

"We've Got the Southwest Covered"

The Texas Office Investment Market – Mid-Year 2006: A View From the Field

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OFFICE INVESTMENT MARKET ACROSS TEXAS REFLECTS STRONG INVESTOR DEMAND

The Texas office investment market is performing at a torrid pace through the first-half of 2006, carrying the momentum set last year as investors anticipate recovery in occupancies and rents. During the past 12 months a total of \$8.7 billion in office sales transactions have been traded in the Lone Star State. The searing level of volume represents nearly a 24 percent increase in comparison to the same time period in 2005. The increase in sales volume derives from investment buyers rallying around strengthening office leasing market fundamentals, while sellers continue to capitalize on heavy investor demand. Additionally, the growing appeal of income producing properties as an alternative investment tool is further fueling demand. As a result, substantial capital is being directed towards real estate. Through mid-year 2006, the average price per square foot in Texas rose in every market, while cap rates stabilized at an average of 7.5 percent. Most impressively, Dallas, Houston and Austin each have witnessed a 5-year record high price per square foot sale within the past year.

HOUSTON

Office investment activity remains strong in Houston, as interest rates remain low and real estate returns continue to outshine alternative investment options. According to *Real Capital Analytics*, private, public and institutional investors have spent nearly \$3.0 billion within the past 12 months (through June 2006) to acquire office properties in the Greater Houston area. Consequently, investors' appetite for top-notch, well-leased buildings has driven investment sales to record prices. Within the past year, sales prices have increased by 11 percent in the Greater Houston area, which signals that improving rents and occupancies are becoming primary price drivers.

The most popular assets within the past year have been Class A buildings, located primarily in the CBD, Galleria and West Houston. The largest office investment sale transaction for the year involved Thomas Properties Group Inc. through its joint venture with the California State Teachers' Retirement System, closing on its \$295 million acquisition of BMC Software Inc.'s campus. The disposition included a four-building, 1.5 million square foot campus and 24 acres of adjacent developable land in the Westchase area of Houston. Another recent notable sale involved FSP Phoenix Tower Corp., a REIT sponsored by Franklin Street Properties Corp., which acquired Phoenix Tower from Peak Phoenix Tower LP. According to RCA, the buyer paid \$169 per square foot, or nearly \$100 million for the 34-story, 629,000 square foot, Class A office building.

DALLAS/FORT WORTH

Record breaking sales and institutional buyers have also dominated investment market news in the Dallas/Fort Worth Metroplex within the past year. Through mid year 2006, the Dallas/Fort Worth market continues to lead the Lone Star State in total transaction volume. According to *Real Capital Analytics*, investment deals have accounted for \$4.3 billion worth of activity over the past 12 months. Meanwhile, average capitalization rates for closed deals in the past six months were 7.54 percent and 7.25 percent on new offerings.

The tight North Dallas office market has attracted many prospective buyers, resulting in two high-profile trades during the past nine months. Closing in December 2005, MetLife sold the three-building 1.6 million square foot Lincoln Centre to the Teachers Insurance and Annuity Association-College Retirement Fund (TIAA-CREF) for \$255 million. Just minutes away on the Dallas North Tollway, two Brooklyn-based investors acquired the prestigious 1.1 million square foot JP Morgan International Plaza from the State Teachers Retirement System of Ohio for a remarkable \$300 million.

While investment activity has been brisk in the suburban office submarkets, particularly Far North Dallas and Las Colinas/Irving, activity is slowly gaining momentum in the Dallas CBD. Construction cranes in Victory Park and the Arts District have contributed to the revitalization of downtown Dallas, and the investment market is beginning to heat up. In the news most recently, Los Angeles-based Younan Properties Inc. became the largest private owner of Class A office properties in Dallas when the firm acquired the 900,000 square foot KPMG Centre in the CBD for an estimated \$70 million.

AUSTIN

Investment trade activity has also been strong in the Austin office market totaling \$1 billion for the twelve months ending June 2006, based on data from *Real Capital Analytics*. Now in an economic rebound, office buildings in Austin have been attracting buyers willing to pay premium prices for Class A and B office assets. Leading the Texas market, Austin is currently averaging in excess of \$150 per square foot for investment grade office properties.

The most significant office sale transaction in the Capital City within the past year involved 300 West Sixth, a 23-story downtown office tower which sold in October 2005 for a record price to Equity Office Properties Trust which has expanded its holdings with its fifth Austin purchase in less than a year. EOP paid \$131.7 million for the four-year-old building. At \$295 per square foot, the sale may also be a Texas record. Another notable sale involved Behringer Harvard REIT I Inc. recently purchasing a four-building office park known as The Terrace. According to RCA, the buyer paid \$270 per square foot, or nearly \$167 million for the 618,000 square foot office park.

SAN ANTONIO

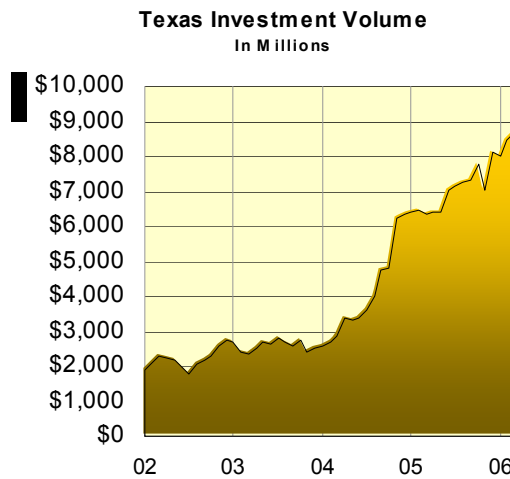
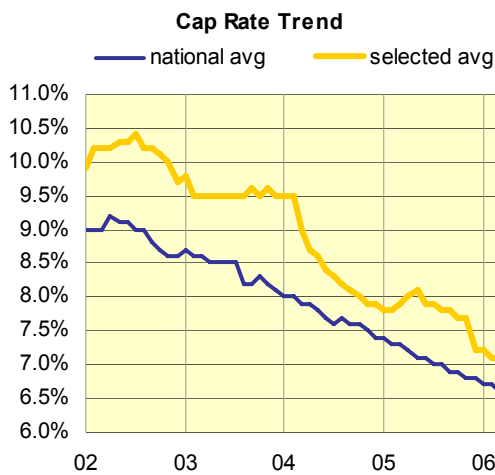
The San Antonio investment sales market has also been active with the anticipation of improved leasing momentum, which has outweighed investor fears of rising interest rates. According to *Real Capital Analytics*, investment deals have accounted for \$210 million worth of activity over the past 12 months. Meanwhile, cap rates for the San Antonio investment market have steadily decreased since the second half of 2003, but have leveled out and currently are averaging around 7.5 percent.

In recent months, private investors have accounted for the lion's share of the transactions as they take advantage of the local street-knowledge they possess. However, these opportunities are fast becoming scarce with the national investors now expressing more than casual interest in San Antonio's office product. For instance, the largest office investment sale within the past year involved San Diego-based, Equastone in the acquisition of One International Centre, a 15-story, 298,943 square foot, Class A office tower located adjacent to San Antonio International Airport at 100 NE Loop 410. In addition, Equastone has recently acquired North Central Executive Tower (formerly called Tetco Tower), a 256,000 square foot, Class A office tower located at 1777 NE Loop 410 in San Antonio.

Brand-names such as Washington Mutual, World Savings, and Toyota, have helped put San Antonio on the radar of investors across the nation. Washington Mutual's decision to relocate its headquarters to San Antonio, as well as Toyota's decision to lay stakes in the Alamo City has illuminated the benefits of making San Antonio a viable location for expansion and new venture opportunities.

INVESTMENT MARKET FORECAST

While much of the Class A office market has recently changed hands, the second-half of 2006 will likely see more property trades in the Class B market. Rents are rising and vacancies falling in this sector, and it's been mainly overshadowed by high profile Class A deals. Look for the Class B office market to emerge and increase its sales volume and values. While capitalization rates are hovering in the 7.5 percent range, cap rates are unlikely to fall any further in the face of long-term interest rates that are finally beginning to rise. Yet the sheer volume of capital still searching for commercial real estate in Texas will keep cap rates from rising very much over the next few quarters. Even if cap rates rise a little in tandem with higher interest rates, property prices should remain firm as rising asking rents provide a boost to net operating income.



All charts monthly, 12-month trailing, reported closed or in contract

Source: Real Capital Analytics, Inc.

Data believed to be accurate but not guaranteed; subject to future revision; based on properties & portfolios \$5 million and greater.