City of Alexandria, Virginia

MEMORANDUM

DATE: MARCH 16, 2001

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: PHILIP SUNDERLAND, CITY MANAGER PS

SUBJECT: BUDGET MEMO # 2 : *TRENDLINES 2001: NEW ECONOMY; NEW CHALLENGES*

Attached is a copy of Delta Associates' *Trendlines 2001* report that was recently released. This report is an annual publication of a nationally recognized Alexandria firm, Delta Associates, and covers the prospects for the regional economy in 2001. The report is also now produced in partnership with regional economist Dr. Stephen Fuller.

In general, the conclusion of the report is that while a national economic slowdown is occurring, the Washington, D.C. region will continue to be very strong (albeit with a somewhat slower rate of job growth). The report also discusses challenges in the region (p. 13), notes the positive economy, and discusses Alexandria's PTO decision in relation to smart growth policies. While Delta's report may be viewed as too optimistic by many, it does provide some comfort that the local economic conditions in the next few years ahead, including those in the City, are likely to continue to be positive and grow in real terms.

Attachment: *Trendlines 2001: New Economy; New Challenges*

cc: Mark Jinks, Assistant City Manager
Richard Sanderson, Director, Real Estate Assessments

Attachment 1 58

Price: $100

TRENDLINES 2001
IN WASHINGTON/BALTIMORE REAL ESTATE

New Economy; New Challenges

A 2/15/01 Collaborative Publication of:

TRANSWESTERN COMMERCIAL SERVICES

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Delta Associates

Gregory H. Leisch, CRE
Chief Executive Officer

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To our friends, clients and colleagues:

We are pleased to provide you this fourth annual edition of *TrendLines*: *Trends in Washington/Baltimore Real Estate*. This is a collaborative publication of the research department at Transwestern Commercial Services and the commercial real estate appraisers and consultants at Delta Associates. Our purposes are to distill the trends of the year just completed and to shed light on pivotal forces and issues which we believe will affect the region's real estate in the coming year.

As with most economic phenomena, real estate moves in cycles. We believe 1999 and 2000 were years that defined the peak of this cycle. 2000 was a banner year in our industry by any measure. Supply/demand fundamentals improved for every property type. Rents rose significantly, vacancy tightened further, and absorption set records for most asset classes.

Notwithstanding the continuity in market fundamentals from 1998 to 2000, we sense a sea change – a transition from one phase of the real estate cycle to another. The correction in the tech sector did not bring this about, but has focused us on economic fundamentals. We have high expectations for continued opportunities in our industry in the period ahead. These expectations include:

- In consultation with our newest colleague and chief economist, Dr. Stephen Fuller, ***we expect a soft landing to the national economy***, not a recession. But we also expect the Washington area to out-perform the national economy. We have assets here that buffer the region against a downturn – the Federal government and a solid tech industry devoid of the risk profile attendant to dot.com and e-tailing sectors.
- ***We expect the capital markets to provide the governance*** that will avoid excessive speculation. This "self discipline" will curtail construction and thereby extend this cycle. Vacancy rates will rise gently this year in office and apartment product. We expect vacancies to hold steady in retail and industrial. Cap rates will continue to drift up and sale prices will stabilize. Opportunity investors will struggle to find deals with up-side.
- ***We expect rental rate increases, so strong in 1999 and 2000, to moderate.*** This in turn will require more rigorous property management as a source of upside in property performance.
- ***We expect to find as many opportunities in our industry in 2001 as we did in 2000.*** We expect they will be of a different nature and harder to find than in the past 4 years.

And we hope the information following helps provide some insights into our collective opportunities. All the professionals at Transwestern Commercial Services and Delta Associates look forward to helping you interpret everything you see and being your service partner in the successes we know you will achieve in the period ahead.

60

Table of Contents

Acknowledgments: The editor, Gregory H. Leisch, CRE, wishes to acknowledge and thank this project's research team at Delta Associates: Elizabeth Barger, Mid-Atlantic Research Director, and Scott Price, National Director of Research. The creative layout team, headed by Amy Wychulis has our gratitude, and most of all our appreciation is hereby expressed to the 125 or so industry leaders who spent their valuable time with us responding to questions about the future of our industry here in the Washington/Baltimore region. This includes thanks to our newest collegue, Dr. Stephen Fuller for his insight on the national and regional economy.

Sources: We rely on a lot of sources for information as footnoted following. But a special thanks and acknowledgement goes to Co-Star on whom we rely for vacancy and construction data for office and industrial markets.

61

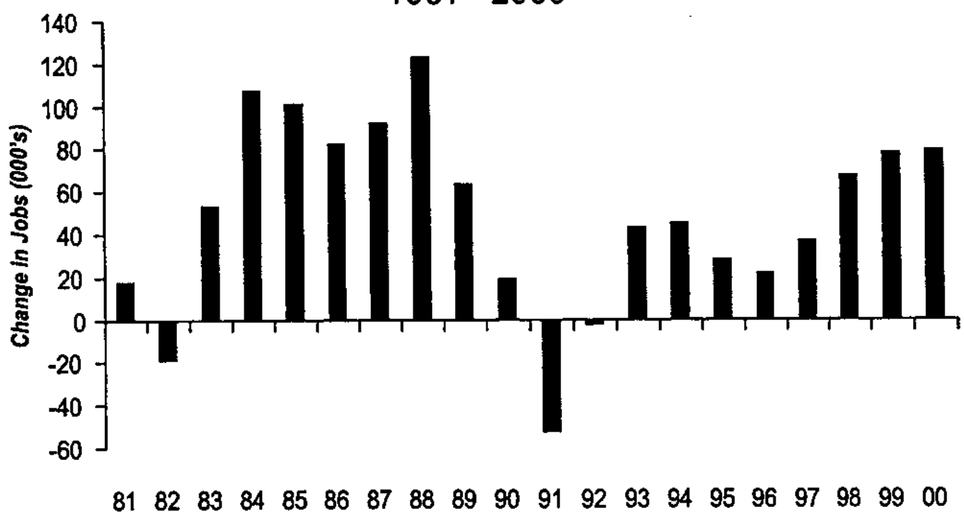
The Regional Economy: 2000 Review and 2001 Prospects

Section One

Area Employment Growth

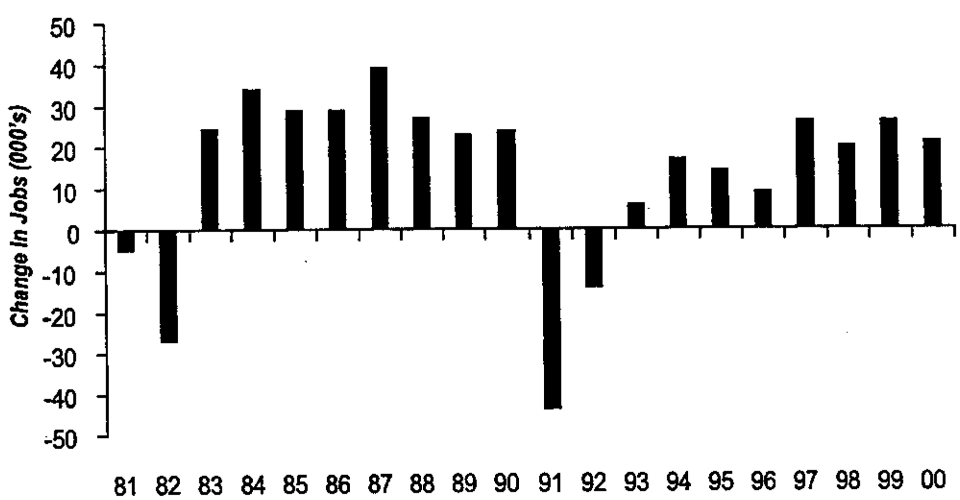
Job Growth in the Washington Area

1981 - 2000



Job Growth in the Baltimore Area

1981 - 2000



The Regional Economy: 2000 Review and 2001 Prospects

It was not long ago that we all used the expression ***"It's the economy, stupid!"*** when attempting to explain the obvious. Well, we appear back to that point in this economic cycle – this time to warn of a slowdown in economic growth and its impact on our industry. Recognizing this, during the past year we formed a strategic alliance with the renowned regional economist, Dr. Stephen Fuller of George Mason University. As a result, we have been providing cutting edge economic insights to our customers since the Spring of 2000. And this resource is a primary ingredient in the insights contained herein.

Before we review the Washington/Baltimore regional economy, a few words on the national economic events of the past year and our thoughts on their meaning. These perhaps define the parameters of what we can expect locally in 2001.

The National Economy

We believe the robust phase of the current national economic growth cycle is coming to an end, after an unprecedented 9 year run. The indicators that lead us to this conclusion include:

Consumer confidence declined this Fall for the first time this cycle. Although still very high by historic standards, this has led to:

- A decline in auto and home sales since August 2000
- Sagging retail sales since the Spring

Corporate earnings have disappointed analysts, although they are still at historically high levels. This disappointment in turn has led to:

- A decline in the Dow by 5% and NASDAQ by 40% in 2000.
- Corporate right-sizing to regain profitability. This, in turn, has led to an up-tick in the unemployment rate.

The tech bubble has burst – creating a pull back in IPO's and venture capital flows and a decline in the 'wealth-effect'. This in turn has shaken business and consumer confidence.

Our Gross Domestic Product (GDP) declined to a 1.4% annual growth rate in the 4th quarter, from the lofty levels of over 4% for several years.

We believe that we are in a period of a national economic slowdown but that a recession will be avoided, as defined in 'old economy' terms. Economic experts project GDP annual growth rates of 2% to 3% for the next year or two. We agree for the following reasons:

1. **There is an absence of the 'old economy' indicators of a recession** – rising inflation, plummeting capital spending, and an excessive build-up of producer inventories.
2. We have avoided the more traditional maladies of a recession with 'new economy' **productivity gains and better market tracking** by producers.
3. **Even inflation is under control** in spite of spiking energy prices, construction costs, and wage rates.
4. **Capital spending will likely continue at higher rates than experienced in prior slow downs** – because the 'new economy' spends on capital goods to create productivity gains and to reduce costs so as to remain competitive. In the 'old economy', capital spending was cut as a recession began because there was no need to expand productive capacity by investing in plant and equipment.
5. **The Fed is a better fine-tuner of our economy.** The Fed lowered interest rates twice in January and continues to monitor the economy to protect against a hard landing. Until January 2001, higher interest rates acted as a restraint on inflation.

64

We believe this period of economic slowdown will feel like a recession by comparison to the lofty performance of the economy over the past 4 years. This, in turn, will perpetuate the slow performance of the economy – especially hard hit will be the retail sector, so driven by consumer confidence, and commercial real estate, so dependent on long term capital.

The pull back in capital markets that support real estate development will reduce new construction. For many metro areas, this will not come in time to avoid rising vacancy rates and sagging rental rates. In others, such as Washington, it will prolong this real estate cycle.

Regional Economic Outlook

Two early indicators of how the region will likely fare in a slowing national economy:

Job growth continues to spike in both Baltimore and Washington, compared to other major metro areas. A sample follows.

Washington and Baltimore 4th Quarter 2000 Job Growth Compared to Other Metro Areas

Market	*4th Quarter Change in 12 Month Job Growth*
Baltimore	**+9,000**
Washington	**+6,000**
Los Angeles	-2,000
Phoenix	0
Orange County, CA	-4,000
Houston	0
Dallas/Ft. Worth	-4,000

Source: U.S. Bureau of Labor Statistics

And 4th quarter office market absorption is holding up well in the Washington/Baltimore area compared to many other markets.

Washington and Baltimore Office Market Performance in 2000 Compared to Other Metro Areas

Market	*4th Quarter Office Space Absorption as a % of Annual Total*
Baltimore	**26%**
Washington	**24%**
Los Angeles	13%
Phoenix	10%
Orange County, CA	8%
Houston	7%
Dallas/Ft. Worth	2%

Source: Delta Associates regional reports, year-end 2000.

Core Industries Washington Metro Area 1999

Industry	*GRP (Billions $)*
Federal Government	$68.4
Tech Based Businesses	$35.2
Building Industry	$20.1
International Business	$14.1
Hospitality Industry	$6.7
For Reference: GRP 1999	**$222.4**

Source: Dr. Stephen Fuller, January 2001.

We believe the Washington area economy will substantially out-perform the national economy, while Baltimore will do slightly better. We conclude this for the following reasons:

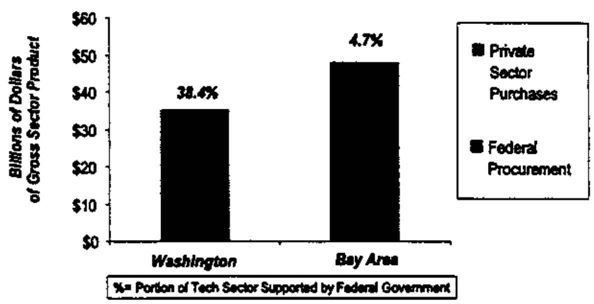
1. Technology companies in our region are less susceptible to the ills plaguing tech companies elsewhere.
2. Washington is not as dependent on technology employment as other major metros, such as the Bay Area.
3. The Federal Government, enjoying budget surpluses, is a stable foundation to the area's employment base.
4. The Federal Government continues to increase its procurement spending significantly in the region, generating high-paying private sector jobs.

Technology companies in our region are less susceptible to the ills plaguing tech companies elsewhere. We find this to be the case for two reasons:

1. **The Federal Government purchases 38% of all goods and services produced locally by the tech sector** – a stabilizing influence unparalleled elsewhere in the nation.

Percent of Tech Sector Supported by Federal Government

Washington vs. Bay Area



Source: Dr. Stephen Fuller, 01/01

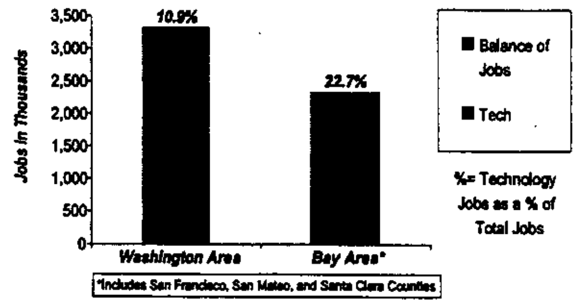
2. **The tech businesses in our region are in clusters of activity that are less risky and more insulated from economic swings.** Tech industry clusters:

Tech Industry Clusters Located in Washington vs. the San Francisco Bay Area	
Washington Area	*San. Fran. Bay Area*
Internet portals, service and content providers	Electronic designers: web pages, games, animation, and entertainment
Network applications	Software developers
Telecom	Hardware manufacturers
Bio-med	Dot.com retailers

Tech employment growth will slow, if not stop, for a short period. So **the regional economy is fortunate not to be as dependent on tech employment as other metro areas.** It enjoys the growth that a large tech presence brings to the general economy, without being so dependent on it. 10.9% of the Washington area's employment is tech based, compared to 22.7% in the Bay Area.

Local Economy Dependence on Technology

Washington vs. Bay Area

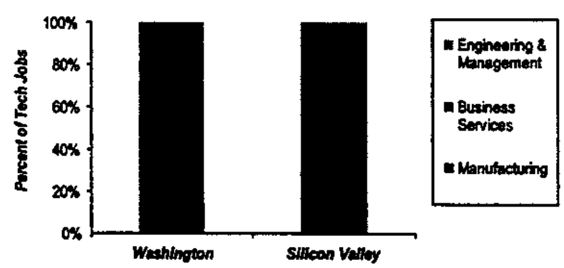


Source: Dr. Stephen Fuller, 01/01

With so many un-filled tech jobs in the region (estimated by Dr. Fuller at 35,000 currently), the few layoffs that we are seeing at troubled Washington area companies put workers back to work in profitable companies. The result: recent announcements of layoffs are good for the regional economy. And so far they are not producing any relief for staff-starved industries.

Tech Sector by Major SIC Group

Washington vs. Silicon Valley

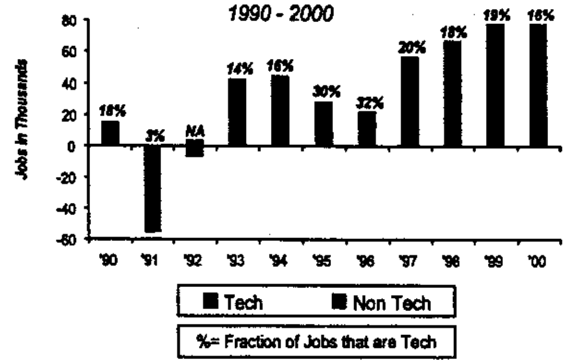


Source: Dr. Stephen Fuller, 01/01

Job Growth: Tech V. Non Tech

Washington Metro Area

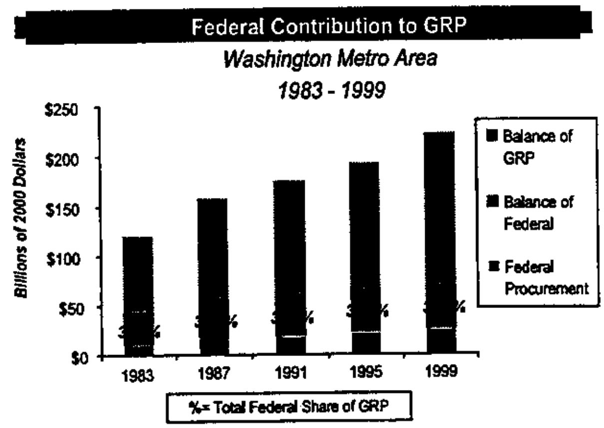
1990 - 2000



Source: Dr. Stephen Fuller, 01/01

66

The Federal government has an enormously stabilizing influence on the region, as it is the largest component of the regional economy – accounting for one-third of the area's economic vitality as measured by GRP (Gross Regional Product).



Source: Dr. Stephen Fuller, 01/01

The Federal Government will continue to expand its procurement spending in the region by a minimum of $1 to $2 billion per year, creating 10,000 to 15,000 new private sector jobs per annum. And this trend will not likely change during the new Bush Administration.

Federal Government Employment is Half as Significant Today as it was in 1970

	1970		*2000*	
Federal Gov't	321,700	27%	330,900	12%
State/Local Gov't	134,600	11%	269,900	10%
Subtotal	456,300	38%	600,800	22%
Private Sector	728,300	62%	2,157,000	78%
Total non-farm	**1,184,600**	**100%**	**2,757,800**	**100%**

Source: Bureau of Labor Statistics

Regional Economic Indicators

Turning for the moment from economic prospects to recent performance, the regional economy turned in a beauty in 2000. For a second year running the Washington/Baltimore region generated over 100,000 new jobs.

Washington sets a pace for the nation:

- 12-month **job growth** through November 2000 was an astounding **81,000!**
- The area **unemployment rate** was just 2.3% in November, compared to the national rate of 4.0%.

Trends in Employment by SIC Code
Washington Metro Area
(In 000's)

	11/99	*11/00*	*12 Month Job Growth*
Services	1,069.6	1,115.3	45.7
Trade	492.0	502.8	10.8
Manufacturing	101.0	101.5	0.5
Government	595.7	600.8	5.1
TCPU[1]	128.1	134.1	6.0
FIRE[2]	145.4	149.3	3.9
Construction	143.8	152.8	9.0
Mining	1.2	1.2	0.0
Total	**2,676.8**	**2,757.8**	**81.0**

[1] Transportation, Communications, Public Utilities
[2] Finance, Insurance, Real Estate
Source: Bureau of Labor Statistics.

Trends in Employment by SIC Code
Baltimore Metro Area
(In 000's)

	11/99	*11/00*	*12 Month Job Growth*
Services	425.7	436.0	10.3
Trade	283.6	289.9	6.3
Manufacturing	97.4	95.5	(1.9)
Government	220.1	223.2	3.1
TCPU[1]	59.5	61.3	1.8
FIRE[2]	75.7	75.4	(0.3)
Construction	73.9	75.6	1.7
Mining	0.4	0.4	0.0
Total	**1,236.3**	**1,257.3**	**21.0**

[1] Transportation, Communications, Public Utilities
[2] Finance, Insurance, Real Estate
Source: Bureau of Labor Statistics.

Baltimore maintains momentum of late 1990s:

- 12-month **job growth** through November 2000 was 21,000.
- The area **unemployment rate** was 4.1% in November, compared to 4.0% nationally.

Challenges to Our Region

Venture capital may be drying up as a source of fuel for the region's high-tech growth. Venture capitalists across the country are moving away from first time investments and focusing on existing companies. Venture capital invested in the Washington/Baltimore region dropped 24% in the 3rd quarter of 2000, compared to the 2nd quarter. Nevertheless, total venture capital invested in the region in 2000 is expected to exceed the 1999 figure.

Venture Capital Invested in the Washington/Baltimore Region

Year	*$ in Millions*
1997	$539
1998	$1,018
1999	$3,027
2000*	$2,866

* Through the 3rd Quarter
Source: PricewaterhouseCoopers and NASDAQ/AeA

The region ranks among the largest recipients of venture capital in the nation. How will it fare with less of this fuel? Given the types of firms in the area, we expect venture capital to decline, but not by much. We simply do not house the start-ups and other riskier clusters that venture capitalists are currently avoiding. Nonetheless, adjusting to this change, however moderate, will be a challenge in the period ahead.

Investment in transportation infrastructure remains underfunded. Traffic congestion in the Washington area is the second worst in the country. If not addressed adequately, economic prosperity in the region may be threatened. The infrastructure improvements needed in the area continue to grow and estimates are now up to $25 billion.

The bad news in all this is two fold: (1) congestion can choke out economic development by making the commute not worth the struggle for those decision makers that help drive the local economy, and (2) congestion is miss-interpreted by the public and becomes anti-growth sentiment.

We believe this is the most serious of the region's challenges. And local government leadership appears to lack the vision and political courage to address it. And even the State governments have pulled back from intelligent thinking: Maryland has pulled the plug on the Cross-County Connector and Virginia appears destined in the current legislative session to turn down a local initiative to create a Northern Virginia transportation district with the right to tax.

Major Infrastructure Projects in the Washington Area

Project	*Cost (Millions)*
Woodrow Wilson Bridge	$2,200
I-495 Widening (including Mixing Bowl)	$2,000
Dulles Metro Extension	$2,000
Rt. 301 Transformation	$1,800
Western Bypass	$1,600
Potomac Mills Metro Extension	$1,500
I-95/Rt. 301 Bridge	$1,000
Inter-County Connector	$1,000
DC Convention Center	$700
I-66 Widening	$650

And finally, ***no list of challenges is complete without inclusion of the new brand of no-growth sentiment sweeping across the region.*** Smart growth to this group is no-growth.

We think smart-growth means steps like that taken by Fairfax County in early January 2001 when it enacted zoning changes around Metro stations – encouraging higher density development at Metro served locations, thereby reducing dependence on private vehicles while encouraging needed subway patronage. We think smart-growth was at the heart of the Spring 2000 Alexandria decision to allow the PTO to occupy space at the King Street Metro station. Smart because it finally begins to create some economic base in this low-density residential enclave. And at the same time it practices smart transit policies.

What impact will Loudoun's new growth management have on the region? More sprawl. Less manageable traffic patterns and demands. Less economic base in Loudoun. More commercial development in Western Prince William County. More urban pressure on Fauquier County. Greater need for a northern Potomac River bridge crossing between Montgomery and Fairfax/Loudoun. And these factors affect the economic prospects of the region for generations to come. With the benefit of hind-sight, imagine if you can how very different the Washington region would be today had Arlington said no to the Pentagon in the 1930s and the Navy in the 1960s. And Montgomery County had said no to NIH in the 1950s. Those functions might be in a much wealthier West Virginia today had it not been for smart growth policies and courageous local leadership.

Economic Prospects For The Region in 2001 and Beyond: Very Strong

The outlook for the Washington/Baltimore regional economy is excellent, in spite of press to the contrary.

Washington: Mixed signals; Strong prospects. According to Manpower, 27% of employers in the Washington Metro area plan to increase their staff in the 1st quarter 2001, on par with the national average.

Employers' Plans to Change Size of Its Workforce
Washington Metro Area
1st Quarter 2001

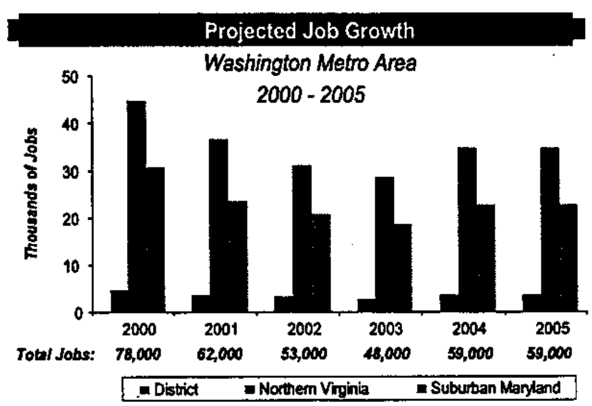
Plan to Increase Staff	27%
No Change	61%
Decrease	5%
Net (Increase-Decrease)	22%

Source: Manpower.

In spite of continued strong economic conditions in the Washington area, news of a national slowdown has affected area residents' outlook. In our annual survey of industry leaders, 40% of respondents believe 2001 economic conditions will be worse than in 2000. This is compared to just 9% expressing a comparable sentiment last year, reflecting a more pessimistic outlook for 2001.

Last year at this time, industry consensus was that the economy would turn down in 6 quarters. The majority of respondents this year believe the good times will last only 3 more quarters.

We believe the Washington area economy will grow an average of 56,000 jobs per annum for the next 5 years – well below the nearly 78,000 per annum growth of the 1998-2000 period, but on par with the 48,000 average of the period 1970-2000.



Source: Dr. Stephen Fuller, 01/01

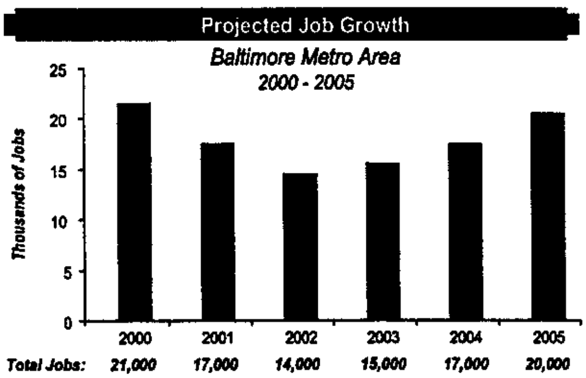
Baltimore: Strong signals; Mixed Prospects. The Baltimore area will likely mirror the national trend of a slowing economy in 2001. Without a comparable boost of Federal government spending and high growth of the technology sector like in the Washington Metro area, Baltimore's economy will experience a more substantial slowdown.

Nevertheless, Baltimore area employers remain upbeat – 34% plan to increase their workforce in the 1st quarter 2001, compared to the national average of 27%.

Employers' Plans to Change Size of Its Workforce Baltimore Area 1st Quarter 2001	
Plan to Increase Staff	34%
No Change	50%
Decrease	7%
Net (Increase-Decrease)	27%

Source: Manpower.

We believe the Baltimore area economy will grow an average of 16,500 jobs per annum over the next 5 years – some 20% below the average of the past 7 years and half the rate of the 1980s.



Regional job growth provides plenty of market for continued significant real estate development and investment opportunities. However, greater care must be exercised in underwriting deals in this market environment, as the no-brainer phase of this economic cycle is behind us.

Washington High-Tech Industry

Category	*Number*	*National Rank*
Jobs	177,729	4
Firms	7,282	2
Concentration	93 per 1,000	13
Absolute Job Growth (93-98)	46,429	3
Growth Rate (93-98)	35%	23
Payroll	$12.4 billion	3
Average Wage	$70,038	7
Venture Capital Invested (99)	$2.45 billion	6
University R&D spending	$503 million	8

Source: NASDAQ, AeA Cybercities Report, 2000.
Data as of 1998 except where indicated.

Baltimore High-Tech Industry

Category	*Number*	*National Rank*
Jobs	38,289	31
Firms	1,701	26
Concentration	41 per 1,000	46
Absolute Job Growth (93-98)	5,323	39
Growth Rate (93-98)	16%	41
Payroll	$2.2 billion	28
Average Wage	$57,780	25
Venture Capital Invested (99)	$581 million	19
University R&D spending	$988 million	2

Source: NASDAQ, AeA Cybercities Report, 2000.
Data as of 1998 except where indicated.

Top 20 High-Tech Markets By Number of Employees as of 1998

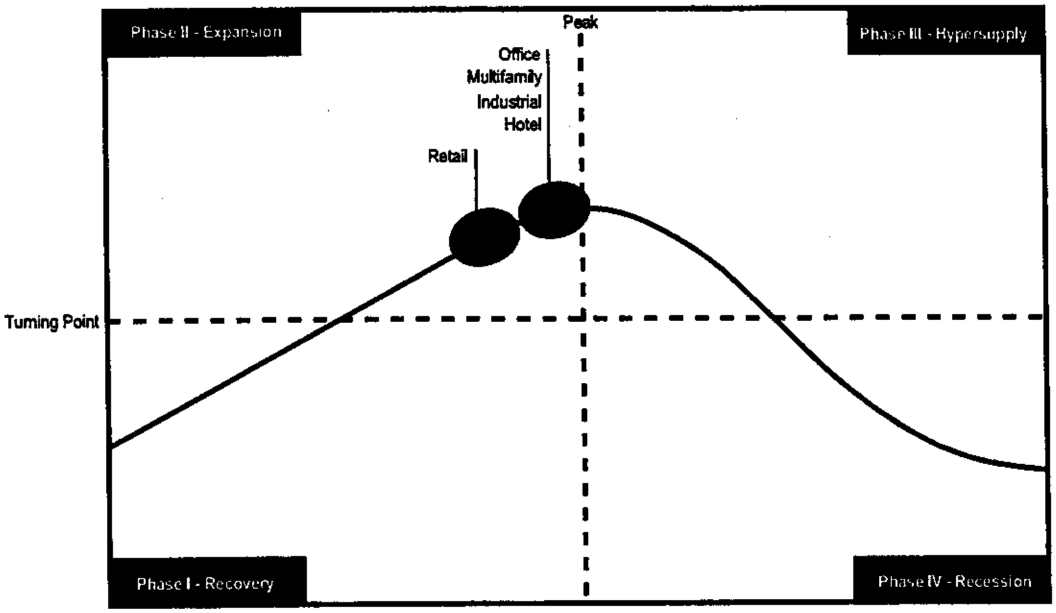
Rank	*Market*	*Jobs*	*Firms*	*Concentration (Per 1,000)*
1	San Jose	252,888	4,773	288
2	Boston	234,822	7,348	89
3	Chicago	180,425	7,114	52
4	**Washington**	**177,729**	**7,282**	93
5	Dallas	176,633	3,947	109
6	Los Angeles	160,544	5,712	47
7	Atlanta	117,279	4,962	67
8	New York	115,860	6,454	35
9	Minneapolis-St. Paul	98,431	4,042	69
10	Orange County	93,585	3,123	80
11	Philadelphia	88,647	3,599	45
12	Phoenix	82,588	2,338	64
13	Seattle	75,565	2,642	66
14	Houston	71,525	2,650	42
15	Denver	71,502	2,983	76
16	Austin	68,938	1,330	148
17	Oakland	66,878	2,840	82
18	Rochester	65,650	754	147
19	Portland	64,179	1,696	79
20	San Francisco	62,229	3,121	69
31	**Baltimore**	**38,289**	**1,701**	**41**

Source: NASDAQ, AeA Cybercities Report, 2000.

The Washington/Baltimore Area Real Estate Market

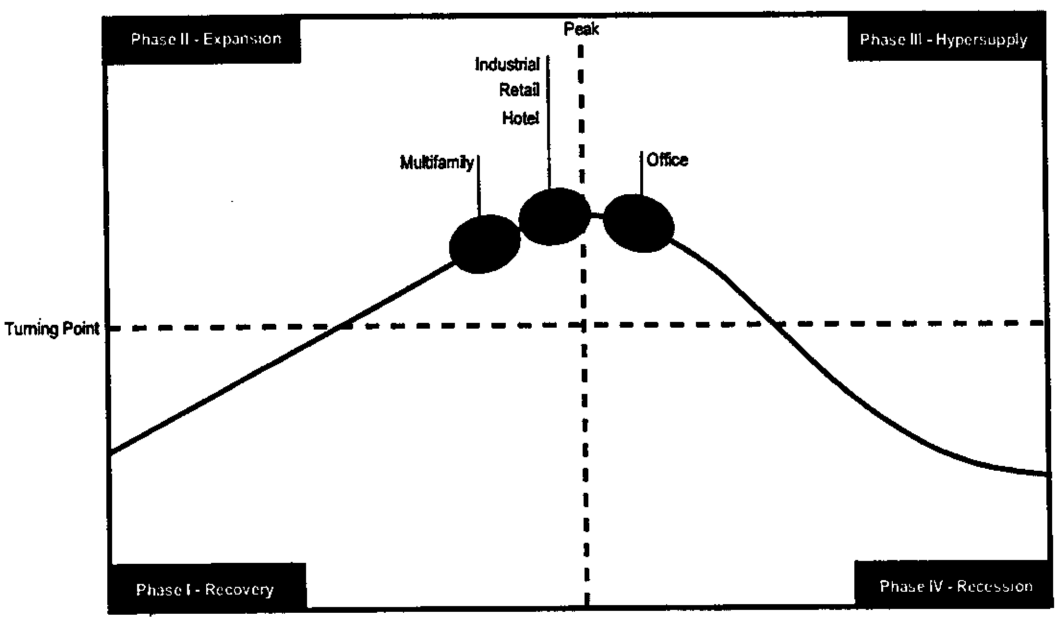
Section Two

Market Cycle Index by Property Type
Washington Area
Year-End 2000



Source: Data and analysis per Delta Associates with thanks to Dr. Glenn Mueller for pioneering this cycle graph concept as a method of understanding real estate cycles; 01/01

Market Cycle Index by Property Type
Baltimore Area
Year-End 2000



Source: Data and analysis per Delta Associates with thanks to Dr. Glenn Mueller for pioneering this cycle graph concept as a method of understanding real estate cycles; 01/01

The Washington/Baltimore Area Real Estate Market

The Region's Real Estate Market In 2000: A Record Setting Performance

The performance of the region's real estate market in 2000 was remarkable. We expected a good year, with some topping out of performance indicators in the apartment and office markets. Instead we got a stunning performance in all product types.

- **Office** space absorption: 18.3 million SF – an all time high for this market area and 2nd most in the nation, behind New York.
- **Industrial** market: A real estate cycle high with 9.8 million SF of net absorption. And new uses for old assets come into full swing.
- Class A and B investment grade **Apartment** vacancy remains below 1.5% in the region. High-rise rents up 20%; gardens up 15%. Many are asking: Is there a limit?
- Infill and pedestrian friendly **Retail** is all the rage. The District is attracting retail for the first time in decades. The region has become the destination of virtually every up and coming regional and national retailer. So much for e-tailing's impact on this segment!

With the National Economy Slowing, Is the Regional Market Peaking?

Are real estate markets at the peak of this cycle? ***We think all product types are approaching the peak or at it; but we expect all will stay at the peak for the next 3 years without tipping into hyper-supply.***

There are some ominous signs, though. Here is our angst list:

- **Office:** 27 million SF under construction. A high concentration of tech companies. Enough said? But so far, absorption has held up through the 4th quarter of 2000 and early into 2001. The slow down in starts of the 2nd half of 2000 must continue if a wreck is to be avoided. Vacancy continues to tighten in Washington, but has leveled off in Baltimore. We look for it to rise in all submarkets. How much? Read on.
- **Industrial:** 8.5 million SF under construction – slightly ahead of demand. But so far, vacancy continues to decline in both Washington and Baltimore. This asset class is particularly susceptible to economic swings, so watch construction starts and job formations closely.
- **Apartments:** Vacancy has dropped to its lowest level ever. Production levels are high, but the region desperately needs the supply. Concern here: too much deluxe product that is affordable only to the highest wage earners. We expect vacancies to rise in all submarkets. Which to avoid? Read on.
- **Retail:** A tale of three markets: Big box and regionals – tough times ahead. Grocery-anchored neighborhood centers and town center/street retail – excellent fundamentals ahead. Theaters: Curtains for many, as the lights go out on even the bigger chains.

Before we fully explore the angst list, let's first review just how these asset types fared in 2000 and where we recommend playing in the period ahead.

The Office Market

The office market had a record setting year in 2000. But with the economy cooling off, it appears that the office market may finally be at the peak of this cycle.

- **Absorption** totaled 18.3 million SF in 2000 – the most ever in the region and among the top two markets in the nation.

- The region's direct **vacancy rate,** at 4.5%, is the lowest on record and remains among the 3 lowest in the nation.
- **Rents** spiked 11% in Washington in 2000, but rose just 3% in Baltimore.
- **Sales** volume increased to $3.1 billion as institutional, foreign and entrepreneurial investors prioritized this region as a safe haven for investment. But what do opportunity investors do?
- **New construction** is up to 27 million SF, highest in the country. 46% of the space is pre-leased – 12.5 million SF.

Prospects: The Washington area office market remains very strong, although we expect its vacancy rate to edge up in 2001. Baltimore's market appears to be significantly weaker at this point.

Washington/Baltimore Office Market Snapshot: 2000

Direct Vacancy Rate @ 12/00	4.5%
Net Absorption	18.3 Million SF
SF Under Construction @ 12/00	27.1 Million SF
Investment Sales	$3.1 Billion

The Industrial Market

The industrial market had a very strong performance in 2000, with excellent prospects for 2001. But watch for a slowdown in economic activity.

- Regional **absorption** totaled 9.8 million SF in 2000, the most since the mid-1980s.
- The regional industrial direct **vacancy** rate decreased to 7.3% at year-end 2000, from 9.2% a year earlier.
- Industrial **rents** rose 7.5% regionally; 14% in Northern Virginia.
- **Sales** volume up 10% over 1999 to $367 million in 2000. Prices rose 3.5%.
- There is 8.5 million SF of industrial space **under construction** regionally at year-end 2000, compared to 3.7 million SF a year ago. 22% is pre-leased.

Prospects: Supply is now outpacing demand and we expect vacancy to increase modestly in 2001. However, steady demand will maintain healthy fundamentals in the industrial market. Watch for an over-play in data centers and distribution facilities for e-commerce. Stick with the bread and butter part of this asset class.

Washington/Baltimore Industrial Market Snapshot: 2000

Direct Vacancy Rate @ 12/00	7.3%
Net Absorption	9.8 Million SF
SF Under Construction @ 12/00	8.5 Million SF
Investment Sales	$367 Million

The Apartment Market

The Washington/Baltimore area apartment market had another phenomenal year in 2000 with excellent prospects for 2001 for the right product at the right location.

- The Washington area **vacancy** rate tightened even further in the last twelve months – to 0.8%. The Baltimore area vacancy rate decreased to 1.2% at year-end 2000.
- 5,935 units were **absorbed** in the Washington area in 2000 – the highest level in 12 years.
- **Rents** continue to spike at alarming rates. Class A rents increased 16% in the Washington area over the last twelve months and Baltimore area Class A rents increased 10% in the same period. This can't continue, can it?

- The average **sale price** for Class A garden apartment projects in the Washington area jumped to $125,044 per unit in 2000, from $87,781 per unit in 1999. With cap rates rising, yet more capital pouring into this asset class, we expect prices to remain high, but rates of increase to moderate.

Prospects: Early indicators: supply will likely outpace demand in the Washington area over the next 36 months. However, the Baltimore area will likely retain better fundamentals for the next couple of years.

Washington Apartment Market Snapshot: 2000

Vacancy Rate @ 12/00	0.8%
Units Absorbed	5,935
Units U/C & Planned For Near Term Delivery	25,774
Investment Sales	$952 Million

The Retail Market

The neighborhood retail market in Washington turned in another strong performance in 2000. And with a lack of product in the development pipeline, prospects remain extremely bright into 2002.

- The **vacancy** rate for grocery-anchored shopping centers decreased to 2.2% – its lowest point in two decades.
- In-line tenant **rents** increased 6.3% in 2000, to $21.76 per SF.
- **Investments sales** volume totaled $276 million in 2000, versus $323 million in 1999.

Prospects: Strong for grocery-anchored shopping centers, street retail and town centers. However, the full impact of e-commerce on this asset class is still unknown, and as a result, investor interest is down. An opportunity for a contrarian.

Washington Area Grocery-Anchored Retail Market Snapshot: 2000

Vacancy Rate @ 12/00	2.2%
In-line Rents at Grocery-Anchored Centers (per SF)	$21.76
Investment Sales	$276 Million

The Hotel Market

The Washington area hotel market had an exceptional year in 2000 due to a strong economy and favorable supply/demand fundamentals driven by investor avoidance of this asset class.

- Average **occupancy** increased to 76.1% in 2000, up from 72.9% in 1999.
- **Average daily room rates (ADRs)** increased 6% to $116.61.
- As with most other asset classes, **investor sales** were down from 1999 levels. Investment volume totaled $224 million in 2000.

Prospects: With the impact of the new convention center still to materialize and continued under development of this product type, we like full service hotel plays in center city locations such as DC, Bethesda, and the RBC/Dulles corridors. Not for all investors.

Washington Hotel Market Snapshot: 2000

Occupancy Rate	76.1%
ADR	$116.61
Investment Sales	$224 Million
Sales Price Per Room	$126,000

Investment Sales

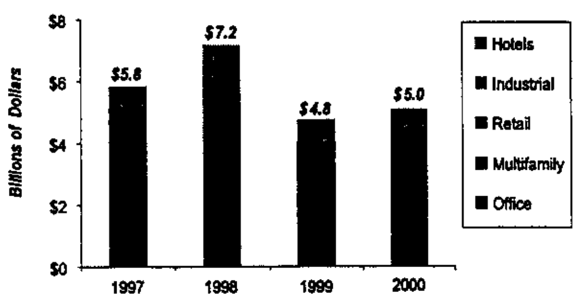
Investment sales volume increased to $5.0 billion in the Washington area in 2000, compared to $4.8 billion in 1999. Sales volume rose in spite of higher interest rates and an uncertain economic outlook for much of the year. Real estate sales decreased in numerous markets around the country as investors – due to the weakening economic outlook – focused on core markets with 24-hour environments, including Washington.

Investment sales volume: up 32% for office properties and 16% for industrial assets. Surprisingly, investment sales volume of apartments decreased in 2000, despite very strong market fundamentals and spiking rents. Sales of retail properties and hotels were also somewhat down in 2000.

Sale prices for apartments spiked in 2000, shadowing rent increases and reflecting institutional interest in this asset class. Prices were up modestly for office and industrial buildings.

Investment Sales

Washington / Baltimore Area



2001 Prospects and Beyond

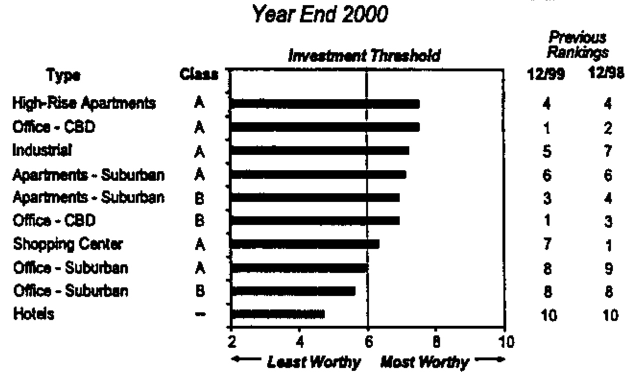
Class A CBD office buildings and high-rise apartments were selected as top investment choices for 2001 in our annual December 2000 survey of those who make and shape our market in Washington and Baltimore. Recent performance of these assets, the continued rejuvenation of Downtown Washington, and strength of the close-in suburbs make these assets very attractive.

Class A Industrial Distribution facilities and Suburban Garden Apartments also rate high with investors. Investors often move to these assets in times of economic uncertainty.

These local preferences are consistent with national patterns. Institutional investors gravitate to these product types due to perceived risk-adjusted returns and the preference for investment in the center of 24-hour cities. ***It appears that there remains some price upside in these asset classes in 2001 and beyond.***

Investment Worthiness Index Washington Metro Area

Year End 2000



Source: Delta Associates survey of 125 Industry Leaders, 12/00

Cap rates increased significantly in 2000 – by 42 basis points. Moving forward, rental escalations are likely to slow due to an abundance of new supply and a weakening economy. However, interest rates are now being cut. So, with these two forces counteracting, we expect cap rates to stabilize in 2001.

Cap Rate Movement
Average of All Products
DC Metro Area

1997 (Actual)	Down 21 Basis Points
1998 (Actual)	Down 26 Basis Points
1999 (Actual)	Down 22 Basis Points
2000 (Actual)	Up 42 Basis Points
2001 (Expected)	Stable to Up Slightly

Source: Delta Associates Survey of 125 Industry Leaders, 12/00.

So, What Do We Recommend You Invest In At This Time?

Institutional Investors:

- **Class A Office buildings** in DC and at suburban Metro locations.
- **Class A Apartment buildings** at trophy locations.
- **High bay warehouse/distribution facilities.**

Opportunity Funds and Developers:

- **Adaptive re-use of old space,** especially for housing.
- **Full service hotels** in the central business districts of DC, Bethesda, and Metro served corridors of Northern Virginia.
- **Town Center/Street Retail** at in-fill locations.
- **Grocery-Anchored shopping centers** in out-lying counties.
- **Active Adult communities.**

The Washington/Baltimore Region
Net Absorption

	Actual 2000	*Projected 2001*
Apartments	*6,704 units*	*8,200 units*
Office Space	*18.3 M SF*	*11.5 M SF*
Industrial Space	*9.8 M SF*	*8.7 M SF*

Washington Area Cap Rates Compared to U.S.
1997–2000

	Washington Area				
Product Type	*1997*	*1998*	*1999*	*2000*	*National 2000*
Apartments ~ High-Rise ~ Class A	8.45	8.69	8.39	8.33	8.60
Apartments ~ Gardens ~ Class A	8.80	8.70	8.42	8.52	8.74
Office ~ CBD ~ Class A	8.78	8.61	8.47	8.81	8.84
Apartments ~ Gardens ~ Class B	9.80	9.30	9.03	9.09	9.75
Office ~ Suburban ~ Class A	9.41	8.56	8.96	9.43	9.26
Industrial ~ Class A	NA	9.36	9.23	9.52	9.02
Office ~ CBD ~ Class B	10.61	10.35	9.29	9.55	10.68
Office ~ Suburban ~ Class B	10.50	10.13	9.67	10.07	10.98
Neighborhood Shopping Center ~ Class A	9.60	9.22	9.10	10.95	9.86

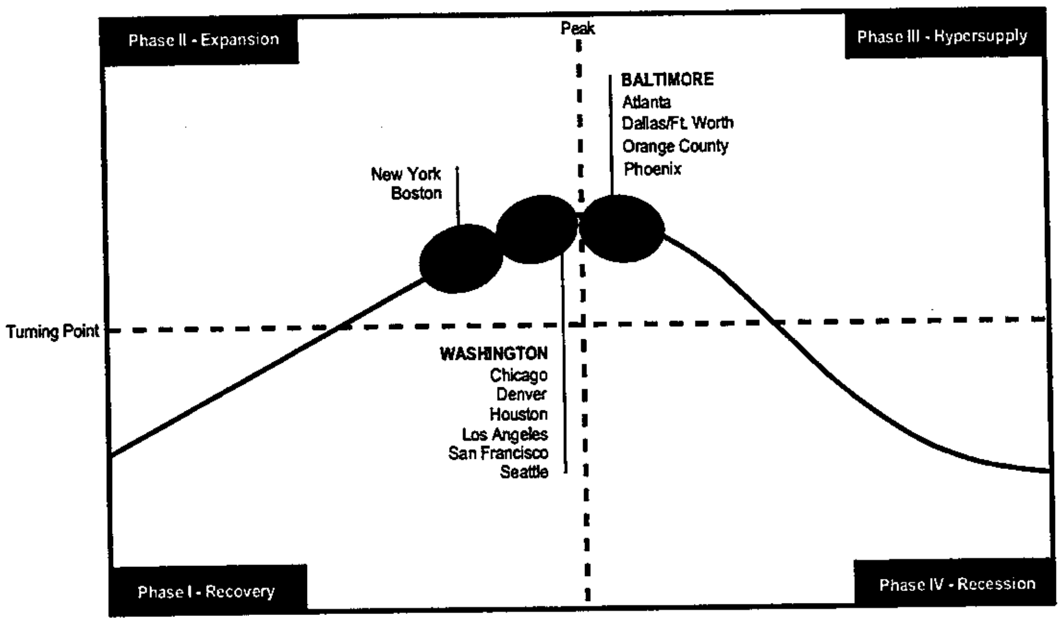
Source for national cap rates: Korpacz

The Office Market

Section Three

Office Market Cycle Index

Year-End 2000



Source: Data and analysis per Delta Associates with thanks to Dr. Glenn Mueller for pioneering this cycle graph concept as a method of understanding real estate cycles; 01/01

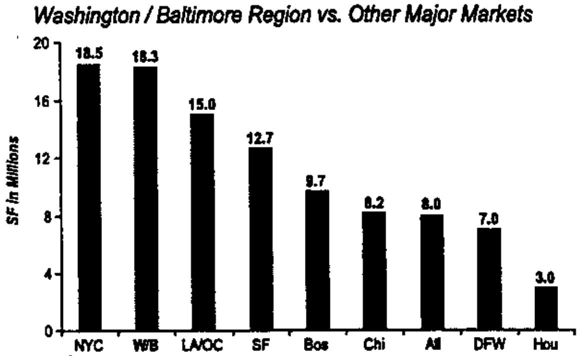
Washington/Baltimore Office Market is Among the Top Markets in The Nation

Not only did the region turn in its best year on record, it set the pace for top performing markets in the nation.

- **Absorption:** At 18.3 million SF, the region is #2, behind New York.
- **Direct Vacancy Rate:** At 4.5%, the bi-metro area is #2, behind San Francisco.
- **NCREIF Total Return Index:** Third in the nation at 14.99% for the 12 months ending September 2000, behind only Boston and San Francisco.
- **Pre-leasing:** 46% of the space in the region is pre-leased – ranking it among the top markets in the nation.

Office Space Absorption in 2000

Washington / Baltimore Region vs. Other Major Markets



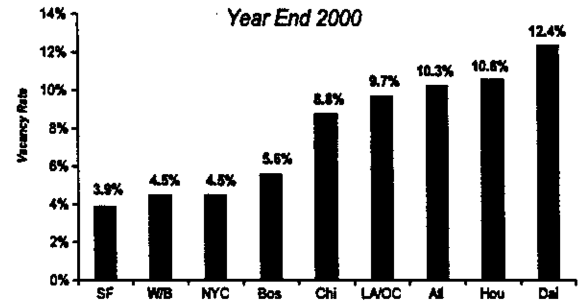
So, where is the bad news?

- **Under Construction Space:** At 27.1 million SF, the region is first in the nation in this regard. And this volume is concerning as the national economy slows.
- **Tech Industry:** The region is among the top two or three concentrations of tech tenants in the nation, and that industry segment is regarded to be in a tail-spin.

But before we speculate on where this market is headed, let's look back at 2000.

Office Vacancy Rate Washington/Baltimore Region

Second Lowest Among Major Markets



The Washington Area Office Market: Best Performance On Record

The Washington Metro Area office market in 2000 turned in its best performance ever recorded and it continues to be one of the top office markets in the nation. Extremely strong job growth and the expansion of the local high-tech industry fueled remarkable absorption of office space. With chronically low vacancy rates, rents spiked.

Although the national economy appears to be slowing, as the high-tech sector contracts, the ***Washington Area office market performed extremely well in the 4th quarter.*** The reasons:

1) The stabilizing influence of the Federal Government
2) The tech clusters found in the Washington Area are less risky and less prone to economic swings

All eyes are on the future, as many observers are concerned about the market's ability to continue such strong performance in light of a growing sense the national economy is slowing, and perhaps slipping into a recession. Before we address this concern, let's look at Year 2000 highlights.

Absorption: Unbelievable!

The Washington Area experienced 15.6 million SF of net absorption in 2000 – its most ever recorded and second in the nation behind New York. Northern Virginia continued to dominate market share, at 62%. While this is down from 65% for the prior 4 years, what is remarkable here is that the other sub-state areas kept pace with the tech-boom going on in Virginia.

Washington Area Net Office Absorption (Millions of SF)

Market	*1996*	*1997*	*1998*	*1999*	*2000*
NOVA	2.8	1.4	3.1	7.6	9.6
Sub MD	1.4	1.0	1.0	1.6	2.4
District	0.3	1.4	3.3	1.8	3.6
Total	**4.5**	**3.8**	**7.5**	**11.0**	**15.6**

The Washington Area experienced no softening of demand for space in the 4th quarter – as 24% of the year's total was absorbed in that quarter. And this is quite a contrast to other large metro areas where early evidence of softening is appearing:

Metro Area	*Fraction of Yr. 2000 Absorption in 4th Qtr.*
LA/Orange County	11%
Phoenix	10%
Houston	7%
Dallas/Ft. Worth	2%

Absorption is related to job growth. There does not appear to be excessive absorption in relation to the growth in office jobs, as there was in the last cycle in the 1980s. So all this absorption seems to be for real. And tenants are not taking down more space than they need.

Vacancy at Record Low

The overall Washington Area direct vacancy rate decreased to 3.6% at year-end 2000:

- Compared to 5.0% a year ago and 3.8% at 3rd quarter 2000
- Only 3.1% for Class A space
- A new low for the Washington Area
- The lowest of any metro area in the nation

Washington Area Vacancy Rates

	All Space					
	Direct Vacancy Rate		*Vacancy Rate w/Sublet*		*Class A Direct Vacancy*	
	At End of:					
Market	*1999*	*2000*	*1999*	*2000*	*1999*	*2000*
NOVA	4.0%	2.8%	6.0%	3.9%	4.9%	3.3%
Sub MD	7.3%	5.5%	8.5%	6.2%	3.9%	3.1%
District	4.8%	3.3%	6.7%	4.0%	3.5%	2.8%
Metro Total	**5.0%**	**3.6%**	**6.8%**	**4.5%**	**4.3%**	**3.1%**

Source: Co-Star

The Washington Area vacancy rate, with sublet space, is 4.5% at year-end 2000. This 90 basis point spread above direct vacancy was relatively unchanged in the 4th quarter – indicating no effect yet from a slower growing national economy. And this spread is among the lowest in the nation, indicating the economic health of the region's tenants. We believe this is a very significant indicator to follow as we enter a period of slower economic growth.

Office Space Under Construction (Millions of SF) at end of:

Market	*Q2 '99*	*Q4 '99*	*Q2 '00*	*Q4 '00*
NOVA	9.9	11.7	14.8	11.7
Sub MD	2.9	2.7	3.3	3.5
District	3.5	6.2	5.2	6.1
Metro Total	**16.3**	**20.6**	**23.3**	**21.3**

Source: Co-Star

New Construction Slows Slightly; Pre-Leasing Steady

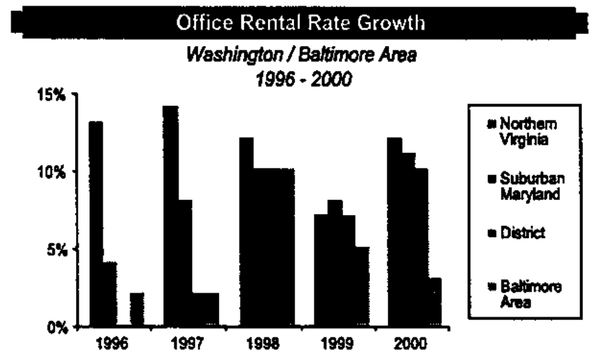
Ground breakings slowed in the second half of 2000. But probably not enough to avoid modestly rising vacancy rates in 2001-2002. As a result, the amount of space under construction has moderated: 21.3 million SF of office space was under construction at year-end 2000, compared to 22.0 million SF at the end of the 3rd quarter. Notwithstanding what might be a moderation in the rate of construction, the Washington area has nearly twice as much space under construction as any other metro area in the nation! Cause for alarm? We think not. Reason to expect that vacancy rates will ease in the next two years? We think so.

The good news in this, and in contrast to the last real estate cycle, 53% of space under construction at year-end 2000 is pre-leased. And this is up from 42% a year ago. And of the 12.9 million SF of office space delivered in the Washington Metro Area in 2000, 69% was leased upon delivery.

Rents Continue to Spike

Rents increased 11% in the Washington Area in 2000. In some of the stronger corridors – Dulles and I-270 – rents spiked 20% or more. With vacancy rates so chronically low, little wonder. And these rates of increase come on the heels of three prior years of comparable rates of increase. So, is there an end to what tenants can afford? We think there is more room for rental rate movement, at least when rates here are compared to other 24-hour cities. But underwriters are not counting on "excess rents" in their exit strategy. Result: investment sales prices have not moved up much in the past 18 months.

Top rents for new Class A space continue to break new barriers for the Washington Area – $60/SF in Downtown Washington and the mid-$40s in Northern Virginia. But these rates are a bargain compared to other comparable cities in the U.S. We see $100/SF for suburban office space in Silicon Valley, $90/SF in the Financial District in San Francisco and over $100/SF in Midtown Manhattan.



Investment Sales: Volume Up; Prices Steady

Investment sales volume totaled $3.0 billion in the Washington Area in 2000 – up 30% over 1999. Why is volume up? The Washington Area is increasingly viewed as a "safe haven" by the investment community as it eyes a slowing national economy.

The average sales price was up only 2% in the Washington Area in 2000 – to $189/SF – in spite of dramatic spikes in rental rates and stable operating expenses. Our underwriting clients just are not counting on what they call "excess rents" in their exit values.

As a result, ***cap rates are up somewhat compared to 1999 levels.***

Average Capitalization Rates for the Washington Area Class A Office Properties

	1997	*1998*	*1999*	*2000*
NOVA	8.75%	8.65%	8.85%	9.24%
Sub MD	9.77%	8.59%	9.40%	NA
District	8.78%	8.61%	8.27%	8.89%
Average:	9.06%	8.63%	8.80%	9.18%

Who is buying? **Developers/entrepreneurs** were the dominant investor type in Washington Area office buildings in 2000, followed by **Institutions** and **Foreign Investors.** Institutional allocations shifted to apartments and warehouses in the 2nd half of 2000. Foreign Investors stayed in the District for the most part. **Opportunity Funds** and **REITs** combined made up less than 25% of the investment market, as the former ran out of deals with up-side and the latter remains incentivized to build rather than buy.

Who Bought Office Assets in Washington in 2000?

	$ Volume (in Millions)	% of Total Volume
Developer/Entrepreneur	$1,093	36%
Pension Fund/Institution	$676	22%
Opportunity Fund	$435	14%
REIT	$319	11%
Overseas	$517	17%
Total	$3,040	100%

Investment Returns: Among The Best in the U.S.

Office building investment returns in the Washington Area averaged 14.99% (the sum of current yield and capital appreciation) for the 12 months ending September 2000, according to NCREIF. This is 203 basis points higher than the national average. Another reason investors favor this region – the area is ranked 3rd nationally on this index. And after adjusting for risk, these are spectacular returns.

Washington/Baltimore Office Stock Year-End 2000 (SF)

Northern Virginia	127,991,000
Suburban Maryland	67,853,000
Washington, D.C.	102,310,000
Baltimore Area	64,907,000
Regional Total	**363,061,000**

NCREIF Return Index[1] for Office Properties

Metro Area	*12 Month Total Return at 3rd Quarter 2000[1]*
San Francisco	23.09%
Boston	17.99%
Washington	**14.99%**
Los Angeles	13.43%
National Average	12.96%
Chicago	7.78%
Atlanta	7.72%
Houston	6.78%
Dallas	5.76%

[1] NCREIF compiles returns based on its members' $36 billion office portfolios. The index includes both current income and capital appreciation returns.

Source: NCREIF 3rd quarter report; re-formatted by Delta Associates.

Land Sales: Volume Slows; Prices Up

Land sales volume drifted down to $283 million in 2000, compared to $321 million in 1999 and $338 million in 1998, as investors began to back away from additional land inventory at this stage of the market cycle. Nevertheless, ***land prices continue to increase steadily in the Washington Area.***

Average Office Land Prices in 2000 Washington Area

Market Area	*Price per FAR*
Washington, D.C.: CBD	$80 - $90
Northern Virginia:	
Inside Beltway & Reston	$30 - $40
Outside the Beltway	$15 - $25
Suburban Maryland	
I-270 Corridor	$15 - $25

Development Economics Working Well in Spite of Construction Cost Spikes

Our office developer clients report that spec office deals pencil nicely even in the face of rising land prices and galloping construction costs. For deals to pencil, rents need only range between $27 to $37 per SF, full service, in the suburbs and average $48 per SF, full service, in the CBD.

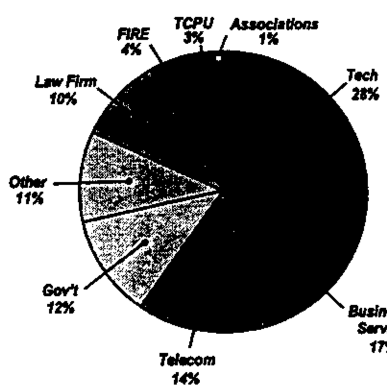
Cash-on-cost returns average 10.67%. On a risk-adjusted basis these are high rates, attracting a lot of capital that in turn is fueling our construction boom.

Prototypical Office Development Economics for 2000 (per SF)			
Location:	**Suburban Office**		**CBD Office**
Stories:	4	10-15	8-12
Parking:	Surface	Structured	Structured
Typical Locale:	Reston/N. Rockville	Bethesda/Arlington	Washington CBD
Total development cost (hard & soft):	$136	$197	$242
Plus land cost:	$30	$35	$75
Equals all-in cost:	$166	$232	$317
Required rent (GFS) per SF to support all-in cost	$27	$37	$48

Source: Annual survey by Delta Associates, conducted December, 2000

Office Space Leased by Type of Company

Washington Area in 2000



Office Space Leased by the Tech Sector in the Washington Area 1999 and 2000

	Millions of SF		
Market	*Total Net Absorption*	*Tech Net Absorption*	*Percent Tech*
Northern Virginia	17.2	7.7	45.0%
Suburban MD	4.0	1.0	25.0%
The District	5.9	0.4	7.5%
Washington Metro	**27.1**	**9.1**	**34.0%**

Source: Delta Asocates, January 2001.

Office Space Occupied by the Tech Sector in the Washington Area (Millions of SF)

				Hypothetical Downside	
Market	*Existing Office Inventory*	*Occupied Office Space*	*Portion Occupied by Tech Sector*	*10% Tech Contraction*	*Impact on Vacancy Rate*
Northern Virginia	128.0	123.0	35.7	3.6	2.8%
Suburban MD	67.9	65.0	11.7	1.2	1.7%
The District	102.3	98.7	4.9	0.5	0.5%
Washington Metro	**298.2**	**286.7**	**52.3**	**5.2**	**1.8%**

Source: Delta Associates, January 2001.

The Baltimore Area Office Market: Mixed Results

The Baltimore Area office market turned in a mixed performance in 2000. Office space **absorption** was very strong, but **vacancy** remained elevated and **rents** increased only modestly. Baltimore's increased diversification and high-tech growth fueled space needs, but increased production of **new supply** prevented the area's vacancy rate from declining. With the economy slowing and production levels remaining high, the Baltimore Area office market is showing early signs of a pending slow down.

Absorption: Best Year of This Cycle

The Baltimore Area experienced 2.7 million SF of net absorption in 2000, compared to 2.3 million in 1999. That is the most since 1988.

And the Baltimore Area experienced 678,000 SF of net absorption in the 4th quarter 2000 – 25% of its annual total – indicating no substantial weakening yet as a result of the national economic slowdown.

Top Performing Baltimore Area Office Submarkets for 2000 (ranked by SF of net absorption)

Submarket	*Net Absorption*
Columbia	896,000
BWI	582,000
Baltimore County West	484,000
Total of top performers	1,962,000

Vacancy: Elevated but Stable

The Baltimore Area direct vacancy rate ticked up a notch to 8.8% at year-end 2000 – from 8.7% at year-end 1999. This rate remains too high going into a softer economy. No cushion, as found in the DC area.

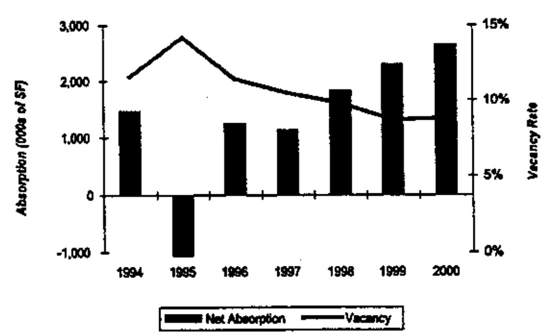
The Baltimore Area vacancy rate with sublet space is 10.2% at year-end 2000 – also up modestly from year-end 1999 when it stood at 10.0%. This 140 basis point spread over the direct rate is moderately high by national market standards. And this spread increased during the 4th quarter by 30 basis points. Both the level and change in this rate are of concern.

There is better news though: The Baltimore Area Class A direct vacancy rate at year-end 2000 was 6.1% – compared to 6.6% at the end of the 3rd quarter. This lower Class A rate suggests the strength of tenant confidence in the region's prospects.

Net Office Absorption and Direct Vacancy Rate Trends

Baltimore Area

1994 Through 2000



Construction Up; Pre-Leasing Down

Ground breakings accelerated in the Baltimore area in 2000 – pushing space under construction to its highest level since the mid-1980s. 5.8 million SF of office space is under construction in the Baltimore area at year-end 2000, up from 3.6 million SF at year-end 1999. Simply stated: construction starts are out-stripping demand.

Construction began on nearly 1.4 million SF of space in the 4th quarter – far too much at current levels of demand. If it continues, this level of construction will expedite softening in the Baltimore Area office market.

More concerning news: ***Only 23% of the space under construction at year-end 2000 was pre-leased*** – compared to 53% in Washington. And of the 3.1 million SF of office space delivered in the Baltimore area in 2000, 58% was pre-leased upon delivery – down from 68% in 1999.

Office Space U/C and Renovation
Baltimore Area
Year-End 2000

Submarket	*SF*	*% Pre-leased*
Baltimore County West	530,000	12%
Baltimore County North	92,000	0%
Baltimore County East	115,000	0%
Baltimore CBD	529,000	56%
Baltimore City Balance	2,461,000	21%
Columbia	1,269,000	17%
Route 1 North	150,000	0%
BWI	500,000	42%
Anne Arundel South	162,000	15%
Total	5,808,000	23%

Source: Co-Star

Rents: Modest Increases

Rents increased only 3% in the Baltimore area in 2000 due to elevated vacancy rates. BWI experienced the biggest increase at 6.0%, followed by Columbia at 3.6%.

Baltimore's CBD commands the highest Class A rents in the metro area – $26.30/SF, full service. The top asking rent in the city is $31.50/SF at 100 E. Pratt Street.

Average Asking Full-Service Class A Rents
Selected Submarkets of the Baltimore Area

	Yr-End '97	*Yr-End '00*	*% Increase Per Annum*
Baltimore CBD	$22.00	$26.30	6.5%
Columbia	$20.50	$23.20	4.4%
BWI	$18.15	$21.40	6.0%

Investment Sales: Very Light

Investors are concerned about upside in this market place, so for the most part they stayed away during 2000. As a result, investment sales totaled just $60 million in the Baltimore Area in 2000 – less than half the volume of 1999. Corporate Office Properties Trust remains an active buyer in the Baltimore Area, accounting for 80% of the investment dollars in 2000.

Washington Area Outlook: Good

We expect vacancy rates to drift up to the 7% to 8% range within 2 years, as production of new space out-strips demand. We believe that this upward trend in vacancy will be short lived and rather evenly distributed among the sub-state areas of the region:

	Vacancy Rate[1]	
Sub-State Area	*at 12/00*	*at 12/02*
Northern Virginia	3.9%	7.7%
Suburban Maryland	6.2%	9.3%
The District	4.0%	7.2%

1/ Including sublet space.

Rental rate increases will moderate from the period 1998-2000 when we experienced 8% to 12% per annum increases. We believe rental rates will increase during the next three years, notwithstanding rising vacancy rates, at the following rates:

Sub-State Area	*Average Annual Rent Increase 2001-2003*
Northern Virginia	3% to 4%
Suburban Maryland	1% to 3%
The District	6% to 8%

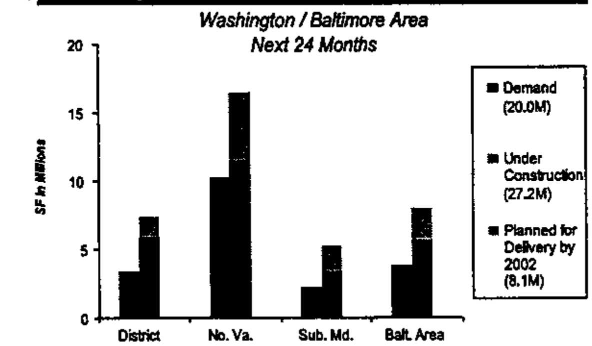
Some observers are more pessimistic than this. ***Here is why we subscribe to these projections:***

- We believe the Federal Reserve will keep the economy's nose up and accomplish a **soft landing.**
- We believe Dr. Fuller's employment projections – they appear consistent with the Fed's policies and an understanding of our regional economy. And how **Washington is likely to react to a slowing national economy.**
- In contrast to the last office market down cycle of 1990, **we are entering this period of economic slow-down with low vacancy rates and high levels of pre-leasing** in space under construction.
- Early signs of **moderation can be seen:** Reduced construction starts in the 2nd half of 2000, for example. Tougher underwriting standards. Pre-leasing requirements. Did we actually learn from the 1990 crash?

What if we have under-estimated the depth of the tech industry problems? We have looked at that scenario and have concluded that with a deep re-sizing of our regional tech industry, vacancy rates could increase to 10% (like they were in late 1996) and rent rates could decline in tech heavy submarkets up to 5% or 10% per annum. We do not subscribe to this scenario at this time, however. But as a down side, this sure beats 1990.

In summary, we expect solid job growth – although at reduced levels – steady absorption and rent increases while the vacancy rate remains below equilibrium. As a result, the ***Washington Area will remain one of the strongest markets in the country for an extended period of time.***

Projected Office Space Supply and Demand



Baltimore Area Outlook: Softer Times Ahead

We project the Baltimore Area vacancy rate, with sublet space, will increase to the 13% level over the next 2 years, from 10.2% today.

The Baltimore Area office market should continue to be viewed with caution. Opportunities in this metro area will be largely tenant-driven. And will likely be found in the BWI and Columbia submarkets, where better market conditions prevail.

We expect rents to flatten in this period as the vacancy rate exceeds the equilibrium vacancy rate over the next 2 years.

In summary, Baltimore office deals should be underwritten carefully. Perhaps other product types should be considered in the interim.

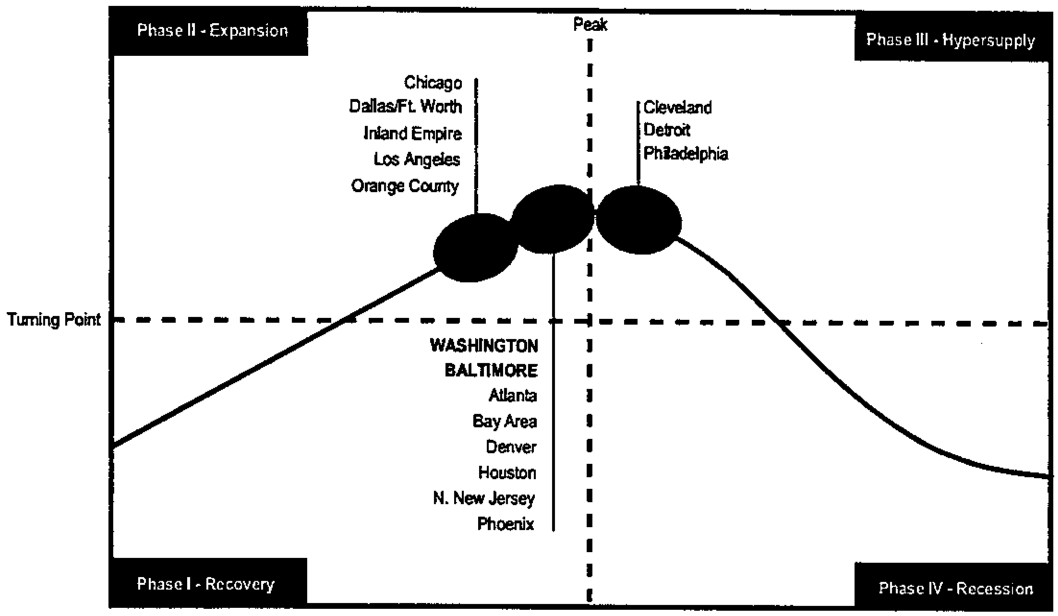
The Industrial Market

Section Four

88

Industrial Market Cycle Index

Year-End 2000

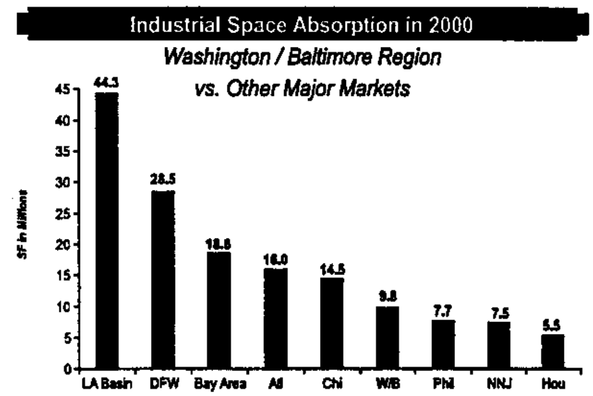


Source: Data and analysis per Delta Associates with thanks to Dr. Glenn Mueller for pioneering this cycle graph concept as a method of understanding real estate cycles; 01/01

The Industrial Market

Wow, What a Year!

Many industry observers hypothesize that e-commerce increases the need for industrial/distribution space. Others believe that the Just-in-Time inventory system reduces the need for warehouse space. Enter data centers. Add to it stronger than expected consumer demand for goods and services. What did we get in 2000? ***The strongest performance on record of the industrial market, both locally and nationally.*** Last year we pronounced the market was reaching the mature part of this real estate cycle. This year it appears to have plenty of steam for another several years of upside.



The Washington/Baltimore regional industrial market is experiencing its strongest conditions ever recorded. The region's strong economy and dynamic growth of high tech firms is driving demand in the industrial market. The need for data centers and expansion of e-commerce has brought about new uses for traditional industrial space. As a result, increased demand is tightening conditions across the region. Industrial market highlights include record setting absorption, a dramatic fall in vacancy rates, and spiking rental rates.

Absorption: The Best This Cycle

The Washington/Baltimore region enjoyed 9.8 million SF of net absorption in 2000, compared to 6.0 million in 1999 and substantially above the average of 7.2 million SF from 1996 to 1999. This level is the most the region has experienced since the mid-1980s.

The Washington market out-performed the Baltimore Metro Area, largely driven by a stronger economy and the impact of the tech industry on this product type. Washington recorded 5.8 million SF of absorption compared to 4.0 million SF in Baltimore. Washington's experience in 2000 bettered its average of the past 4 years by a factor of 2.

The B/W Corridor was the star performer – with a 53% market share. Prince George's and Howard Counties, at 2.4 and 2.3 million SF of net absorption, respectively, experienced high levels of demand in 2000.

Location of Industrial Inventory and Absorption
Washington/Baltimore Region: 1996 through 2000
(Millions of SF)

	Inventory at 12/00		Net Absorption: Annual Average 1996-1999		Net Absorption: 2000	
Location	*SF*	*%*	*SF*	*%*	*SF*	*%*
Washington Area	150.5	52%	3.3	45%	5.8	59%
Baltimore Area	139.6	48%	4.0	55%	4.0	41%
Total	290.1	100%	7.2	100%	9.8	100%

Bulk warehouse demand in 2000 exceeded the levels of prior years by 100%. Flex warehouse was the product of choice in 2000 with 46% of industrial net absorption.

Type of Industrial Inventory & Absorption
Washington/Baltimore Region: 2000
(Millions of SF)

	Inventory at 12/00		Net Absorption 2000	
Type of Space	*SF*	*%*	*SF*	*%*
Bulk Warehouse	80.3	28%	4.2	43%
Flex/Warehouse	178.9	62%	4.5	46%
Flex/R&D	30.9	10%	1.1	11%
Total Industrial	290.1	100%	9.8	100%

Vacancy Continues to Decline

The regional industrial direct vacancy rate decreased to 7.3% at year-end 2000, from 9.2% at year-end 1999. The Washington Metro area vacancy rate is 6.2%; the Baltimore Metro area vacancy rate is 8.4%.

The year-end 2000 Washington/Baltimore vacancy rate with sublet space is 50 basis points higher than the direct rate – at 7.8%. The 50 basis point spread above direct vacancy is down 30 basis points from year-end 1999, indicating significant depth to this market.

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

Market	*Year-End 1996*	*Year-End 2000*
Washington/Baltimore Region	12.3%	7.3%
Washington/Baltimore Suburbs	10.4%	6.1%
Baltimore/Washington Corridor	10.8%	7.5%
Washington Metro Area	10.5%	6.2%
Baltimore Metro Area	14.5%	8.4%

Source: Co-Star

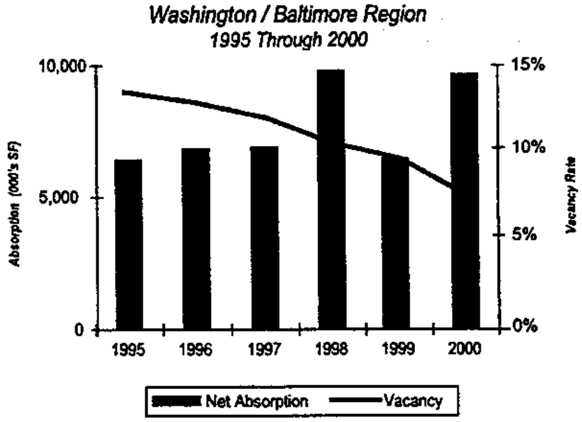
Vacancy rate declines were recorded among all product types in 2000. At year-end 2000, the direct vacancy rates by product type:

- Bulk Warehouse 7.5%
- Flex Warehouse 7.5%
- Flex/R&D 5.5%

Industrial Net Absorption and Direct Vacancy Rate Trends

Washington / Baltimore Region

1995 Through 2000



Construction Way Up; Pre-Leasing Keeps Pace

Space under construction: 8.5 million SF at year-end 2000, compared to just 3.6 million SF last year at this time. 22% of this space is pre-leased at year-end 2000, compared to 19% at mid-year 2000, and 29% at year-end 1999.

Industrial Space Under Construction & Pre-leased: Year-End 1999 and Year-End 2000 (Millions of SF)

	At 12/99		*At 12/00*	
Metro Area	*SF U/C*	*% Pre-leased*	*SF U/C*	*% Pre-leased*
Washington	2.0	40%	5.1	21%
Baltimore	1.6	17%	3.4	24%
Regional Total	**3.6**	**29%**	**8.5**	**22%**

Source: Co-Star

Deliveries: 7.0 million SF in the region in 2000, up from 5.2 million SF in 1999. 57% of industrial space delivered in 2000 was pre-leased, compared to 64% in 1999.

Industrial Space Deliveries & Pre-leasing Washington/Baltimore Region: 2000

Metro Area	*Millions of SF Delivered*	*% Pre-leased*
Washington	4.6	56%
Baltimore	2.4	58%
Regional Total	**7.0**	**57%**

Source: Co-Star

Rents: Big Spikes in Northern Virginia; Steady Growth in Maryland

Industrial rents increased 7.5% in the region in 2000. Warehouse rents increased 12% in Northern Virginia, 6% in the Baltimore suburbs and 4% in Suburban Maryland. Rental rate increases appear to be propelled by low vacancy, stiff competition for space, and the effect of data centers on this product type.

Industrial Flex/Warehouse Rents Washington/Baltimore Region At Year-End 2000		
Submarket	*Asking Rent (triple net)*	*12 Month Change*
Northern VA	$9.87	12.2%
Suburban MD	$5.57	4.3%
Baltimore Suburbs	$4.65	6.4%

Investment Sales: Volume and Prices Up

Industrial investment sales volume totaled $367 million in the region in 2000, up 10% from the $338 million experienced in 1999. This pattern is seen all over the country due to institutional investors shifting allocations to this product type, as office markets fall out of favor.

Industrial sales prices increased 3.5% in the region in 2000 – to an average of $55.63/SF. Average regional sales price by product type:

- Bulk Warehouse $37.39 per SF
- Flex Warehouse $60.34 per SF
- Flex/R&D $83.11 per SF

Land Sales: Volume Tripled; Prices Up

Industrial land sales totaled more than $150 million in 2000, versus $50 million in 1999. This appears to be the result of the development community rushing to inventory land for future development of this hot product type.

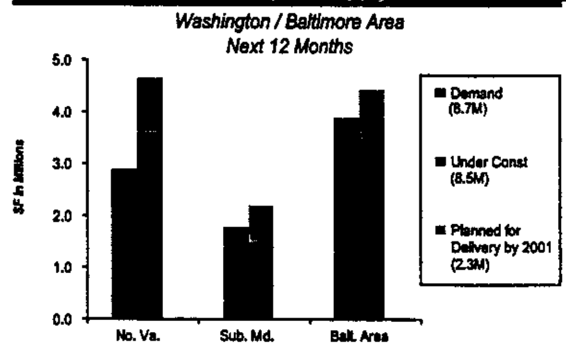
Land sale prices have increased approximately 15% per annum over the past several years in the region. Average prices at year-end 2000:

- Northern Virginia $3.44/SF
- Suburban Maryland $4.95/SF
- Baltimore Suburbs $3.96/SF

The Washington/Baltimore Regional Industrial Outlook

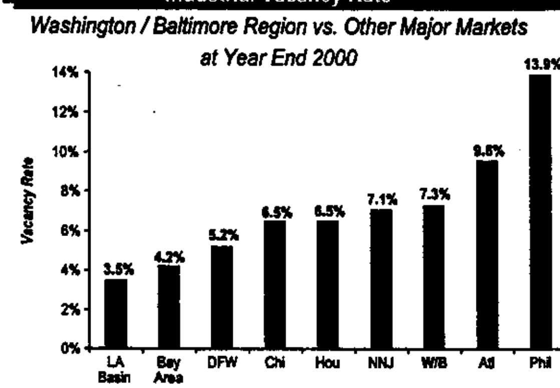
We project the regional industrial vacancy rate, with sublet space, to increase slightly over the year 2001 – to 8.2%. This compares to 7.8% today.

Projected Industrial Space Supply and Demand



The outlook for the Washington/ Baltimore industrial market is strong. Although the national economy appears to be slowing, strong growth is likely to prevail in the Washington/Baltimore region. However, the development pipeline is so heated, supply will likely outpace demand, albeit by a slight margin. As a result, rents and values will continue to increase, but at rates more temperate than in 2000.

Industrial Vacancy Rate

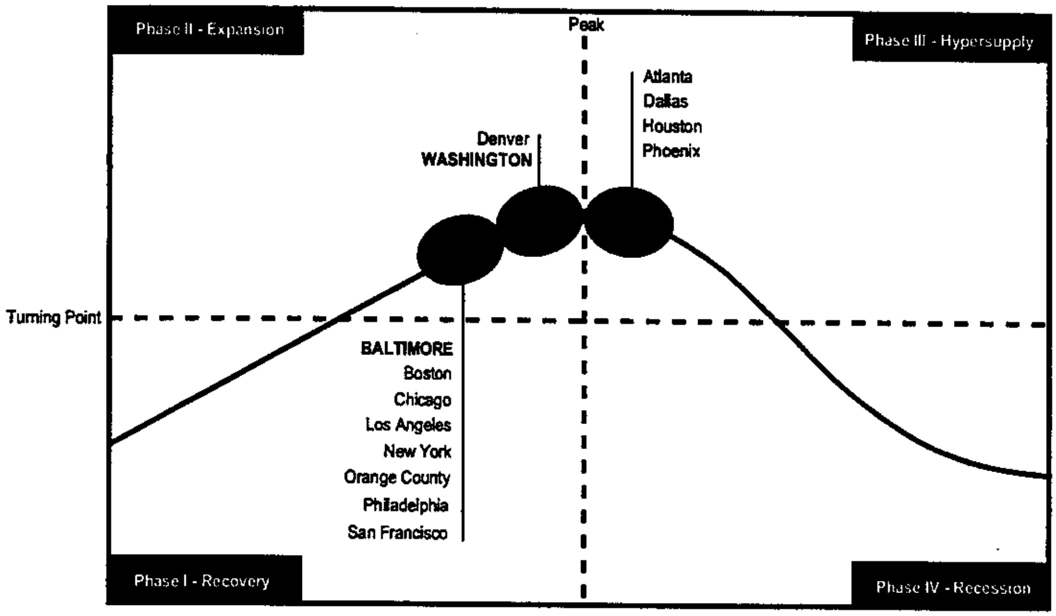


The Apartment Market

Section Five

Apartment Market Cycle Index

Year-End 2000



Source: Data and analysis per Delta Associates with thanks to Dr. Glenn Mueller for pioneering this cycle graph concept as a method of understanding real estate cycles; 01/01

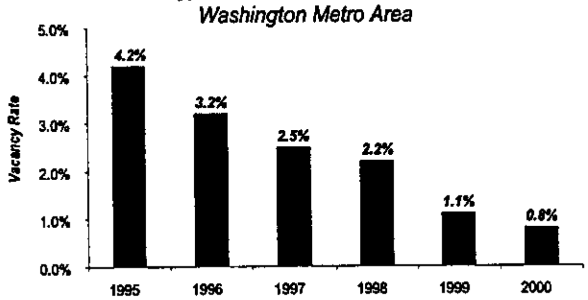
The Washington Area Market: Records Set; Early Signs of Market Peaking?

Records continue to be set, thanks to a dynamic economy, barriers to entry that have kept production in check, and changing life-styles that favor apartment living. A look at a few records:

- **Returns** on investment grade apartments, as measured by the *NCREIF Return Index,* are at the highest levels since records have been kept, and now stand as the highest in the nation at 18.39% for the 12 months ending 9/00.
- **Vacancy rates,** for all classes and types of investment grade projects, continue to decline – from 1.1% at year-end 1999 to 0.8% at year-end 2000.
- **Absorption,** constrained by supply inadequacies, hit 5,935 units in 2000 – the highest level in 12 years.
- **Rental rates** increased 13.7% during 2000.

Stabilized Vacancy Rates

All Types and Classes of Apartments
Washington Metro Area



Source: Delta Associates, 01/01

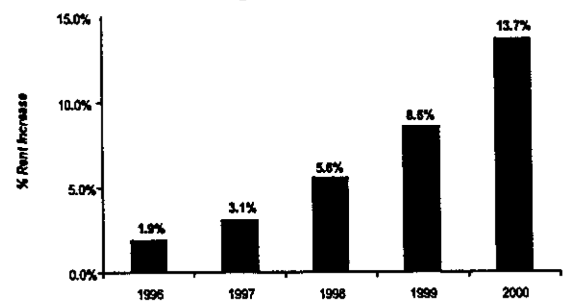
Early signs we are peaking? Some say we are "looking for trouble", and these are minor ups and downs of a dynamic market. Our job is to look for trouble, to keep you out of it.

- **Vacancy** at stabilized properties inched up in Northern Virginia over the past year for Class A gardens - from 0.6% to 1.1%.
- **Overall vacancy** (including units in active lease-up) inched up to 6.6% at 12/00 for Class A gardens, from 6.1% a year ago.
- **Concessions** have made a re-appearance at some actively marketing properties in more congested submarkets.
- **Cap rates** stopped their 8-year decline in 2000, at least as measured by hurdle rates – the rate used by buyers to shop for stable assets. This will likely translate into a topping out of prices in 2001.

Helping to prolong the peak: Some self-restraint is evident in the planning pipeline: At year-end 2000, 25,774 units are in the 36-month pipeline (likely to deliver in the next 3 years). This is the same number as mid-year – and ***the first pause in the upward spiral in the pipeline index since the recovery began in 1993.***

Increase in Effective Rents

All Types and Classes of Apartments
Washington Metro Area



Source: Delta Associates, 01/01

Are We at the Peak of This Cycle?

We think so. But we also think the market is so strong that we are likely to stay at the peak for 2 years or more. We normally define the peak of the real estate cycle as that point when the delivery of new product outpaces absorption. This, in turn, leads to an increase in vacancy rates and eventually a period of flat rents. While we have seen deliveries outpace absorption for three-quarters in a row, the difference has not been enough to increase vacancy significantly or reduce rental pressure. Peak of the cycle? That will ultimately be answered by the relationship between demand and pipeline.

Has the pipeline flattened out soon enough? Given what many observers believe will be an economic slowdown in 2001, job growth is likely to total only 60,000 or so. ***We think the slowing of job growth will be offset by a rise in demand for apartments.***

What is Causing All This Demand?

At a time when home ownership is hitting record levels, and mortgage interest rates are declining, what suggests we are entering a period of increased apartment demand?

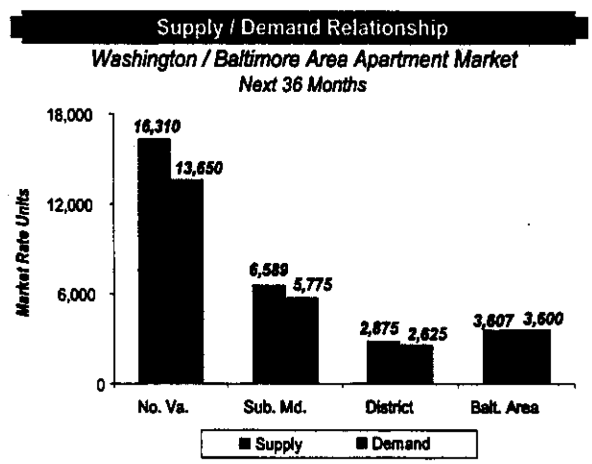
- **Tax law changes** facilitate empty nesters entering the apartment market, without the capital gains tax on the sale of a residence.
- **Continued, even if decelerating, job growth.**
- **A growing preference for in-town living,** where apartments are more plentiful than singles. The *new urbanism*.
- **Growing job transience,** especially among tech workers.
- **Unsettled economic conditions** that foster a sense of unease that in turn reduces the market's appetite to buy. Yet with high personal income that fosters un-doubling.
- **Product innovation** facilitates the market to be a renter by choice. Short-term rentals, hotel-like services, and unparalleled amenities are a few of the reasons we are choosing to be renters.
- **Traffic congestion.** Apartments tend to be located closer to employment nodes. Class A apartment residents have a shorter commute than homeowners.

Washington Market Outlook

We do not expect overbuilding to occur. The development pipeline, while growing, will likely not result in over building in the next three years. We are projecting the following overall vacancy rates by year-end 2003:

- Northern Virginia: 5.5%
- Suburban Maryland 3.1%
- The District 6.0%
- Metro wide 4.7%

However, look for some of the hot apartment submarkets, for short periods of time, to demonstrate elevated vacancies and modest concessions.



Source: Delta Associates, January 2001

We look for the steam to be out of rental rate growth by this time next year. While we expect rents to continue to rise over the next three years, we do not expect these rates of increase to parallel what has happened in the recent past.

Proceed, but do so with caution. With a growing production pipeline, we are riding the peak of this cycle and we believe, therefore, now is the time to hold the line on land prices and to be extremely site selective. We have moved through the no-brainer part of this market cycle, so ***it is time to compete better in the coming years on all three classic factors: price, product, and location.***

Highlights of Submarket Performance In The Washington Area

Northern Virginia. ***Performance in Northern Virginia continues to lead the nation.*** We know of no market that has performed this well during the past year. Yet we see the first signs of the market peaking.

Stabilized **vacancy** among garden apartments ticked up to 1.1% and **rent growth** accelerated 14.4% for the year. Despite increased competition, actively marketing projects are experiencing solid **absorption paces**, with record paces among the best located/executed projects – a 42 unit per month high for gardens and 36 per month for high-rise.

The strength of the Northern Virginia market is reflected in the number of planned projects moving forward in the **development pipeline.** The total number of available units in projects under construction and units in the advance planning stages (likely to deliver in the next 36 months) has grown by 2,144 over the past year – to 16,310 units at year end 2000. These projects are heavily concentrated near the region's employment nodes. The technology submarkets of Reston/Herndon and Eastern Loudoun have 6,629 units in the pipeline, while Alexandria has 3,520 units of product planned – a reflection of this market's close-in location and in anticipation of the PTO relocation.

Competition will intensify over the coming two to three years, as properties adjust to the additional supply. Vacancy rates have shown the first signs of drifting up from today's remarkably low levels. Perhaps select submarkets, during short periods of time, will experience concessions or periods of flat rents.

Properties most proximate to employment growth centers, those with the best visibility and transportation access, and those of the highest design caliber, will fare the best.

Without a material change in demand or pipeline, ***we expect the overall vacancy rate (including units in initial lease-up) to remain about the same as found today – 5% to 8%.***

The District of Columbia. ***The District of Columbia Class A apartment market continues to flourish, but we are concerned about affordability issues with so many projects underway that require rents in the $2.50/SF range.*** Yet these rental rates are moderate compared to comparable product at good locations in New York, Boston and San Francisco.

Rental options among Class A, investment grade assets remain limited in the District, as Class A **vacancies** are 1.5%, per annum **rent growth** is 15.7%, and **waiting lists** have become standard.

The District is supply constrained in all types of housing. Even the Class B market is tight: effective rents average $1.66 per square foot, per annum rent growth is 20.4%, and vacancy is a slim 0.5%. The $0.71/SF difference in effective rents between Class A and B product, together with tight vacancy rates, should promote supply solutions for rehab/conversion and new construction in pioneering locations and TIF zones.

New construction of innovative product in pioneering locations that can reach the $1.60 - $1.90/SF range has yet to take shape, as developers have directed their efforts towards serving the luxury end of the market. The depth of consumers at the luxury price level ($2.50 per square foot and up) is concerning when considering 3,179 units in the pipeline are aimed at this group.

If all the planned projects move forward as announced and are completed by December 2003, ***we estimate the District's overall vacancy rate (including units in initial lease-up) will increase modestly to levels like the suburbs. By comparison to today, it will seem like a tenant's market.***

Suburban Maryland. ***Suburban Maryland preformed well in the past twelve months***, as **vacancy** moved to only 0.8%, Class A garden **rents** increased 11.4% over the past year, and a large number of **deliveries** were **absorbed** without the use of **concessions**.

Suburban Maryland accounted for 27% of the region's deliveries over the past twelve months – 2,008 of 7,341 units. Net **absorption** was 2,531 units over the past twelve months. Suburban Maryland absorbed 715 units more in the 12 months ended 12/00 than the previous twelve-month period ending 12/99.

Garden projects in Suburban Maryland continued to perform well over the past twelve months, with stabilized vacancy at 1.1% and effective per annum rent growth of 11.4%. The **Rockville** submarket led Suburban Maryland in overall performance, managing a 22.1% gain in effective rents over the past twelve months, while the stabilized vacancy rate drifted lower, from 1.9% to 1.5%.

A reduction in deliveries and a strong Summer/Fall leasing season has temporarily abated some of the pressure presented by the Spring introduction of new supply along the I-270 corridor. The number of units likely to be delivered in the next 36 months has increased from 5,557 units at December 1999, to 6,589 units today.

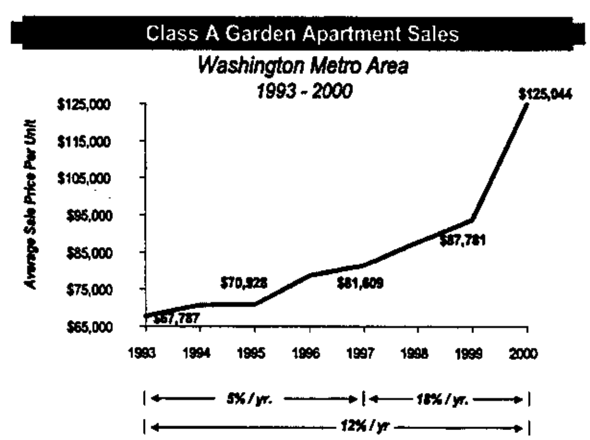
Stabilized vacancy rates are extremely low in Gaithersburg and Prince George's County – 1.2% and 0.7%, respectively – while concessions are barely noticeable.

A potential concern is the staging of deliveries over the next 12 to 18 months, and the pressure these 6,589 units may put on select submarkets. The Montgomery County submarkets of Rockville, Gaithersburg, Germantown and Bethesda will be affected in the short term because they will see the bulk of these deliveries – 4,555 units. But if these submarkets continue to grow jobs at recent rates, then we expect vacancies to remain at healthy levels.

Bethesda has had an excellent run over the past year, enjoying several quarters with limited introduction of new supply. The vacancy rate in Bethesda has dropped 120 basis points since December 1999, and rests at 0.6% today, while effective rents have climbed a staggering 23.5% in the past 12 months.

Despite digestion bubbles in the short run, ***we project Suburban Maryland to be a star performer over the next 36 months.*** Vacancy at stabilized projects is likely to drift up a bit from today's chronically low levels.

Investment Sales. Investors' appetite for stable Class A apartments was down in 2000 – to $290 million, from $541 million in 1999. Lack of confidence in this market? We think not. Rather, a belief that there is limited short term upside in prices. Only six Class A garden apartment projects closed in the Washington Metro area in 2000.



98

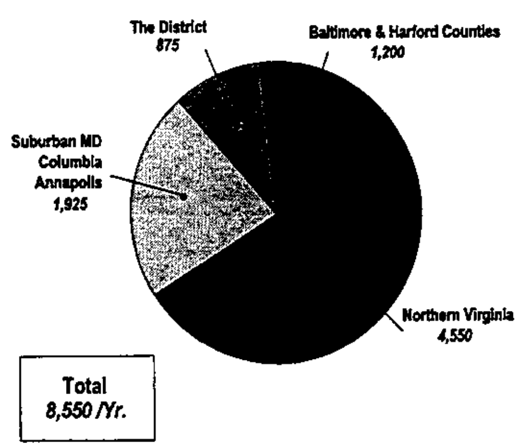
Yet prices are up – way up, to an average of $125,044 per unit. So those buyers who are in the market are paying top dollar to be in the strongest apartment market in the nation, albeit with limitations on short-term appreciation. Risk adjusted returns are regarded by the institutions to be superior in this market place.

Cap rates on trophy deals closed in 2000: 7.50% to 7.75%. Class B's: 8.00% to 8.75%. But we detect an increase in the hurdle rate used by buyers – up three basis points over the year. This will likely translate to reduced pressure on sale prices in 2001.

Land Sales. ***Land prices in the Washington area continue to rise, as developers, led by new market entrants, continue to be aggressive.*** Several deals under contract will break the per unit price barrier of $25,000 for gardens well outside the Beltway. And prices for high rise seem to know no limit: $30,000 per unit in Metro served suburban locations and $50,000 per unit in the District.

Projected Annual Demand For Apartments

Washington / Baltimore Region
Through the End of 2003



The Baltimore Market: Notable Year; Good Prospects

The creation of 21,000 jobs and continued diversification of the Baltimore economy has propelled Class A rent growth over the past 12 months to more than double the historic average. ***Excellent market conditions are likely to persist in this metro area for the next three years, if Baltimore's economy holds up.***

Stabilized vacancies for Class A properties in the Baltimore metro are holding steady at 1.2%.

Class A product in the Baltimore metropolitan area enjoyed 10% **rent growth** during the past twelve months, compared to 5.4% in 1999. The average effective rent at year-end 2000 is $1.10/SF for the Southern Suburbs and $0.91/SF for the Northern Suburbs. The City of Baltimore averaged $1.24/SF.

The Southern Suburbs outperformed the Northern Suburbs by a solid margin, with Class A garden apartment rent growth in Anne Arundel County averaging 12.1% for the 12 month period ending 12/00. In Columbia rents were up 11.7%. Meanwhile, vacancies dropped to 0.4% in Anne Arundel and 0.8% in Columbia.

The Northern Suburbs continue to perform well, with effective rent growth at Class A gardens down slightly to 6.1% and stabilized vacancy roughly the same, at 1.8%. North/NE Baltimore County was the most improved of the Northern Suburbs. Vacancy declined 40 basis points to 0.2%, and rent growth was 6.7% for the past year.

The West/NW Baltimore County submarket continues to perform well despite a steady diet of new supply, with vacancies also down 40 basis points to 1.9% and a per annum rent growth of 6.4%.

The City of Baltimore Class A apartment market remains impressive, with a vacancy rate of 1.4% at year-end 2000 and rent growth of 15.8% over the year. The Fells Point/ Inner Harbor submarket continues to have the most promise in Baltimore City, with effective rents at $1.41 per SF and per annum rent growth of 20.1%. This trend is certain to continue, as few deliveries are planned in the next 36 months in this submarket.

Baltimore Market Outlook

The number of units in the Baltimore pipeline at year-end 2000 (those units which are available in projects under construction, or likely to be delivered in the next 36 months) has increased a sensible 331 units since last year at this time, to 3,607 units. With annual demand now running 1,200 units in the Baltimore area, ***we feel Baltimore will remain at supply/demand equilibrium, with solid rent growth and an overall vacancy rate hovering between 2% and 4%.***

Pipeline of Under Construction and Planned Apartments: Washington/Baltimore Region at Year-End 2000 (Units)

	Northern Virginia	Suburban Maryland	District of Columbia	Baltimore Metro	Regional Total
Available Units in Projects Under Construction	8,633	2,202	726	660	12,221
Units in planned projects that are likely to be delivered within 36 months	7,677	4,387	2,149	1,917	16,130
Subtotal, likely deliveries through 12/02	16,310	6,589	2,875	2,577	28,351
Units in longer-term planned projects (likely delivery after 2003)	8,977	8,830	3,160	2,750	23,717
Total Pipeline	**25,287**	**15,419**	**6,035**	**5,327**	**52,068**

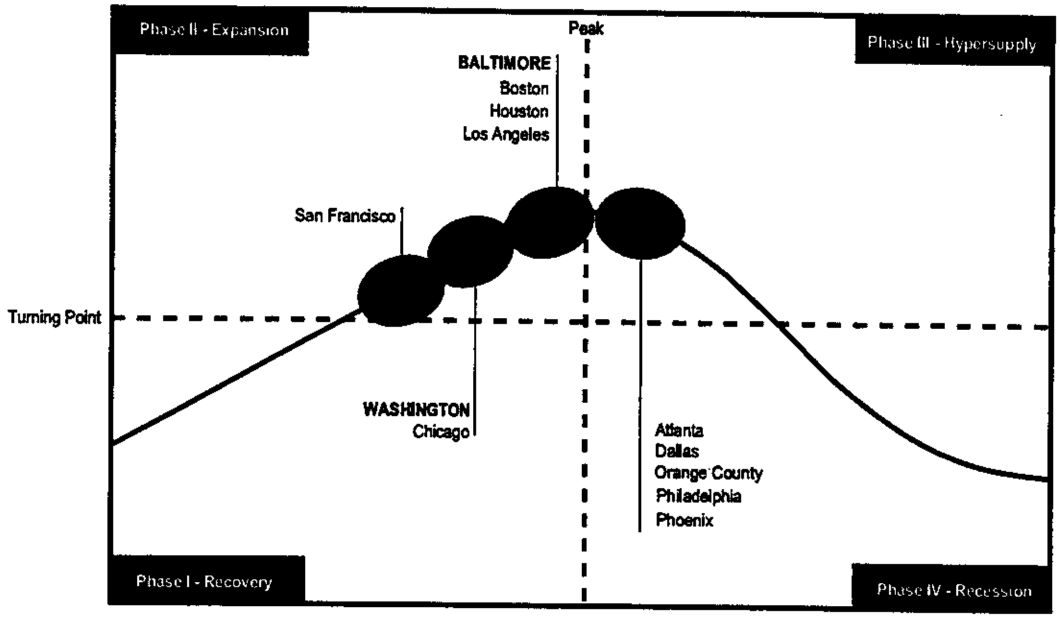
Source: Delta Associates Year-End 2000 Apartment Market Publication.

The Retail Market

Section Six

Retail Market Cycle Index

Year-End 2000



Source: Data and analysis per Delta Associates with thanks to Dr. Glenn Mueller for pioneering this cycle graph concept as a method of understanding real estate cycles; 01/01

Neighborhood And Community Shopping Center Market Excellent; Other Venues Mixed

Retailing: A Hot Sector

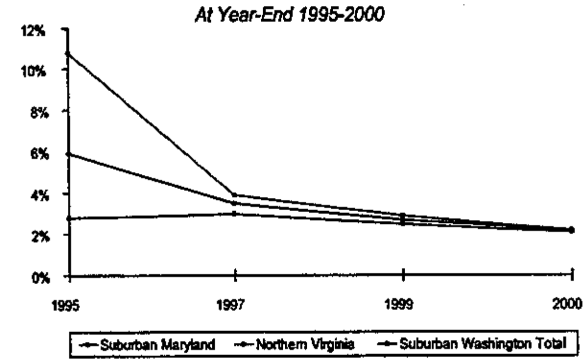
The Washington Metro area continues to be a hot market for retailing, due to: (1) the highest per capita income of any major metro area in the US, (2) its high growth rate (25,000 new households each year since 1993), (3) a low volume of development, in relation to demand, of new product since the early 1990s, and (4) the stability of the Washington regional economy. Evidence? **Return rates** in Washington retail investments are nation pacing – 200 basis points better than the national average, according to NCREIF. **Retail sales per square foot** – the common method of keeping score on how well retailers are doing – are also among the highest in the US. And the list of **retailers that plan to enter or expand** in the region is most impressive.

Notwithstanding generally strong market conditions for this product type, ***some sectors are thriving while others are not:***

- **Grocery-anchored centers** are performing extremely well. Hence an avalanche of drug stores and grocers entering into or expanding in the region.
- **Power Centers** are approaching overbuilt conditions in most submarkets. Some jurisdictions are talking restrictions, for fear of large dark spots in community shopping centers.
- **Movie theatres** are hurting.
- A new *urbanism* is benefiting **Street Retail** and **Town Centers** as well as creating a renewed interest in **in-city development**.
- **Regional malls** are re-inventing themselves to compete with e-tailing – by becoming **entertainment centers**, or going **Outlet**, or both.
- **E-tailers** are drowning in red ink – even some brand names have shuttered in the past year. Others have figured out e-commerce and are thriving.

Neighborhood Shopping Center Vacancy Rates

At Year-End 1995-2000



Source: Delta Associates, 01/01

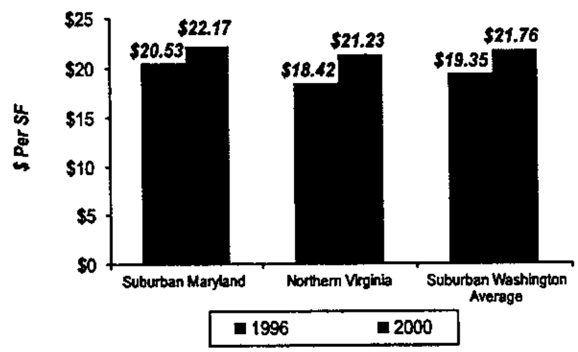
The Strongest Sector: Grocery-Anchored Shopping Centers

The Washington grocery-anchored shopping center market is experiencing the best market conditions in two decades.

- **The region wide vacancy rate declined to 2.2%** at year-end 2000, from 10% in 1990 and 5.9% in 1995.
- **Rents for in-line tenants are up to an average of $21.76/SF** at year-end 2000 – a 6.3% increase over the past 12 months.

Average In-Line, Non-Credit Asking Rents

Investment Grade, Grocery-Anchored Shopping Centers
Year End 1996 and 2000



Source: Delta Associates, 01/01

So Why Has Investment Preference Dropped?

Investor preference for grocery-anchored shopping centers has remained low since 1998. Market conditions continue to strengthen for grocery-anchored shopping centers and values are increasing. So why has there not been an improvement in favor among investors? We believe it is jitters over the uncertain impact of e-tailing. The web is changing the retail market in many ways including how we buy groceries, how we buy holiday gifts, and even how we make restaurant reservations. Until the direction of e-tailing is better understood, we expect even the star performing sectors of retail will be under-favored by investors.

E-tailing: A Force To Reckon With?

On-line purchases have been steadily increasing. According to Forrester Research, on-line purchases reached $4.4 billion in October 2000 – double what it was just eight months prior. More and more consumers are buying more and spending more on-line.

High expectations face e-tailers as the shakeout continues. Uncertainty in the industry has led investors to back off retailers that do not have a sound financial plan and a competitive advantage. Many retailers, including Toysmart.com and 1-800-Flowers.com, have gone out of business or have seen stock prices tumble due to low customer satisfaction, billing errors, and poor delivery systems.

The consensus of industry observers: ***e-tailers that will succeed are those based in traditional brick-and-mortar stores or a strong catalog business*** – like The Gap, LL Bean, and Barnes and Noble – that already have brand value and a proven track record for high customer satisfaction and excellent distribution channels.

Implications for store based retailing? In this rapidly changing e-tailing environment, ***retailers are easing up on store-based expansion and shortening lease commitments to adopt a more flexible real estate strategy.***

On-line grocers are in a shake-up. The Washington area is known for its over-achieving work force that works long hours, high disposable income, easy access to the Internet, and bad traffic congestion. So is that not a recipe for on-line grocery success? Not so far.

- **HomeRuns.com** opened a 145,000 square foot fulfillment center in Landover, Maryland in December 2000. **Peapod.com**, partner with Giant Food, also opened earlier this year. Together, these two on-line grocery dealers expect to serve over one million households by 2002.
- Facing increased competition and poor customer satisfaction, several on-line grocery stores once serving the Washington area have vanished in the past year. **Webvan**, the first on-line grocer to enter the market, leased 300,000 square feet in Springfield, Virginia during the 2nd quarter 2000, and has since left the Washington market area.

So, what does e-tailing mean to the real estate industry? There is no doubt that the Internet is changing the way we live – from on-line travel reservations to the food we buy. But the impact of e-commerce can not be fully understood just yet. In the meantime, it appears to be directing

Washington Area Shopping Center Inventory
2000
(SF)

	Neighborhood & Community	*Power, Regional & Super-Regional*	*All Centers*
DC	4,086,064	894,142	4,980,206
Suburban MD	22,605,276	21,324,168	43,929,444
Northern VA	27,227,565	22,707,704	49,935,269
Total Metro	53,918,905	44,926,014	98,844,919

Source: Shopping Center Directory, 2000.

capital away from investing in retail real estate, encouraging retailers to seek more flexible lease terms, and forcing retailers to sell across more than one venue – stores, catalogs, and the Internet. Whatever direction e-tailing takes, it appears it will impact least those stores that are found in neighborhood, grocery-anchored centers. This would then appear to be the best bet for investing in retail real estate.

The New Urbanism: Revitalization in the District

The District of Columbia is experiencing a boom in retail development not seen for 2 generations. Several factors have contributed to this trend:

- The **new urbanism** taking hold around the nation is bringing back to town affluent couples and singles.
- A **hot housing market** is exploding in DC, as evidenced by the burgeoning number of new residential developments and the lowest rental vacancy rate ever seen in the District.
- The **strong economy** has contributed to the increase in new office development downtown, which has further contributed to demand for housing and retail services in the center city.

Retailers and developers are recognizing the opportunity of inner-city development. Some communities do not have grocery-anchored shopping centers. Retailers have identified the customer base in these areas and the following developments are underway:

- Near the **Rhode Island Metro** station: Plans include a Giant Food and a Kmart in a center that could exceed 275,000 square feet. Construction is expected to begin in April 2001.
- **Southeast DC** at the corner of 15th Street and Alabama Avenue: The District government is working with potential developers to build a grocery anchored shopping center.

Other large-scale retail developments and revitalization efforts are underway in the District.

- **14th Street corridor** – several large retail developments are under construction or planned in the area including a recently opened Fresh Fields and CVS Pharmacy at 14th Street and P Street.
- **Gallery Place** – a 1.5 million square foot development in the Chinatown section of the District, next to the MCI Center. Planned tenants include a 12-screen movie theater and a possible big-box retailer.
- Rumors of a **Macy's Department Store** going into the old Woodward and Lothrop building has District officials and residents alike hopeful that this will spark a major revitalization of fashion and soft-goods retailing in the old F Street Retail Corridor.

No discussion of downtown retail revitalization would be complete without mentioning the **Golden Triangle Business Improvement District Corporation (BID)** – and the impact it has had on a 38 block area in Northwest, Washington. There are over 600 retail and service businesses in this district that have benefited from improved public safety, sanitation, vagrancy, and a sense of hospitality from its trained hospitality and maintenance personnel.

High-end Retailers and Restaurants Enter the Hot Washington Retail Market

Here is just a small sample of some of the nicer retail and restaurant establishments that have set-up shop in the Washington area recently:

- Artcraft Collection – Old Town Alexandria
- Cartier – Tysons Corner
- Thomas Pink – NW Washington
- Jared's Jewelry – Tysons Corner
- Gorden Biersh – NW Washington
- Colvin Run Tavern – Tysons Corner, VA

- TenPenh – NW Washington
- Teatro Goldoni – NW Washington
- Palena – NW Washington
- The Caucus Room – NW Washington

Movie Theater Woes

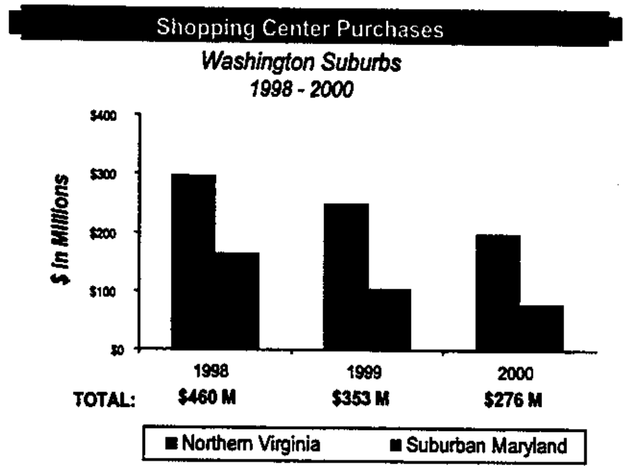
The problem: Overbuilt, too costly, and lower than expected demand.

Overbuilt: According to the National Association of Theater Owners, by 1999 the number of screens grew to 37,185 – up 57% from 1990.

Lower than expected demand: During the period 1990 to 1999, ticket sales grew at a mere 24%, to 1.46 billion in 1999. Demand has not kept pace with supply in the movie theater industry. Lower than expected demand has been helped along with a poor Hollywood motion picture year and the increasing interest in alternative forms of entertainment including video games, DVD's, and of course the Internet.

Too costly: The type of theatres being developed today are very costly – some costing over $1 million per screen – due to the inclusion of competitive luxuries such as stadium seating, surround sound, and hot snacks.

The final curtain for many movie theaters. The Washington area has been no exception when it comes to the movie theater shakeout. **Edwards Cinema** filed for Chapter 11 bankruptcy in August 2000. This left vacant a 106,000 square foot, 16-screen theater located at Dulles Town Center. In addition, Edwards was to have occupied space in the newly rebuilt Town Center of Silver Spring. **General Cinema** Theaters Inc., owner of many theaters in the Washington Metro area, has also filed for bankruptcy protection.



Investment Sales Transactions: Volume Continues Downward Trend; Prices Firm

Investment purchases of shopping centers continued a downward trend since the peak of the market in 1998. Only 20 centers, totaling $276 million, traded during the first 11 months of 2000. This compares to 23 centers, totaling $460 million, in 1998. But this trend is also seen in most other real estate sectors. The low number of transactions can be attributed to the following:

- Few centers are on the market, as owners hold out for appreciation that will surely come from rising rents and low vacancies.
- Institutional investors are not sanguine about this asset class as a place to play the real estate market at this point in the cycle.

We Believe This Asset Class Contains Sectors With Remarkable Investment and Development Opportunities

For Street Retail, Town Centers, and grocery-anchored shopping centers, market fundamentals are strong. Vacancy is down, rents are up, prices are on the rise, and we are likely to see a continued under production of these product types in the Washington Metro area for at least the next two years.

Several factors suggest an exceptional investment and development opportunity in the years to come for grocery-anchored shopping centers:

- **A lack of investment over the past 10 years** by the development community has caused supply to not keep pace with demand. Pipeline of new development is not adequate to serve demand.
- **Shopping for groceries over the Internet is in turmoil** and the shakeout is raising questions as to its validity for success.
- **Retail spending is increasing** at a tremendous rate in the Washington area and the overall local economy remains strong. It will likely out-perform the national economy by a significant margin.

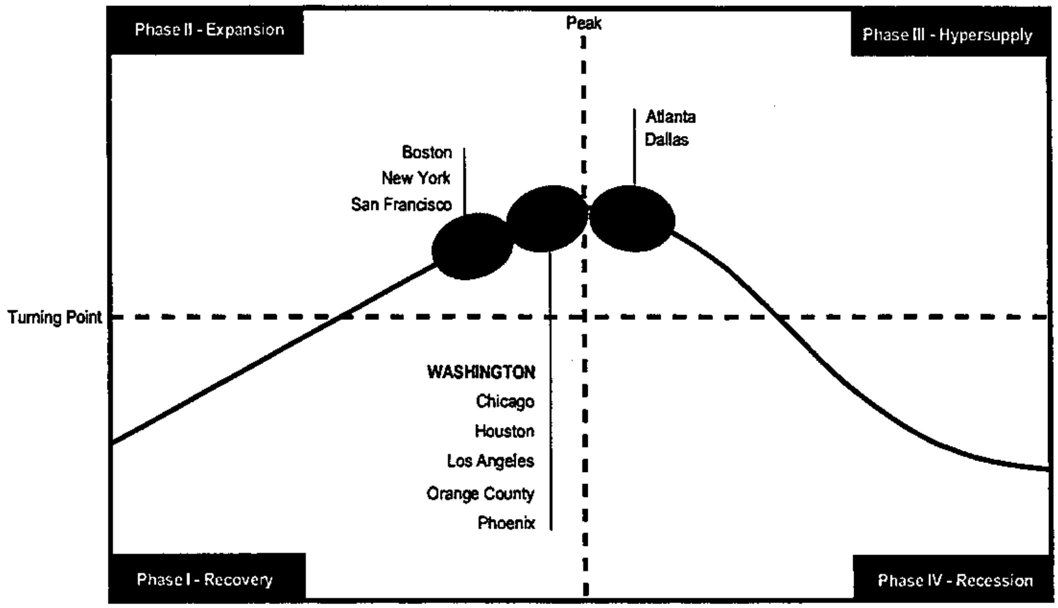
For those who move counter to the herd, the retail real estate sector has many opportunities.

The Hotel Market

Section Seven

Hotel Market Cycle Index

Year-End 2000



Source: Data and analysis per Delta Associates with thanks to Dr. Glenn Mueller for pioneering this cycle graph concept as a method of understanding real estate cycles; 01/01

The Hotel Market

The Hotel market in the Washington Metro area experienced another strong year in 2000 due to surging local, national, and international economic conditions. The Washington area remains one of the top tourist destinations in the country; however, the lack of large convention space (by today's standards) continues to result in lost business for the area. But, with the new convention center scheduled to open in 2003, the area can anticipate increased business in the future. And the change in Presidential Administration is a boost to the local industry.

Total Visitors to the Washington Area 1990-1999 (Millions)

Year	Visitors
1990	19.0
1991	18.3
1992	19.2
1993	19.7
1994	21.4
1995	20.5
1996	19.3
1997	19.8
1998	21.2
1999	20.9

Source: Washington, DC Convention and Visitors Association

Types of Visitors to the Washington Metro Area

Type of Travel	No. of Visitors (in millions) in 1999
Pleasure	10.2
Business	7.2
Business/Pleasure	1.2
Other	2.3
Total	20.9

Source: Washington, DC Convention & Visitors Association

Washington Area Meetings and Convention Industry 1993-97 (Dollars in Millions)

	Conventions		Meetings		Total	
Year	#	Revenue Generated	#	Revenue Generated	#	Revenue Generated
1993	32	$622	1,206	$1,548	1,238	$2,170
1994	25	$425	1,146	$1,479	1,171	$1,904
1995	23	$378	1,198	$1,553	1,221	$1,931
1996	22	$431	1,212	$1,447	1,234	$1,878
1997	21	$410	1,276	$1,524	1,297	$1,934

Source: Washington, DC Convention and Visitors Association

Washington's Hotel Industry: 1997

	# of Properties	# of Rooms
Washington, DC	103	23,998
Montgomery County	34	6,524
Prince George's County	59	6,335
Suburban Maryland Total	93	12,859
Arlington County	37	9,300
Alexandria	17	3,346
Fairfax County	54	11,600
Loudoun County	26	1,513
Prince William County	22	2,100
Northern Virginia Total	156	27,859
Metro Area Total	*352*	*64,716*

Source: Washington, DC Convention and Visitors Association

Occupancy & ADR: Steady Increase

Hotel occupancy increased 320 basis points in the Washington Metro area in 2000, to 76.1% – well above the industry break-even point of 60% to 65%. With occupancy levels so high, watch for an increase in planned development. And it is needed to accommodate the new convention center.

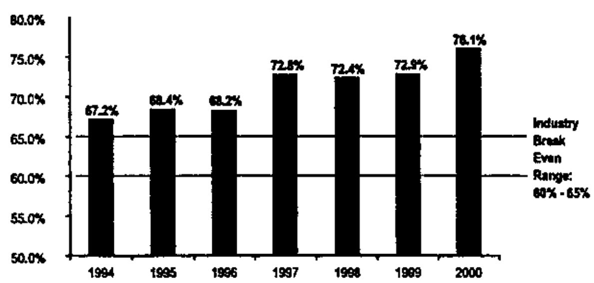
Average daily room rates (ADRs) increased 6% – to $116.61 in 2000, from $109.79 in 1999.

110

Hotel Occupancy Rate

Washington Metro Area

1994 - 2000



Source: Smith Travel Research

Washington Area Hospitality Industry Trends

	Hotel Occupancy	*Avg. Daily Room Rate*
1987	69.2%	$71.62
1988	68.6%	$75.62
1989	68.9%	$78.78
1990	64.8%	$80.48
1991	63.4%	$80.07
1992	65.0%	$81.61
1993	68.2%	$84.69
1994	67.2%	$86.46
1995	68.4%	$90.72
1996	68.2%	$94.62
1997	72.8%	$101.17
1998	72.4%	$106.14
1999	72.9%	$109.79
2000[1]	76.1%	$116.61

[1] *Through October 2000.*

Source: Wash. Business Journal, Smith Travel Research

Hotel Sales

Hotel sales decreased to $224 million in 2000, from $370 million in 1999, continuing a decade long trend. This asset class remains out of favor with institutional and foreign investors. It is for opportunity traders and specialty players, who largely were on the sidelines in 2000.

New Convention Center Results in Big Plans

With the anticipation of the new convention center opening in 2003, the list of proposed hotels continues to grow. ***Nearly 3,000 new rooms are planned in the District over the next three years*** – an increase of 12% to the current inventory of 24,000. However, according to two feasibility studies conducted by the DC Hotel Association and the Washington Convention Center Authority, the city can handle 4,000 new rooms.

Sales of Investment Grade Hotels

	1998			1999			2000		
	#	*Sales Volume (Millions)*	*$/Room (000's)*	*#*	*Sales Volume (Millions)*	*$/Room (000's)*	*#*	*Sales Volume (Millions)*	*$/Room (000's)*
Northern Virginia	8	$228	$119	5	$133	$103	2	$47	$113
Washington, DC	2	$126	$194	1	$227	$170	2	$163	$152
Baltimore Area	8	$86	$63	1	$10	$76	0	--	--
Suburban Maryland	3	$35	$56	0	--	--	2	$14	$77
Regional Total:	**21**	**$475**	**$105**	**7**	**$370**	**$134**	**6**	**$224**	**$126**

Source: Delta Associates, COMPS: January, 2001

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A Sample of Hotels in Downtown, Washington, DC That are Planned or Under Construction at January 2001

Property Name	*Location*	*Planned Number of Rooms*
Renaissance	999 9th Street	550
Mandarin Hotels	Portals, SW	500
Urban Development Group	1000 K Street	472
DC Laundry Renovation	New York Avenue	430
Sofitel Hotel	806 15th Streets	225
St. Gregory	20th & M Streets	154
Kimpton Hotel & Restaurant Group	7th & F Streets	120
Residence Inn by Marriott	20th & P Streets	107
Ritz Carlton	31st & K Streets	93

Source: Delta Associates, January 2001

Hotel Market Outlook for 2000

The hotel market in the Washington Metro area should remain strong with a solid base of tourism and an anticipated increase in conventions. However, the large increase in supply may result in a lower occupancy and ADR in non-convention times. Hotel groundbreakings in the next two years will be a good indicator to watch.

This asset class is not for every one, but we believe full service hotels in the central business districts of Washington, Bethesda, Alexandria, Arlington, Tysons and Reston offer an exceptional development and investment opportunity. It is a contrarian approach worth investigating.

The Washington Area's Most Highly Visited Tourist Destinations in 1998

Attraction	*# of Visitors (in Millions)*	*Jurisdiction*
National Air & Space Museum	10.1	Washington, DC
National Museum of Natural History	6.4	Washington, DC
National Gallery of Art	6.2	Washington, DC
National Museum of American History	5.6	Washington, DC
Arlington National Cemetery	5.0	Northern Virginia
Vietnam Veterans Memorial	4.7	Washington, DC
Lincoln Memorial	4.0	Washington, DC
Korean War Veterans Memorial	3.4	Washington, DC
National Zoo	3.0	Washington, DC
Jefferson Memorial	2.1	Washington, DC
U.S. Holocaust Memorial Museum	2.0	Washington, DC

NOTE: The Washington Monument was closed for 5 months during 1998 while it was being renovated.
Source: Commonwealth of Virginia Tourism Authority, Maryland Department of Business and Economic Development - Office of Tourism Development, Washington DC Convention and Visitors Association and the attractions

112

Executives at the following companies are among the many who have generously contributed their time and provided insights for this publication by responding to our annual survey of market makers.

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