When safe isn't safe: Why secondary office/flex transactions present a compelling alternative to core real estate acquisitions in gateway cities

September 2012

Market Update:

Recent quarters have shown measured improvement in the United States economy. The current situation, however, contains uncertainty and investors must proceed with what leading economists refer to as "tempered optimism."[1] Allowing this mindset to guide decision-making creates a "flight to quality," leading investors to pursue expensive Class A assets and core assets (such as trophy office towers and multi-family complexes in gateway markets New York City, Boston, Washington D.C., San Francisco and Los Angeles) purchased on historically low cap rates. These premium priced trophy assets attract investors who are looking to allocate equity to perceived stable products, due to an appetite for current yield driven by the record low U.S Treasury bond rates.

Although these properties appear to offer security because of their location, prestige and historically stable occupancies, the high purchase price and low cap rates make these investments susceptible to interest rate risks and may present a difficult exit strategy due to an investor's high basis. As the economy continues to recover and benchmark interest rates eventually increase, investors could encounter difficulty realizing appreciation when selling assets purchased at unsustainably low cap rates. Recent history offers a warning in regards to these types of investments, as similarly low cap rates for commercial properties created high investor basis in 2005-07 and played a role in the country's real estate collapse.

Opportunity:

Cap rate averages in the aforementioned gateway markets continued to drop in the first quarter of 2012, New York (6.58%), Boston (6.83%), Washington D.C. (6.58%), San Francisco (6.08%) and Los Angeles (6.92%).[2] Cap rates in New York and Boston for trophy office assets are now below 5.0% and approaching 4.0% in selected cases. Additionally, office rents for these and other similar markets remain consistently high. As many investors flock toward these core products, they have largely ignored flex (single-story office/warehouse) space along with suburban office in non-gateway markets. However, research from leading institutions shows that the pattern of excessively high valuation of Class A office space will lead investors to pursue secondary markets and flex spaces in search of better yields.

As pricing and bidding continue their upward trends, returns decline and many investors find themselves unable to attain suitable deals commensurate with the return hurdles currently offered by Class A assets. In response to the inverse relationship between pricing and returns, Macfarlan believes that current opportunities lie in overlooked markets across the southern United States. These markets show strong potential due to their signs of job growth, attractive rental rates and reasonable cap rates. Macfarlan is underwriting value-added investment opportunities with stable current yield at 9.5%-10% cap rates in

major sun belt cities like Dallas, Houston, Austin as well as, Nashville, Atlanta, Denver, Colorado Springs, and Phoenix.

> *"Investors are now running to these forgotten cities that were left for dead because they were associated with single-family overbuilding. The reality is the office sectors in those markets are starting to rebound. That's why investors are going to these markets before the herd shows up."*
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> *-Mitch Roschelle, U.S. Real Estate Advisory Practice Leader at PriceWaterhouseCoopers, told PERE.*[3]

The disparity between the returns and risk of Class A core space and that of flex space or suburban office in secondary markets is not commensurate with the significant price gap between the two. Furthermore, the efficient floor plans offered by flex spaces enable a wide range of tenant uses and draw the interest of new companies. In the San Francisco market, for example, tenants have already begun to gravitate toward the open floor plans of flex spaces, tightening the vacancy rate spread between the different class buildings. Tenants electing to move to secondary markets will also benefit from lower rents and competitive tenant improvement allowances available in these markets. These regions also offer companies the advantage of a cheaper labor force that is generally as well-educated as those in core markets. This results in lower operating costs for new and migrating companies. With the high rental rates of core spaces noted above and with little construction expected on the horizon in most major markets, Macfarlan anticipates that this trend will spread beyond the gateway markets and into the more affordable, secondary markets across the southern U.S.

1Q Cap Rates - Integra Realty Resources

	NY, NY	Boston	D.C.	San Fran	L.A.
CBD Office	5.25%	5.50%	5.50%	5.50%	7.00%
Suburban Office	7.00%	7.25%	7.25%	6.50%	7.00%
Warehouse	7.50%	7.75%	7.00%	6.25%	6.75%
Avg. CBD & Suburban	6.13%	6.38%	6.38%	6.00%	7.00%
Avg. Sub. & Warehouse	7.25%	7.50%	7.13%	6.38%	6.88%
Total Avg.	**6.58%**	**6.83%**	**6.58%**	**6.08%**	**6.92%**

[1] CBRE 1Q 2012 "U.S. Office MarketView: Tempered Optimism" http://www.cbre.us/AssetLibrary/USOfficeOccupierMarketView_Q12012.pdf
[2] Integra Realty Resources 1Q 2012 Viewpoint http://www.irr.com/_FileLibrary/FileImage/Viewpoint_Q1_2012.pdf
[3] Comtois, James. PERE "PwC: Investors warming to 'forgotten cities'" 06 July 2012
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