



This article brought to you by **Commercial Investment Real Estate**, the magazine of the **CCIM Institute**.

To read the entire issue or find out more about the Institute, go to www.ciremagazine.com.





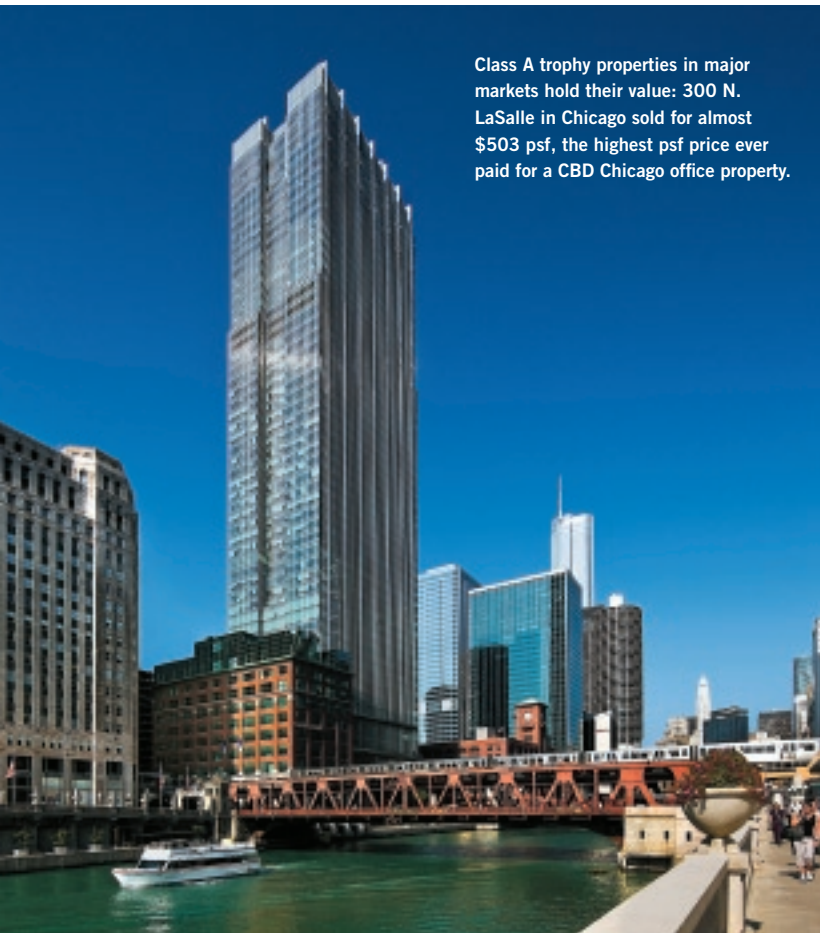


Running on Empty

Despite the stalled labor market, office investors are revving up for a recovery.

by Rich Rosfelder

The road is clear. Lenders have given the green light. Office investors sit in the driver's seat, poised to push the transaction pedal to the metal. But when they stomp on the accelerator, the car just creeps along. Its economic engine, **fueled by job growth**, only sputters.



Class A trophy properties in major markets hold their value: 300 N. LaSalle in Chicago sold for almost \$503 psf, the highest psf price ever paid for a CBD Chicago office property.

Hines

from 2Q09, reports Cassidy Turley. And stabilizing supply and demand drivers indicate that the office sector's natural healing process has begun in earnest.

"In my opinion, base rent economics have hit bottom," says Richard Egitto, CCIM, senior managing director with Crimson Services in Littleton, Colo. "And while I do not see rental rates increasing by the end of the year, I am hopeful that the market is stabilizing and that concessions will start to decline as we move into 2011."

But for office

investors ready to shift into high gear, hope may not be enough. "Where we have seen an uptick in leasing activity in the first half, it reflects firms' greater confidence in a sustained economic recovery — however prodding that may be — and an expectation of a return to job growth," says Sam

Chandan, global chief economist and executive vice president with Real Capital Analytics. "For activity to be sustained, however, those expectations must be substantiated by meaningful progress in the labor market."

Alternative Fuel

Traditionally, those searching for the gateway to recovery in the office investment sector could look past stagnant employment numbers and focus on the books of the companies that do the hiring, says Kevin Thorpe, chief economist for Cassidy Turley. Corporate profits, which were up 34 percent in 2Q10 from 2Q09, often lead job creation by six months to nine months. However, uncertainty about the impact of new government policies and renewed caution resulting from a particularly grueling downturn have delayed hiring. "Corporate America is still catching its breath and won't be too aggressive this year," Thorpe says.

The numbers bear this out. The financial-services sector, which normally leads office-using job recovery after a downturn, shed 17,000 jobs in July, according to BLS. "Now the recovery is being led by atypical office sector users including education companies/universities, the energy sector, healthcare companies, and the federal government," says John Sikaitis, director of office research, Americas, for Jones Lang LaSalle.

Why can't the office market speed to recovery?

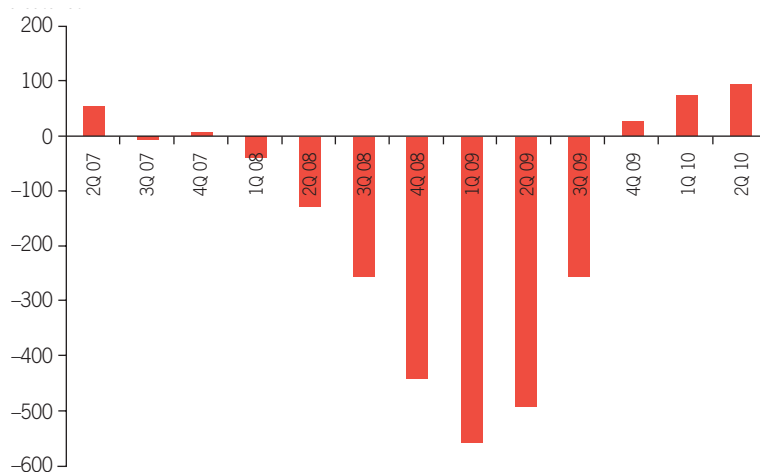
One problem is the gas: It's leaden. The private sector added only 71,000 jobs in July, according to the Bureau of Labor Statistics. Though this was an improvement over the 41,000 added in May, it still falls well short of the hiring activity needed to sustain a recovery. July also marked another round of layoffs among temporary census workers, leaving 143,000 unemployed again and offsetting the gains in the private sector.

Despite the correlation, a lack of significant job growth has not completely stalled real estate investment activity. "From institutional investors down to private-capital money, including some new to commercial real estate, financial planners are recommending that their clients diversify their portfolios outside of stocks and mutual funds," says Jerry A. Williams Jr., CCIM, vice president of Grubb & Ellis Co. in San Antonio, where office sales transaction activity increased 6 percent from second quarter 2009 to second quarter 2010.

In 2Q10, national office sales volume reached \$7.42 billion, a 39 percent increase

U.S. Office-Using Employment

(in 100,000s)



Source: U.S. Bureau of Labor Statistics/Cassidy Turley

In the Phoenix area, for example, several medical trade schools and universities are planning to expand to meet the need in both the healthcare and higher education sectors. “There are partnerships being discussed between healthcare providers such as the Mayo Clinic and Arizona State University,” says Julie Johnson, CCIM, executive vice president with GPE Commercial Advisors in Scottsdale, Ariz.

Healthcare reform legislation also has spurred development and sales activity. In Denver, “Kaiser Permanente just announced a number of new [medical office buildings] and hospital locations throughout the metro area, and Centura soon will break ground on an MOB and emergency center in Castle Rock,” Egitto says. “And cap rates, while higher than three years ago, remain attractive versus the rest of the food groups.”

But growth in these employment sectors alone probably won't be enough to help maintain healthy office investment levels. “Most office-using tenants still seem to be in cost-cutting mode, either downsizing or knocking on the owner's door with their hands out, which obviously doesn't help recovery,” says John Hale, CCIM, SIOR, of Davlyn Investments in San Diego. Though, he adds, “anxious buyers may overlook such dynamics by relying more on replacement cost than cash flow and yield.”

Though rare, bargains are out there for such buyers. According to the Pricewaterhouse Coopers *2Q10 Korpacz Real Estate Investor Survey*, suburban office buildings are trading at 50 percent to 100 percent of replacement cost. For now, however, competition for these properties remains stiff.

Investors and Lenders Shift Gears

In addition to their healthy appetite for bargains, investors are eager to find solid office assets. “The biggest complaint we're getting is about the lack of supply,” says Dan Fasulo, managing director of Real Capital Analytics. “There's an excess amount of capital that wants to be in commercial real estate, and prime core product is getting a lot of bids.” The resulting competition is driving up prices for the few well-positioned properties coming to market.

Much of this core activity is being fueled by institutional investors. Portfolio sales had

all but dried up last year, Thorpe says, but 2Q10 saw large funds returning to the game. A prime example is the \$1.4 billion sale of a 33-property office and industrial portfolio totaling 11.8 million sf from iStar Financial to Dividend Capital Total Realty Trust.

The return of debt capital also has energized investors. The Mortgage Brokers Association reported a 29 percent increase in loan originations for office properties from 4Q09 to 1Q10.

But financing isn't surfacing everywhere. “Office deals that can get done are in primary markets with little to no near-term rollover risk,” says Jeff Majewski, executive managing director of Grubb & Ellis' debt and equity finance group. “Sources of capital are the usual suspects. Life companies are in the 50 percent to 55 percent range of current underwritten value, and when it gets above 60 percent, the Wall Street players jump into the game.” Banks, too, are lending, says Majewski, but usually only to borrowers with which they already have relationships.

This year also marked the return of commercial mortgage-backed securities, which

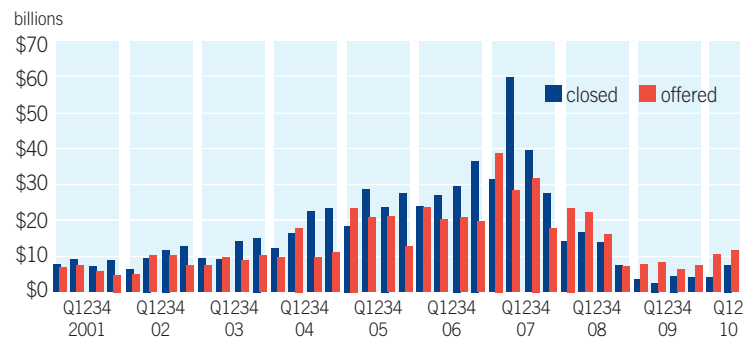
saw a 430 percent increase in loan volume from 4Q09 to 1Q10, according to the MBA. The \$2.4 billion total issuance for the first half of the year, however, is still well below even pre-boom lending levels.

Investors and users looking for properties priced under \$10 million in secondary and tertiary markets still need cash, seller financing, or alternative funding sources such as Small Business Administration loans. This situation isn't likely to change until the economic engine gears up.

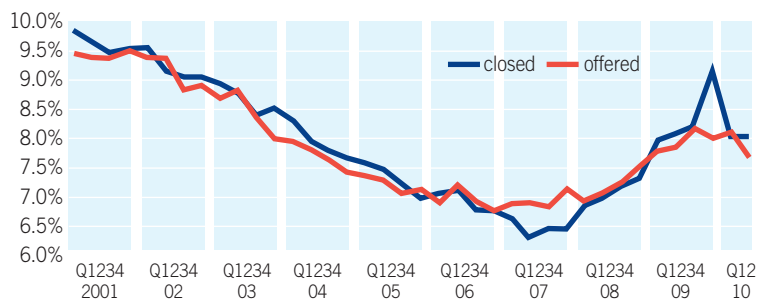
Porsches and Pintos

The influx of investors and dearth of available assets, coupled with the lackluster employment situation, have helped to create a bifurcated office market. “Outside of user-driven acquisitions, trophies and train wrecks are the only assets trading,” Williams says, citing the recent sale of the 325,600-square-foot, 95 percent-leased Union Square office portfolio in San Antonio from Urdang Fund/Griffin Partners to RL Worth and Associates. These class A and B office properties with stable cash flow “offer a good opportunity for

National Office Sales Volume



Average Office Capitalization Rates



Source: Real Capital Analytics

institutional investors looking to ride the real estate cycle as potential upside in rents,” he explains.

Thanks in part to similar trophy transactions, office asset values are recovering rapidly in first-tier markets such as Washington D.C., Boston, New York, and Chicago. For example, in June Hines Interests sold the 1.3 million-sf 300 N. LaSalle Chicago office tower to KBS Realty Advisors LLC for \$655 million or \$503 per sf, the highest psf price ever paid for a Chicago office building. The current value recovery is inextricably linked to these “core assets with bond-like qualities,” Fasulo says.

The extreme bifurcation of the market also encourages value recovery, since a separate set of comps is produced for stabilized assets and distressed assets. This way, Thorpe says, “pricing of distressed assets won’t bleed into core assets and affect pricing.”

But most markets are still waiting for the sell-off of distressed assets that will produce comps for those properties. Though RCA recorded \$9.3 billion worth of new distressed assets in May, up from \$5 billion in April, more than half of that increase can be attributed to the transfer of one \$4.9 billion portfolio. In the majority of metros, where distressed assets make up less than 5 percent of the total office inventory, lenders are working out loans or “brokering” sales to qualified buyers. And in San Antonio, “Competition for distressed assets is causing these properties to trade at above what we feel are proper market values,” Williams says. This, in turn, perpetuates the bid/ask gap and keeps other properties off the market.

When these properties do hit the market, listing agents will need a good sales pitch. Beth Young, CCIM, LEED-AP, vice president with Grubb & Ellis in Houston, and her partner Henry Hagedorf, CCIM, LEED-AP, recently listed two distressed office assets that have generated interest from investors as well as users. “Since the buildings are advertised as value-add opportunities and both are in stressed submarkets, we need to make sure potential buyers understand how great the renovations are and that there are justifiable reasons for the low occupancy,” Young explains. “Investors have been very cautious about this category; and if they don’t

have cash on hand, they are not likely to get a loan on a distressed asset.”

Though the train wreck tracks have been relatively quiet, there will be an increase in distress before the end of the year, Thorpe says, “but whether this grows into a tidal wave or remains a series of ripples depends on the speed of the economic recovery.”

Despite mixed signals coming from the labor market, office investors seem confident

that the economic engine will purr once again. “Sales activity is up 20 percent from last year,” notes Thorpe. “You wouldn’t see investors betting on office properties if they didn’t expect a continued recovery.”

In the meantime, settle in for a Sunday drive.

Rich Rosfelder is associate editor of *Commercial Investment Real Estate*.

HOW WILL THE NEW HEALTHCARE LAW AFFECT THE MOB SECTOR?

On March 23, President Obama signed the healthcare reform bill, which requires most people to obtain health insurance coverage by 2014 and is expected to add an estimated 32 million people to health insurance rolls by 2019. Though some uncertainty remains about the legislation’s long-term impact on the medical office sector, the influx of newly insured patients, coupled with the 80 million baby boomers who are now reaching the age of high healthcare needs, is expected to bolster the demand for medical office space.

“Healthcare is an industry that will not diminish,” says Ken Rochester, CCIM, manager with Lord Baltimore Properties in Baltimore. “While the legislation may change the way healthcare professionals practice their business, it will not affect the demand for medical office product and the desire of investors to seek out well-located properties with attractive amenities and features.”

The question that remains, however, is: *How* will the legislation increase demand for MOB space?

The answer lies in the financials. As they prepare to accommodate the influx of new patients, healthcare professionals are expected to scrutinize overhead, personnel, and real estate costs. “Sole practitioners will have a hard time staying solo,” says Joanne Vollmer Mirelez, CCIM, MHA, an associate with the healthcare division at Investment Realty Co. in San Antonio. “With the consolidation of practices will come the need for larger office spaces.” And because often it is cost-prohibitive to convert regular office properties into MOBs, Mirelez anticipates that MOB construction will increase.

“The size of the new practice will likely be 5,000 sf to 7,000 sf rather than 1,500 sf to 2,500 sf as more practices will be purchased by hospitals and those physicians become employees,” explains Julie Johnson, CCIM, executive vice president, GPE Commercial Advisors in Scottsdale, Ariz. “The medical delivery model will be more of a larger medical clinic with integrated service delivery of radiology, outpatient surgery, or lab services rather than a small to midsize practice.”

However, until 2014, many MOB tenants are making decisions based on today’s market. “They’re blending and extending to take advantage of the depressed marketplace,” says Sam DiFranco, CCIM, SIOR, CEA, managing principal with Cresa Partners in Cary, N.C. “If they know they’re going to be in business, like where they are, and have less than two years remaining on their current lease, it makes sense to renegotiate now.”