

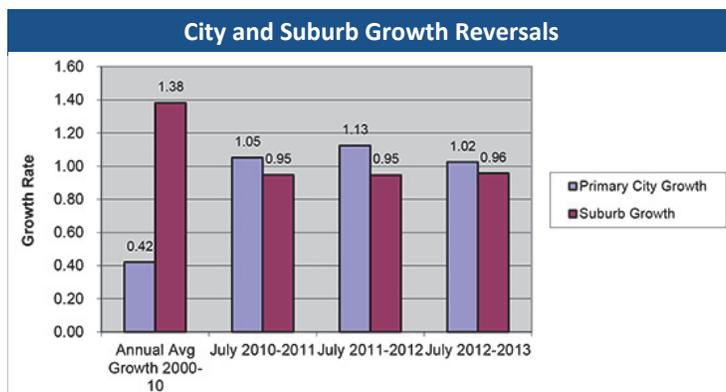


PCCP Market Commentary The 'Burbs Second Quarter 2015

The eponymous movie starring Tom Hanks was released in 1989 at the onset of a massive population shift away from the urban core of American cities and into the suburbs. In the years that have passed since the Great Recession, however, America’s inner cities have led the way in the recovery, leading many to the conclusion that we have entered into a new paradigm of re-urbanization. As it relates to commercial real estate, the thought is that a shift in population growth away from the American suburb will have a profoundly negative impact on suburban office as employers follow their workforce back into the CBD. Our instincts tell us that the “death of the American suburb” drum beat proliferated in the media is misguided and overplayed, a recipe for a good investment opportunity. In the end, success in real estate investing all boils down to supply and demand. Let’s take a step back and look at the macro forces at work.

In the 1990s and 2000s, Americans were moving out of downtown areas and into the suburbs in droves. In large metro areas (with a population of over 500,000), the share of residents living in suburbs increased from 66% to 69%, equal to roughly six million people¹. This outward shift has been prevalent in the majority of cities throughout the country and is driven by cheaper cost of living and better public schools. Meanwhile, office developers opened the floodgates on new construction in the suburbs, resulting in a spike in non-CBD office inventory of 20% during the first decade of the new millennium alone².

Things began to change in 2007 as America plunged into recession. Migration rates fell to their lowest levels in over 50 years, resulting in a population boon for cities and inner suburbs, which held on to residents that might have otherwise moved outward. With more homes than businesses, outer suburban and exurban portions of cities were the most vulnerable to the downturn in the housing market and experienced the biggest decline in population growth.



Source: Brookings Institute

*Metropolitan areas over one million

With a glut of new supply and lagging demand, suburban office markets throughout the country suffered. The hardest hit suburbs saw vacancy spike to over 20 and 30 percent, figures widely covered by journalists. Overall, however, the vacancy differential between suburban and CBD peaked in Q4 2008 at just 2.46% and has been tightening steadily ever since as suburban buildings have captured an outside share of tenant demand relative to their inventory as a percentage of the total market. As of Q4 2014, the vacancy differential was 1.55%, compared to an average since Q1 2001

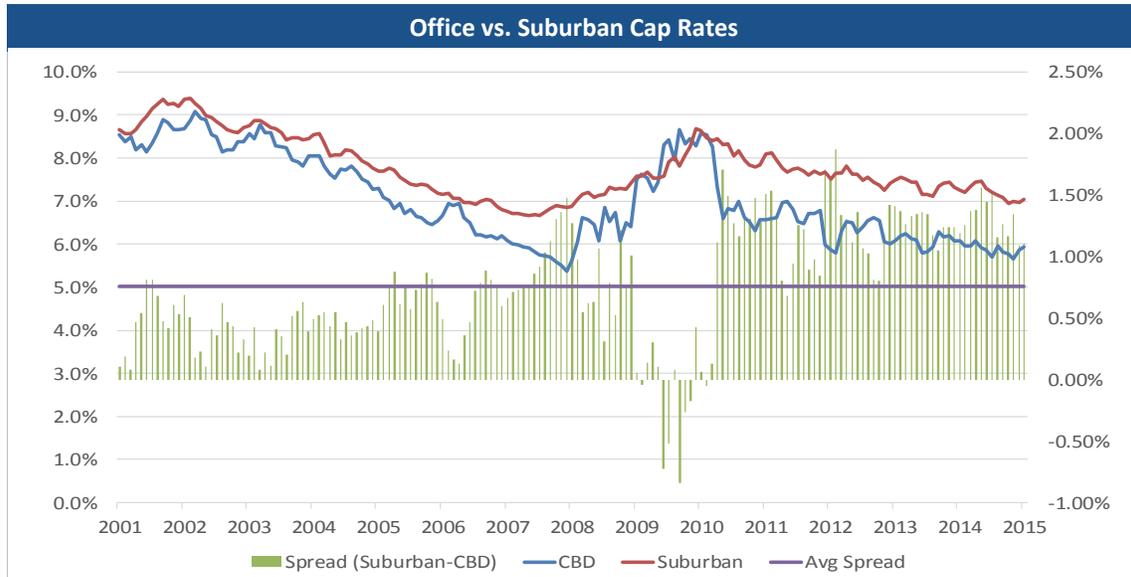
of 0.20%. In the CBD, as vacancy recovered, rent growth followed suit. According to CoStar, CBD rents now stand at a 62% premium to suburban rents, an all-time high, compared to a low of 38% in Q1 2006 and an average since Q1 2001 of 48%³. We expect this spread to compress as small- and medium-sized firms take advantage of depressed rental rates in the suburbs and vacancy tightens to historic norms, offering investors the prospect of capturing outsized rent growth in the suburbs.

¹ United States Census Bureau

² CoStar

³ CoStar

We believe that the “reversion to the mean” theory is also applicable to capital markets activity. Looking at the chart below, one can see that the spread differential between suburban and CBD cap rates has been well above the 14-year average of 76 basis points. Since peaking at 187 basis points during Q2 2012, the figure has rallied to its current level of 111 basis points as of January 2015. We expect this trend to continue, creating the opportunity for near-term cap rate compression in addition to cash flow upside via occupancy gains and rent growth.



Source: Real Capital Analytics, as of Jan 31, 2015

We believe that there are bright times ahead for suburban office. The change in migration patterns seen in the years since the recession has been driven by a sluggish recovery in the labor market and single-family home construction. However, the primary drivers of suburban migration – affordable housing and good public education – are every bit as relevant today as they were in the decades preceding the Great Recession. Over the next five years, the largest wave of college graduates in United States history will be hitting the workforce, resulting in a projected 10.6% increase in office jobs⁴. CBD office construction will be constrained by lack of land availability and high residential demand, whereas in the majority of suburban submarkets, rents remain well below levels needed to entice developers to build. While the containment of supply is a benefit for the office market as a whole, we expect it to have a more pronounced impact on suburban markets given the glut of construction last cycle. Furthermore, the increased cost of housing in the urban core should result in an increase in workforce migration to the suburbs over time, making a suburban office location more viable for employers.

To summarize, our view is that suburban office continues to be overlooked by capital and offers financial upside due to attractive supply and demand dynamics. Specifically, we are attracted to supply-constrained suburban submarkets that offer all of the amenities of a CBD location with proximity to more affordable residential. We believe that the most compelling investment opportunities in this part of the cycle will combine an advantageous market environment with the opportunity to add value through financial problem solving or physical repositioning of an asset – and that the American dream is alive and well in the ‘burbs.

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⁴ U.S. Bureau of Labor Statistics