PRIVCAPRE REPORTS/

In-depth Analysis From PrivcapRE.com
Q3 2014

Office

How global office market dynamics are changing, and what it means for investors

With Experts From:

Clarion Partners
Reis
Rockspring
TIAA-CREF
Shorenstein
JRT Realty
The Davis Companies

Office /

Editor's Letter

Office market fundamentals are transforming. From the type of tenants to the volume of space and the way offices are used, the sector, globally, is in a state of flux. This PrivcapRE Special Report pinpoints which trends private real estate LPs and GPs should concentrate on, and those that can be discounted.

First, we bring together four experts from Clarion, Reis, Rockspring, and Shorenstein to answer four questions that investors should be asking about U.S. and European office investments. With capital flows to core markets pushing valuations ever higher, concerns are mounting about whether capital is running ahead of fundamentals. For our experts, select markets and submarkets are experiencing aggressive pricing, and fundamentals largely remain in check, thanks in part to constrained supply.

That doesn't mean there aren't challenges ahead. Front-of-mind for the experts in our report are declining space needs as tenants look for ways to cut costs. Also a major concern are the shift in tenant demands as a new wave of industries—including tech, media, and energy—take the lead in space absorption from traditional industries like banking and financial services.

The demand created by such high-growth industries in markets like New York City (highlighted in this report in our interview with JRT Realty's Greg Smith) has been good news for landlords, pushing vacancy rates in some submarkets as low as 5.3 percent and resulting in a 30 percent spike in rents in just two years. For tenants, it is creating an affordability crisis, which could prompt more firms to their leasing options in peripheral markets.

For The Davis Companies, the key to successful office investment is creating unique spaces able to compete with the best Class A space. In an interview with PrivcapRE featured in this report, CEO Jonathan Davis shares his firm's vision for such a property, Pittsburgh's historic Union Trust Building, and discusses the cap-ex required to make his plans a reality.

Enjoy the report,

Zoe Hughes
Editor
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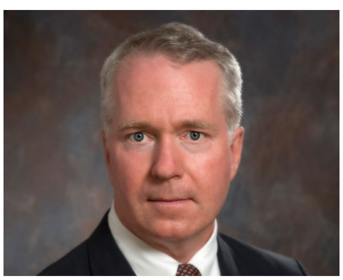
In This Report

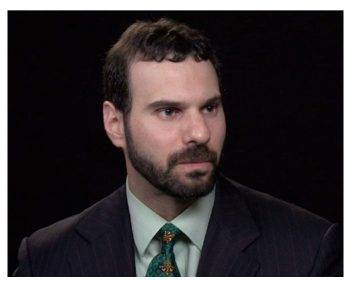
Four Questions Office Investors Should Be Asking

The office sector is undergoing a transformation amid dramatic changes in tenant demand, slow growth, and more efficient use of space. PrivcapRE spoke to professionals from Clarion Partners, Reis, Rockspring, and Shorenstein about their outlook for the office sector, and the four questions investors should be asking.



David Gilbert
Chief Investment Officer,
Head of Acquisitions
Clarion Partners

Glenn Shannon
President
Shorenstein



Ryan Severino
Senior Economist,
Reis, Inc.

Jose-Luis Pellicer
Head of Research,
Rockspring

Bio

David Gilbert is a member of Clarion Partners' executive board and operating committee, chairman of the firm's investment committee, and responsible for the firm's investment research group. He has previously worked at CalPERS and was global head of real estate for JP Morgan Partners. He has also worked at Prudential Real Estate Investors, First Boston, and Salomon Brothers. Gilbert holds degrees from the University of Massachusetts and the Wharton School of the University of Pennsylvania.

Bio

Glenn Shannon works in the Shannon joined Shorenstein in 1994. After spending seven years heading the company's New York office, he relocated to San Francisco to assume the role of president. Prior to Shorenstein, Shannon was partner at Shearman & Sterling LLP. He has degrees from Williams College and from the University of Michigan Law School.

Bio

Ryan Severino works in the research and economics department at Reis. Prior to Reis, he served as the associate director of research at MetLife Real Estate Investments, responsible for macroeconomic and real estate market analysis. Severino has also worked at Starwood Capital Group as director of investment strategy. He is an adjunct professor at Columbia University and New York University and holds degrees from Columbia University and Georgetown University.

Bio

Jose-Luis Pellicer is head of research at Rockspring and helps the firm's fund managers shape investment and sales strategies throughout the U.K. and Europe. He has previously worked for Deutsche Bank, as well as for the European Bank of Reconstruction and Development, Goldman Sachs, and AEW Europe. He holds degrees from the Universidad Carlos III de Madrid, the Université Catholique de Louvain in Belgium, and the Cass Business School in London.

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#1. Are valuations ahead of fundamentals in core U.S. markets?

When central business district offices can trade hands for sub-4-percent cap rates, it's time to ask whether office property valuations are ahead of fundamentals.

The reality is complicated, says David Gilbert, chief investment officer of Clarion Partners. "Values are nothing more than the intersection of capital flows, rents, and fundamentals, and it's impossible to disaggregate them." But while the impact of capital flows into, and within, the U.S. are being felt in an array of markets, with aggressive pricing in some areas, it doesn't mean fundamentals are lagging behind.

Glenn Shannon, president of Shorenstein, says demand for U.S. core office has never been stronger and isn't going to weaken soon, because it represents good value relative to other investment options. In a few key markets, such as New York, Boston, San Francisco, and Silicon Valley, Shannon says there are "some very astute investors selectively making the bet that we are going to have very significant rental growth [in the office sector] over the next three to five years." Given the track records of the investors and the amount of equity being committed to the markets, Shannon says, "you have to take seriously the possibility that their investment thesis will prove correct."

For Shorenstein, the focus is broader. "We believe there are going to be 15 to 20 distinct [U.S.] office markets and submarkets that will outperform," he says, "because they offer a confluence of factors that produce a vibrant live-work-play environment that will attract the employee base that companies are seeking."

Gilbert agrees that the pace of foreign capital flows into the U.S. is "significant," but it isn't all going to the top five markets of New York, Los Angeles, San Francisco, Washington, D.C., and Boston. "It's surprising how broad the destinations of foreign capital flows have been, including Houston, Atlanta, Miami, and Seattle," he says.

The challenge for the top five markets is expected to be the pace of economic growth, according to Gilbert. "Much of the rental growth we've seen is a recovery from cyclical lows, and that's over. "And cap rates are also unlikely to decline further. From here on in, it will be about the impact that fundamentals have on rental growth."

#2. Is new supply a concern in core office markets?

The topic of supply is critical to any conversation about valuations and fundamentals. Given the slow pace of recovery in Europe and the U.S., there's little concern about an oversupply of new offices and a subsequent rise in vacancy rates and fall in rents, says Reis senior economist Ryan Severino. But there are pockets of development in the U.S. to be aware of.

"A lot of the construction that's occurring [in the U.S.] right now still requires a significant amount of pre-leasing in order for the construction financing to become available, probably at least 40 percent to 50 percent, if not a greater extent than that," says Severino, adding that the industry is "a ways removed from seeing construction come back in any meaningful fashion."

Gilbert agrees, saying there is a "narrow list" of markets where new office construction makes economic sense. Where development is occurring, it is clustered in submarkets such as New York's Hudson Yards and the downtown World Trade Center area. San Francisco and Houston have also been home to significant new development, Gilbert says, but these markets have seen exceptional demand and pre-leasing as well.

With this supply-and-demand profile, in the next four to five years, U.S. office vacancies are likely to fall to 14 percent from 17 percent, and rent growth to accelerate to 3.5 percent or 4 percent, Severino says. "That's not, in the broader context of the office market, the healthiest market environment that I can imagine, but it's certainly a lot better than where we've been over the last five to six years."

For Europe, the supply story is much more muted, says Rockspring Property Investment Managers' head of research, Jose-Luis Pellicer, with a lack of financing and stricter planning systems constraining new development.

"The European banks, contrary to the U.S., are still clearing their balance sheets, so any development has to be financed predominantly through equity, and the return is far too low," says Pellicer. That fact, though, makes Europe an interesting investment option.

"Never forget that the fundamental difference between Europe and U.S. is the supply side," Pellicer says. "Planning in Europe is far more stringent than the U.S., so you don't need to be consistently investing in assets to keep them competitive. U.S. investors looking at Europe see low cap rates and low economic growth, but they're missing a crucial element, which is the structural lack of new supply —and that makes investments far safer."

#3. Is it all about the tech industry?

The technology, advertising, media, and information technology (TAMI) industries are shaping demand and rent dynamics in certain office submarkets across the U.S. and Europe. By taking office space in formerly staid or neglected areas, they are transforming unloved markets into cool, hip places to work. And by demanding different types of office

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space—largely open-plan offices in existing buildings—these TAMI industries are forcing landlords to change the way they look at their assets.

"It's about the 'next big thing' in business, and targeting businesses that are willing to pay a premium to be in the very best locations," says Pellicer. During the financial boom, the next big thing was hedge funds. Today it's the tech sector, Pellicer says, but he warns that not all tech firms are created equal. "Tech startups…are not making the high revenues and revenue growth that the likes of Amazon and Google are."

Gilbert agrees that the high prices being achieved in core U.S. markets could result in a "wake-up call" regarding affordability and occupancy costs, pushing tenants into other areas.

"For Google and Salesforce and the like, they want unique high-quality real estate, and occupancy costs are not their top concern," Gilbert says. "But for niche firms that are growing fast, there's an affordability issue, and we are seeing it in New York's Midtown South, where rents three years ago were in the region of $50 a square foot.

"When those leases come up for renewal and the new rent is $80 a square foot, what will those tenants do?" asks Gilbert. They're going to go downtown, to Long Island City, to Brooklyn and further west—to areas that still allow them access to talent but provide cheaper rents."

This new pattern of tenant demand is shaping investment strategies at Clarion and Shorenstein. Gilbert says it isn't just tech firms eyeing new markets and submarkets. Finance, insurance, and real estate industries are also looking to move jobs to "lower-cost places like Dallas, Phoenix, Salt Lake, Austin, Raleigh—and that's a function of cost pressures and seeking high-quality places for employees to live."

Shannon says the "demand recovery [in U.S. office] has clearly spread beyond technology, media, and other creative uses" with increased occupancy and demand across all industries, "including expansions and extensions by more traditional office tenants who had previously been reluctant to take on more space."

For Shannon, success in the office sector is all about differentiating the product. Today that often means more efficient, and flexible, floor plates, higher ceilings, increased light and air flow, and in the case of older offices, "an authentic feel." However, redeveloping older office space is not for the faint of heart, Shannon says. "Some older properties, notwithstanding the amount of capital you pour into them, will never be sufficiently distinctive or efficient to command premium rents," Shannon says. "And the costs of these types of renovations can be difficult to estimate and hard to control. Mistakes will be made, I'm afraid, by investors who try to play into the creative office trend with the wrong projects."

Gilbert says investors can't ignore the dramatic growth in the energy sector. "I don't think there was a headline in the world that could have predicted the U.S. would be energy independent in the space of just a few years," he says. "In terms of real estate, the number one problem for energy firms is how to attract talent, so occupancy costs are low on their list of issues. It's about occupying real estate assets that allow them to capture talent."

#4. Should landlords be providing offices with only open-plan, collaborative spaces?

Reis' Ryan Severino says the answer is no, pointing to recent studies that indicate a decrease in worker productivity when traditional service and finance firms convert to open-plan office layouts. For TAMI industries, open-plan is here to stay. For more traditional industries, such as law firms, banks, and real estate service firms, Severino says it could end up being an "unmitigated disaster," and there could be a backlash against this style of workplace.

"If someone comes from an industry that's not used to this format, the research pretty conclusively shows that it actually decreases productivity," he says. "Instead of this sort of massive productivity boost that [office] landlords have certainly been touting, the empirical evidence fairly conclusively shows that the opposite occurs."

The shift to open-plan offices is due, in part, to a slack labor market and cost pressures resulting from the recession. "And so I think that this is a temporary response to very unique circumstances," he says. "Now, there are some industries that I think will probably stick with this format, but I think there a lot that are trying it out right now, and—I would say this is just some of my own anecdotes—the more I hear about business and professional services firms that haven't used this space trying it out, it just ends up being an unmitigated disaster." ■

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Changing Offices Put the Squeeze on Employees

The changing nature of office plans could make 100-square-foot-per-person office spaces a reality, says **TIAA-CREF's Martha Peyton**

Bio

Martha Peyton, head of real estate research and strategy at TIAA-CREF, provides investment research and portfolio strategy for its fixed-income and real estate portfolios. Previously, she worked with HSBC/Marine Midland Bank's credit policy division and domestic economics group. She also taught economics at Fordham University and Manhattanville College. Peyton received a B.A., M.A., and Ph.D. in economics.

PrivcapRE: The performance of the office sector has lagged behind other property types. Is that due to changing use of space by tenants?

Peyton: I don't think the jury has come back yet with a judgment about how important the structural change is versus the cyclical issues [and performance post–financial crisis]. Structurally, everyone recognizes that the way office workers carry out their activities has been evolving. There's less and less paper. Law firms are dismantling their libraries. Filing cabinets are disappearing. And the result of that is that businesses can squeeze more people into less physical space.

And what makes it even easier to accomplish that is that we are communicating differently. There's less talking on telephones. There's a whole lot more texting. There's a whole lot of movement toward varying styles of space within the same office complex.

Do you expect economic growth to really come back to help drive returns in office?

Peyton: We are seeing employment growth strengthen. And that is contributing to NOI growth in the office sector. It's contributing to slow but ongoing declines in vacancy rates. But what we are also seeing is that the preferences of tenants are shifting toward space that is more centrally located, space that we call more strongly amenitized space that's close to public transportation, space that offers retail to tenants, space that offers fitness centers. So there are winners and losers as the office market recovers. Every office property will not be a winner.

Will older CBD offices be the losers?

Peyton: In fact, those older CBD properties may actually have an advantage in that they are very attractive as redevelopments into what is being called creative space. Tech firms, tech operations in particular, have a taste for open ceilings, brick walls, older buildings. It's highly desirable space. What is having more competitive problems is isolated, smaller footprints, suburban office. And in that part of the office sector, there will be winners that are in better locations with more amenities, higher-density locations. And there'll be losers that just lose their place in the market and have to look for alternative uses.

So how low will density go, in terms of how much space each employer may take up?

Peyton: We are thinking that 100 square feet per employee may be a little bit too optimistic. But we think you can get pretty close to it, primarily because people do not necessarily come to the office every single day. So you may get to 100 square feet per employee, but you may have a third of them working in other locations every day.

I worry that this is one of the places where the story is better than the fundamentals. The fundamentals are improving, but they're not as good as a lot of people would have you believe.

What does all this mean for absorption and vacancy rates?

Peyton: If the supply of new office construction was coming online at its historic average, we would be looking at a problem, because we would then have too much. Vacancy rates would go up, and we'd put downward pressure on rents. But in actuality, there's very little new office space under construction. Part of the reason for that is the response of the supply side to this evolution in demand. So the market does work. ■

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NYC Office Tenants Look Beyond Manhattan

Manhattan's lack of affordable Class B and Class C office space is pushing tenants into Brooklyn, Long Island City, and the Bronx, says **JRT Realty's Greg Smith**

Bio

Greg Smith, Executive Vice President, JRT Realty Group is responsible for spearheading client services nationwide. He joined JRT in 1998 and has more than 24 years' experience. He has exclusively handled agency assignments totaling more than 13 million square feet and negotiated more than $2B in leasing, sales, and retail transactions. He provides strategic oversight for an 11-million-square-foot portfolio on behalf of TIAA-CREF and has exclusively represented the United Nations Federal Credit Union's real estate requirements for 15 years. Smith earned a bachelor's degree from Lafayette College and is a member of the Real Estate Board of New York.

PrivcapRE: You can't look at the performance of the U.S. office sector without addressing the radical change in tenant demands and appetites. And nowhere has that demand for office space shifted more than New York City. What are you seeing when it comes to that shift in demand?

Smith: One of the big drivers in the market is the TAMI tenants—what is described as technology, advertising, media, and information—and those tenants are pushing the bounds of the market as they look to move west and down. They're moving out of the traditional Midtown area into [submarkets such as] Midtown South, which is [now] one of the largest markets in the country.

Has this been a recent change?

Smith: It was always the case that the preferred locations were Midtown and Downtown, and Midtown South was kind of the no-man's-land in the middle. But now, because of the driving force of these new industries and the younger workforce, people are looking for more creative space. They're looking for open spaces that have shared desk space, high ceilings, big windows, and so they're finding themselves looking toward the kind of buildings in Midtown South.

So what does this mean for demand from the more traditional office tenant?

Smith: We had a large institutional bank come to visit a property that we are now handling in Long Island City. They have an Internet group within the bank, and they're finding that the staff working there want to find the same kind of cool creative space that advertising and media firms are going to. They're looking beyond the normal bounds of office space.

JRT did a survey for the New York City Economic Development Corporation recently, studying the competitiveness of the office market and the implications for Class A, Class B, and Class C space. Does NYC have enough supply of Class B and C space to meet demand?

Smith: No, we don't. And the demand is well in excess of what the supply, and that's why tenants are moving beyond Midtown South to find the space and looking to the outer boroughs, be it Brooklyn, Long Island City, or the Bronx.

Is building new Class B space even feasible now?

Smith: No, that animal doesn't exist. A building has character because it's an established building. It has wood floors and brick walls, and if the building were to be created new, it would be wildly expensive.

So as you look at the NYC market over the next five to 10 years, what are your expectations for rental growth?

Smith: We've reached a peak in that we're coming back to the pre-recession levels. [But recent reports] show that population growth by 2025 will be another 1M people, so as long as New York is a cool place for people to live and work, it will be on a growth spurt. And people will need to find space—and if they can't find it in Manhattan, they'll have to look elsewhere. ■

Major Shortfall in Class B and C Space to Leave NYC Tenants Wanting

New York City is expected to suffer a 6.3M-square-foot shortfall between demand and supply for Class B and C office over the next decade. In a December 2013 report to the city's Economic Development Corporation, JRT Realty, together with Alvarez & Marsal Real Estate Advisory Services, revealed no area of New York City would be left unaffected.

Driving Office Demand

Top Five High-Growth Industries and Their Future Appetite for NYC Office Space

Industry	Incremental Demand (Sq Ft) 2013-2025
Management, Scientific, and Technical Consulting	2.9M
Individual and Family Services - Healthcare	2.8M
Information Services	2.5M
Computer Systems Design and Related Services	2.2M
Home Healthcare Services	1.2M

Location, Location, Location

High-growth industries will account for 60% of the total growth in office demand in New York City's five boroughs over the next decade, focusing on Class B and C space.

Incremental Demand (Sq Ft) 2013-2025

	Manhattan	Brooklyn	Queens	Bronx	Staten Island	Total
Class A – all industries	8.4M	0.8M	3.7M	0.2M	0.2M	13.2M
Class B-C – all industries	7.6M	4.7M	1.8M	1.3M	0.6M	16M
Class A – high-growth industries	3.8M	0.3M	1.6M	0.1M	0.1M	5.9M
Class B – high-growth industries	7M	2.6M	0.7M	0.6M	0.5M	11.4M

Falling Inventory

New York City faces a 6.3M square foot shortfall in office space by 2025, with Brooklyn most affected.

(Sq Ft)	Manhattan	Brooklyn	Queens	Bronx	Staten Island	Total
Supply 2025	155.1M	29.6M	24.2M	7.1M	5.1M	221M
Demand 2025	154.2M	33.8M	25.8M	7.7M	5.6M	227.3M
Gap	1M	(4.2M)	(1.7M)	(0.6M)	(0.5M)	(6.3M)

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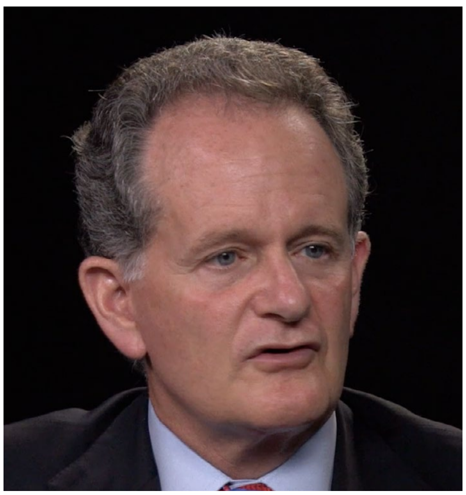
Performing Due Diligence via Bankruptcy Filing

Armed with nothing more than bankruptcy documents, **The Davis Companies** won the foreclosure auction for Pittsburgh's historic Union Trust Building. **CEO Jonathan Davis** explains the firm's strategy for turning the tired office property into Class A space.



Bio

Jonathan Davis the founder and chief executive officer of TDC, with responsibility for the general oversight of the company. He has more than 38 years of real estate management and development experience and has a central role in the identification and evaluation of new opportunities, capital raising, and performance of the company's portfolio. He graduated from Brandeis University.

PrivcapRE: You bought a Pittsburgh office building that you're repositioning out of bankruptcy. Why the Union Trust building?

Davis: The Union Trust Building was an opportunity made in heaven. It's 500,000 square feet, and it's in a prominent location in downtown Pittsburgh, which is growing and is experiencing a new vibrancy right now that is unparalleled in the last 60 or 70 years. But on top of that, it's a project that fell into deep distress. It's a building that was bought by California investors just before the recession hit, and they were not able to fill it. They got one lease done for about 40 percent of the property, and then the leasing market shut down. And when it came back, they were so far under water with their debt that there was no hope for recovery.

What did the sheriff's sale mean in terms of performing property due diligence?

Davis: The sheriff's office had no information at all, and [the lender] U.S. Bank, having just been through two very contentious bankruptcy proceedings with the borrower, was extremely hesitant to provide any information to anybody. They thought they were going be the only bidder and were going to buy it back at the auction.

What are your plans for the property? How much equity are you going to put in it?

Davis: We've hired a world-class firm that is doing the redesign of the property. We'll be spending a multiple of the purchase price [$14M] in capital improvements. The property needs a great deal of work. It's a magnificent structure, but it's suffered from many years of deferred maintenance.

Will you be converting this into Class A office space?

Davis: There is a real bifurcation in the Pittsburgh office market. The vacancy rate for Class A space is about 6 or 7 percent. For Class B office space, it's in the 15 or 16 percent range—still relatively healthy, but nothing like the really tight conditions in the Class A market. We believe we can compete, because of the unique architectural character of the property, it's location, and the improvement program that we envision for it.

What kind of tenants are you targeting, and does that really impact how you plan a redevelopment?

Davis: Traditionally the downtown tenant base in Pittsburgh, as in many CBDs, is financial services, professional services, and corporate firms. We actually think that there is a booming tech sector in Pittsburgh. It's more focused on the eastern neighborhoods of the city: Shady Side, East Liberty, and Oakland. But this building is so unusual we're already finding that tech tenants are perking up their ears and taking notice. ■

From the Archives

PERFORMANCE & PORTFOLIO MANAGEMENT

UPS Eyes Deal Control, JVs, Debt

Greg Spick is in charge of UPS's $1.3B real estate portfolio. He guides us through the company's asset allocation assumptions and the role RE needs to play in the corporate pension plan.

The Most Overlooked Ways to Drive NOI

A panel of experts from Yardi, CBRE, and Taurus explore the impact on returns of reducing expenses and driving revenue, and which focus gives the biggest bang for the buck.

DEBT

U.S. Debt Markets: Overfunded and Mispriced

Former CBRE Capital Partners president Ethan Penner talks about finding relative value in debt, how the European markets offer better opportunities than the U.S., and how broader mandates are critical to success as a PE real estate GP.

The Prospects for Real Estate Debt

Talmage LLC's CEO, Ed Shugrue, looks at what lies ahead for the real estate debt market.

JVs & CO-INVESTS

The Easiest JV Mistake to Make

GID International's Kenneth Munkacy offers tips on sourcing and structuring JV partnerships, and common mistakes to avoid.

The Rise and Fall of Catch-ups and Co-investment

Pamela Wright of Greenhill's real estate capital advisory group talks about the rise and fall of the two trends, and how GPs need to adapt their fundraising strategies accordingly.