purchasing 400 7th Street, SW in the Southwest submarket for $734 million ($524/SF). GSA recently backfilled the unneeded Securities and Exchange Commission space at this location. The building is now fully leased.

The District of Columbia took the largest share of total sales volume during 2012, at 63%. Northern Virginia took 27% of the total sales and Suburban Maryland took 7%. We expect the District of Columbia to remain the leader in sales volume in the near-term as investors are targeting quality core downtown assets.

There is evidence that investment sales started to pick up pace during 2012, particularly during the 3rd quarter. However, this activity lessened as the year came to a close, with 23 transactions completed during the 4th quarter, down from 38 transactions during the 3rd quarter. Notwithstanding this evidence, the Washington metro area remains a prime target for foreign and domestic investors.

The average cap rate for core office assets in the Washington metro area, on a 12-month trailing basis, was 6.0% at the end of the 3rd quarter 2012, according to Real Capital Analytics. The average cap rate is down 61 basis points from one year ago. Any further decline in cap rates during 2013 is likely to be modest. However, trophy assets will continue to trade at lower cap rates. Cap rates for recent Class A/Trophy trades have been in the 5.0% to 6.0% range.

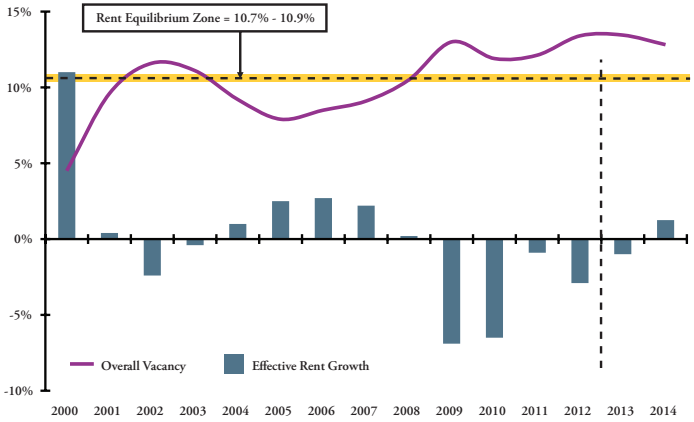
Investment Returns

For the past decade Washington lead the nation in office building investment returns, as measured by the office building total return index of NCREIF. However, with the region's run-up in values and weak performance metrics, total returns (cash flow plus appreciation) realized in the Washington office market were just 7.28% for the 12 months ending September 2012 – below the national return of 9.85%.

This worse-than-national performance will not last long. We expect the Washington area to remain among the premier long-term investment markets in the nation, although in the short run, say through 2014, other metro markets could continue to outperform Washington in the recovery cycle. Washington's still-high pricing and rising vacancy rate are weakening investors' returns in the short run.

Office Vacancy Rate vs. Effective Rent Change

Washington Metro Area



Source: Delta Associates; January 2013.

NCREIF Return Index[1]

Office Properties

Metro Area	12-Month Total Return at 3rd Quarter 2012[1]
San Francisco	21.55%
Denver	13.01%
Boston	12.53%
Houston	12.11%
New York	10.86%
Dallas	9.95%
National Average	**9.85%**
Chicago	8.39%
Los Angeles	7.49%
Washington	**7.28%**
Wash. CBD	*7.28%*
Wash. Suburbs	*7.23%*
Atlanta	7.97%
Phoenix	**5.63%**

[1] NCREIF compiles return based on its members' $110.8 billion office portfolios. The index includes both current income and capital appreciation returns.

Source: Delta Associates, based on data in NCREIF's 3rd Quarter 2012 Real Estate Performance Report.

Land Sales

There were four notable office land sales, totaling $52.4 million, in the Washington metro area during 2012, compared to seven sales, totaling $133.8 million, during 2011. Notably, Carr Properties purchased 1.3 acres for $18.2 million at 4500 East-West Highway in Bethesda/Chevy Chase during 2012. This company broke ground during the 4th quarter on 220,000 SF on this parcel.

We expect land sales in the Washington metro area to gradually pick up pace during 2013. Although the development climate should remain soft next year in most submarkets, developers will be looking to purchase land – planning for the next round of development and delivering during 2015 when the market transitions back to landlord favor.

Office Market Outlook: Succeeding in a Competitive Market

We expect the Washington metro area market to remain one of the best performing office markets in the nation in the intermediate and long run. The question is: What about the short run?

In the short run, recovery will continue to be slow as uncertainty about the broader economic climate and direction of the Federal budget causes hesitancy among tenants, developers and investors. We believe these conditions will persist through much of 2013 and perhaps into 2014.

We expect government leasing to remain limited for the foreseeable future, as Congress scrutinizes any large lease deal and agencies are forced to do more with less. Leasing by the private sector should gradually start to rise. However, we expect leasing activity to remain sluggish despite job growth, as tenants figure out how to use less office space per worker.

Companies with the budget to secure space at lowered rents will remain active in the market during 2013. However, tenants currently inking deals are downsizing the total amount leased, as they right-size their office space due to staff reductions and more diligent use of space. Meaningful growth in demand will not be felt until 2014 or 2015.

We project the metro-wide overall vacancy rate will edge down from 13.4% today to 12.8% by December 2014. Although we expect new demand to gradually pick up pace over the next two years, we do not believe this demand will be robust enough to lower the vacancy rate significantly as other tenants consolidate or vacate space and new product delivers. A significant portion of demand will be generated by pre-leased deliveries arriving to the market over the next two years. Demand is likely to average approximately 5.0 million SF per year in 2013-14. This is an improvement from 2011-12 but below the long-term average of 5.7 million SF per year, and nearly half what the region is used to in an expansion cycle. Demand over the next two years will be back-loaded into 2014.

We believe average metro-wide effective rents will likely edge down by 0.5% to 1.5% during 2013, as vacancy remains elevated. As the vacancy rate gets closer to the rent equilibrium zone, a zone where rents tend to neither rise nor fall, landlords will start to push rents and limit concessions. We expect it will not be until 2014 when the Washington metro area experiences modest gains in rent. Better buildings in stronger submarkets will see rent growth sooner.

We expect the Washington metro area market to remain one of the best performing office markets in the nation in the intermediate and long run. The question is: What about the short run?

We expect it will not be until 2014/2015 when the Washington metro area will experience meaningful growth. As a result, the successful investor and developer will:

1. Selectively accumulate assets at below replacement cost while prices and interest rates are lower.

2. Invest in repositioning older, under-performing assets at superior locations.

3. Manage assets to perform better through leasing enhancements and investment in operating system improvements.

4. Acquire/entitle sites for development and deliver as follows:
   - Before 2014 for tenant-driven (pre-leased) deals and for spec deals in the few submarkets where supply/demand fundamentals warrant.
   - Throughout the metro area in 2014 and beyond as more "normalized" conditions return to the market.

5

The Washington/Baltimore Regional FLEX/INDUSTRIAL MARKET

5

The Washington/Baltimore Regional FLEX/INDUSTRIAL MARKET

Shifts in Retailing and Technology Create Solid Market Performance as Rents and Absorption Rise While Vacancy Declines; Investment Sales Volume Nearly Double That of 2011

After muted performance in 2011, the Washington/Baltimore flex/industrial market experienced solid performance in 2012. What were the demand drivers in 2012?

- **The cloud:** data centers that support technological changes as to how we compute, access, and store information.
- **Retailing:** more retailers are incorporating online retailing in addition to a bricks and mortar store. These retailers are storing merchandise in industrial space. In addition, strictly online retailers, like Amazon, are growing and demanding more industrial space. And shipping retail goods takes industrial space as well.

When you combine these technological and retailing structural shifts with a curing housing market you have the ingredients for a regional "boomlet" in industrial space.

Flex/industrial net absorption in the Washington/Baltimore region totaled just above the long-term average and vacancy declined 110 basis points during 2012. Given improving conditions, asking rents increased 3.2% during 2012.

The flex/industrial market is making gains, albeit at a slower pace compared to past cycles. But this asset type is a stand-out compared to others. We expect this stand-out performance to continue during 2013. Growth may be slow during the 1st half of 2013, as tenants remain hesitant about leasing space due to uncertainty regarding the Federal budget and its potential impact on the local economy. We expect conditions to quicken during the 2nd half of 2013 with a more robust market during 2014.

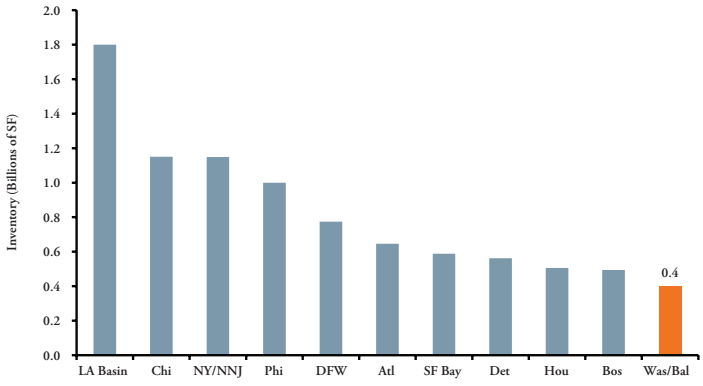
National Context

The Washington/Baltimore flex/industrial market, at 397 million SF, is the 11th largest market in the country. Our market's primary function is regional distribution and accommodation of R&D and low-cost office uses in flex space. With the exception of some older product in the Baltimore area, there is little manufacturing in this region.

When you combine these technological and retailing structural shifts with a curing housing market you have the ingredients for a regional "boomlet" in industrial space.

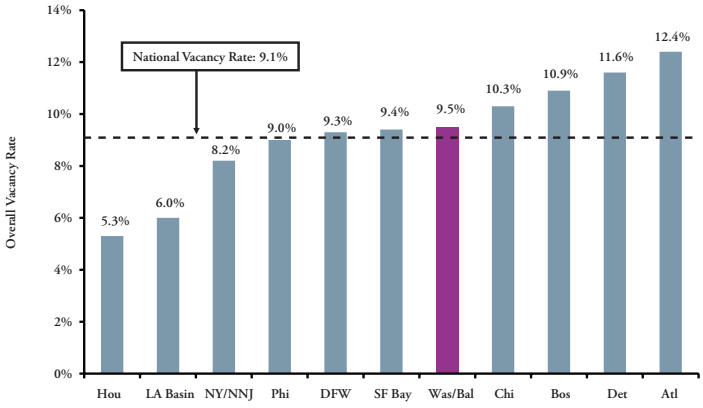
At 9.5%, the Washington/Baltimore region's overall vacancy rate is just above the national average of 9.1%. The Washington/Baltimore overall vacancy rate ranks middle of the pack among major metro areas, with Houston holding the lowest rate at 5.3%.

Largest Flex/Industrial Markets
Selected Metro Areas | 2012



Source: CoStar, Delta Associates; January 2013.

Flex/Industrial Vacancy Rates
Selected Metro Areas | Year-End 2012



Source: CoStar, Delta Associates; January 2013.

Flex/Industrial Market Highlights
Washington/Baltimore Region | Year-End 2012

Net absorption: 4.3 million SF during 2012, compared to 1.4 million SF during 2011.

Sublease space: Decreased by 121,000 SF during 2012. Available sublease space represents just 0.4% of standing inventory.

Overall vacancy rate: 9.5%, down from 10.6% one year ago.

Direct vacancy rate: 9.1%, down from 10.1% a year ago.

Under construction: 1.2 million SF, down from 1.9 million SF one year ago.

29% of the space under construction is **pre-leased,** compared to 19% a year ago.

Rents: Up 3.2%, in contrast to rising just 0.2% during 2011.

Investment sales: $1.2 billion ($73/SF) during 2012, compared to $726 million ($87/SF) during 2011.

Net Absorption

Flex/industrial net absorption totaled 4.3 million SF in the Washington/Baltimore region during 2012, compared to 1.4 million during 2011. This compares to the 15-year average of 4.2 million SF per annum.

Bulk warehouse as well as flex/warehouse were both strong performers during 2012, as pre-leased deliveries and a handful of notable lease deals bolstered absorption. For instance:

- Unilver purchased for occupancy 386,000 SF at 3701 Southwestern Boulevard in Baltimore City.
- 8560 Progress Drive delivered 330,000 SF in Frederick County, fully leased to the National Cancer Institute.
- TIC Gums purchased for occupancy 188,000 SF at 1 Mercedes Drive in Harford County.
- Raytheon leased 48,000 SF at 23030 Ladbrook Drive in the Dulles Corridor.

Sublease space decreased 121,000 SF during 2012, compared to decreasing 155,000 SF during 2011. Sublease space represents just 0.4% of the standing inventory.

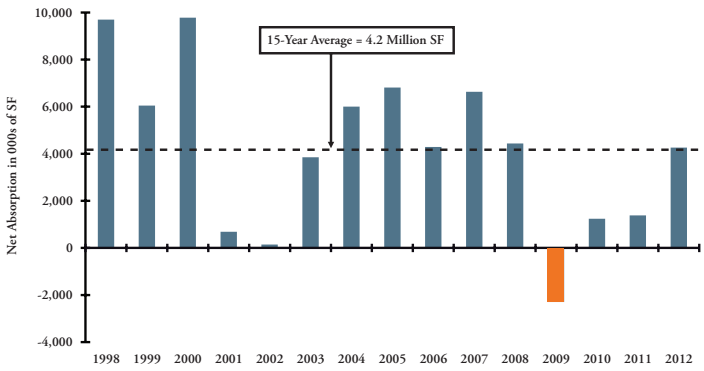
Net absorption of newer space (built after 1987) totaled 2.5 million SF during 2012, compared to 1.2 million SF during 2011. For newer space, the Washington metro area absorbed 2.5 million SF and the Baltimore metro area absorbed 58,000 SF during the past 12 months. Net absorption for newer space was lackluster in the Baltimore metro area during 2012, as a handful of the lease deals inked were for older space. For example, White Marsh Transport leased 200,000 SF at 2010 Reservoir Road in Baltimore County East, an asset built in 1964.

Vacancy Rate

The region's overall flex/industrial vacancy rate declined to 9.5% at year-end 2012, from 10.6% one year ago. The Baltimore area's overall vacancy rate is 150 basis points lower than the Washington area's rate. The region's direct flex/industrial vacancy rate was 9.1% at December 2012, down from 10.1% one year ago.

Although the overall vacancy rate has declined 110 basis points since year-end 2011, it remains elevated compared to a low of 7.3% at year-end 2000.

Flex/Industrial Net Absorption
Washington/Baltimore Region



Source: Delta Associates; January 2013.

Flex/Industrial Inventory & Absorption
Washington/Baltimore Region | 2012

Type of Space	Inventory at 12/2012 (millions of SF)		Net Absorption 2012
	SF	%	SF
Bulk Warehouse	115.5	29%	1,844,000
Flex/Warehouse	251.7	63%	2,259,000
Flex/R&D	30.2	8%	160,000
Total Flex/Industrial	**397.4**	**100%**	**4,263,000**

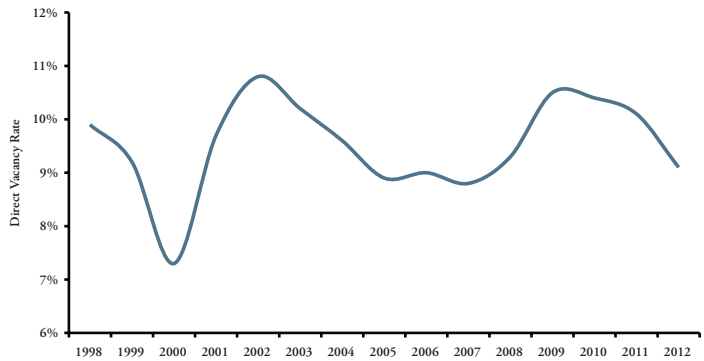
Source: Delta Associates; January 2013.

Flex/Industrial Inventory & Absorption
Washington/Baltimore Region | 2012

	Inventory at 12/2012 (Millions of SF)		Net Absorption (Thousands of SF)			
			Direct Space		Including Space	
Metro	SF	%	SF	%	SF	%
Wash	196.7	49%	3,106	73%	3,258	74%
Balt.	201.8	51%	1,157	28%	1,126	26%
Total	397.4	100%	4,263	100%	4,384	100%

Source: Delta Associates; January 2013.

Flex/Industrial Direct Vacancy Rate
Washington/Baltimore Region



Source: CoStar, Delta Associates; January 2013.

Direct Flex/Industrial Vacancy Rates
Washington/Baltimore Region for All Space at:

Market	Year-End 2000	Year-End 2005	Year-End 2012
Wash/Balt Region	7.3%	8.9%	9.1%
Wash/Balt Subs.	6.1%	8.9%	9.4%
Balt/Wash Corr.	7.5%	9.1%	10.0%
Wash. Metro Area	6.2%	7.9%	9.8%
Balt. Metro Area	8.4%	9.9%	8.5%

Source: CoStar, Delta Associates; January 2013.

Flex/Industrial Space Under Construction
Year-End 2011 vs. Year-End 2012 | (Millions of SF)

	At 12/2011		At 12/2012	
Metro Area	SF U/C	% Pre-leased	SF U/C	% Pre-leased
Washington	1.0	37%	1.0	37%
Baltimore	0.9	0%	0.2	0%
Regional Total	**1.9**	**19%**	**1.2**	**29%**

Source: CoStar, Delta Associates; January 2013.

The region's overall vacancy rate for newer product (built since 1987) decreased to 9.6% at year-end 2012, from 10.8% one year ago. The region's direct vacancy rate for newer product is 9.0% at December 2012, down from 10.0% one year ago.

Construction

The amount of flex/industrial space under construction in the region is 1.2 million SF at year-end 2012, down from 1.9 million SF one year ago. Space under construction is 29% pre-leased at December 2012, compared to 19% one year ago.

Developers started on 1.1 million SF of flex/industrial space in the Washington/Baltimore region during 2012, compared to 1.2 million SF during 2011.

Most recently, St. John Properties broke ground on two buildings, totaling 108,000 SF, at 44190 and 44200 Waxpool Road in the Dulles Corridor. The company plans to deliver the projects by the end of 2013.

Raging Wire recently announced plans to add to the data center inventory in the Dulles Corridor. The company purchased 75 acres of land from Loudoun County during the 2nd half of 2012. The parcel is slated for up to 750,000 SF of data center space.

We expect some groundbreakings in select submarkets, particularly for data centers, for those developers armed with capital.

Developers added 1.2 million SF of flex/industrial inventory to the market during 2012, compared to 768,000 SF during 2011. Projects came on line at 59% pre-leased during the past year, compared to 61% pre-leased on projects delivering during 2011.

Supply vs. Demand

The regional flex/industrial vacancy rate likely will tick down to 8.8% by year-end 2013, from 9.5% today. The overall vacancy rate will edge down 70 basis points, as we project demand to outpace new supply by approximately 2.6 million SF. Demand should gradually pick up pace during 2013, causing the vacancy rate to decline further. However, demand will be muted compared to the robust part of the business cycle as tenants are cautious about leasing space due to uncertainty about the Federal budget and its potential impact on the regional economy.

Asking Rents

Flex/industrial asking rents in the Washington/Baltimore region increased 3.2% during 2012, compared to just a 0.2% rise during 2011. Each property type experienced gains in rent during the past 12 months.

Flex/industrial rents should experience gains during 2013. However, growth will be restrained as tenants are hesitant to lease space due to uncertainty in the Federal budget and the overall economy. We expect rents to rise 2.5% to 3.5% during 2013.

Investment Sales

Flex/industrial investment sales volume totaled $1.2 billion ($73/SF) in the Washington/Baltimore region during 2012, compared $726 million ($87/SF) during 2011.

Notably in 2012, Blackstone purchased a 65-asset portfolio for $770 million from Dexus Property Group. Of the 65 properties, nine are in the Baltimore suburbs and three are in Northern Virginia.

We expect investment sales activity to remain steady during 2013. We anticipate those with cash will continue to take advantage of purchasing flex/industrial assets in the Washington/Baltimore market, given its long-term growth prospects and stable nature.

Land Sales

There were three notable flex/industrial land sales during 2012, compared to two notable transactions during 2011.

- Raging Wire purchased 75 acres from Loudoun County for $20 million during the 2nd half of 2012. The company plans to build a 750,000 SF data center on the parcel.
- Safe Soil, Inc. purchased two parcels, totaling 289 acres, at North Andrews Employment Park and South Andrews Employment Park for $18 million during the 2nd half of 2012. The company plans to prep the land and search for a long-term build-out for an industrial user, according the Prince George's County Newsletter.
- Liberty Property Trust purchased 18.6 acres of land located at 7460-7462 New Ridge Road in the BWI submarket during the 2nd half of 2012. This parcel was part of a three parcel portfolio – with the other two parcels located in Houston and Dallas. The parcel located at 7460-7462 New Ridge Road sold for $8 million.

Flex/Industrial Deliveries
Washington/Baltimore Region | 2012

Metro Area	Millions of SF Delivered	% Pre-leased
Washington	1.1	56%
Baltimore	0.1	100%
Regional Total	**1.2**	**59%**

Source: CoStar, Delta Associates; January 2013.

Flex/Industrial Projected Vacancy Rates
Washington/Baltimore Region | (Millions of SF)

	Wash. Metro	Balt. Metro	Regional Total
Inventory			
Inventory at 12/12	195.7	201.8	397.4
Pipeline Thru 12/13[1]	1.5	0.7	2.1
Inventory at 12/13	197.1	202.4	399.5
Supply[2] vs. Demand			
Vacant Space at 12/12	20.2	17.7	37.9
New Supply Thru 12/13	1.5	0.7	2.1
Avail. Space at 12/13	21.7	18.3	40.0
Demand Thru 12/13	2.7	2.0	4.7
Vacant Space at 12/13	19.0	16.3	35.3
Vacancy Rate[2]			
Vacancy at 12/12	10.3%	8.8%	9.5%
Vacancy at 12/13	9.6%	8.1%	8.8%

[1] Pipeline equals buildings under construction and those planned that may deliver by year-end 2013.
[2] Includes sublet space.

Source: Delta Associates; January 2013.

Land sale activity should rise during 2013. Although we expect market conditions to remain slightly tepid, developers will be in search of land deals, holding off on breaking ground until conditions improve further.

Asking Rent Change by Product Type
Washington/Baltimore Region | 2012

Submarket	% Change December 2011 to December 2012
Bulk Warehouse	3.9%
Flex/Warehouse	4.1%
Flex/R&D	1.3%

Source: CoStar, Delta Associates; January 2013.

Flex/Industrial Market Outlook: Succeeding in a Competitive Market

Flex/industrial market conditions in the Washington/Baltimore area should improve during 2013. We expect leasing activity to pick up pace, particularly surrounding Fort Meade and Aberdeen Proving Ground in the Baltimore metro area and Fort Belvoir in Northern Virginia – spurred by the residual effects of BRAC. In addition, we expect the demand for data center space, specifically around Dulles Airport in Northern Virginia, and retail distribution space to play a role in rising demand.

Flex/industrial market conditions in the Washington/ Baltimore area should improve during 2013. We expect robust market conditions during 2014.

We project overall vacancy will tick down to 8.8% by year-end 2013, as demand picks up pace gradually during the next 12 months. Given these conditions, we believe effective rents will gradually rise in 2013, by 2.5% to 3.5%. Although we project the overall vacancy rate to decline 70 basis points over the next 12 months, it remains elevated compared to a low of 7.3% at year-end 2000. However, it is making gains on this benchmark. We expect robust market conditions during 2014.

Overall, we expect the Washington/Baltimore flex/industrial market to steadily improve in the near-term. As a result, the successful investor and developer will:

1. Selectively accumulate assets in 2013 at below replacement cost while prices and interest rates are lower.

2. Invest in repositioning existing, under-performing assets at superior locations.

3. Manage assets to perform better through leasing enhancements and investment in operating system improvements.

4. Position now for development of new projects during late 2013/early 2014 in select locations.

6

The Washington Area
APARTMENT MARKET

6

The Washington Area

APARTMENT MARKET

In the Short Run: Good News is Mixed with Troubling Trends; Long-Term Prospects are Extremely Bright

Last year in ***TrendLines*** we noted that "the Washington area apartment market experienced robust conditions in 2011, but the amount of new product in the pipeline presents challenges to investors and developers in the near term." We indicated that readers should expect "a slower-growth market requiring recalibration by investors and developers." That caution was warranted, as 2012 saw rents begin a cyclical decline in some submarkets, and the number of units under construction remains too great, notwithstanding steady demand. In 2012, on balance, there was a mix of good news and troubling trends in the apartment market:

In the positive column:

- Class A **absorption** levels and absorption **pace per project,** despite an increasingly competitive marketplace, point to solid demand.
- The region's **development pipeline** has plateaued and **construction starts** are back down to more reasonable levels in the 4th quarter.
- **Rents** continue to increase in most submarkets, albeit at much more modest rates than at earlier points in this cycle.
- The Class A stabilized **vacancy** rate declined from 5.0% at year-end 2011 to 4.2% at year-end 2012.

However, there are troubling trends observed in 2012:

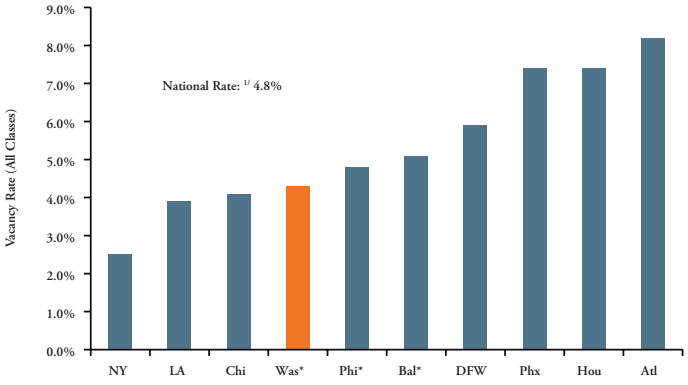
- **Rents** have begun to decline in several submarkets, particularly in those that are burdened with high levels of new supply.
- The **pipeline** remains outsized compared to projected demand.
- And the future of our **regional economy,** in light of Federal austerity measures, remains a large question mark.

In the long term, the region's apartment market prospects remain extremely bright, given lifestyle, economic, and demographic trends.

National Context

Though eighth in population, with an inventory of approximately 543,000 units, the Washington metro area is the fifth-largest apartment market in the U.S., behind New York, Los Angeles, Chicago, and Houston. The Washington metro-wide vacancy rate is 4.3% for all classes of apartment product. The national rate at year-end 2012 is 4.8%.

Apartment Vacancy Rates
Major Apartment Markets



1/ The 57 largest apartment markets in the U.S.
* Mid-year 2012 data except for Washington, Baltimore, and Philadelphia which are as of year-end 2012.

Source: MPF, Delta Associates; January 2013.

Size Matters

Average apartment size has been declining over the past decade in the face of changing demographics. For example:

- The District: Average high-rise apartment size down 5.0% to 845 SF
- Northern Virginia: Average garden apartment size down 7.0% to 945 SF

This trend is comprised of two factors: smaller unit sizes and a change in unit mix. Over the past decade there has been a shift to accommodate single person households. This shift reflects the dramatic change in household composition. Nationally 28% of households contain just one person. In urban areas that share is much larger, with the District of Columbia having the highest share in the nation according to the U.S. Census, at 48% – even higher than Manhattan, at 46%.

Developers in the region have reacted to this trend in a variety of ways, each particular to the project's target demographic and geography. For example, the average number of bedrooms per unit in The District high-rise product has declined 10%: from 1.36 in 2000-2001 to 1.23 in 2010-2011. However, if potential bedroom spaces are counted, e.g. dens, the ratio of bedrooms remains virtually unchanged, suggesting dens have taken the place of what were previously bedrooms. In Northern Virginia, the shift in bedroom ratio has been less pronounced, declining by only 4.1%. However, a sizeable change in unit mix has taken place, with a large share of 2BR/Den and 3BR units shifting toward 2BR units.

2012 Washington Area Apartment Market Highlights

- **Stabilized vacancy** for investment grade apartments (Class A and B) is one of the lowest in the nation at 4.3%, up from 3.8% a year ago.
- **Rents** for all investment grade apartments were up 1.7% during 2012.
  - Class A rents rose by 1.9 % over the past year, down from the 2.4% growth posted in 2011.
  - Class B rents increased by 1.3%.
- **Annual Net Absorption,** at 360 Class A and B apartments (7% of our long term average), declined significantly in 2012, measuring well below the region's long-term average. This reduction is due to several factors including:
- Increase in Class B vacancy from its extremely low vacancy rate of 2.2% one year ago to 4.4% at year-end 2012.
- Job growth has moderated since early 2011.
- The trend toward renting (vs. owning) appears to have run its course in the Washington metro area.

However, Washington recorded 5,073 Class A units absorbed during 2012.

As predicted by Delta Associates, and demonstrated by the latest U.S. Census Bureau data, the structural shift toward renting appears to have played out in the Washington area. This trend is further illustrated by Washington's nation-leading for-sale housing market performance. Absorption over the next 36 months will remain somewhat below the region's long-term average of 5,222 units per annum, as demand is muted by moderating job growth, rather than a combination of job growth and structural shift away from ownership, as it had been in 2009 and 2010.

- **Average monthly absorption** at new projects held steady over the year at 18 units per project per month. This pace bodes well for projects delivering in 2013, as the number of projects in lease-up begins to climb. The number of projects in lease-up has increased from 20 to 33 over the past 12 months and there are more to come in the period ahead.
- **Concessions** at Class A projects halted their declines for the first time since the first quarter of 2010. While still extremely low, concessions increased slightly to 2.7% of face rent at year-end 2012 compared to 2.6% one year earlier. Over the past year concessions for projects in initial lease-up increased from 5.0% to 8.0%, driven by a particularly large increase for projects in Suburban Maryland.
- The **development pipeline** reached a cyclical low of 16,606 as of year-end 2009. Since then improving market fundamentals and improving financing pushed the pipeline to 34,449 units at year-end 2011. At year-end 2012, the number stands at 35,767 as the market seemed to discount the threat of overbuilding.

Rents

Effective rents for both Class A and Class B apartments posted growth region-wide, increasing over the year by 1.7%.

- High-rise Class A product, almost entirely inside the Beltway, increased 2.0%.
- Class A low-rises, largely outside the Beltway, increased 1.9%.
- Overall, Class A rents were up 1.9%.

Vacancy

Washington metro area stabilized vacancy for all classes of apartments remains one of the lowest in the nation. The year-end 2012 rate ticked up slightly to 4.3%, compared to 3.8% at year-end 2011. However, demonstrating there is a flight to quality, the vacancy rate for Class A apartments declined to 4.2% from 5.0% a year ago.

Concessions

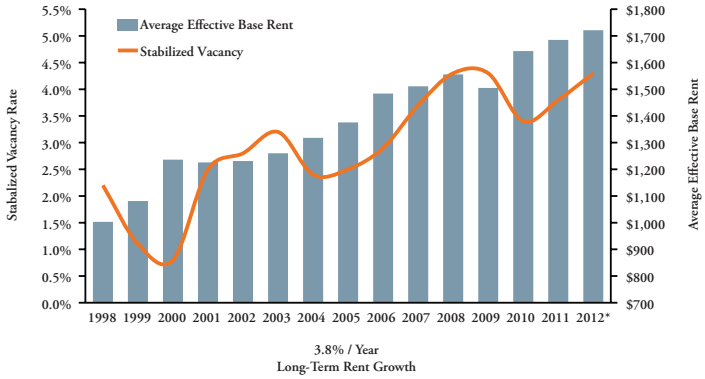
Notwithstanding an increase in the number of actively marketing projects, concessions remained nearly unchanged for Class A projects overall: 2.7% at year-end 2012 vs. 2.6% at year-end 2011. This barometer of the market may lose some of its efficacy as the share of properties in the region using rent optimization software increases, and thereby "real-time pricing" without concessions becomes more wide-spread. Concessions for all Class A properties (those filling up as well as those replacing turnover) continued to trend upward.

Concessions for projects currently filling up, and not yet stabilized, are up over the year with a particularly large increase posted by projects in Suburban Maryland.

Concession rates have increased markedly over the year as the number of projects in lease-up has risen from 20 projects at year-end 2011 to 33 projects at year-end 2012. As the number of projects in lease-up continues to increase, we expect an increasingly competitive landscape, and correspondingly higher concessions.

Effective Rental Rate And Vacancy Rate

All Types and Classes of Apartments | Washington Metro Area



* As of year-end 2012.
Source: Delta Associates; January 2013.

Concessions for All Class A Properties

	Year-End 2009	Year-End 2010	Year-End 2011	Year-End 2012
No. VA	6.8%	3.3%	2.3%	2.7%
Sub. MD	7.3%	3.3%	2.9%	2.5%
District	8.7%	4.9%	2.9%	3.6%
Metro-Wide	7.2%	3.5%	2.6%	2.7%

Source: Delta Associates; January 2013.

Concessions for Projects Currently Filling Up, and Not Yet Stabilized

	Year-End 2009	Year-End 2010	Year-End 2011	Year-End 2012
No. VA	14.9%	11.6%	6.1%	6.7%
Sub. MD	15.0%	10.5%	4.8%	11.8%
District	17.8%	10.9%	4.3%	6.1%
Metro-Wide	15.7%	11.0%	5.0%	8.0%

Source: Delta Associates; January 2013.

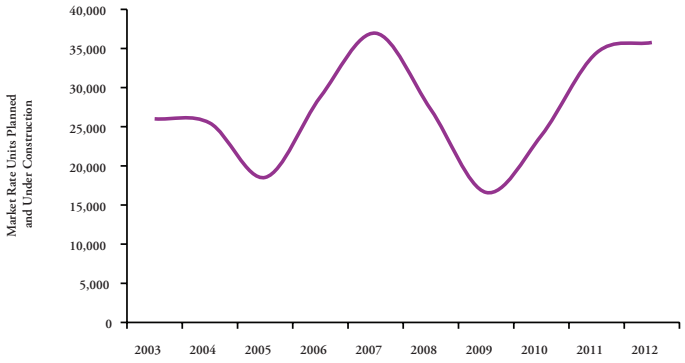
Share of Planned vs. Under Construction in 36-Month Pipeline

Period	% Planned	% Under Construction
4Q 2012	19%	81%
3Q 2012	23%	77%
2Q 2012	28%	72%
1Q 2012	32%	68%
4Q 2011	40%	60%

Source: Delta Associates; January 2013.

Market Rate Apartment Development Pipeline

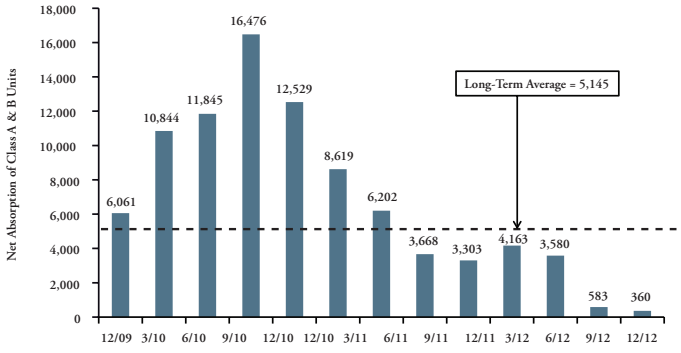
Washington Metro Area



Source: Delta Associates; January 2013.

Annual Net Apartment Absorption

Class A & B Units | Washington Metro Area



Source: Delta Associates; January 2013.

Pipeline

The share of planned units vs. units under construction is declining. We expect the pipeline to continue shrinking in 2013 as the region moves further through the current development cycle. As financing became available in 2010 following the recent recession, the pipeline grew rapidly, with a record-setting construction pace in 2011. After declining for the first half of 2012, the pipeline resumed its growth and settled at 35,767 at year-end. The number of planned units projected to deliver in the 36-month pipeline is 6,869 at year-end 2012 and units under construction total 28,898.

We project 15,543 units will deliver in 2013, of which 99% are currently under construction. Deliveries are expected to decrease to 11,431 units during 2014. Approximately 78% of these expected deliveries are under construction at year-end 2012.

Substate Recap

The District's Class A apartment market is beginning to feel the cumulative effects of deliveries in the second half of 2012. Class A rents remained positive, climbing 0.6% over the past year, yet rent decreases were registered in the NoMa/H Street, Columbia Heights/Shaw and Upper NW submarkets. Even so, Columbia Heights/Shaw posted the highest effective base rent in the District at $3.09/SF.

The District's 36-month pipeline of projects stands at 9,863 units as of December 2012. A large share of the projects is slated for delivery in 2013.

Stabilized vacancy, at 3.4%, changed little from the rate of 3.5% one year ago, despite an influx of new product easing undersupply in the District. Vacancy will likely edge upward over the coming year due to an imbalance between deliveries and absorption. Much of the new product coming to market over the next 24 months is concentrated in emerging markets such as Mt. Vernon Triangle, NoMa, H Street, and the Capitol Riverfront. These thousands of units have reversed the supply/demand balance in favor of renters and are moderating performance metrics, with concessions required to maintain occupancy in most submarkets. Rising concessions will increase the competitiveness of the District vs. other close in submarkets, elevating its share of total regional absorption.

Northern Virginia's 36-month pipeline stands at 14,924 units at year-end 2012, with 82% of those units under construction. The year-end 2012 Class A stabilized vacancy rate is 3.8%, down from 5.1% one year prior. Projected deliveries in 2013 are set to increase by 40% to 5,909, from the 4,218 units delivered during 2012, outstripping recent and project Class A absorption levels of approximately 2,500 units per year. This imbalance will push up stabilized vacancy over the coming year.

Low-rise Class A properties in Northern Virginia posted rent growth of 1.3% over the year. Rents are up 3.0% for Class A high-rise apartments in Northern Virginia, with Alexandria posting the strongest increase of 6.1%.

Suburban Maryland's 36-month pipeline is 10,980 units at year-end 2012. 5,593 units are expected to deliver in this substate area in 2013; a 94% increase over the 2012 month total of 2,882 units. This level of deliveries will continue to outpace a market recently absorbing approximately 1,200 units per year. Current stabilized vacancy stands at 5.0%. Twelve projects containing nearly 3,000 units are slated for delivery in the first half of 2013, putting upward pressure on vacancy and downward pressure on rents in this substate area.

Class A low-rise properties in Suburban Maryland experienced rent growth of 2.6% over the past year while Class A high-rise properties saw rent increases of 1.7%. Rents are up 2.4% for all Class A apartments in Suburban Maryland. Howard County/Columbia is the top performing submarket at this time, with 1.0% concessions and effective rents increasing by 7.5% over the year.

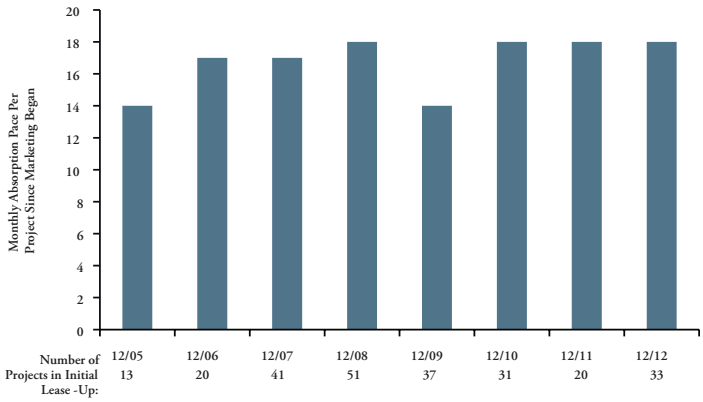
Growing Demand the Old-Fashioned Way

The Washington area's Class A apartment absorption was 5,073 units during 2012 – a bit below its long-term average. Contributing factors to the trend include:

- Flight to quality by heretofore Class B renters.
- Apartment supply that is no longer constrained.

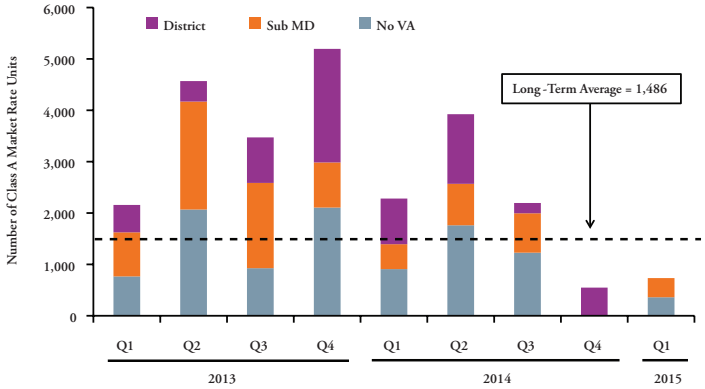
Class A & B absorption combined edged lower at year-end 2012 to just 360 units for the preceding 12 months (7% of the region's long-term average). This significant drop off in overall absorption is due to units being returned to the market within the region's Class B stock, with vacancies rising from 3.8% in year-end 2011 to 4.3% at year-end 2012.

Absorption Pace Per Project Per Month
For Projects in Initial Lease-Up | Washington Metro Area



Source: Delta Associates; January 2013.

Projected Deliveries
Projects Currently Under Construction | Washington Metro Area



Source: Delta Associates; January 2013.

Absorption, Deliveries, Starts, and Pipeline Summary

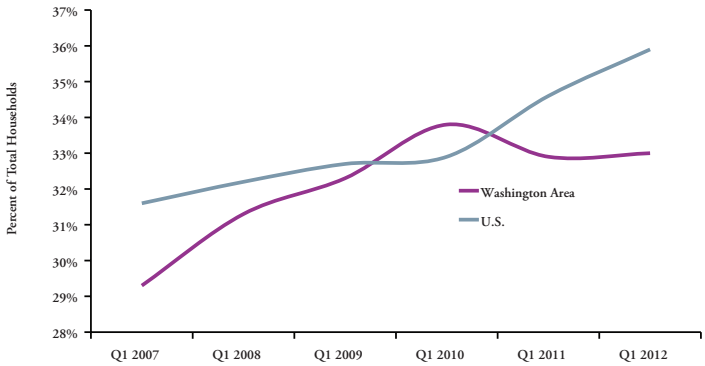
Net Absorption Class A & B	NOVA	SUBMD	District	Metro-Wide
12 mo. ending 12/12	-384	-536	1,280	360
12 mo. ending 12/11	1,468	995	840	3,303
12 mo. ending 12/10	7,106	4,250	1,173	12,529
Deliveries:				
12 mo. ending 12/12	4,218	2,882	2,217	9,317
Projected:				
12 mo. ending 12/13	5,909	5,593	4,041	15,543
12 mo. ending 12/14	4,623	3,364	3,444	11,431
12 mo. ending 12/15	2,214	1,635	1,125	4,974
Starts:				
4Q 2012	1,387	524	607	2,518
12 mo. ending 12/12	5,831	4,908	3,644	14,383
36-Month Pipeline				
At 12/2012	14,924	10,980	9,863	35,767
At 12/2011	13,802	11,449	9,198	34,449
At 12/2010	10,792	7,112	5,976	23,880

1/ Includes vacant units in projects leasing up, units under construction and units expected to begin construction and deliver in the next 36 months.

Source: Delta Associates; January 2013.

Renter Households

Washington Metro Area vs. U.S.



Source: Delta Associates; January 2013.

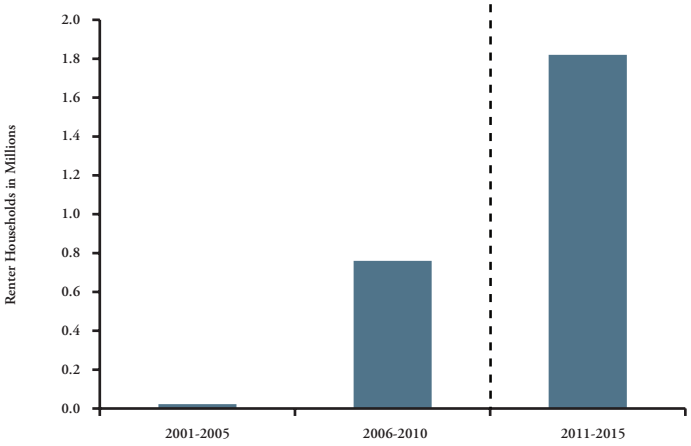
Over the coming quarters, two factors will be necessary for rental demand to increase:

- Job growth
- Demographic shifts:
  - The "de-nesting" of 25- to 34-year-olds who are living with their parents
  - The "un-coupling" of 25- to 34-year-olds who are living together to save money

We expect "de-nesting" and "un-coupling" to take place in the 2013 to 2015 period with improved job growth and reduced uncertainty in the region over the intermediate term. This trend will produce solid, though not spectacular, Class A apartment absorption. Therefore, we project demand of approximately 5,100 Class A units per annum over the next three years; this is in line with the metro region's long-term average of 5,145 units. For more on these demographic shifts at the national level, please see the sidebar on the next page.

Annual Change in Total Renter Households

United States



Source: U.S. Census Bureau, John Burns Real Estate Consulting, Delta Associates; January 2013.

Demographic and housing trends in the U.S. will power a healthy apartment market over the next five years.

While living with parents has always been a fallback option for the younger generation during tough economic times, the scale of future potential renters currently foregoing the traditional rental market is well beyond any recession and recovery in the past. As the economy continues to recover, this national group of over 5.5 million people represents a huge pool of likely future renters, which leads to the next bright spot on the horizon.

Due to a confluence of factors, including the Generation-Y demographic bulge and the increased preference to rent rather than own following the national housing collapse, there is an extremely large cohort of renters expected to emerge from 2011 through 2015 (9.1 million) – nearly three times the increase the nation experienced during the period from 2006 to 2010. This pool of renters should power a strong national and local rental market over the intermediate to long term.

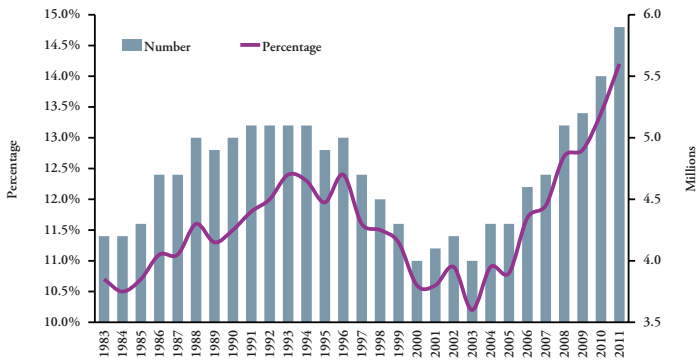
Per project monthly absorption climbed in 2011 due to a below-average number of deliveries over the past two years. Even as the number of projects in lease-up increased at year-end 2012, the market saw the per project monthly lease-up pace hold steady at 18 units from one year prior. There are 33 projects in active lease-up, up from 20 at year-end 2011. This number of projects in lease-up will continue to climb with a large slate of projects set to deliver over the next 24 months, eventually putting downward pressure on per project lease-up pace.

Construction Update

After limited construction in 2009 and 2010 due to tightened credit markets and poor property performance metrics, construction came roaring back in 2011 with 14,827 units breaking ground – the largest number recorded by Delta Associates since we began tracking the market in 1994. Construction pace plateaued in 2012, with another 14,838 units breaking ground. This continued elevated level of production will delay the market's return to supply/demand equilibrium until 2015-16.

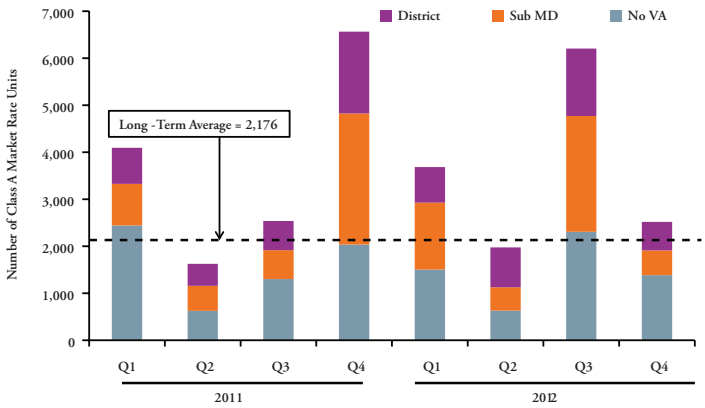
In the near term however, the opening of the development spigot in 2011 is easing the previous supply constrained market with 9,317 units delivering in 2012. An additional 15,543 units will come to market in 2013 and approximately 11,431 units will arrive in 2014.

25-34 Year Olds Living With Their Parents
United States



Source: U.S. Census Bureau, John Burns Real Estate Consulting, Delta Associates; January 2013.

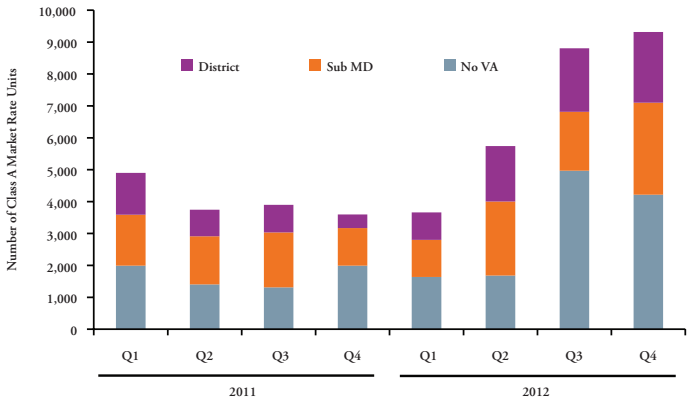
Class A Apartment Unit Starts
Washington Metro Area



Source: Delta Associates; January 2013.

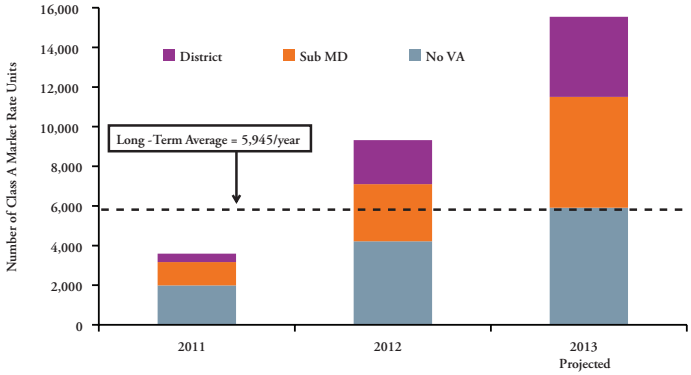
As job growth has moderated and deliveries continue at elevated levels, market fundamentals will likely become more competitive over the next 18 months. Close monitoring of the overall health of the Washington economy will be important in 2013, as steadily improving job growth and demographic and lifestyle shifts are key to producing the absorption necessary to fill the large slate of projects delivering over the coming months.

Annual Class A Apartment Unit Deliveries
Washington Metro Area



Note: Bars reflect 12 months ending in each period.
Source: Delta Associates; January 2013.

Annual Class A Apartment Unit Deliveries
Washington Metro Area



Source: Delta Associates; January 2013.

Supply/Demand and Rent Outlook

We expect stabilized Class A vacancy rates in the Washington area to increase from 4.2% today to 5.3% at year-end 2015.

Given the projected delivery schedule of projects currently under construction, we expect the region-wide vacancy rate for stabilized Class A apartment properties to edge upward to 5.3% by year-end 2015 and a bit higher before then. However, there will be significant variance in conditions within the region.

Class A rents will face downward pressure over the next 24 months at the regional level due to the large slate of scheduled deliveries compared to projected demand levels. Rent growth has slowed over the past 12 months in most submarkets and turned negative in several during late 2012. Given headwinds on the demand front, and a robust delivery schedule, modest rent declines are probable at the regional level in 2013. Better projects in stronger submarkets will outperform these market averages. We expect rental rates to recover to the long-term average rate of growth of 4.5% per annum by 2016.

Return on Investment

Total return on apartment investment (cash flow plus appreciation) in the Washington market continues to track below the national average, as reported by NCREIF. While this index reports a solid 7.33% 12-month total return, this measure is significantly off the cyclical peak of 28.64% in 2010. This breather is to be expected after such a huge run-up earlier this cycle in area prices.

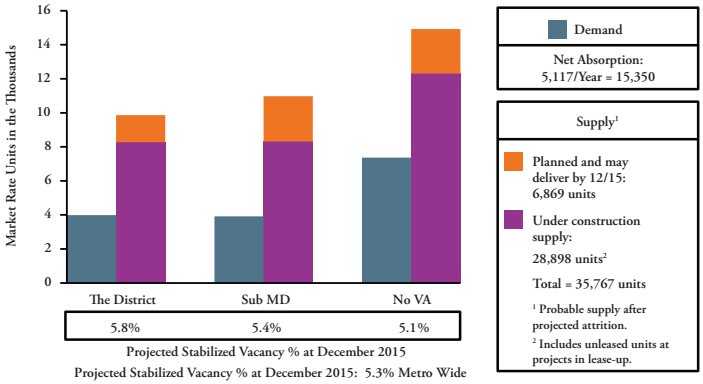
Washington Investment Sales

In 2012 through November, we note $1.27 billion of multifamily Class A building sales (seven low-rise properties and seven mid-rise/high-rise properties). The 2012 average per-unit price for closed sales is 14.5% lower than for year-end 2011 for low-rise units (at $196,000), due in part to the geographic composition of sales-to-date. High-rise prices are off 12.3% from year-end 2011 at ($377,000). Of note in the Washington region in 2012 is the break up and sale of stalwart developer and operator, Archstone, to AvalonBay and Equity Residential. This transaction, covering numerous properties and development sites throughout the region, is expected to close in the first quarter of 2013.

It is our sense that cap rates trended lower during the first half of 2012 but stabilized since. We believe that cap rates will likely stabilize or nudge up slightly in 2013, as market conditions become more competitive amid increased supply and job growth is muted in the region. Apartments will remain in favor as an asset class, however, as indicated in our year-end 2012 Market Maker Survey of the region's senior commercial real estate executives.

Seventeen multifamily land sales closed through November 2012, totaling $190.3 million, with the capacity for over 3,700 apartment units.

Class A Apartment Demand and Supply Projections
Washington Metro Area | Dec. 2012 - Dec. 2015



Source: Delta Associates; January 2013.

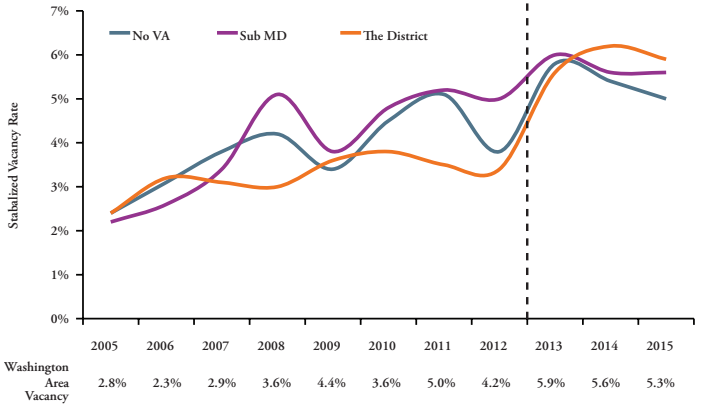
NCREIF Return Index: 12 Months Ending September 2012[1]
Investment-Grade Apartment Properties

Metro Area	12-Month Total Return[1]
Dallas	13.53%
Chicago	13.10%
Austin	12.76%
Atlanta	12.35%
National Average	11.96%
Houston	11.89%
Phoenix	10.45%
Washington	7.33%

[1] NCREIF compiles returns based on its members' $70 billion apartment portfolio. The index includes both current income and estimated capital appreciation returns.

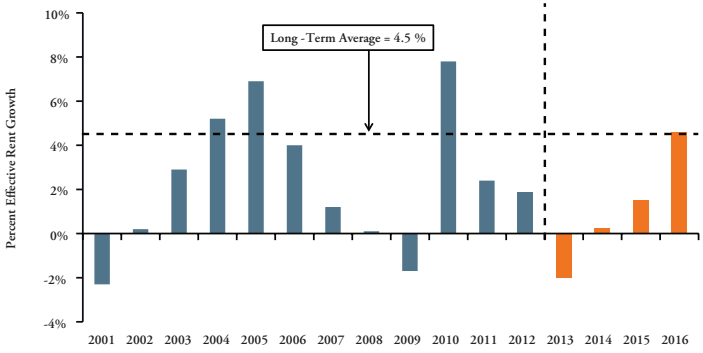
Source: Delta Associates, based on trailing 12-month data in NCREIF "Real Estate Performance Report: Third Quarter 2012."

Class A Apartment Vacancy Rate
Washington Metro Area



Source: Delta Associates; January 2013.

Annual Class A Apartment Rent Growth
Washington Metro Area



Source: Delta Associates; January 2013.

Apartment Market Outlook: Succeeding in a Competitive Market

As the market becomes more competitive, we find that our more successful developer clients are competing with superior product, at superior locations, with best-in-class management and marketing. Specifically, they are doing the following:

1. Investing in repositioning existing under-performing assets, with particular attention paid to the demographic segments that will likely be attracted to the property based on location, product type, and unit mix.

2. Positioning to take advantage of the long-term prospects for apartment living in the region. While near-term conditions may be competitive, demographic trends paint a bright future for the apartment marketplace:
   - Millions of prospective renters in Generation-Y will continue to join the workforce over the coming decade and demand flexible housing arrangements that apartments provide.
   - Those in the Generation-Y cohort currently doubling-up or living with their parents will eventually "age out" (or be nudged out) and look for their own place, further enhancing demand over the long term.

3. Innovating with new features and community amenities, including:
   - Pet-centric amenities such as pet care centers, dog-walking areas, etc.
   - Interactive media stations in club rooms and electronic concierge notification systems.
   - Built-in audio systems and flexible furniture, such as moveable kitchen islands, to maximize small unit spaces.
   - Bike storage and bike- and car-sharing infrastructure, especially near Metro.
   - Outdoor spaces, including movie screens, screened-in porches, or fireplaces that expand the living space of the property and extend the summer "outdoor" season.
   - Units uniquely targeted to roommate shares.

4. Going for Metro-oriented, urban-place locations that appeal to those renters who demand to be near their place of work or near the action, and which appeal to the increasing number of tenants who choose not to own a car.

A Word About Our Definition of Vacancy Rate

We sometimes hear from apartment developers and managers that their portfolio vacancy rate is 200 to 400 basis points higher than the numbers we report, which places them under unfair investor scrutiny. As a result, we thought it appropriate to describe here our term "vacancy."

When we conduct our surveys, we obtain information on "units available to lease" – that is, physical vacancy. Obtaining the information this way, of course, may produce several important differences from "vacancy" as reported in your financial statements. Simply stated, the difference can be characterized as:

Delta's Definition: Available units to lease
Operating Statement Vacancy: Economic vacancy

Our definition (available units) may therefore be understated compared to yours (economically vacant) by our exclusion of units occupied by non-paying tenants (which we cannot know), and of units not available for lease, such as employee units and model apartments. We estimate that this adds about 100 to 150 basis points to your definition of vacancy, as compared to ours. Our vacancy rate may also be understated, compared to yours, by our exclusion of what at present are economically vacant, on-notice units for which a lease to occupy in the future has been signed (hence, they are not currently available to lease). We estimate that this potentially adds another 150 to 200 basis points to your definition of vacancy, as compared to ours.

7

The Washington Area
CONDOMINIUM MARKET

The Washington Area CONDOMINIUM MARKET

Prices, Volume, and Pace Up in 2012; Pipeline Continues to Decline; Expansion Phase of Recovery Cycle to Continue into 2013

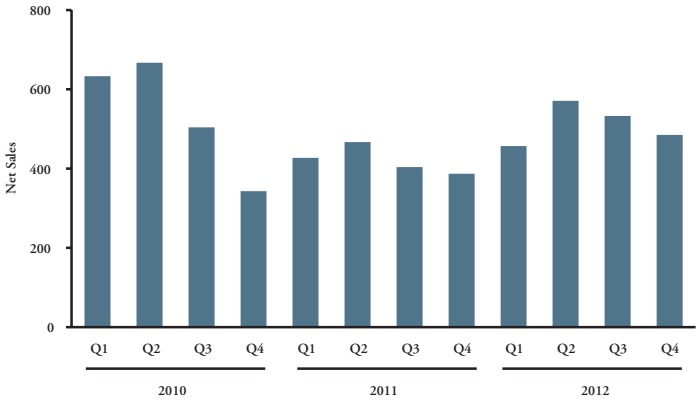
Last year in ***TrendLines*** we lamented the slowness of the condominium market's recovery but said that 2012 would be a rebound year. Indeed, after several years of malaise, the Washington condominium market now appears to be in the expansion portion of the recovery cycle as measured by all metrics:

- **Sales volume and sales pace are on the rebound.** Sales volume in 2012 improved markedly from 2011, but was lower than 2009 and 2010 levels, which were influenced by the first time homebuyer credit incentive. Record low interest rates contributed to the rebound in sales velocity in 2012; however, sales volume may have been constrained in 2012 by the lack of new supply. Meanwhile, average sales pace at newer projects was more than triple the rate of average sales pace at projects that have sold out during the past two years, which suggests meaningful pent up demand for newer product.
- **The unsold pipeline continues to tighten, but with fresher product.** While the actively marketing pipeline is at record lows, there were more new market entrants in 2012 than in 2011, so a higher percentage of units now actively marketing have been available for sale for less time than in previous years.
- **New unit prices are increasing – finally.** A tight pipeline coupled with more new product fostered meaningful price increase metro-wide during 2012 – for the first time since 2005. While a select number of submarkets saw price appreciation starting in 2011, it was in 2012 when prices were on the rise more uniformly across the region.
- **The resale market is strong.** The resale inventory is at its tightest since 2005, while sales velocity has remained steady over the past four years. This has also resulted in price increases for the first time in seven years.

However, there are several wildcards that continue to threaten this nascent expansion:

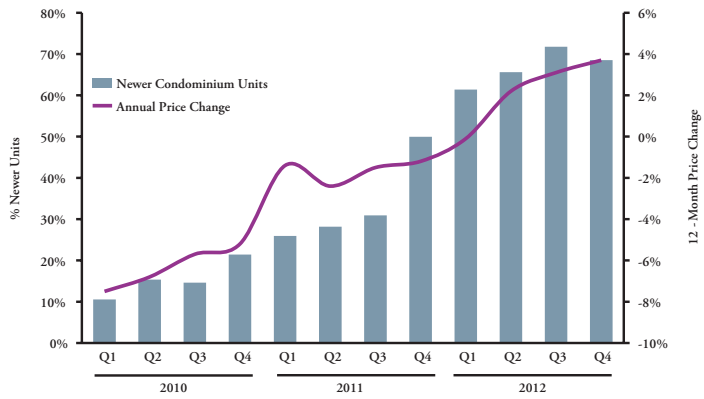
- Condominium construction financing remains difficult for developers to obtain without very significant pre-sales.
- The mortgage underwriting process remains in flux and down-payments are high.
- Economic uncertainty remains high (both at home and abroad), yielding a fragile economy and reduced consumer sentiment.

New Condominium Sales Activity
Washington Metro Area



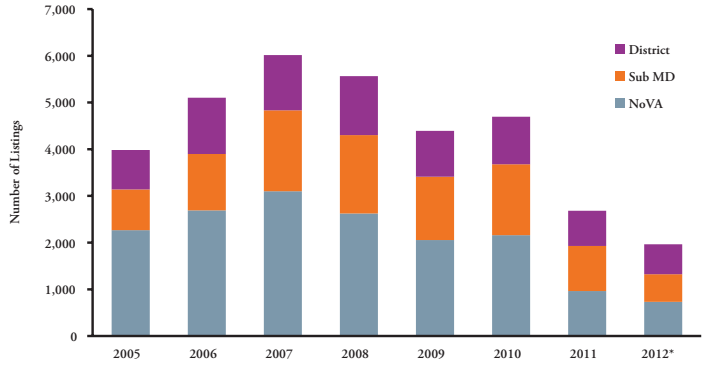
Source: Delta Associates; January 2013.

Newer Condo Units* as a Percent of Total Inventory and 12-Month Price Change
Washington Metro Area



* Defined as units two years old or less.
Source: Delta Associates; January 2013.

Resale Condominium Active Listings Trend
Washington Metro Area



* As of November 2012.
Source: Delta Associates; January 2013.

The Washington Metro Area Condominium Market at Year-End 2012:

- **Sales Volume:** New unit sales volume (defined as net binding contracts written with security deposits up) totaled 2,046 for the year. This compares favorably to 1,617 new unit sales in 2011.
- **Prices:** New unit prices increased by 3.7% metro-wide in 2012. Condominium resale prices increased 7.9% over the year.
- **Concessions:** Metro-wide concessions average 1.9% of asking price as of year-end 2012. This is 70 basis points lower than a year ago.
- **Pipeline:** There are currently 2,577 unsold new condominium units that are either actively marketing or under construction (and yet to begin marketing) in the metro area. As a result, there now is one year of condominium inventory on the market at current rates of sales velocity. This metric varies a great deal by submarket: In Upper NW DC, there is virtually no new inventory available, but in Loudoun/Prince William, there is 2.0 years of inventory. At the metro level this is an extremely low level and suggests continued price increases in 2013.
- **Sales pace:** Projects that have sold out since 2011 have averaged 2.8 sales per month. Projects introduced to the market during the past 12 months have sold at an average of 10.5 sales per month.

The Washington condominium market now appears to be in the expansion portion of the recovery cycle as measured by all metrics.

National Context

The Washington metro area, the 8th largest in population, is the sixth-largest condominium market in the nation, with approximately 125,000 units. Only the nation's three largest cities (New York, Los Angeles, and Chicago), plus Boston and the popular second-home location of South Florida, have a larger inventory of condominiums than the Washington area.

Sales Activity: New Unit Volume Increases 27% in 2012

Sales of new units increased 27% in 2012 as compared to 2011 – to 2,046 units. Sales numbers improved in all three substate areas in 2012 compared to a year ago, especially in Suburban Maryland, where sales were up by 82% and had the highest annual total since 2008. Montgomery and Prince George's Counties made up over 22% of all sales metro-wide, higher than the long-term average share of 18.3%.

The Loudoun/Prince William Counties submarket continues to lead the metro area in new condominium sales activity, with mostly 2-over-2 development, followed closely by Arlington/Alexandria. During 2012 in Suburban Maryland, Montgomery County led in sales activity. In the District, the Mideast submarket (which includes Shaw, Columbia Heights, and the 14th Street corridor) led. This area of the District has seen several new condominium projects in the past couple of years, mainly in the form of boutique buildings of less than 50 units and conversions.

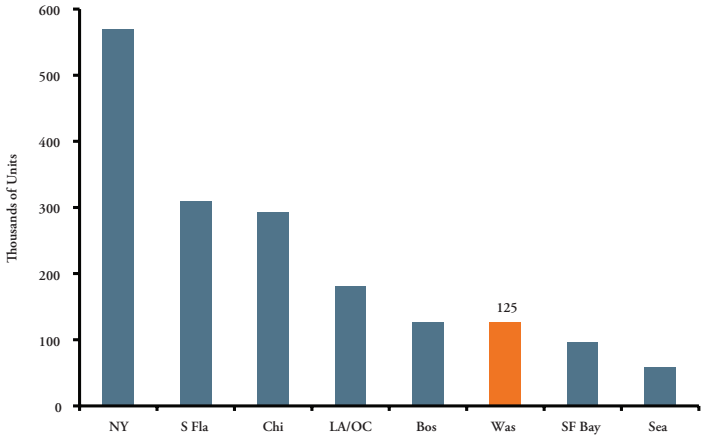
Prices: Up 3.7% in 2012

The average effective price per square foot for "same-store" new condominium sales in the metro area during 2012 rose by 3.7%. In 2012, prices increased the most in the Arlington/Alexandria submarket (by double-digits), but in Capitol East DC (which includes Capitol Hill, NoMa, Southwest, Capitol Riverfront, and communities east of the Anacostia River), prices fell by 3.2%.

The region's highest effective prices per square foot are found in Central DC, whereas the lowest are in Loudoun/Prince William. Most of the product currently selling in Central DC is in luxury buildings while in Loudoun/Prince William, the majority of inventory on the market is townhouse-style condominium developments.

Resale prices are also on the rise. As of November 2012, resale condominium prices were up 7.9% metro-wide from a year earlier, while single-family resale home prices rose by 9.6% during the same time period.

Largest Condominium Markets
United States | 2012



Note: Estimated.
Source: Delta Associates; January 2013.

Sales Compared to Remaining Inventory
Year-End 2012

Condominium Submarket	Q4 Sales/Remaining Inventory
Central DC	27 / 262
Mideast DC	52 / 259
Upper NW DC	8 / 22
Capitol East DC	2 / 103
Arlington/Alexandria	132 / 265
Fairfax/Falls Church	23 / 131
Loudoun/Prince William	147 / 966
Montgomery	72 / 535
Prince George's	22 / 34

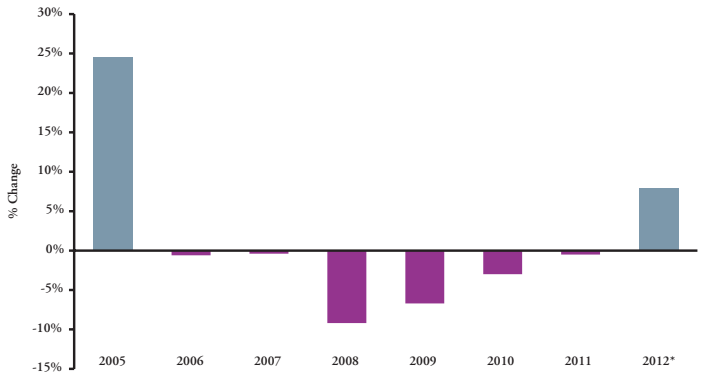
Source: Delta Associates; January 2013.

Net New Unit Sales by Submarket
2012

Condominium Submarket	# of Units Sold[1]
Loudoun/Prince William	472
Arlington/Alexandria	449
Montgomery	322
Mideast DC	203
Fairfax/Falls Church	201
Capitol East DC	160
Prince George's	134
Central DC	76
Upper NW DC	29
Wash. Metro Total	**2,046**

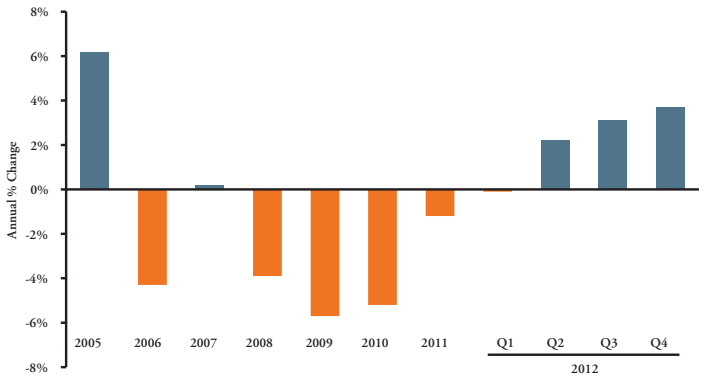
[1] Net new unit sales by submarket.
Source: Delta Associates; January 2013.

Resale Condominium Sales Price Change
Washington Metro Area



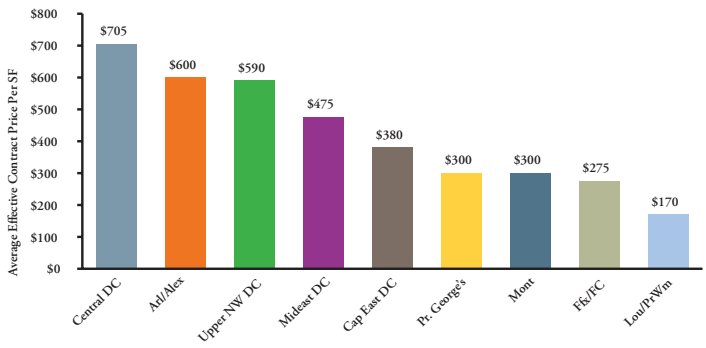
* 12 months ending November.
Source: Delta Associates; January 2013.

Effective New Condominium Sales Price Change
Washington Metro Area



Source: Delta Associates; January 2013.

New Condominium Prices Per SF*
Washington Metro Area | Year-End 2012



* Reflects prices of condominium projects currently selling, so averages should not be compared from quarter to quarter since locations of projects change each quarter.
Source: Delta Associates; January 2013.

Concessions: Down 70 Basis Points in 2012

Concession rates decreased by 70 basis points metro-wide during 2012, with all three substate areas experiencing declines ranging from 50 to 90 basis points. Concessions are lowest in Central DC and Mideast DC where they are hardly being offered and highest in Fairfax/Falls Church at 2.9%.

Pipeline: Lowest Total in Ten Years

The number of **unsold units** in projects currently marketing or under construction (and not yet marketing) was 2,577 units at December 2012 – the lowest it has ever been since Delta Associates began tracking the condominium pipeline ten years ago. In addition, there are 2,677 units that are planned to start sales within the next 36 months – the first time this number has been higher than the actively marketing pipeline amount since 2005. On top of that, about 9,100 units are in the longer-term condominium pipeline and another 52,700 multifamily units are in various stages of planning and can either be built as rental apartments or condominiums.

In recent quarters, the pace at which "stale" inventory has made its way out of the market has accelerated; that older inventory is being replaced by **"fresh units"** – units that have been on the market for two years or less. As of December 2012, over two-thirds of condominium units currently selling are classified as "fresh" units. This is a stunning turnaround from 2009 when less than 10% of the pipeline was "fresh."

The **inventory-to-sales ratio** (years of supply at current rates of sale) metro-wide is currently one year. The ratio is expected to rise in 2013 as some larger projects currently under construction but not yet actively selling, and others in the 36-month pipeline, make their way to the market. We know from experience that a market with less than two years of inventory and more than 70% "fresh units" will experience price appreciation. Therefore, the market should remain under positive price pressure for the foreseeable future.

Approximately 1,148 new units began selling in 2012, an increase of 62% from the number of **new market entrants** in 2011. Out of the total new market entrants, more than 43% of those units have been sold, which compares favorably to the 19% of new market entrants that sold during 2011.

New Condominium Price Change
2012

Substate Area	Effective Price Change
District of Columbia	-0.3%
Northern Virginia	6.3%
Suburban Maryland	1.2%
Wash. Metro Average	**3.7%**

Note: "same store" sales.
Source: Delta Associates; January 2013.

Median Condominium Re-Sale Prices
Percent Change in 2011 and 12 Months Ending November 2012

	Median Price Change	
Substate Area	2011	11/11 - 11/12
District of Columbia	-2.3%	5.0%
Northern Virginia	9.1%	6.8%
Suburban Maryland	-17.7%	9.1%
Wash. Metro Average	**-0.5%**	**7.9%**

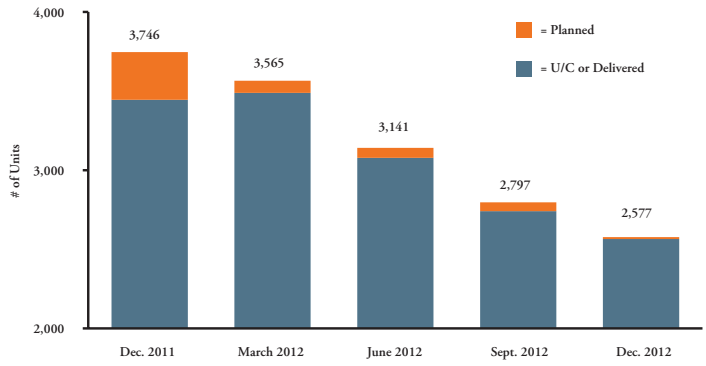
Source: Delta Associates; January 2013.

Concessions as a Percent of Average Sales Price by Sub-State Area
Year-End 2011 and Year-End 2012

	% of Sales Price	
Substate Area	YE 2011	YE 2012
District of Columbia	1.0%	0.3%
Northern Virginia	3.3%	2.2%
Suburban Maryland	2.3%	1.8%
Wash. Metro Average	**2.6%**	**1.9%**

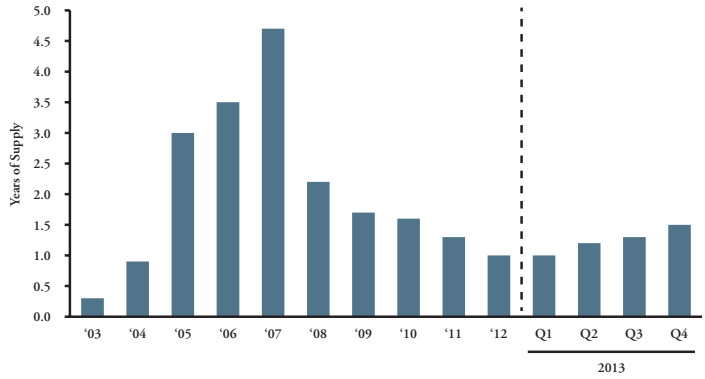
Source: Delta Associates; January 2013.

Condominiums Actively Marketing or Under Construction
Washington Metro Area



Source: Delta Associates; January 2013.

Years of Condominium Supply
Washington Metro Area



Source: Delta Associates; January 2013.

Inventory-to-Sales Ratio by Sub-State Area
Year-End 2011 and Year-End 2012

	Inventory-to-Sales Ratio	
Substate Area	**YE 2011**	**YE 2012**
District of Columbia	1.1	0.4
Northern Virginia	1.4	1.2
Suburban Maryland	3.2	1.2
Wash. Metro Average	**1.3**	**1.0**

Source: Delta Associates; January 2013.

Most of the District remains **supply-constrained.** In the apartment market, over 8,000 units are currently under construction and available and an additional 1,900 apartment units plan to deliver in the next 36 months. By contrast, only 182 new condominium units are currently available for sale city-wide, with only two units available in Upper NW. Even if resale inventory is added (currently at its lowest level since 2005), the total number of condominium units on the market satisfies less than six months of demand. There are an additional 464 condominium units under construction and/or pre-marketing that will soon begin sales and 1,378 units are in the 36-month pipeline.

Meanwhile, Loudoun/Prince William and Montgomery County are above the average metro-wide range of 1.0 to 1.3 years of inventory. Both of these submarkets have a large amount of townhouse-style condominiums in exurban areas, while traditional condominium flats remain in short supply, especially in Montgomery County's inner suburb communities of Bethesda and Silver Spring. The demand for condominiums in these two inner suburbs is evident based on the sales performance of new projects that recently entered the market.

Condominium Starts: Insufficient to Keep Pace with Sales Velocity

At least 24 condominium projects started construction or converted in 2012 for a total of nearly 800 units, which is a drop of over 40% from 2011. Several projects that were supposed to start construction in 2012 were either delayed or reprogrammed as apartments. For 2013 we estimate about 1,900 condominium units will begin construction, not including conversions. If all of these units actually begin construction, this will be the most new construction starts in one year since the boom years of 2005-06. Even at 1,900 starts, this is insufficient to keep pace with sales velocity, which is expected to be higher in 2013 than it was in 2011-12.

Sales Pace: Improving

Projects that sold out since 2011 have averaged 2.8 sales per month and actively marketing units that started selling in 2012 have sold 10.5 units per month, although a few "star performers" have skewed the average upwards. Regardless of any outliers, sales velocity has been improving over the past few quarters. Following are a few examples of sales pace among newer entrants to the market:

- **The Marvin** is a 39-unit condominium conversion located in Kalorama by Adams Investment Group that began sales in October. So far, 28 units have sold (mostly to existing tenants) with prices averaging $585 per SF.
- Sales began in October at **Northern Exchange,** a 36-unit development by PN Hoffman along the 14th Street corridor. Half of the units have sold already at an average price of $623 per SF.
- In Chantilly, sales began in November at Phase One of **East Gate,** a 193-unit project by M/I Homes. Since then, 29 units have sold averaging $180 per SF.

Current Inventory-to-Sales Ratio
Year-End 2012

Condominium Submarket	Inventory/Sales Ratio[1]
Upper NW DC	0.1 - 0.8
Prince George's	0.3
Mideast DC	0.3 - 1.3
Captiol East DC	0.4 - 0.6
Arlington/Alexandria	0.6
Central DC	0.6 - 3.4
Fairfax/Falls Church	0.7
Wash. Metro Average	**1.0 - 1.3**
Montgomery	1.7
Loudoun/Prince William	2.0

Note: Calculated by dividing actively marketing inventory by sales during the past 12 months.
[1] The lower end of the ratio range only counts selling inventory while the upper end of the range also includes units U/C and/or pre-marketing.
Source: Delta Associates; January 2013.

Select Condominium Projects that Started Construction in 2012

Name of Project	Submarket	# of Units
Northern Exchange	Central DC	36
The Lima	Mideast DC	40
The Five	Mideast DC	35
Hailey House	Mideast DC	25
The V	Mideast DC	23
Dakota Crossing Condominiums	Mideast DC	22
1700 Euclid	Mideast DC	19
1421 Florida Avenue	Mideast DC	16
4226 7th Street	Mideast DC	15
The Oronoco	Arl/Alex	60
Old Town Commons - Phase I	Arl/Alex	44
Printer's Row	Arl/Alex	20
East Gate - Phase I	Lou/PrWm	193
The Darcy	Montgomery	64
Quarry Springs Stoneyhurst - Ph I	Montgomery	51
Summit Crossing	Montgomery	21

Source: Delta Associates; January 2013.

Washington Condominium Market Outlook: "Boomlet" to Continue

The Washington metro area currently has one year of inventory at current rates of sales velocity. As a result, a shortage of new condominium product has developed. Unlike the previous cycle when several apartment projects converted to condominiums or "switched" mid-way through construction to become condominiums in order to satisfy demand, this time the financial markets do not have the appetite to finance large-scale conversions or "switches." There are some newer 80-unit to 140-unit apartment buildings that could be candidates for conversion and some under construction that could "switch" to condominium, but these opportunities are few and far between. Consequently, the eventual ramp-up of new condominium supply will be largely built from scratch, supplemented with smaller conversions of older apartment buildings, mostly inside the Beltway. It will take longer to replenish the condominium supply in this cycle since it takes more time to build a new condominium project from scratch or renovate an older building for conversion than it does to convert newer apartment projects or "switch" buildings to condominiums as was done in the previous cycle.

As a result, we anticipate product shortage for an extended period with resulting upward price movement. We anticipate these constrained market conditions to persist for at least 18 to 24 months and perhaps longer. We expect the Washington metro area sales pace to pick up in 2013 over the levels of 2011-12. We estimate sales for 2013 to be in the 2,000-unit to 2,500-unit range. However, in order to sustain the condominium market expansion underway, the following conditions are necessary:

1. Interest rates need to remain low, which is likely for the time being since Federal Reserve Chairman Ben Bernanke announced after the Fed's December policy meeting that the Fed will keep interest rates low at least until the national unemployment rate falls below 6.5% and as long as inflation remains low.

2. A shock to the regional economy (such as sequestration) needs to be avoided.

3. More new product needs to enter the market to maintain sales velocity.

Critical to successful condominium development in the period ahead will be:

- Excellent design with state-of-the-art features.
- Best-in-class marketing.
- Customer targeting.
- Thoughtful place-making – integrating new product into existing neighborhoods (or creating new mixed-use projects) that afford residents the luxury of nearby shopping, particularly for daily necessities and groceries.
- Selection of superior locations with good supply/demand fundamentals.

8

The Washington Area
RETAIL MARKET

8

The Washington Area
RETAIL MARKET

Retail Market Improves, Despite Consumer Hesitancy at the National Level

Last year in ***TrendLines,*** we stated that the Washington metro area retail market was due for stronger recovery in 2012, despite consumer pullback due to economic uncertainty. Good call. Regional retail is the darling of asset types as compared to other asset classes and retail in the region is among the strongest in the nation. Have a look:

- Overall vacancy for all types of shopping center retail declined to 5.0% at year-end 2012 – lowest in the nation, from 5.5% at year-end 2011. This compares to a national vacancy rate of 9.0%. And grocery anchored center vacancy in the region declined to 4.9%.
- In-line store rents at grocery anchored centers increased 1.2% during 2012, compared to 2.1% during 2011. Not as much as expected, given low vacancy and rising retail sales. But this will improve in 2013.
- Investment sales of grocery anchored centers remained strong – $453 million during 2012, comparable to 2011.
- The region has less than 3 million SF of grocery anchored development underway at year end 2012 – insufficient to keep pace with demand.
- In our annual Market Maker survey at year end 2012, Grocery-Anchored Centers scored highest of all property types on the investment worthiness scale.

We expect the Washington metro area retail market to continue its expansion during 2013. We expect the core and inner ring submarkets to rebound at a faster clip, compared to the outer ring submarkets, as close-in centers have been able to keep and lure quality tenants. We expect investors to target core, stable, community/neighborhood centers.

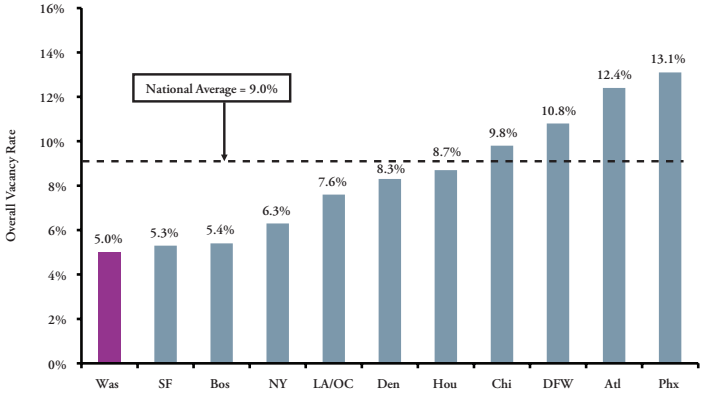
National Context

The Washington metro area has the lowest shopping center vacancy rate among large metro areas at year-end 2012. Overall vacancy for all types of shopping centers was 5.0% in the Washington metro area at year-end 2012, down from 5.5% one year ago. This compares favorably to the national average of 9.0% at December 2012.

Shopping center retail maintains a relatively low vacancy rate in the region because of:

- Steady population growth

Shopping Center Vacancy – All Types
Select Metro Areas | Year-End 2012



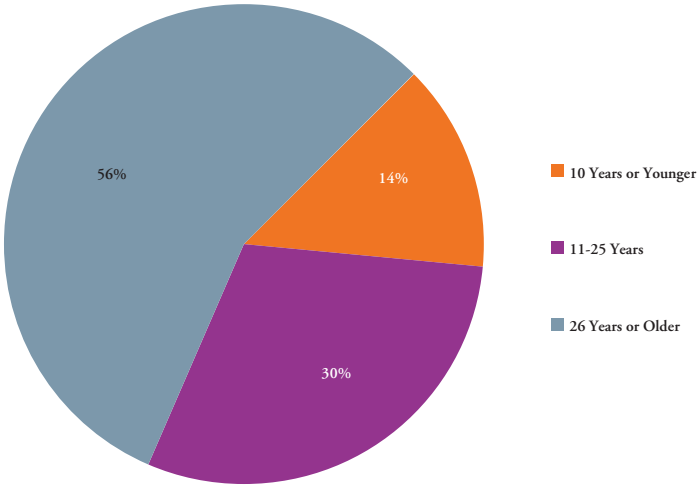
Note: Includes shopping centers of all types.
Source: Delta Associates; January 2013.

Average Household Income

Jurisdiction	2000 (Actual)	2012 (Est.)	2017 (Proj.)
Washington Metro Area	$80,600	$108,400	$124,000
U.S.	$56,600	$68,200	$77,100

Source: ESRI, Delta Associates; January 2013.

Shopping Center Age Distribution
Washington Metro Area | 2012



Source: CoStar, Delta Associates; January 2013.

- High incomes
- Low pipeline of new product

Incomes in the Washington metro area grew by 34% from 2000 to 2012, compared to just 20.0% nationally. By 2017, the Washington metro area's average household income is projected to rise 14%, compared to a rise of 13% nationally.

Retail Market Conditions

The Washington metro area has over 135 million SF of shopping center retail space, inclusive of all types of retail, in over 1,200 shopping centers. Just over half of the Washington area shopping centers are over 25 years old, while only 14% are aged ten years or less. Although new retail projects have entered the market, older centers remain the bulk of retail space – providing opportunity for renovation and upgrade.

The metro area has 27.5 SF of shopping center retail space per capita as of year-end 2012, compared to the national average of 23.7. Although Northern Virginia and Suburban Maryland are above the national and Washington metro averages, the District remains underserved at just 8.0 SF of shopping center retail space per capita, as population growth outpaces retail development – an obvious opportunity for retail developers and retailers alike.

Grocery-Anchored Shopping Center Market Conditions

Given the demand for groceries at all points of the economic cycle, grocery-anchored shopping centers maintain the greatest stability compared to other retail property types. Therefore, the analysis that follows is focused on grocery-anchored shopping centers.

Of the total retail inventory in the Washington metro area, 55.8 million SF is located in 317 grocery-anchored shopping centers, which is just under half of the total shopping center retail inventory in the metro area.

The grocery-anchored shopping centers inventory is down from 57.6 million SF at year-end 2011, as a handful of grocery stores shuttered within centers over the past year and were therefore removed from the inventory. Notably, Delhaize America has been closing underperforming Food Lion stores, which includes Bloom and Bottom Dollar stores. Of the 113 stores that closed nationwide, eight closed in the Washington metro area. As centers sign a grocery store as a tenant, the center will return to our inventory.

We perform an annual year-end survey of over 300 Washington area grocery-anchored shopping centers, and tabulate vacancy and rent data. The adjacent charts summarize trends from 1999-2012.

The metro-wide vacancy rate for grocery-anchored shopping centers edged down to 4.9% at year-end 2012, from 5.5% at year-end 2011. The vacancy rate in Suburban Maryland declined to 4.5% at year-end 2012, from 5.6% one year ago. Northern Virginia vacancy was 5.3% at year-end 2012, down slightly from 5.5% one year ago. The Suburban Maryland vacancy rate experienced a sharper decline over the past year, as a handful of larger deals were inked and a handful of centers with elevated vacancy rates were removed from our inventory due to a vacating grocery store. In addition, the Suburban Maryland inventory is smaller compared to Northern Virginia, which makes the vacancy rate more volatile.

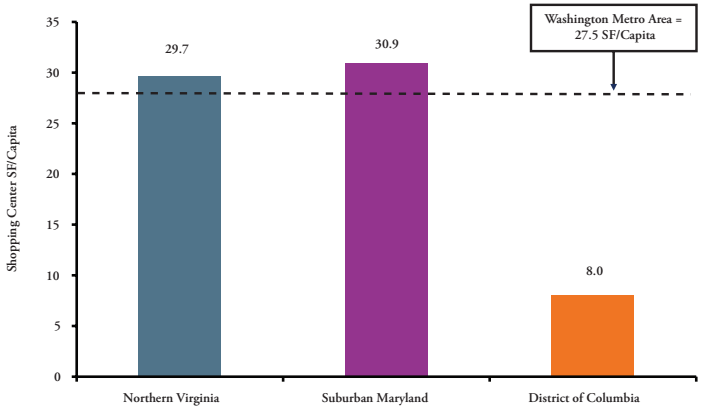
The core and inner ring submarkets both experienced a 70 basis point decline over the past year, as newer, closer to the core centers are in demand due to tenants trading up in quality. Both the core and inner ring submarkets hold vacancy rate averages that are under the Washington metro area vacancy rate of 4.9% at year-end 2012. This compares to the outer ring experiencing a 60 basis point decline in vacancy. Despite this decline, the outer ring submarkets remain above the Washington metro area vacancy rate at year-end 2012.

Rental rates at grocery-anchored centers increased 1.2% in 2012, after rising 2.1% in 2011. Metro-wide average in-line tenant rents were $32.04/SF at year-end 2012, compared to $31.65/SF at year-end 2011. Suburban Maryland rents were $32.30/SF, a 1.4% rise from year-end 2011. Northern Virginia rents were $31.47, up 1.0% from year-end 2011.

The core submarkets experienced a 2.3% rise in asking rents during 2012, as tenants sought to remain in the core. Also, this area has limited availability, with just under 200,000 SF of available space on the market. The inner and outer rings experienced rent increases at a less robust pace, 0.9% and 1.6%, respectively, as these submarkets have less demand and a greater amount of available inventory. Of note, the inner ring has the most available SF at 1.6 million SF.

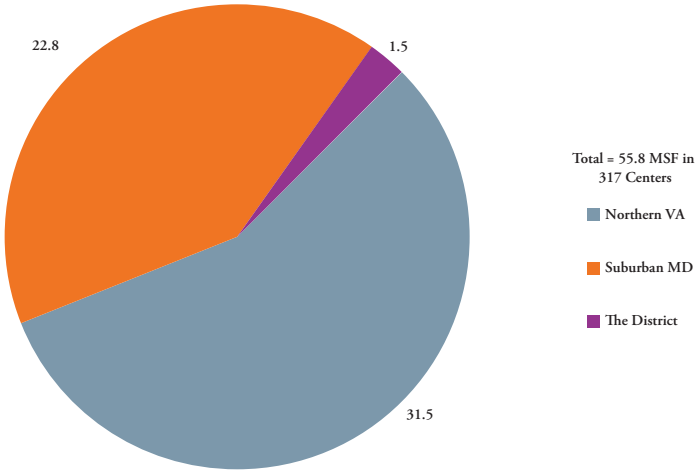
Overall, newer grocery-anchored shopping centers outperformed market averages during 2012. Centers built after 1999 in the Washington metro area hold a 4.6% vacancy rate at year-end 2012, a 190 basis point decline from 6.5% at year-end 2011. Centers built in 1999 or earlier hold a 5.0% vacancy rate at year-end 2012, a 20 basis point decline from 5.2% at year-end 2011.

Shopping Center Space per Capita
Washington Metro Area | Year-End 2012



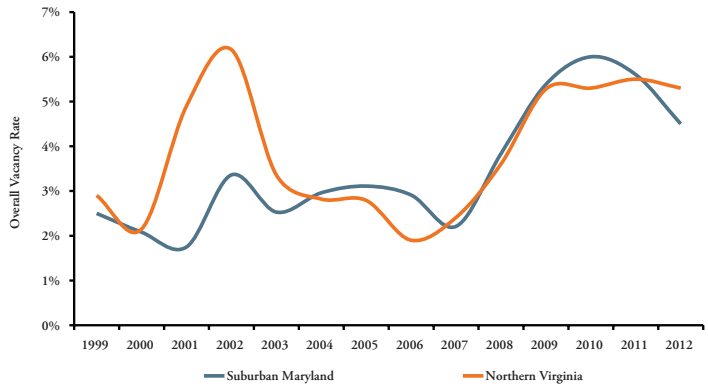
Source: CoStar, ICSC, Delta Associates; January 2013.

Grocery-Anchored Shopping Center Scale
Washington Metro Area | 2012



Note: Estimate; In millions of SF.
Source: CoStar, Delta Associates; January 2013.

Grocery-Anchored Shopping Center Vacancy Rates
Washington Metro Area



Source: Delta Associates; January 2013.

Grocery-Anchored Shopping Center Vacancy Rates
Washington Metro Area

Jurisdiction	2012	2011
Core	4.3%	5.0%
Inner Ring	4.1%	4.8%
Outer Ring	7.3%	7.9%
Washington Metro	**4.9%**	**5.5%**

Core = DC, Arlington, Alexandria
Inner Ring = Fairfax, Montgomery, Prince George's
Outer Ring = Loudoun, Prince William
Source: Delta Associates; January 2013.

Grocers, discounters, gyms, restaurants, and household goods stores have been actively signing deals in the Washington metro area during 2012. We expect the vacancy rate to decline during 2013. Although some underperforming retailers will close, there will be new and expanding retailers looking to take the vacated space. Top tier shopping centers in prime submarkets will have greater ease backfilling space.

New Development

There are 10 notable grocery-anchored shopping centers, totaling 2.5 million SF, under construction or renovation in the metro area at December 2012. A handful of notable projects are under development:

- **Cathedral Commons:** Bozzuto and Southside Investment Partners have started redeveloping a Giant Food store along Wisconsin Avenue near the National Cathedral in the District of Columbia. The $130 million project, Cathedral Commons, will include 128,000 SF of retail – inclusive of a new 56,000 SF Giant Food store, 137 apartments and 8 townhomes. The project is scheduled to be completed by year-end 2013.
- **Dunn Loring Metro:** Mill Creek Residential has started on a mixed-use project near the Dunn Loring Metro station in Fairfax County, VA. Once completed, the project will include 628 residential units, 75,000 SF of ground-floor retail, and a 50,000 SF Harris Teeter.
- **Dulles Landing:** Beatty Management Companies started on Dulles Landing, a 600,000 SF mixed-use development project, located in Loudoun County during the 3rd quarter. Walmart, with a grocery component, will anchor the center. The project is scheduled to be completed by Fall 2013.
- **Laurel Town Center:** Lerner Enterprises and the Tower Companies have started demolition on Laurel Mall, a mall that gradually lost shopper traffic. On the site, the companies plan to build Towne Center at Laurel, a mixed-use development that will include 435 residential units and 400,000 square feet of retail, including a grocery store and a movie theater. The $130 million project is projected to deliver by the fall of 2014.

There are additional grocery-anchored shopping centers in the planning stages that are not included in the adjacent table, some of which may deliver by 2013/2014. As lending continues to loosen, groundbreakings should continue to rise. Given the long-term demand for goods in the metro area, we believe developers will look to deliver new product by 2014, as the market strengthens further.

At year-end 2012, to construct a shopping center in the Washington metro area, the minimum rent needed was $24.00/SF, on a triple net basis, up from $22.00/SF one year ago. The current average asking rent for grocery-anchored shopping centers at year-end in the metro area is $32.14/SF, indicating rents can be met at newly constructed centers. In fact, the average rent in each surveyed jurisdiction currently exceeds this $24.00/SF threshold.

Cash-on-cost return requirements for shopping centers declined to 8.8% in 2012, from 9.1% one year ago, as investors have remained confident in the Washington area market – particularly for retail. With low mortgage rates, investors are more willing to accept lower rates of return.

We expect few spec projects to move forward in the near-term. Rather, projects with notable pre-leasing and financing in place will be the norm. However, given the long-term demand for goods in the metro area, we believe developers will look to deliver new product during 2014, as the market strengthens.

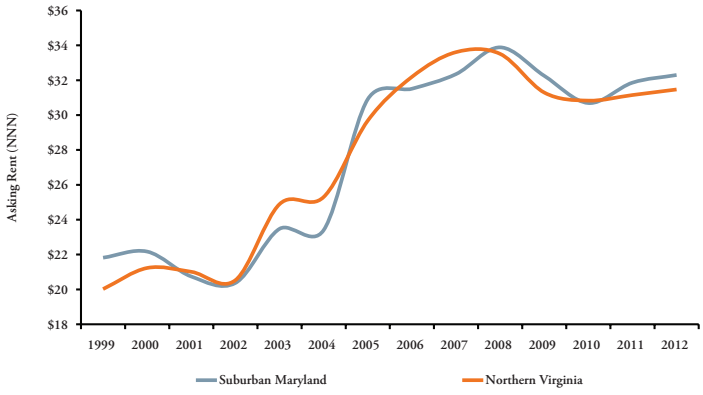
Investment Sales

There were eight notable investment sales of grocery-anchored shopping centers in the Washington metro area suburbs during 2012. Sales volume totaled $453 million ($301/SF) during 2012, compared to $454 million ($276/SF) during 2011.

Most recently, Katz Properties purchased Festival Shopping Center in Prince William County for $15.8 million ($134/SF) in August 2012. This center is anchored by Global Food. This deal follows the purchase of Westgate Plaza in Prince William County for $33.8 million ($207/SF) at the start of the year. Westgate Plaza is anchored by Giant Food.

Grocery-Anchored Shopping Centers scored a 6.4 for investment worthiness in 2012, up from 6.1 in 2011, according to respondents to our annual Market Maker survey. Grocery-anchored shopping centers are typically a favorite with investors during soft economic periods, since consumers still need groceries and basic goods during lean times. In addition, consumers are increasingly shifting to online shopping. This shift impacts malls and power centers moreso than grocery-anchored shopping centers, concentrating the attention of retail investors on grocery-anchored shopping centers.

Grocery-Anchored Shopping Center Asking Rents
Washington Metro Area



Source: Delta Associates; January 2013.

Grocery-Anchored Shopping Center Asking Rents
Washington Metro Area

Jurisdiction	2012	% Change During 2012
Core	$42.30	2.3%
Inner Ring	$32.49	0.9%
Outer Ring	$26.98	1.6%
Washington Metro	**$32.04**	**1.2%**

Core = DC, Arlington, Alexandria
Inner Ring = Fairfax, Montgomery, Prince George's
Outer Ring = Loudoun, Prince William
Source: Delta Associates; January 2013.

Notable Grocery-Anchored Shopping Centers Under Construction or Renovation
Washington Metro Area | December 2012

Shopping Center	Jurisdiction	RBA	Anchor
Dulles Landing	Loudoun	600,000	Walmart
Laurel Town Center	Prince George's	400,000	TBD
CityCenter DC	District	325,000	TBD
Hilltop Village Center	Fairfax	250,000	Wegmans
Tysons West Promenade	Fairfax	247,000	Walmart
Shops at Seneca Meadows	Montgomery	200,000	Wegmans
Westfield Wheaton	Montgomery	148,000	Costco
Cathedral Commons	District	128,000	Giant
Dunn Loring Metro	Fairfax	125,000	Harris Teeter
CityMarket at O Street	District	88,000	Giant
Total:		**2,511,000**	

Source: *Washington Business Journal,* CoStar, *Washington Post,* Delta Associates; January 2013.

Protypical Development Economics for a Shopping Center
Washington Metro Area | Year-End 2012 | Per Rentable SF

A.	Hard Costs	$160
B.	Soft Costs	$50
C.	**Sub-Total, Development Costs (Excluding Land)**	**$210**
D.	Land Costs (Per FAR)	$44
E.	**Total, All-In Development Costs**	**$254**
F.	**Required Rents (NNN) Needed to Support New Development**	**$24**
Pro Forma Rent Calculations		
A.	Cash on Cost Return Requirement (%)	8.8%
B.	Cash on Cost Return Requirement ($)	$22.35
C.	Divided by Occupancy Rate	95%
D.	Equals Required Rent (NNN)	$23.53

Source: Delta Associates' Market Maker Survey; January 2013.

Our Market Maker Survey respondents noted that cap rates for Class A grocery-anchored shopping centers have declined to 6.39% at October 2012, from 6.42% one year ago. This decline is a result of low interest rates and increased demand for quality Washington metro real estate assets. We expect demand for quality assets to rise as equity-laden investors take advantage of this market. Given the tepid nature of the economy, we believe any further decline in cap rates during 2013 is likely to be modest. Therefore, most price increases will likely be earned from property performance improvement.

Retail Market Outlook: Succeeding in a Competitive Market

We expect the Washington metro area retail market to continue its expansion during 2013.

We project hiring to remain focused on high-skilled positions, particularly within the Professional/Business Services sector, which should generate 46,500 new jobs through 2016. This sector generates high-wage jobs – the type that spend retail dollars, occupy office space, buy homes, and rent Class A apartments.

As the economy gradually improves, consumers will regain confidence, which will help stimulate retail spending to keep the vacancy rate lowered in the Washington metro area. We expect the vacancy rate for grocery-anchored shopping centers to remain low during 2013, as new retailers enter the Washington metro market and existing retailers look to expand. As demand improves, we expect asking rents to rise by approximately 2.0% to 3.0% during 2013.

Given high disposable incomes and a solid, highly educated employment base in the area, we expect the Washington area retail market to remain one of the premier retail markets in the nation.

We expect the core and inner ring submarkets to rebound at a faster clip, compared to the outer ring submarkets, as close-in centers have been able to keep and lure quality tenants. We expect investors to target core, stable, community/neighborhood centers.

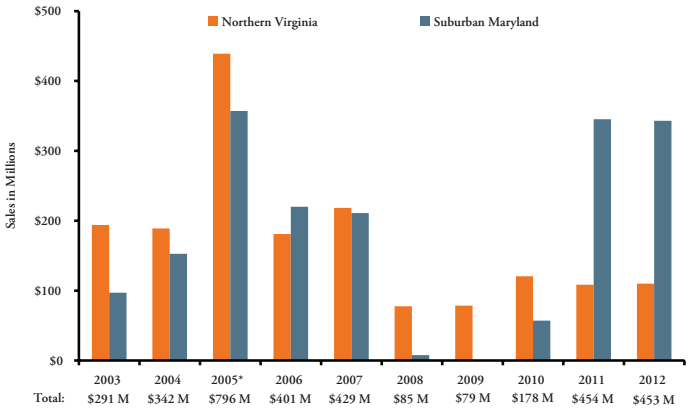
Given demand for Class A space, we believe property owners will continue to invest, where the cash is available, in repositioning existing under-performing assets – either upgrading or transforming shopping centers. Currently, tenants seeking space are interested in newer, Class A space with high foot traffic. Centers that focus on everyday needs, such as groceries and other necessities, remain successful during economic downturns or slow-growth periods.

Given high disposable incomes and a solid, highly educated employment base in the area, we expect the Washington area retail market to remain one of the premier retail markets in the nation.

As a result, the successful investor and developer will:

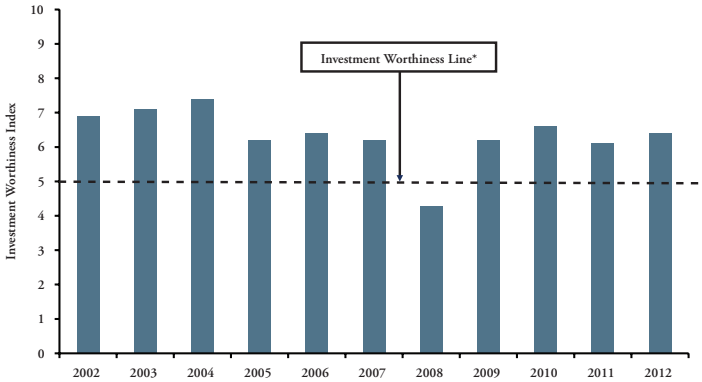
1. Selectively accumulating assets at below replacement cost while prices and interest rates are lower. The window is closing, as prices are rising.
2. Acquiring debt or recapitalizing assets.
3. Repositioning underperforming assets, especially with a mixed-use, grocery anchored, outdoor format.
4. Invest in existing assets to enhance operational performance via better leasing and/or reduced cost.
5. Developing new projects in select submarkets with good supply/demand fundamentals.

Grocery-Anchored Shopping Center Sales
Washington Metro Area Suburbs



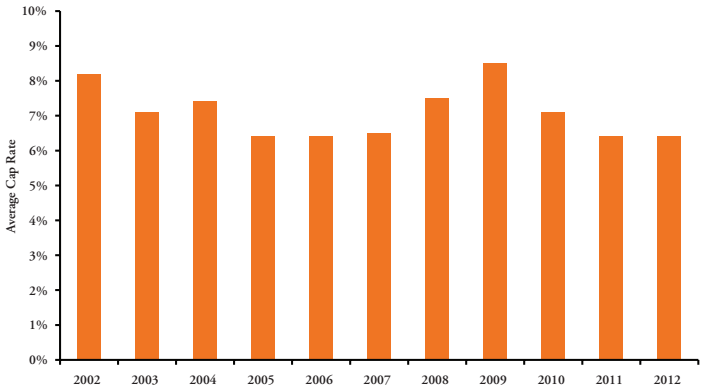
Note: Excludes properties under contract. * Includes large portfolio sale by CalPERS.
Source: Real Capital Analytics, graphic by Delta Associates; January 2013.

Grocery-Anchored Shopping Center Investment Worthiness Index
Washington Metro Area



* A score below 5.0 is considered to have more interested sellers than interested buyers.
Source: Delta Associates' Market Maker Survey; January 2013.

Grocery-Anchored Shopping Center Average Cap Rate
Washington Metro Area | Each Year At October



Source: Delta Associates' Market Maker Survey; January 2013.

9

Capital Markets and INVESTMENT TRENDS

9

Capital Markets and INVESTMENT TRENDS

Commercial Real Estate Investment Continues to Compare Well to the Alternatives; Washington Assets Appeal Despite Austerity Concerns

Continuing the trend we saw emerge so strongly in 2010, investors continue their preference for commercial real estate – it seems to beat the less predictable stock market and low returns in the bond market, and it has not lost its luster as a hedge against inflation.

During 2012 we saw four major themes emerge in the investment sales market:

- Volume was generally comparable in 2012 to 2011, with some variation by product type and market. On balance, we faced many of the same threats and investors responded similarly to the prior year. Notably, both office and multifamily volume in Washington experienced declines in 2012, for different reasons. Office investors pulled back late in the year as the fiscal cliff and the threat of sequestration drew near, while multifamily investors expressed concerns over the robust pipeline of new product scheduled to deliver in 2013.
- Investors went after real estate for its solid, consistent returns, especially in core product – 11% nationally for the 12 months ending in September 2012. However, real estate did not perform as well in 2012 as it did in 2011 and faced considerable competition from equities.
- Investors continue to put capital into Washington despite concerns about Federal austerity. Both domestic and foreign investors have expressed confidence in the region's ability to produce solid long-term results.
- Cap rate compression slowed, as near-term asset performance remains full of challenges nationally and especially in Washington.

Let's examine the investment market for commercial real estate in 2012, starting with the big picture and then zeroing in on Washington. What does the market's performance tell us about 2013?

Nationally, Steady Volume and Solid Returns Define 2012

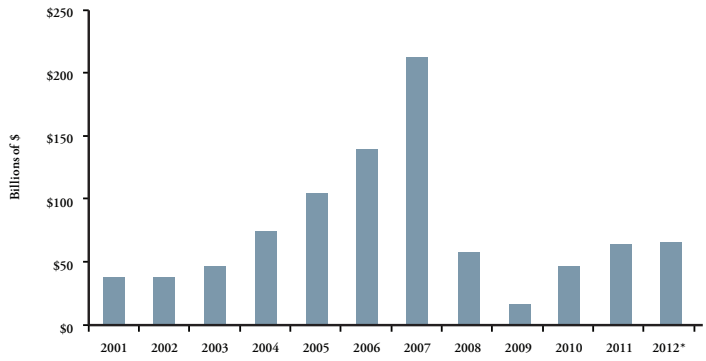
The market faced many of the same threats in 2012 as in 2011 and investors responded similarly, maintaining real estate as a key element of a diversified portfolio. For example, in 2012, U.S. office sales volume totaled approximately $67.1 billion – comparable to the 2011 total of $64.9 billion. In fact, office sales volume reached its highest level since the end of the last boom cycle in 2007.

Investors continue to put capital into U.S. commercial real estate because of the solid returns this asset class offers. For the 12 months ending in September 2012, the NCREIF Property Index, a measure of core asset performance, showed an 11.00% return. This performance exceeded the index's returns for both the trailing five-year and ten-year periods.

Over the past five years, real estate generated an annualized total return of just 2.27%, a reflection of the significant decline in both asset values and performance during the recession. Nevertheless, real estate outperformed stocks during this period.

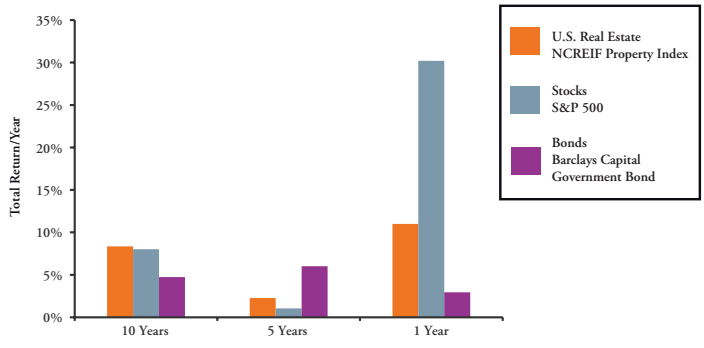
Over the past ten years, real estate outperformed both stocks and bonds, with total returns for real estate of 8.35% per annum. Since the 1990s, commercial real estate has been viewed as a critical component of a diversified portfolio, particularly by pension funds and other institutional investors. This solid long-term performance explains why.

Investment Sales of Office Buildings
United States



* Estimate.
Source: Real Capital Analytics, graphic by Delta Associates; January 2013.

Investment Alternatives
Commercial Real Estate vs. Stocks vs. Bonds
12 Months Ending September 2012



Source: NCREIF, Delta Associates; January 2013.

Who were the significant buyers of commercial real estate during 2012? At the national level, private equity was the greatest source of capital for sales across all product types, with 40.7% of the total – an increase from the 37.4% share in 2011. Institutions and funds also were significant players in 2012, sourcing a combined 29.9% of capital invested. REITs and other public buyers were active players in 2012, accounting for 14.3% of investment dollars, comparable with the prior year. Foreign buyers maintained a steady share of the market, contributing 7.5% of total investment dollars, nearly the same as their 7.4% share of the market in 2011.

Washington Metro Returns: Down in 2012 as Other Markets Surpass the Region in Price Increases

As the national commercial real estate sales market produced strong returns, the Washington metro area remained among the world's top investment markets. However, its performance declined compared to other major markets as the run-up in pricing here in 2010-11 and the tepid performance in 2012 combined to produce below-average returns for investors.

For comparison purposes, last year (during the 12 months ending in September 2011), Washington office assets produced a total return (cash flow plus appreciation) of 18.76% while the national figure was 15.33%. This year (for the 12 months ending September 2012), total returns realized in the Washington office market were 7.28% while national returns were 9.85%, as other metro areas are exceeding the Washington market's price gains and performance metrics.

Look at these figures another way: For the 12 months ending in September 2012, Washington office returns ranked tenth among major markets; for the prior 12-month period, Washington ranked third. This decline relative to its peers speaks to the newly competitive nature of our market and the challenges ahead.

Yet, despite the weaker returns, office building sales in 2012 in the Washington area reached a total volume of $6.7 billion. This total is comparable to the $6.9 billion figure from 2011. Office transaction volume in Washington in 2012 was on par with the prior year despite concerns about the Federal government's plans to cut spending and the potential impact on government contractors, a major user of Washington office space.

Over the long term, returns are more predictable in Washington than in most other metro areas. This led to a flood of capital entering the market from 2004-07. Because of the run-up in values for Washington assets during that period – and the downturn in market conditions brought about by the recession – returns turned negative in 2009. However, total returns moved back into positive territory in 2010 and were strong in 2011. By 2012, risk had been fully re-priced in Washington and Washington's returns began to lag the national average for all four major product types, as shown in the accompanying graph.

Domestic and Foreign Investors Continue to Funnel Capital into Washington Assets

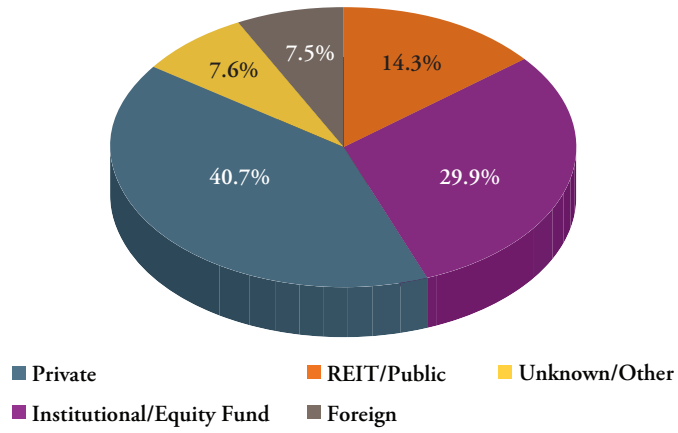
Because of the long-term strength of its employment market and its sound mix of public and private tenants, the Washington office market continues to attract investment dollars, pounds, euros, krone, and yen. For years, Washington has far exceeded the office investment sales volume in Los Angeles and Chicago, for example – markets of similar size and prominence.

Given Washington's long-term performance, it is no surprise that Washington was named by the Association of Foreign Investors in Real Estate (AFIRE) as one of its top markets for 2013, ranking behind only New York and San Francisco among U.S. cities and fourth (behind New York, London, and San Francisco) among global markets.

Investors in Washington focused on office and multifamily purchases in 2012. Total volume for all four product types was $10.6 billion in 2012, down 17% from the $12.7 billion of asset value that changed hands in 2011. The primary culprits in declining volume were the office and multifamily sectors, for different reasons. Office investors pulled back late in the year as the fiscal cliff and the threat of sequestration drew near, while multifamily investors expressed concerns over the robust pipeline of new product scheduled to deliver in 2013.

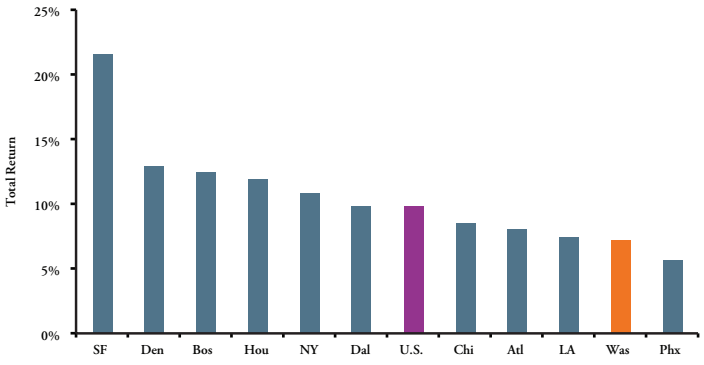
Flex/industrial and retail sales were limited in 2012, as they were in 2011 – we recorded less than $500 million of investment sales for each of those product types in 2012. Investors with access to capital tended to focus on trophy office assets or well-located multifamily product in 2012, planning to hold these well-performing assets for the long term. This extends a pattern seen in 2010 and 2011. Given the solid performance of both grocery-anchored retail and flex/industrial product, we expect to see these two sectors attract more investment capital in 2013.

Most Active Capital Sources
Investments in U.S. Commercial Real Estate | 2012



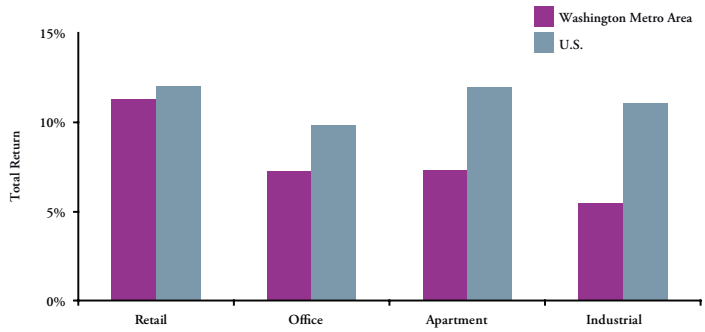
Note: Excludes portfolio sales and properties under contract; through September 2012.
Source: Real Capital Analytics, graphic by Delta Associates; January 2013.

Total Returns for Office Assets
Selected Metro Areas | 12 Months Ending September 2012



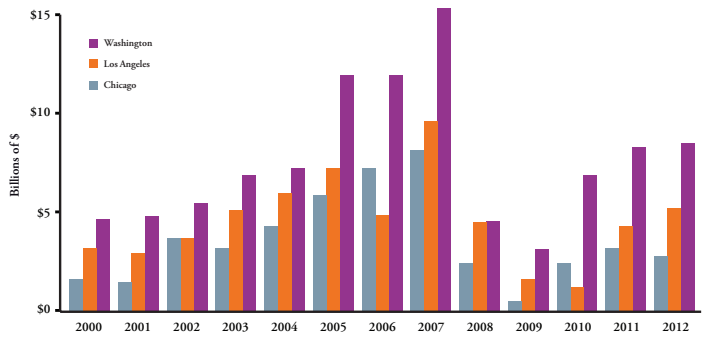
Source: NCREIF, Delta Associates; January 2013.

Total Investment Returns: Core Commercial Real Estate
Washington Metro Area vs. U.S. | 12 Months Ending September 2012



Source: NCREIF, Delta Associates; January 2013.

Comparative Investment Sales Volume: Office Buildings
Selected Metro Areas



Note: Excludes whole-company transactions.
Source: Real Capital Analytics, graphic by Delta Associates; January 2013.

Top U.S. Cities Among Foreign Real Estate Investors in 2013

U.S. Rank	Market
1	New York
2	San Francisco
3	Washington, DC
4	Houston
5	Boston

Source: AFIRE, Delta Associates; January 2013.

We expect the Washington area to remain among the premier long-term investment markets in the nation in 2013, although returns from other markets should continue to close the gap as those cities move forward in the recovery cycle.

Pricing Declines and Cap Rate Compression Slows on Near-Term Performance Challenges

Office market pricing plateaued in 2012 in the Washington metro area, likely a function of the near-term performance challenges and the recent run-up in pricing, which could not continue indefinitely. Sales prices averaged $355/SF in the Washington metro area during 2012, compared to $373/SF during 2011. The most notable deal of the year was MetLife purchasing 400 7th Street, SW (Constitution Center) in the Southwest submarket for $734 million ($524/SF). The General Services Administration (GSA) recently backfilled the unneeded Securities and Exchange Commission space at this location. The building is now fully leased.

The District of Columbia took the largest share of Washington metro area office sales volume during 2012, at 63%. Northern Virginia took 27% of the total sales and Suburban Maryland took 7%. The remaining 3% resulted from partial-interest transactions. Despite the challenges it faces, which are rooted in potential Federal government spending cuts, we expect the District of Columbia to remain the leader in sales volume in the near term as investors are still targeting quality core downtown assets.

Apartment pricing declined in 2012 for both high-rise and garden product. In 2011, the region recorded $2.41 billion of multifamily Class A building sales: 19 low-rise properties and 10 mid-rise or high-rise properties. In 2012 (through November) the region posted $1.27 billion of multifamily Class A building sales (seven low-rise properties and seven mid-rise or high-rise properties). The 2012 average per-unit price was 12.5% lower than in 2011 for low-rise units (at $195,600), due in part to the geographic mix of properties trading hands. High-rise prices are off 10.8% from 2011, at $376,900. Of note in the Washington region in 2012 was the break up and sale of stalwart developer and operator, Archstone, to AvalonBay and Equity Residential.

In the Washington area, the average cap rate for core office assets rose 39 basis points in 2012, compared to a decline of 37 basis points in 2011. For all product types combined, the average cap rate rose one basis point in 2012, compared to a decline of 30 basis points in 2011.

Other product types saw cap rates trend downward over the course of 2012, as shown in the accompanying table. Movement was modest as pricing flattened.

Top Global Cities Among Foreign Real Estate Investors in 2013

Global Rank	Market
1	New York
2	London
3	San Francisco
4	Washington, DC
5	Houston

Source: AFIRE, Delta Associates; January 2013.

Washington Area Product Type	Basis Point Change in Cap Rate 10/11-10/12
Apartments	-23
Industrial/Distribution	-23
Shopping Center	-3
Office	39

Source: Delta Associates' Market Maker Survey; January 2013.

Apartment Pricing Exceeds Replacement Cost, But Gap is Closing

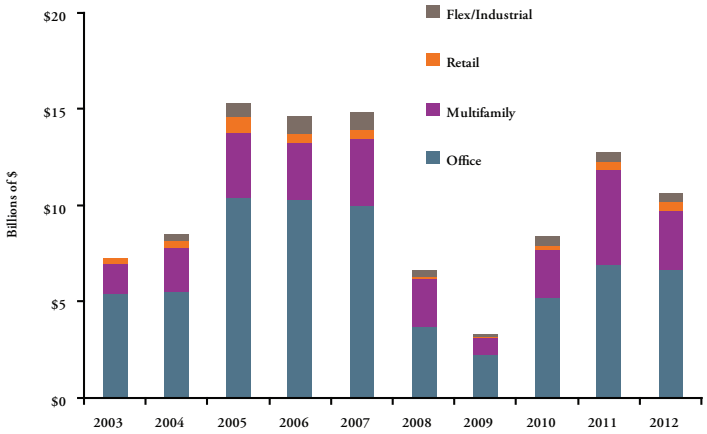
By the end of 2010, pricing had risen to the point where it was near replacement cost for apartment and office properties in Washington. A year later, pricing on apartments shot past replacement cost, which, in conjunction with strong demand for rental units, led to an increase in development. By year-end 2012, existing apartment product remained more expensive than new development, but the gap was closing, as pricing for standing inventory declined and construction costs were stable. The robust pipeline curtailed demand for existing product and the desire to build.

For example, here are the facts for a ***Class A high-rise apartment project:***

Average price per unit in 2012:	$376,900
Replacement cost in 2012 [1/]	$343,000

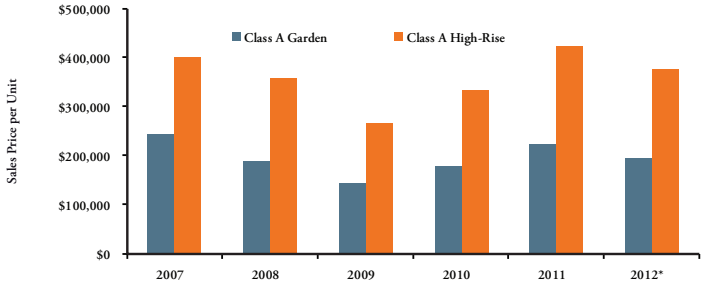
[1/] $273,000 development cost plus $70,000 land cost.
Source: Delta Associates' Market Maker Survey; January 2013.

Investment Sales
Washington Metro Area



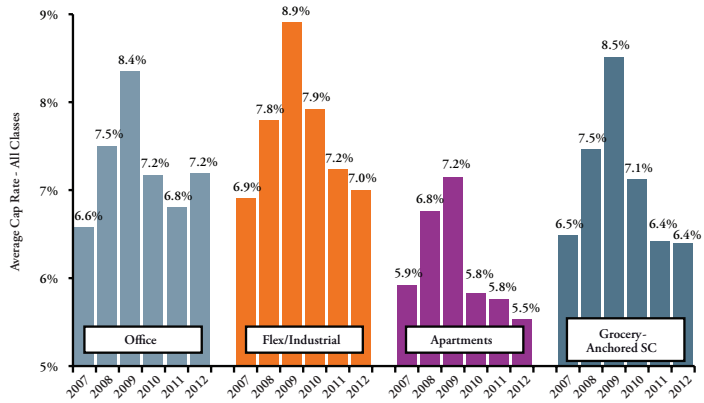
Note: Excludes whole-company transactions.
Source: Real Capital Analytics, graphic by Delta Associates; January 2013.

Class A Garden and High-Rise Apartment
Average Sales Price | Washington Metro Area



* Through November 2012.
Source: Delta Associates; January 2013.

Survey of Year-End Cap Rates
Washington Metro Area



Source: Delta Associates' Market Maker Survey; January 2013.

For ***downtown office product,*** however, pricing is below replacement cost, as future demand, particularly from the Federal government, is suspect:

Average price per SF in 2012:	$487
Replacement cost in 2012 [1/]	$573

[1/] $438/SF development cost plus $135/SF land cost.
Source: Delta Associates' Market Maker Survey; January 2013.

We expect the gap on apartment pricing to close further in 2013 as there is little need for new development in the short run in many Washington-area submarkets. Apartment cap rates trended lower during the first half of 2012 but they have stabilized since. We believe that cap rates will likely stabilize or nudge up slightly in 2013, as market conditions become more competitive amid increased supply, and job growth is muted in the region.

Investment Sales Outlook

Cap Rates: In 2013, we expect cap rates to edge down nationally, but stabilize or perhaps edge up locally. In general, property performance is likely to improve modestly but both the office and apartment markets have too much supply in the pipeline given demand expectations. In the Washington area, prices have already been bid up, and with concerns about Federal spending, demand for office assets likely will continue to retrench. We expect savvy investors to turn their attention to:

- Flex/industrial product, as the move to online retailing and just-in-time inventory, as well as demand for space driven by cloud computing, is creating the need for more warehouse space.
- Retail, especially lifestyle and grocery-anchored, given an inadequate pipeline of development and demographic trends that support these niches.

Prices: Nationally, we expect prices to rise due to improvement in asset performance and continued modest cap rate compression.

We expect prices in Washington to remain high – among the U.S. leaders – as investors remain attracted to the region's strong track record. However, pricing may move sideways in 2013 due to weak performance metrics and steady cap rates.

In general, price appreciation in 2013 and beyond will be earned the old-fashioned way – by asset performance enhancement.

Volume: We expect national activity in 2013 to be driven by enhanced property performance and foreign investors seeking the safety of U.S. assets. Look for volume in 2013 to be on par with 2012, though the emphasis is likely to shift toward undersupplied second-tier markets and industrial and retail assets.

Locally, we expect investors to seek Class B office product with renovation in mind – the means to achieve yield, with delivery in 2015 or so. There is always a market for Class A office in the nation's capital. Apartments will still be in favor, even with investors wary of the oncoming new supply. Demographic trends demand it.

Notwithstanding concerns about the Federal budget, Washington commercial real estate assets will remain among the most desirable in the world – a concept reinforced by the AFIRE rankings. Investors both domestic and foreign will continue to look to Washington when seeking acquisitions due to its solid track record, prospective employment growth, and strong core industries – notwithstanding concerns about Federal spending. Critical to success will be recognizing the mismatch between existing product and tenant requirements, whether for office or apartment investment. Identifying unique properties that can satisfy a modern office tenant or a Generation Y apartment renter will separate the savvy investor from the rest of the field.

10

2013 TrendSetter Award
RECIPIENTS

10

2013 TrendSetter Award
RECIPIENTS

Each year, Transwestern and its research affiliate, Delta Associates, honor an individual, or individuals, who have made a noteworthy contribution to the commercial real estate industry as a whole, and to the Washington metropolitan area in particular.

This year our TrendSetter honorees are Robert J. Murphy, Managing Principal of MRP Realty, and William B. Alsup, III, Senior Managing Director of Hines.

Robert J. Murphy

Managing Principal
MRP Realty

In a year in which many investors remained on the sidelines, MRP Realty was one of the most active players in the Washington, DC region. The firm currently has over 1,600 units of residential and approximately 1 million SF of office in the development pipeline; a total of over $1 billion. Since co-founding MRP in 2005, Robert Murphy has built a dynamic enterprise that has acquired 2.5 million SF of office and residential projects and invested in nearly $2 billion of deals with its institutional partners. MRP has quickly emerged as one of the most thoughtful, creative and successful real estate firms in the Washington metropolitan area.

With its initial foray into Maryland – the acquisition of the 780,000 SF Air Rights Center in Bethesda – and the formation of a residential real estate division in 2012, MRP Realty is primed to continue its rapid growth trajectory. For his entrepreneurial acumen and visionary leadership, we are very pleased to honor Bob Murphy as our 2013 TrendSetter of the Year.

William B. Alsup, III

Senior Managing Director
Hines

Since joining Hines in 1979, Bill Alsup has been responsible for more than 6.7 million SF of commercial real estate. With overall responsibility for development, acquisition, leasing and property management in the Washington, DC region, Mr. Alsup has been instrumental in positioning Hines as one of the region's preeminent real estate firms.

Known for creating projects of the highest quality, aesthetic relevance and enduring value for its investor partners, clients and local communities, Hines has developed many of the Washington, DC area's signature projects including Columbia Square, Franklin Square and the Gannett/USA Today Headquarters. With the rise of CityCenterDC, a 2.5 million SF mixed-use development in the heart of the District, Hines is poised to continue its legacy of success. For his steadfast leadership and distinguished record of accomplishment, we are very pleased to honor Bill Alsup as our 2013 TrendSetter of the Year.

Past TrendSetter Award Recipients

George F. McKenzie
2012 Private Sector
President and CEO
Washington Real Estate
Investment Trust

Gerald L. Gordon, Ph.D.
2012 Public Sector
President and CEO
Fairfax County Economic
Development Authority

Doug Donatelli
2011 Private Sector
TrendSetter of the Year
Chairman and CEO
First Potomac Realty Trust

Elizabeth Price
2011 Public Sector
TrendSetter of the Year
President
NoMa Business
Improvement District

Thomas S. Bozzuto
2010 Private Sector
TrendSetter of the Year
Chief Executive Officer
The Bozzuto Group

James E. Bennett
2010 Public Sector
TrendSetter of the Year
President & CEO
Metropolitan Washington
Airports Authority

W. Christopher Smith, Jr.
2009 Private Sector
TrendSetter of the Year
CEO
William C. Smith & Co.

Donald Wood
2009 Public Sector
TrendSetter of the Year
President & CEO
Federal Realty Investment Trust

Oliver T. Carr, III
2008 TrendSetter of the Year
President & CEO
Carr Properties

Benjamin Jacobs
2007 Private Company
TrendSetter of the Year
Managing Partner
The JBG Companies

Michael Glosserman
2007 Private Company
TrendSetter of the Year
Managing Partner
The JBG Companies

Andrew Florance
2007 Public Company
TrendSetter of the Year
Founder, Director,
President & CEO
CoStar Group, Inc.

Milton Peterson
2006 TrendSetter of the Year
Chairman
The Peterson Companies

F. Joseph Moravec
2005 Public Sector
TrendSetter of the Year
Commissioner
GSA Public Buildings Service

John E. (Chip) Akridge
2005 Private Sector
TrendSetter of the Year
Chairman
Akridge Real Estate Services

Congressman Tom Davis
2004 Public Sector
TrendSetter of the Year
11th District of Virginia
U.S. House of Representatives

Bryant F. Foulger
2004 Private Sector
TrendSetter of the Year
Principal and Vice President
Foulger-Pratt Companies

Clayton F. Foulger
2004 Private Sector
TrendSetter of the Year
Principal and Vice President
Foulger-Pratt Companies

Douglas M. Duncan
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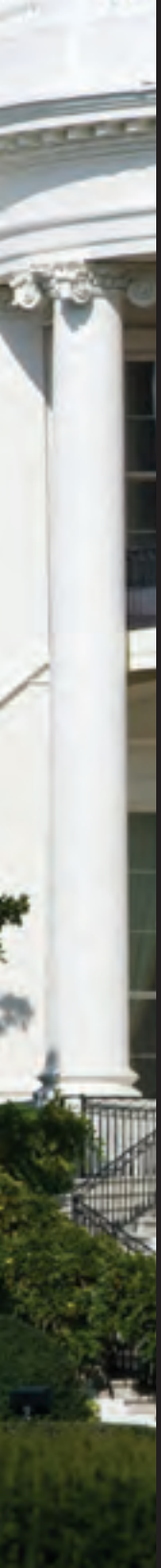

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