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THE ECONOMY

With a large federal sector and its substantial private sector connections, particularly in the health care arena, the longer-term effects of cuts in federal spending on the Suburban Maryland economy are a matter of concern. While all the answers are not yet known, a recent report by Cassidy Turley, *Insights: How will Federal Spending Impact the DC Region?* sheds some light—and suggests cause for optimism that the "cuts may not be as bad as originally thought... Many believe that the announced cuts merely reflect changes in accounting practices." In any event, "funding for agencies and initiatives that are key to the DC region actually increased in 2011 compared to 2010."

With direct impacts expected for Suburban Maryland, the Department of Health and Human Services (HHS) has been awarded a $14.9 billion increase in its budget for FY 2011 (a 2.7% gain year-over-year), this source reports. Over the next five years, the proposed HHS budget is expected to contain a $308 billion (6.0% annual) increase. Included is the investment of $32 billion in biomedical research, including funding for the locally-based National Institutes of Health (NIH). Montgomery County's I-270 biotech corridor also hosts any number of public and private entities that could benefit from investment in bioscience (see *Special Real Estate Factors*). On the private side, meanwhile, the loss this year of patent protection for Lipitor, described by *Washington Business Journal* as "the world's best selling drug," and patent expirations for other pharmaceutical products as well, represent "a costly crisis for big pharmaceutical companies... and a multibillion-dollar opportunity for little biotechs, the very kinds that populate the I-270 corridor... Maryland's life sciences community... could benefit from the increasing need for big drugmakers to license promising new drug candidates and technologies."

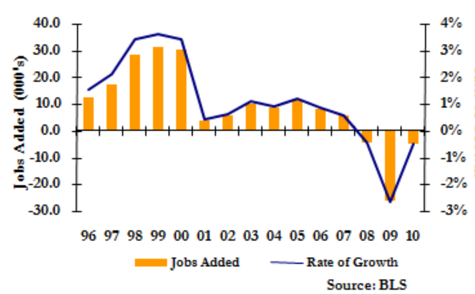
According to data provided by the U.S. Bureau of Labor Statistics (BLS), meanwhile, Suburban Maryland (the composite of two areas as described below) passed through the recent recession with only minor setbacks, relatively speaking. Average non-farm employment decreased by 2.7% (26,000 jobs) in 2009, a small rate of decline alongside what the nation as a whole endured that year. Losses in 2008 (0.4% or 4,300 jobs) and 2010 (0.5% or 4,700 jobs) were minimal. However, these job growth numbers taken alone conceal internal geographic and demographic disparities. The heavily blue-collar Calvert-Charles-Prince-George's area has suffered more substantially than has the largely white-collar Bethesda-Rockville-Frederick Metropolitan Division (Montgomery and Frederick

Employment:

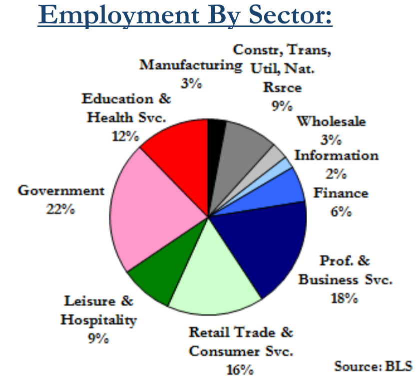
- *The BLS reports a seasonally unadjusted unemployment rate of 5.0% in April for the Bethesda-Rockville-Frederick Metropolitan Division, down from 5.6% one year earlier.*

- *Moody's Economy.com reports a first quarter 2011 average household income of $154,179 for Suburban Maryland. Average household incomes of $121,802 and $140,565 are reported for the top metros in the nation and Northeast region, respectively.*

Employment Growth:



Employment By Sector:



counties). These disparities have persisted into 2011. According to BLS data for May 2011, overall Suburban Maryland non-farm employment was down 0.5% (4,800 jobs) from 12 months prior. While employment in the Bethesda area Metropolitan Division was up 0.9% (5,000 jobs), the greater Prince George County region saw a 2.6% (9,800-job) decline. Employment growth in local federal government sectors varied: a 400-job year-over-year increase in the Bethesda area was accompanied by a loss of 1,200 jobs in Calvert-Charles-Prince George.

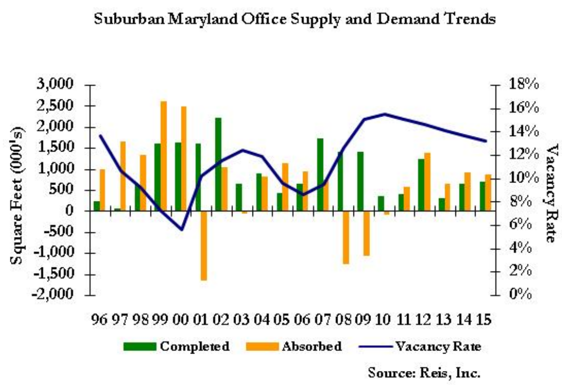
Despite the relative resiliency of the local economy, substantial home foreclosure problems surfaced in Suburban Maryland in the recent term. According to RealtyTrac, which does not separate Suburban Maryland from the greater the Washington area MSA, the MSA ranked 78th among the nation's top 206 metro areas in rate of foreclosure for 2010. At 2.04%, its 2010 rate of foreclosure bested the 2.23% rate calculated for the nation for the year. As reported by *Washington Business Journal* in April 2011, meanwhile, greater Washington "saw some of the biggest drops in home foreclosures in the nation in the first quarter." The overall drop nationwide, however, may be temporary, adds the report.

OUTLOOK

Increasing activity by HHS will be helpful to the bioscience sector. And new growth on the private side also should lend a hand. Employment growth overall, though, likely will be slow. The housing market will remain a sore spot.

THE REAL ESTATE MARKET

OFFICE



The Suburban Maryland office market long has lived in the shadows of its larger and more dynamic neighbors—the markets of the District of Columbia and Northern Virginia. As with its regional companions, however, the federal government and government-related private business have played substantial roles in generating demand. These sectors have tended, generally speaking, to provide an umbrella of protection against economic cycles. Thus, notes Studley, Inc. in a first quarter report, "The federal government led demand [during first quarter] while private-sector firms remained cautious with their leasing decisions." As reported by Cassidy Turley, "Discussions about cutting the federal budget are ongoing, and there is the imminent threat of budget cuts to agencies that are heavily integrated in the market including HHS, NIH, National Oceanic and Atmospheric Administration (NOAA), and the Food and Drug Administration (FDA. The good news is that it is likely that these agencies will not be affected negatively. Consequently, we do not expect them to downsize their space requirements in Suburban Maryland" (see *Special Real Estate Factors*).

As reported by Studley, Inc. the largest lease in the entire greater Washington, D.C. area during first quarter was the 935,386-square-foot deal signed by the General Services Administration (GSA) for the U.S. Department of Health and Human Services at 5600 Fishers Lane in Rockville. Cushman & Wakefield reports a 70,700-square-foot deal by GSA at 12501 Ardennes Avenue in Rockville. On the private side, URS signed a 91,350-square-foot lease in a move from Gaithersburg to Milestone Business Park in Germantown, *Citybiz* reported in March. According to Cassidy Turley, the quarter's largest *new* lease was ICF Macro's for 91,970 square feet in North Rockville.

Special Real Estate Factors:

- ***Office***: *Federal spending. The increases proposed for the U.S. Department of Health and Human Services budget "would bode well for the Montgomery County office market in Suburban Maryland, which is most renowned for its biotechnology community," states Cassidy Turley in its Insights: How will Federal Spending Impact the D.C. Region? report. "The I-270 Technology Corridor in the County has attracted over 200 biotech companies and industry leaders such as Celera, Genomics, MedImmune, and Invitrogen. Montgomery County is also home to 19 federal agencies, including NIH, the National Institutes of Standards and Technology (NIST), the U.S. Department of Agriculture (USDA) Research Center, and the National Naval Medical Center."*

- *More. "Although the reform bill was passed by Congress last year, the House of Representatives passed H.R. 2, 'Repealing the Job-Killing Health Care Law Act' in January, 2011. Congressional Budget Office estimates show that Health & Human Services (HHS) will incur costs*

Net absorption for the quarter, nonetheless, was counted by Reis at negative 94,000 square feet as the vacancy rate added 10 basis points to close the period at 15.6%. Neither change, however, was an indicator of things to come. Net absorption over the next two months was strongly positive at 352,000 square feet; the vacancy rate closed May at 15.1%. Average asking and effective rents, meanwhile, saw small losses: 0.1% declines for each during first quarter resulted in respective rates of $27.90 and $22.82 psf. Additional losses of 0.1% followed for each over the next two months. Meanwhile, notes Studley, Inc. "some strong credit companies with a confident business plan took advantage of the ongoing tenant-favorable market, securing new Class A space at more affordable rents."

Reis expects 395,600 square feet to complete construction all told in two projects in 2011. The largest, the 280,000-square-foot first phase of North Bethesda Town Center, is due on line in July. Also in Bethesda, the largest project underway in Suburban Maryland per the date of this report was the 649,000-square-foot North Bethesda Center phase 1. According to Studley, Inc. the latter has been 100% leased to the U.S. Nuclear Regulatory Commission.

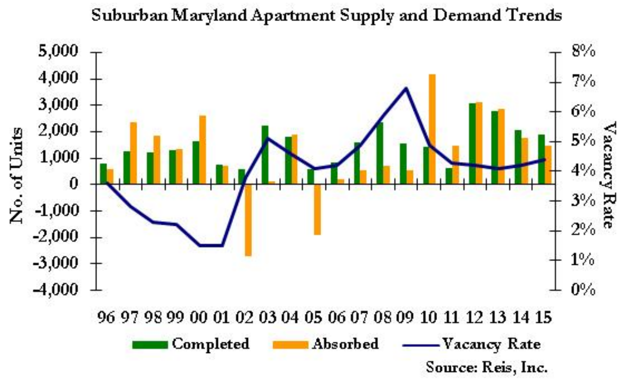
- *Reis expects positive net absorption in excess of 300,000 square feet over the last seven months of the year to result in a year-end count of plus 577,000 square feet. With most of the year's new supply coming on line in July, vacancy should close the year at 15.1%, unchanged from May. Rent growth for the year is projected at about 1.0%. Progress should continue in 2012.*

Special Real Estate Factors:
Continued

between $5 billion to $10 billion over 10 years to carry out its responsibilities for enacting the full reform legislation Depending on what parts of the legislation are repealed or revised, if any, both HHS and private contractors in the Maryland market could feel the impact… While government spending may decrease both nationally and in the D.C. region over the next year, historical evidence suggests that budget cuts will have minor effects on commercial real estate in the D.C. region."

- ***Apartment**: Making a comeback. The Donaldson Group LLC, based in Rockville, recently made a comeback in the Washington area with its acquisition along with New York-based equity partner Angelo, Gordon & Company of a 492-unit garden apartment community in Suitland, Washington Business Journal reported at the end of May. "A planned $12 million in renovations will be tacked on to the $27.4 million acquisition price of the complex, called Pinewood Chase. After refraining from buying local property for roughly three years, the real estate management and investment company closed on*

APARTMENT



The year 2010 was very good for the Suburban Maryland apartment market as the voluminous release of pent-up demand neutralized much of the harm done by the recession. Net absorption leapt to 4,140 units last year, most in a year since the firm began tracking this market more than 30 years ago. As only 1,410 units completed construction, vacancy dropped under 5.0%, shedding 190 basis points to close the year at 4.9%, and rent growth returned in strength.

With the stage now set for additional recovery, 2011 introduced a new wrinkle. The flow of pent-up demand that animated the market last year was a temporary phenomenon. While the demand that would arise as a result of positive job growth will be augmented by demand arising from the single-family market as victims of foreclosure turn to the rental option (and difficulties in securing mortgage financing keep would-be buyers out of the market), net absorption in 2011 will fall far short of the total reached last year. Similarly, however, the year's construction completion total also will run short for the year. The tally at the end of first quarter showed 171 units of positive net absorption accompanied by lack of new supply additions. Vacancy slipped to 4.8%. The 621 units that completed construction in two projects in April and May, however, exceeded the 424 units of same-period net absorption; vacancy ended May at 5.0%. This small imbalance will be quickly redressed. No additional units will complete construction over the remainder of 2011 while net absorption for the year runs to 1,448 units.

Rent growth rates, reflecting the growing strength of the market, will increase this year. At $1,309 and $1,248 per month, asking and effective averages per the latest quarter were up 0.5% and 0.6%, respectively, since year-end. By the end of May additional increases of 0.6% had been recorded for each. A significant issue facing the market is an expected increase in development. Citing "booming" apartment construction in the greater Washington, D.C. apartment market as a whole, "some analysts

Special Real Estate Factors:
Continued

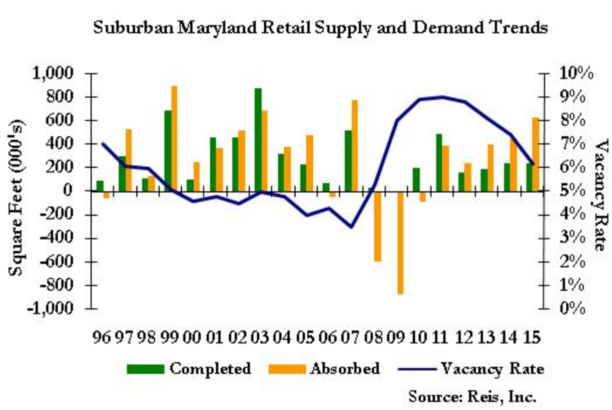
[the] 459-unit... Heather Hill Apartment Homes, in Temple Hills in an all-cash, $38 million transaction with Angelo, Gordon in December and has since started an $8.5 million renovation. The 13-year-old local company, which manages nearly 10,000 units in Virginia and Maryland, announced plans to get two to three more deals like that done in 2011, perhaps in other parts of the region... Just weeks ago, Donaldson and Angelo, Gordon closed on their already-announced purchase of Regency Pointe, a 599-unit apartment community in Forestville, and embarked on a $16 million renovation." See the Transactions Analytics section of this Reis Observer for more information on investment.

- ***Retail**: National Harbor. "An effort is underway by a state legislator to temporarily halt plans to build a collection of high-end outlet stores just outside the Beltway in Prince George's County," The Washington Post reported in June 2011. Sen. C. Anthony Muse has stated that a roadway near The Peterson Companies' National Harbor* fear a crash could be next," *Washington Business Journal* reported in June. While activity will increase in Suburban Maryland, the lion's share of whatever threat may exist will likely be found elsewhere in the region. According to Reis's latest report on construction, 1,025 market-rate apartments in four named projects were under construction or planned for delivery in 2012. A total of 1,409 units in four others currently are assigned 2013 completion dates. A case in point as reported by *U.S. Fed News* in June was the groundbreaking that month for Woodfield Investments' 300-unit Residences at Hidden Creek complex in Gaithersburg. Reis expects delivery in February 2013. The largest project currently underway, also in Gaithersburg, is the 389-unit Archstone at Olde Towne. Construction began in January 2011 and will finish in January 2013. Given the large number of projects in the planning proposal pipeline and the current favorable occupancy and rent profiles, construction totals for 2012 and 2013 are expected to increase.

- *Reis expects 2011 to produce gains of 4.7% and 5.5% in the asking and effective average rents. Vacancy is projected to end the year at 4.3% and to remain low thereafter.*

RETAIL

The effects of three consecutive years of negative net absorption on community and neighborhood center space were mitigated by a sharp cutback in construction. Thus while elevated relative to local market norms, vacancy in this sector ended 2010 at only 8.9%, 200 basis points below the national rate for this property type at that time. With net absorption running positive at 26,000 square feet during first quarter 2011 (it was positive the quarter before as well) and with no new space arriving on line since fourth quarter last year, the rate had slipped to 8.8% by the end of the latest quarter. Two months later, in the wake of 3,000 square feet of



Special Real Estate Factors:
Continued

development in Oxon Hill, where the stores will be built, will not be adequate. "It will be absolute gridlock," Mr. Muse said of Indian Head Highway. "Muse said state and county officials need to address the project's transportation needs before allowing it to move forward," adds the Post. In June, the developer announced an agreement with Tanger Factory Outlet Centers "to bring about 80 stores to the county. The shopping center will be the latest addition to National Harbor, the still-expanding $4 billion complex of condominiums, stores, restaurants and hotels lining the Potomac River near the Woodrow Wilson Bridge." Reis reports 175,000 square feet planned for the first phase.

- ***Industrial**: Bioscience, and more, from China. China-based "a biopharmaceutical" company, Tasly Group, has announced its decision to invest $40 million "to take up 430,000 square feet in Montgomery County," Washington Business Journal reported in June. "The company will open a production facility and* negative net absorption, it had shown no additional change. At $25.11 and $22.14 psf, first quarter asking and effective mean lease rates were down 0.6% and 0.5%, respectively, from a quarter earlier. Each average had lost a penny by the end of May. While additional small losses are expected for the remainder of the year all told, 2011's rates of decline will be but fractions of the losses seen in 2009 and 2010.

In sum, the market is stabilizing. While Reis anticipates the delivery of approximately 500,000 square feet of community-neighborhood center space all told in two projects in 2011, both during third quarter, net absorption will stay close. The largest of the year's two projects, Faison Enterprises' $29.5 million, 375,000-square-foot Clemson Corner community center at routes 15 and 355 in Frederick, will complete in July. Marcus & Millichap notes that Clemson Corner "will not adversely affect vacancy this year, as the property is fully pre-leased." Anchor tenant Marshall's, meanwhile, opened for business in March. The 140,000-square-foot Damascus Centre neighborhood center will follow in September in Damascus (Montgomery County).

The largest project remaining under construction per the date of this report for completion this year is the 800,000-square-foot retail component of the Woodmore Towne Centre mixed-use project in Lanham. Reis expects completion in December. The market, however, will not suddenly be flooded with all that space. JC Penney has signed up for a 104,000-square-foot anchor space, and stores by Costco and Wegman's opened last year at the project. A Best Buy also is on the tenant roster. In addition, 220,000 square feet were under construction per report date for completion in January 2012 at the Twinbrook Commons mixed-use project in Rockville.

Favorable occupancy and little new supply in the power center market are encouraging new development. The $200 million, 1-million-square-foot Ritchie Station Marketplace power center in Capitol Heights (Prince George County), started a while ago. Subsequently delayed by recession, it was "showing signs of life" as of December, *Gazette.Net* reported at the time. A B.J.'s Wholesale Club has opened at the project. Only one power center development with a scheduled completion date appears on Reis's list of construction projects: the 80,000-square-foot second phase of Festival at Waldorf is underway in that town for completion this November. A 40,000-square-foot third phase remains in the planning phase. Reis put first quarter power center vacancy at 5.3%, up from 4.9%

Special Real Estate Factors:
Continued

training center for traditional Chinese medicine in the Shady Grove Life Sciences Center in Rockville. "It is the largest investment in Maryland by a Chinese company, according to Governor Martin O'Malley's office, and is slated to bring 'dozens of jobs' to the state over the next three years." In addition, two "emerging" Chinese firms, Sunscape, a producer and supplier of new building materials and CellPath China, a life sciences company, also have announced plans to open facilities in Maryland's International Incubator in College Park. And China-based solar energy firm DaSol Energy Science and Technology Company will renew its contract with the Incubator.

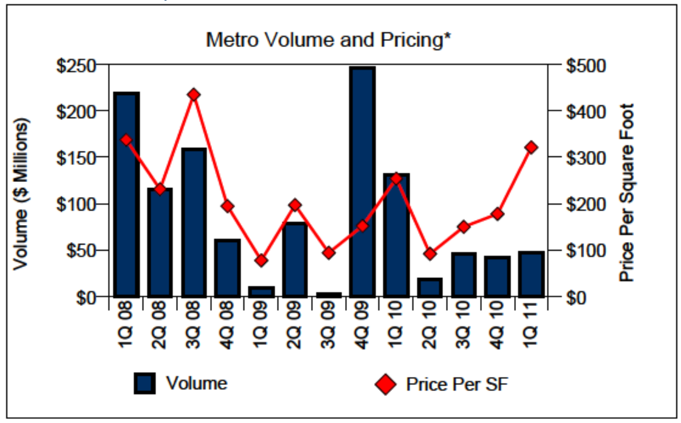
a quarter and year earlier yet still favorable. The first quarter national power center vacancy rate was 7.0%. At $33.73 psf, the average asking lease rate for Suburban Maryland power center space was down 0.4% for the quarter and 1.4% year-over-year.

- *Net absorption will trail new community and neighborhood center supply this year, but only by about 100,000 square feet. Vacancy should close the year at 9.0% before beginning an extended descent in 2012. Growth rates of negative 0.9% and negative 1.3% are projected for the asking and effective average rents for 2011. Next year's rents should run essentially flat; growth should follow slowly thereafter.*

TRANSACTION ANALYTICS

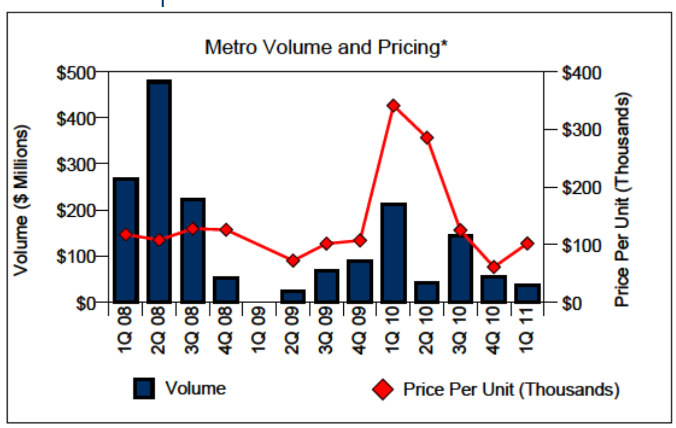
Office

Reis reports the completion of two single-property transactions during first quarter for a combined total of $47 million, nearly identical to the dollar totals recorded for three and four sales, respectively, for the two preceding quarters. At $321 psf, however, the latest quarter's average selling price was the highest by far since the third of 2008. In the latest quarter's largest sale, The Brick Companies paid The Lionstone Group $32 million ($302 psf) for the 105,895-square-foot, 2.0%-vacant Lakefront at Washingtonian multi-tenant office property in Gaithersburg. The sale closed in January at a 6.5% cap rate. The 12-month rolling cap rate per first quarter was 7.9%, unchanged from the quarter before, down from 8.2% as of first quarter 2010.



Apartment

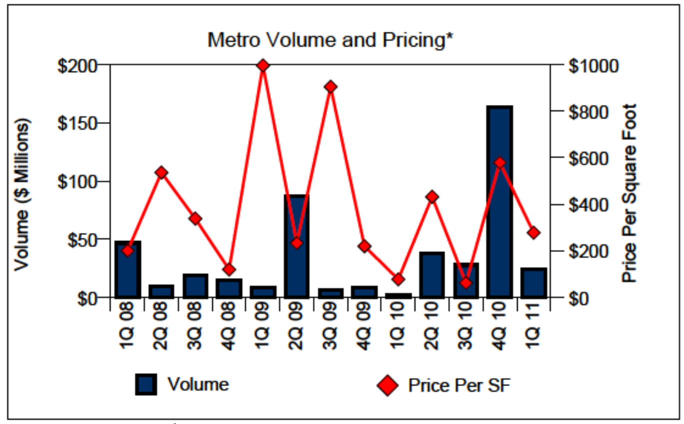
The $37.5 million that changed hands in two single-property transactions during first quarter amounted to the smallest dollar volume for sales of this type since second quarter 2009. The average selling price and mean cap rate for the quarter's pair of deals were $102,000 per unit and 6.4%. The 12-month rolling cap rate was 6.3%, same as the quarter before, down from 7.4% four quarters prior. For the $454.7 million exchanged in 10 deals in 2010 the averages were $190,000 per unit and 7.1%. In the latest quarter's largest deal, The Praedium Group paid MSK Fairfield Hampton $31 million ($129,167 per unit) for the 100.0%-occupied, 240-unit Hampton Hollow Apartments in Silver Spring. The sale closed in February at a 6.4% cap rate.



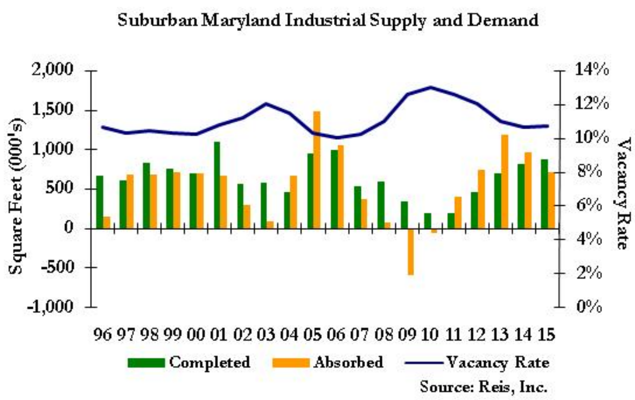
Deals since the quarter ended include AvalonBay Communities Inc.'s $49.5 million ($235,700 per unit) acquisition of the 210-unit Yale Village Townhomes "rental townhome" project in Rockville, *Washington Business Journal* reported in late June.

Retail

A spike in single-property retail real estate sales in fourth quarter last year was followed by a return to the smaller volumes that have been typical here for an extended period. Thus, only one property, fetching $24.1 million, changed hands during first quarter 2011. In the sale at issue, Kimco Realty paid Zimmer Development $278 psf for the 86,734-square-foot, 8.0%-vacant Shops at District Heights neighborhood center in Suitland. The sale closed in January at a 5.4% cap rate. The 12-month rolling cap rate as of first quarter also was 5.4%, same as the quarter before, down from 8.4% per the first of 2010.



INDUSTRIAL



A slowdown in development in Reis's multi-tenant non-manufacturing space market after the recession arrived reached its low point to-date in the delivery of 201,000 square feet last year. While a virtually identical completion total is anticipated for 2011, the negative trend in net absorption, easing up in 2010, will make a decisive turn this year. Last year's net of minus 49,000 square feet (on the heels of negative 584,000 in 2009) will be followed by a positive total on the order of some 400,000 square feet in 2011. The direction of the vacancy curve, accordingly, will change as well. At 13.0%, the rate in this 56.3-million-square-foot market ended the year up 40 basis points from year-end 2009. The year 2011 will take back those 40 points as the rate returns to 12.6%. A larger decline is expected for 2012 with a still larger one to follow in 2013. With the market getting back on track, growth in average rents, following three years of loss, will turn positive this year. At $7.40 psf and $6.95 psf, asking and effective averages ended 2010 down 0.8% and 1.6%, respectively, year-over-year. The gains of 1.9% and 2.1% forecast for 2011 would more than eliminate last year's losses. Still, it will take until sometime in 2013 until all the recession-related losses suffered by the asking average will be redeemed. Full redemption of the losses endured by the effective mean will not be completed until sometime in 2014.

The Suburban Maryland industrial market, like the market in Northern Virginia, has two large and distinct facets—a typical industrial sector dominated by warehouse-distribution space and a large high-technology-oriented flex market. On the Maryland side, the tech sector is dominated by biotechnology entities. Warehouse-distribution space tends to be concentrated most heavily in blue-collar Prince George's County while the flex sector has its roots in the I-270 corridor in white-collar Montgomery County, from Bethesda and Rockville to the Gaithersburg-Germantown area and, farther north, in Frederick County as well. According to

Cushman & Wakefield, which divides the market into Prince George and Montgomery Counties, both areas suffered modest negative net absorption during first quarter. Respective approximate "direct" net absorption totals for the period were negative 149,800 and negative 74,600 square feet. Respective vacancy rates were 15.0% and 11.2%. The average asking rent for warehouse-distribution space in Prince George County was $6.63 psf. The mean asking price for office-service space in Montgomery County for the quarter was $14.79. No space of any type was under construction in either county at the end of the quarter, this source reports.

In first quarter's largest lease as reported by Cushman & Wakefield, A&M Supply rented 102,000 square feet of warehouse-distribution space at 9821 Fallard Court in Upper Marlboro (in the firm's Oxon Hill-Suitland submarket). In the largest property sale, Hampton Park Boulevard LLC paid $21 million for an 189,103-square-foot property on that roadway in Capitol Heights. Reis reports the March sale for $8.5 million ($82 psf) of the fully leased, 103,250-square-foot Colonial Sash & Door Inc. warehouse at 260 Interstate Circle in Frederick. 260 Interstate LLC and Business Space Providers LLC were buyer and seller.

- *Minimal construction along with modest positive demand should help advance the market's recovery. Rent growth at about 2.0% is anticipated for 2011. Both new supply and net absorption totals should increase annually in the years ahead with absorption maintaining the lead.*

Vacancy

Sector	1Q11	1Q10	Chg
Office	15.6%	15.0%	60 bps
Multifamily	4.8%	6.3%	-150 bps
Retail	8.8%	8.1%	70 bps
Industrial	13.0%	12.6%	40 bps

Rents

Sector	1Q11	1Q10	Chg
Office	$27.90 psf	$27.87 psf	0.1%
Multifamily	$1,309 month	$1,272 month	2.9%
Retail	$25.11 psf	$25.66 psf	-2.1%
Industrial	$7.40 psf	$7.46 psf	-0.8%

For additional metro and submarket level information on the top 80 markets for the four principal property types, visit www.reis.com or call Reis at: (800) 366-REIS.