National Highlights

Risk Tolerance Improves for Noncore Assets

As investors see slight, yet promising, signs that the U.S. economy is likely to evade a double-dip recession and that the supply-demand dynamics of the still-frail commercial real estate industry have mostly bottomed, there is an increased willingness to look for buying opportunities beyond either super core markets and trophy assets or vastly distressed properties. "Interest in secondary locations, Class-B properties, and value-added Class-A plays is heating up," remarks a participant. "I'm starting to see a few buyers take on more risk," says another. Such behavior suggests that both investors and lenders are gaining more confidence in the performance of the economy and the industry as a whole.

While buyers are not yet rushing in droves to acquire noncore assets and offerings in secondary markets, riskier plays are enticing a growing number of investors as the market for trophy deals is becoming saturated with eager capital. Heading into 2010, most investors were looking to purchase assets described as either "treasures" – high-quality, well-located properties with strong occupancies and stable rent rolls – or "traumas" – assets in need of repair, tenants, capital or any combination of the three, which could be acquired well below replacement cost. "There was fierce competition at both ends of the quality spectrum, but no takers for the middle assets," states an investor.

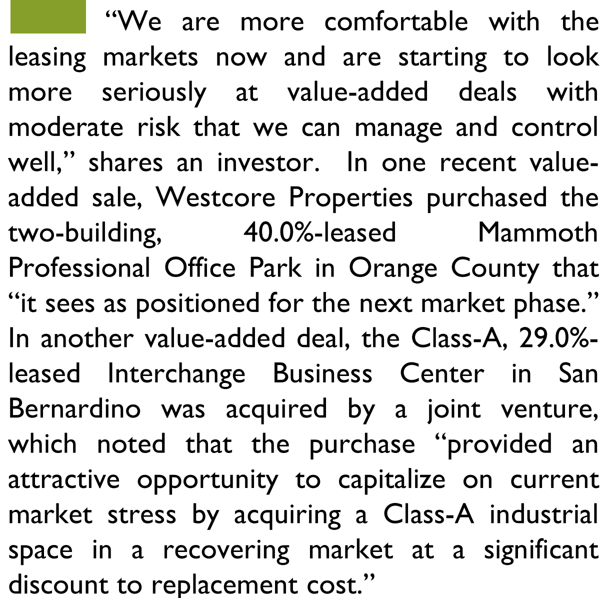
By mid-year 2010, the anticipated number of "trauma" assets fell short, leaving cash-laden investors targeting the same few top-notch offerings and prime markets. A flight-to-quality scenario had clearly emerged. At the same time, lending markets came back to life for quality deals, helping to further fuel investment demand for trophy assets. With a limited number of stellar offerings to satisfy investor demand, competition became intense for the best assets, particularly for core trophy office towers, resulting in lower overall cap rates and higher prices. In fact, the average price of office building sales closing above $25.0 million rose 27.0% year over year in November 2010, according to Real Capital Analytics. In contrast, the average price dipped 5.0% for sales between $10.0 and $25.0 million and rose only 9.0% for sales between $5.0 and $10.0 million.

Rising prices for an evaporating pool of core offerings, a desire for higher yields, and evidence that the economy and industry are both healing are main reasons investors are looking to widen investment parameters and take on additional risk.

CAP RATES

National Markets	Average	Quarterly Change*
Apartment	6.51%	-61
CBD Office	7.53%	-48
Regional Mall	7.58%	-23
Strip Shopping Center	7.63%	-46
Warehouse	7.98%	-40
Power Center	8.08%	-30
Suburban Office	8.17%	-23
MOB**	8.49%	-9
Net Lease	8.69%	-19
Flex/R&D	9.15%	0
Apartment Markets		
Pacific Region	6.58%	-32
Mid-Atlantic Region	6.65%	-50
Southeast Region	6.68%	-107
Office Markets		
Manhattan	6.02%	-21
Washington, DC	6.61%	-3
Los Angeles	7.46%	-30
San Francisco	7.57%	-12
Suburban Maryland	7.65%	-10
Northern Virginia	7.69%	+19
Pacific Northwest	8.25%	-16
San Diego	8.25%	-1
Denver	8.27%	-2
Boston	8.31%	-20
Chicago	8.41%	-16
Houston	8.49%	-33
Charlotte	8.53%	-21
Philadelphia	8.69%	-2
Dallas	8.75%	-1
Atlanta	8.84%	-11
Phoenix	9.23%	0
Southeast Florida	9.39%	+20

** In basis points*
*** Medical office buildings*
Source: PwC Real Estate Investor Survey



"We are more comfortable with the leasing markets now and are starting to look more seriously at value-added deals with moderate risk that we can manage and control well," shares an investor. In one recent value-added sale, Westcore Properties purchased the two-building, 40.0%-leased Mammoth Professional Office Park in Orange County that "it sees as positioned for the next market phase." In another value-added deal, the Class-A, 29.0%-leased Interchange Business Center in San Bernardino was acquired by a joint venture, which noted that the purchase "provided an attractive opportunity to capitalize on current market stress by acquiring a Class-A industrial space in a recovering market at a significant discount to replacement cost."

In 2011, most Survey participants expect many investors to continue to "move up the risk ladder" and look beyond core assets and prime markets for opportunities. As one long-time investor remarks, "Noncore assets have yet to experience the pricing surge currently occurring in the dominant gateway markets and could prove to be very smart investment plays at this point in the cycle."

Overall Cap Rate Analysis

The average overall capitalization (cap) rate decreased in 27 survey markets, increased in two of them, and held steady in two others over the past three months. As illustrated in Exhibit 1, the two highest decreases this quarter are reported for apartment markets – the national market and the Southeast region (declining 61 and 107 basis points, respectively). The national CBD office market also experienced a large drop this quarter due to aggressive bidding on the part of eager buyers for core assets, low interest rates, and an improved lending environment.

Although an increasing number of investors are expanding acquisition searches to include secondary markets and "impaired" assets, cap rate compression continues to mainly occur for better-positioned and well-located assets that exhibit stable rent rolls and limited near-term leasing risk.

Looking Forward

Strong buyer interest, combined with the reopening of the debt markets, continues to be recognized in investors' expectations that overall cap rates will either hold steady or decline over the next six months. As shown in Exhibit 2, Survey participants expect overall cap rates to hold steady in 24 of the Survey's 31 markets over the next six months. While four markets report the potential for decreases in the near term, none are expected to realize increases.

Markets where the majority of participants expect overall cap rates to decline in the near term include the national CBD office market (down as much as 50 basis points), the Charlotte office market (down as much as 110 basis points), the San Francisco office market (down as much as 100 basis points), and the Chicago office market (down as much as 50 basis points).

Key Indicator Breakout

Average overall cap rates remain lower for most CBD submarkets than for their suburban counterparts since higher barriers to entry and a lack of land for new development tend to keep supply and demand a bit more balanced in a market's CBD. As a result, CBD assets typically achieve higher rental rates. In addition, downtown cores tend to provide better forms of mass transportation and embody a 24-hour, live-work lifestyle that appeals to many individuals and firms. As a result, CBD assets are generally perceived as providing less investment risk – less risk, lower overall cap rate.

Local Market

Only 17 investment properties over $2,000,000 sold in Metro Detroit in the second half of 2010. Four office transactions closed with cap rates from 8.7% to 20% with sales per square foot prices of $49 to $380. Nine retail properties sold with cap rates from 7.88% to 14.36% and sales per square foot prices of $14 to $387. Two self storage properties traded with cap rates of 8.29% and 10.00%. Finally, two multi-family properties sold with cap rates of 10% and 11% and sales prices per unit of $20,714 and $30,256.