



PCCP Market Commentary

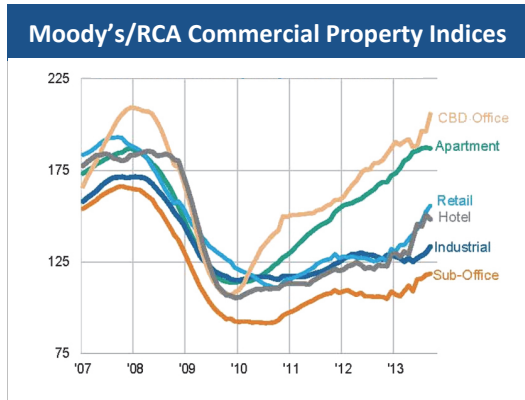
Basic Instinct

Second Quarter 2014

This quarter we're focusing on basic rules of economics: specifically, supply and demand. It is commonly understood that the Global Financial Crisis was not a real estate driven recession powered by commercial oversupply, like the early 1990s recession. Rather, it was caused by residential real estate over-pricing, largely driven by over-heated financial markets.

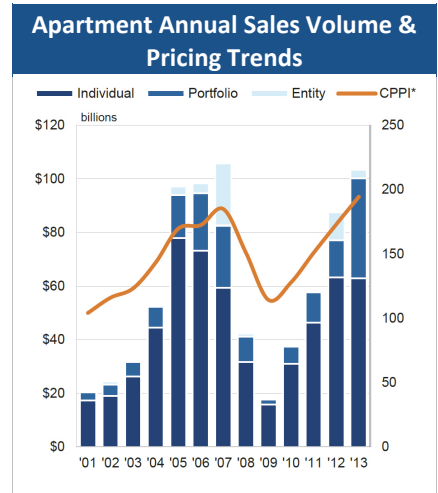
But the rules of supply and demand are still in operation in commercial real estate. We can see them at work in the multifamily sector, where a demographic shift has created fundamental demand, resulting in higher rents and now, more supply. Demand is growing fast enough to absorb new increases in supply, as evidenced by rate increases – is this happening in the office market?

In the core office sector, it is investor demand, rather than fundamentals, that is driving pricing. The global flight to quality is bringing more investor capital to the U.S., and the “risk off” mentality within real estate drives investors to core real estate. As a result, gateway office pricing has taken off, and it may be at or near peak valuation.



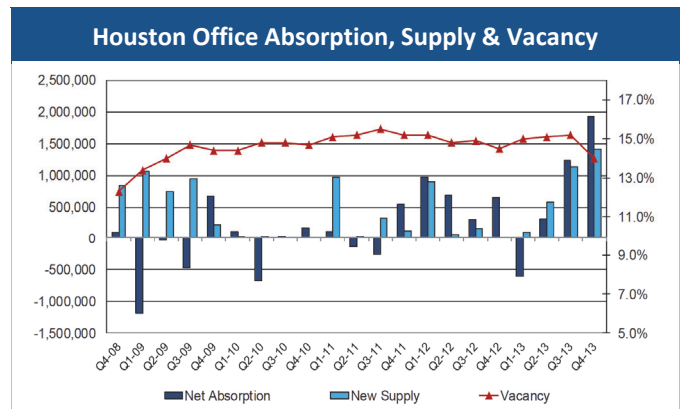
Source: Real Capital Analytics

Historically, Houston has not been a core market. But now with the U.S. becoming more energy self-sufficient, Houston, the energy capital, is attracting core investors worldwide. The fundamentals are strong. Houston saw some of the highest job growth in the U.S. in 2013, with over 85,000 jobs created and 3% growth over 2012.¹ The outlook for 2014 is equally promising, and the speculative office construction numbers tell the same story. There were about 4 million square feet of office space delivered in



Source: Real Capital Analytics

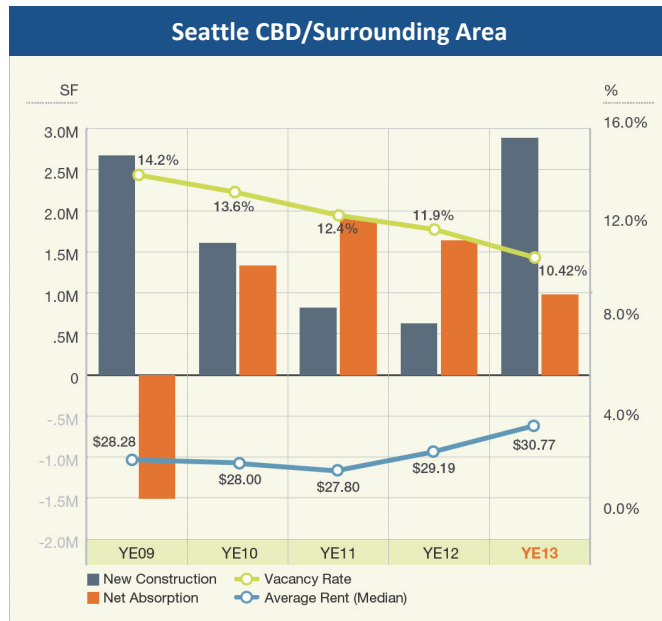
Because real estate developers have a history of over-reacting to demand, we thought it would be interesting to take a look at supply to see if it has caught up with demand, or if it might be starting to overshoot its mark. Our canary in the coal mine is speculative office development. We'll look at two very hot markets, Houston and Seattle, to make our point.



Source: Colliers Q4 Houston Office Report

¹ U.S. Bureau of Labor Statistics, Houston Area Economic Summary, February 4, 2014.

Houston’s 270 million square foot office market in 2013, 74% of which was delivered pre-leased.² That does not feel like oversupply. While these recent deliveries did not add significant vacant supply to the market, let’s note that there are over 18 million square feet currently under construction and an additional 19 million square feet proposed or entitled on top of that. Clearly, Houston’s economy is booming, and this remarkable growth in supply might seem warranted. But 37 million square feet in the pipeline is almost 14% of the whole market, and despite strong pre-leasing momentum, this level of development counsels caution on Houston office.



Source: Kidder Mathews Seattle Q4 Office Report

Seattle is also new to the “core” party. It has long been an attractive, smaller market tucked away in the Northwest. Over time, however, its tech industries have driven demand. Now with more capital flowing into the U.S. from the far east, and with Amazon dominating the retail world, Seattle has become core for many investors. Seattle’s 119 million square foot office market saw only 506,000 square feet delivered in 2013.³ Supply in 2014 and beyond looks a bit different. While 60% of the 4 million square feet currently under construction belongs to Amazon or is otherwise pre-leased, there are another 21 million square feet proposed or entitled. That’s almost 18% of the market.

Do these numbers in Houston and Seattle indicate that speculative office will soon overheat? Will investors, as well as lenders, be disciplined? We continue to see interesting opportunities in both of these markets. But we have our eye on supply.

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² CBRE Market Reports, Houston Office MarketView Q4 2013.

³ Transwestern, Seattle Office 2013 Q4 Report.