# RERC PARTNER PROFILE

## WILLIAM L. CORBIN, MAI

William Corbin serves as managing director of Real Estate Research Corporation's (RERC's) West Coast office, and has nearly 30 years experience in commercial real estate analysis, finance, and valuation. His previous experience in commercial real estate finance gives him particular insight to the capital and investment markets and their impact on institutional real estate activity and values.

Prior to his association with RERC in 2009, Mr. Corbin served with First American Appraisal and Consulting Services, LLC (formerly KTR Real Estate Services), where he was responsible for managing the Los Angeles regional office, developing and managing institutional accounts, and performing direct valuation work for those clients. While with First American, he also headed the firm's national pension fund valuation practice, and served as their designated representative to the National Council of Real Estate Investment Fiduciaries (NCREIF). Prior to his work with First American, he was an appraiser for Landauer Associates from 1992 to 1995.

Mr. Corbin has conducted numerous current value narrative appraisals for national and regional institutional lenders and investors on warehouse distribution buildings, industrial and business parks, office buildings, shopping centers, and apartments.

Mr. Corbin served as a mortgage banker from 1983 to 1992, when he arranged a wide variety of financing structures with institutional lenders and equity investors, including permanent loans, construction loans, and joint ventures. With George Smith Financial Services/Grubb & Ellis and Center Financial Group, he worked with over 90 institutions and closed over 150 transactions totaling in excess of $700 million.

As a consultant with Robert Charles Lesser & Co. in the early 1980s, Mr. Corbin performed over 75 market supply and demand, economic feasibility, and strategic planning assignments for prominent regional and national clients in more than 20 major metropolitan areas in the Western and Central U.S.

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# 2010 Investor Behavior As a Guide for 2011

By RERC Managing Director, William L. Corbin, MAI

After the economic collapse in 2008 and the sorting-out period in 2009 (when minimal transaction activity occurred), market transaction volume increased substantially in 2010. Top quality office assets (along with apartments) drew the majority of investment interest in 2010, propelling investment rates substantially lower than they were in 2009. Today, investment rates are currently approaching all-time lows for the highest quality assets in top national markets.

The decline in capitalization rates was and is driven by several key factors:

1. Flight to safe haven, low-risk investments,
2. Accumulation of idle investment capital needing to be deployed or opportunistic capital looking to capitalize on cyclically low prices,
3. Realization that the leasing markets' occupancy fallout and precipitous rental rate decline has stabilized or is near to stabilizing,
4. Substantial increase in lending activity and historically low borrowing rates, and
5. The limited supply of quality assets offered to market.

**Stabilization of Markets**

Most major California office markets have now experienced three to four quarters of stabilizing vacancies and rents as tenant attrition has waned. While there is essentially no positive office-using job growth yet, most markets seem to have found bottom, or at least the bottom is predictable and further decline is incremental. This has allowed investors to take a forward-looking approach to purchase underwriting. Most investors now view only market upside ahead, but market recovery timing projections vary widely and have low certainty. On the other hand, stabilizing market conditions have provided higher certainty and have given investors and lenders the confidence needed to transact. These market conditions also have signaled to bargain shoppers that the time to buy is now, as market pricing has reached its cyclical low point. In the better markets, values are already on the rise.

**Availability of Debt**

After the absence of meaningful investment and lending activity in 2008 and 2009, and as the general economy stabilized and the real estate markets approached their cyclical low points through 2009, both lenders and investors entered 2010 with pent-up desire and funds. The increasing certainty in seeing market occupancies and rental rates reaching their low points created confidence for lenders to re-enter the market with the expectation of meeting their production goals, and for new lending sources to emerge in early 2010. This, combined with the limited availability of asset offerings, created competition among lenders. As with investors, the competition was either for the top-quality, safest assets in major markets, or to a lesser extent, the bargain-priced distressed assets in quality locations with bright futures. Assets that did not generally fall into one of these two categories found debt difficult to obtain in 2010.

The competition for best assets is still substantial, particularly from life insurance companies and foreign (both Asian and European) and domestic banks, as evidenced by recent sales in California. The property at 333 Market St. in the San Francisco financial district leased to Wells Fargo & Company with 18 years remaining on its lease sold at a 6.50-percent capitalization rate in second quarter 2010, setting an investment rate benchmark. Investor competition was substantial for this asset, but lender competition was equally strong. Following that sale, Oakland City Center, a very good asset but considered not as simple or as safe, was offered in downtown Oakland. Bidders for that property reported that many of the same lenders that competed for (but did not win) 333 Market St. competed for the Oakland property, and debt rates lent were in the same range at both properties.

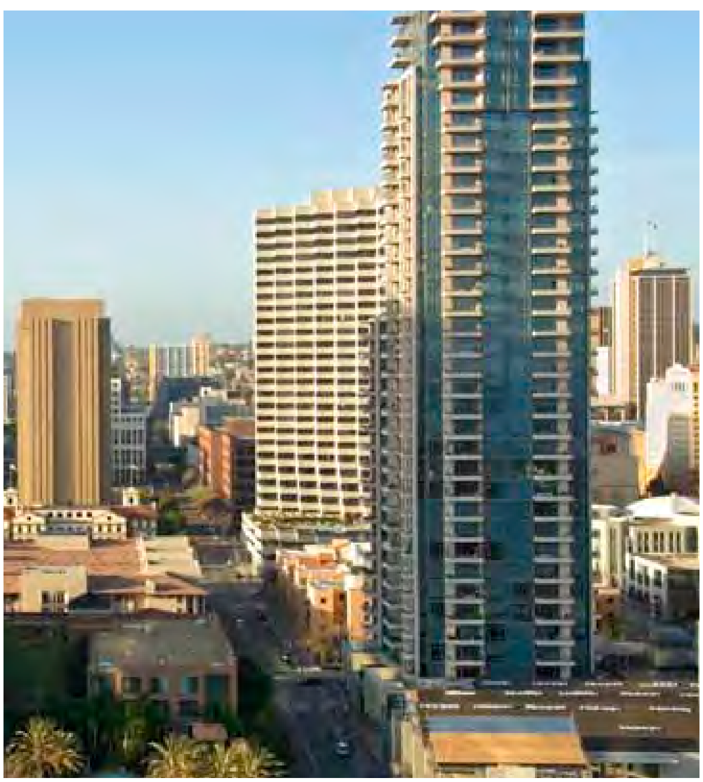
With general interest rates near all-time lows and debt rates close behind providing positive leverage on loan terms from 5 to 10 years, buyers of top properties were able to match expected holding periods with loan terms, creating an ideal situation for borrowers. In mid- to late-2010, fixed rates to the borrower were reported in the range of high 3 percent to mid-4 percent, and often they were interest-only for the first 5 years. Many of these fixed-rate loans were swapped from short-term London Interbank Offered Rate (LIBOR) based rates in the range of 1 percent. Lender spreads were in the range of 175 basis points to 200 basis points during the same time period for top properties, but beginning in 2011, we have heard reports that spreads were narrowing into the 150-basis point to 170-basis point range. Further, fixed-rate lenders and borrowers report that spreads could narrow further as 2011 progresses, if competition dictates and most fixed-rate lenders (banks and life companies) report healthy production targets for 2011. If there is upward pressure on base rates in 2011, some or all of the increase could be absorbed by lower spreads, although most lenders would be surprised if spreads went to 130 basis points or lower.

Mitigating the risk potential for higher rates going forward, Real Capital Analytics (RCA) identified three possible scenarios for general inflation and its effect on capitalization rates (see next page). The two most probable scenarios present muted probabilities for higher capitalization rates.

1. If interest rates increase because economic activity is strengthening, pressure on capitalization rates to increase will be mitigated as buyers will be able to reasonably underwrite rent growth and increasing net operating income (NOI).

2. If interest rates rise simply in anticipation of or concern for inflation, upward pressure on rates should also be mitigated because during past inflationary periods, the spread between capitalization rates and Treasuries has narrowed substantially, and at times has even gone negative, because "hard assets" such as real property (and precious metals) are considered a hedge if real estate market fundamentals are stable, as they are now becoming. RCA reports capitalization rate spreads to Treasuries (the real estate risk premium) are well above historic norms, currently approximately 421 basis points compared to the decade average of 277 basis points (this is for all property classes nationwide, not just top assets). These current higher spreads will allow the market to absorb further increases in interest rates without moving capitalization rates significantly.

3. In the scenario where there are deteriorating leasing fundamentals, a rise in interest rates could cause a rise in capitalization rates, but this would require a double-dip recession, which at this point appears unlikely (as we have reported that major markets in Southern California and the Bay Area have experienced three to four quarters of stabilizing vacancies and market rental rates).



**Limited Supply of Sale Offerings**

The key driver in the current investment market's performance is the limited supply of sale offerings. The only top core assets that have been brought to market since late 2009 have a compelling ownership issue or debt issue. These include portfolio level issues where underperforming assets have compelled a fund to sell best-performing assets, which have depreciated the least, to raise liquidity for the fund; forced sales from loan defaults on overleveraged assets with reduced cash flows as a result of lower market rents; or newly completed single-tenant buildings cashing out the developer. As 2010 progressed, additional best assets were offered nationally to take advantage of the acceleration in prices, where in some major markets, record prices were achieved.

While the volume of office sales was anemic in 2009, the international and national investment community was very active in 2010 for purchasing well-leased, high-quality office buildings in the best national markets, including West Los Angeles, New York (Manhattan), Washington, D.C., and San Francisco—the top performing investment markets over the last decade—as well as Boston, Chicago, and Seattle. Investors involved in bidding and winning these properties typically have long-term hold time horizons, and are seeking investment safety and value in the best properties. As a result of the small inventory of this type offered to market, investors began to expand the quality standards in terms of location and vacancy throughout 2010 and into 2011.

West Los Angeles historically has fewer transactions than the other top national markets. This is because it has more limited offerings, since the majority of the better Class A buildings are held by a handful of owners, with Douglas Emmett & Company and Blackstone/Equity Office holding the top two highest concentrations, in that order. Douglas Emmett & Company is a long-term holder, and Blackstone would possibly divest seeking highest value but also has the highest basis of all major Class A office owners, which has deterred it from selling assets to date. As can be seen in the following table, a few more assets were shaken loose in Southern California toward the end of 2010, but investors again began to stretch some in terms of location in order to obtain assets; none sold were in West Los Angeles proper, except for the former Hilton Hotels headquarters in Beverly Hills (9336-9346 Civic Center Drive), which was 100-percent vacant. This sale possibly represents the next phase in what has been an accelerated investment market recovery at the top end—buying vacancy (albeit for unique sites in top, protected markets). At the least, this sale shows that in 2011, buyers will become more creative and will stretch the envelope regarding what qualifies as a safe, long-term investment in order to place idle capital.

The following table lists the majority of recent sales of major buildings in the top national office markets, and illustrates the high price per square foot achieved by top buildings.

## RECENT HIGH VALUE NATIONAL OFFICE SALES

| Sale Date | Street | City | ST | SF | Age/Renov. | % Leased | Price/SF | Seller | Buyer |
|---|---|---|---|---|---|---|---|---|---|
| **Contract** | 12121 & 12181 Bluff Creek | Los Angeles | CA | 459,917 | 2007 | 90% | **$579** | Lincoln Properties | JP Morgan Asset Mgmt. |
| **Jan-11** | 9336-9346 Civic Ctr. Dr. | Beverly Hills | CA | 184,305 | 1985 | 0% | **$425**** | Blackstone Group | Tishman Speyer |
| **Jan-11** | 3101 Wilson Blvd. | Arlington | VA | 212,000 | 2003 | 100% | **$531** | Angelo Gordon | Heitman Capital Mgmt. |
| **Dec-10** | 521 5th Avenue | New York | NY | 490,000 | 1929/2007 | 93% | **$501** | City Investment Fund | SL Green Realty |
| **Dec-10** | 200 Clarendon | Boston | MA | 1,723,352 | 1971/2006 | 95% | **$540** | Normandy RE Ptrns. | Boston Props. |
| **Dec-10** | 800 Newport Center Dr. | Newport Beach | CA | 280,000 | 1982 | 98% | **$446** | Northwestern Mutual | Irvine Company |
| **Dec-10** | University Towne Centre | San Diego | CA | 125,200 | 2000 | 100% | **$507** | Collins Development | BioMed Realty Trust |
| **Dec-10** | 111 8th Street | New York | NY | 2,961,071 | 1932/2000 | 93% | **$598** | Jamestown/NYSCRF | Google |
| **Dec-10** | 1225 Connecticut Ave. | Washington | DC | 240,811 | 1968/2008 | 100% | **$897** | Brookfield/Blackstone | World Bank |
| **Dec-10** | 71 S. Wacker Dr. | Chicago | IL | 1,472,460 | 2005 | 95% | **$424** | Pritzker Realty Group | The Irvine Company |
| **Nov-10** | 6500 Wilshire Blvd. | Los Angeles | CA | 443,762 | 1986 | 99% | **$412** | TIAA-CREF | Lincoln/Morgan Stanley |
| **Nov-10** | 100 First Street | San Francisco | CA | 465,363 | 1988 | 94% | **$415** | Beacon Capital Ptrs. | Kilroy Realty |
| **Nov-10** | 2121 K St. NW | Washingtion | DC | 190,458 | 1981/2009 | 71% | **$433** | ING Clarion | TF Cornerstone |
| **Nov-10** | 1110 Vermont Ave. | Washingtion | DC | 305,000 | 1980/2007 | 83% | **$426** | GMAC/Perseus Realty | Tishman Speyer |
| **Nov-10** | 1501 M Street | Washington | DC | 170,224 | 1991 | 93% | **$464** | John Buck Company | JP Morgan Asset Mgmt. |
| **Oct-10** | 1111 Pennsylvania Ave. | Washington | DC | 331,264 | 1967/2002 | 100% | **$664** | Karasick/Shorenstein | INVESCO |
| **Oct-10** | 1299 Pennsylvania Ave. | Washington | DC | 560,000 | 1924/1992 | 93% | **$795** | Vornado Realty Trust | CPP Inv. Board |
| **Oct-10** | 180-200 Oyster Pt. Blvd. | S. San Francisco | CA | 205,000 | 2009 | 100% | **$609** | Chamberlin Assocs. | BioMed Realty Trust |
| **Oct-10** | 1750 H Street | Washington | DC | 111,510 | 2002 | 100% | **$583** | Nat'l Treasury Eply. Union | AEW Capital |
| **Sep-10** | 1899 Pennsylvania Ave. | Washington | DC | 186,000 | 1920/2002 | 100% | **$812** | Westwind Cap./DRI Ptnrs. | Paramount/Hamberg Trs. |
| **Sep-10** | 650 F St. NW | Washington | DC | 424,000 | 1924/2003 | 100% | **$625** | Tishman Speyer | Beacon Cap. Partners |
| **Sep-10** | 510 Madison Ave. | New York | NY | 350,000 | 2009 | - | **$786** | Macklowe Props. | Boston Props. |
| **Sep-10** | 11025 NE 8th St. | Bellevue | WA | 755,000 | 2008 | 100% | **$543** | Schnitzer/Investcorp | Principal RE Investors |
| **Aug-10** | 125 Park Ave. | New York | NY | 603,433 | 1922/2003 | 96% | **$547** | Shorenstein Properties | SL Green Realty |
| **Aug-10** | 11900 Gilbert St. | Garden Grove | CA | 11,938 | 1970/2007 | 100% | **$502** | Hewson Properties | Chiu Inv. Trust |
| **Jul-10** | 55 E. 52nd St. | New York | NY | 1,137,452 | 1981/2005 | 100% | **$590** | Fisher Brothers | Rockpoint Group |
| **Jun-10** | 1101 Pennsylvania Ave. | Washington | DC | 225,501 | 1898/1989 | 88% | **$798** | Westwind Capital Ptrs. | TIAA-CREF |
| **Jun-10*** | 300 N. La Salle | Chicago | IL | 1,267,331 | 2009 | 95% | **$499** | Hines Interests | TIAA-CREF |
| **Jun-10** | 1466 Broadway | New York | NY | 298,695 | 1907/2004 | 90% | **$624** | Prudential/Elliman | Highgate Holdings |
| **May-10** | 333 Market Street | San Francisco | CA | 657,177 | 1979/2005 | 100% | **$507** | Principal RE Investors | Downtown Props. |
| **May-10** | 340 Madison Ave. | New York | NY | 738,686 | 1920/2002 | 92% | **$772** | Broadway Partners | RXR Realty |
| **May-10** | 10 Brookline Pl. W | Needham | MA | 160,000 | 1971 | 100% | **$668** | Nat'l Dev./Chas.River RE | INVESCO |
| **May-10** | 1350 Eye St. NW | Washington | DC | 364,302 | 1989 | 100% | **$581** | Beacon Capital Ptrs. | EDGE Fund Advisors |
| **May-10** | 600 Lexington Ave. | New York | NY | 289,386 | 1985 | 94% | **$636** | Hines/Sumitomo | SL Green/CPP Inv. Brd. |
| **Mar-10** | Mission Hospital MOB | Mission Viejo | CA | 136,732 | 2008 | 100% | **$492** | Pacific Med. Bldgs. | Nationwide Health Props. |
| **Mar-10** | St. Joseph Med. Plaza | Orange | CA | 125,970 | 2008 | 100% | **$495** | Pacific Med. Bldgs. | Nationwide Health Props. |
| **Jan-10** | 299 Park Ave. | New York | NY | 1,049,280 | 1967 | 100% | **$600** | UBS Bancorp | Rockpoint Group |
| **Aug-09*** | 1999 K Street NW Bldg. | Washington | DC | 249,000 | 2009 | 100% | **$835** | Vornado Realty Trust | Deka Immobilien Invst. GmbH |
| | | | | | | **Avg.** | **$587** | | |

* Highest $/SF in city history
** Includes $125/SF renovation costs
Source: Real Capital Analytics.

Owners of high-quality assets in the better markets of metro Los Angeles County, Orange County, and San Francisco continue to hold their ownership positions; however, more high-dollar assets in these markets have transacted of late (although as witnessed by the locations, investors are now stretching the envelope to obtain quality assets in markets they project will perform well for the long term, in light of the very limited supply offered). In Los Angeles, 6500 Wilshire transacted at $412 per square foot, where the highest price paid for a Class A building in the Miracle Mile district of Los Angeles was $359 for Wilshire Courtyard in 2005. Horizon at Playa Vista is comprised of two average quality Class A buildings that are 90-percent leased to Fox Interactive Media (including Myspace) to 2021, but the project is vacant seeking sub-tenants. The project is located 4 miles south of Interstate 10 and what is considered West Los Angeles proper in the new Playa Vista master planned community. At $579 per square foot, this is the highest price paid for a Class A office building of at least 100,000 square feet in Los Angeles County or Orange County that is not in West Los Angeles proper.

Most indicative of the changed and changing investment landscape is Tishman Speyer's recent purchase of the vacant former Hilton Hotels headquarters in Beverly Hills located just east of the Triangle. Tishman Speyer paid approximately $300 per square foot for this vacant project. The buyer plans to invest $23 million ($125 per square foot) to modernize the two connected buildings, including mechanical systems, elevators, and landscaping (this does not include final tenant improvements allowances, leasing commissions, and lost rent). Brokers familiar with the transaction report the buyer's view is that the building could be worth in the range of $600 per square foot when completed, either leased to a major credit tenant as a long-term leased investment, or to an owner-user as the market may dictate. This, particularly, is a benchmark sale with the investor buying vacancy (as in the 2005 to 2007 market), albeit an outstanding location compared nationally with an asset size not reproducible in the market.

Emphasizing the dearth of quality offerings in Orange County, only two top Class A core buildings sold in 2010: 2211 Michelson and 800 Newport Center Drive. In San Francisco, there is an existing stock of approximately 47 million square feet of Class A space. In 2009 and 2010, only nine non-distressed Class A buildings totaling about 4 million square feet transacted (and this was one of the most active markets nationally in 2010!). Further, the Airport and Newport Center markets, Orange County's top office markets, and the San Francisco financial district, have no dominant ownership groups suppressing market activity, as does West Los Angeles.

### Underwriting

In fourth quarter 2010 and first quarter 2011, we have received multiple reports from national investment sale brokers and investors that while they "couldn't make the numbers work," they were nonetheless comfortable and felt safe with their purchase price on a per square foot basis in comparison to replacement cost. In other words, they were stretching their economic underwriting of cash flow by use of a combination of accelerated market rent growth, lower reversion capitalization rates, and/or lower discount rates beyond what was recently viewed as reasonable. In major California markets, replacement cost for significant Class A buildings is generally in the range of $450 to $650 per square foot, depending on the scope of the project and the land value estimate. Therefore, discounts to replacement cost are often achieved in the range of 20 percent to 40 percent, even with stretch underwriting. Institutional investors understand they have limited certainty as to when market performance will catch up to underwriting in many cases, but they are generally not concerned (on a relative basis) when buying the best assets in the best locations, as they have more confidence that these assets will appreciate and achieve best rates of increase on a comparative basis to other assets. Clearly, as the discount to replacement cost increases, the buyer is more protected and can afford more market risk with the asset, which has fueled the other active market segment—troubled properties with good long-term potential.

Generally, investors view discount to replacement cost as a risk mitigator because its presence usually reflects a protected market position for a property because construction of new competition

cannot economically be justified until a rise in market rent also increases the purchased property's value to the same level as the cost required for new construction. Now that the leasing market trough is known for most markets, investors are looking forward and are now commonly projecting accelerated market rent growth in better markets to the year in which they project market rent will rise to an economically feasible level for new construction. This level is now generally projected to occur in the later years of the 10-year projection period, depending on the market and the estimated current market rent. In some top Southern California and Bay Area markets, because of severe political constraints that have been in place for years, market rent has not declined below a cost-feasible level and there is no discount to replacement cost. Where these severe constraints exist, they are typically in markets with high demand, which exacerbates the supply and demand imbalance, and which in turn is the fundamental reason they are among the top few office markets in the nation.

Both West Los Angeles and the San Francisco financial district have experienced periods of exceptionally high market rent growth over the past two real estate cycles, because at some point, market saturation has occurred and without sufficient new development to relieve demand, market rents spike sharply. In West Los Angeles, market rent increased approximately 66 percent from 1995 to 2000, and 56 percent from 2004 to 2008, reaching market saturation only near the time of each market peak (and with the market rent trough higher in each successive cycle). In the San Francisco financial district, market rent increased in the range of 100 percent from 1995 to 2000, and in the range of 80 percent from 2003 to 2007 (also with successively higher market trough rents). This potential also exists for the next up market, and is reflected in current investor underwriting with some of the lowest capitalization rates in the nation being achieved and approaching those markets' all-time low rates.

**Summary**

There is a gradient among markets and asset qualities that is still somewhat steep and which reflects where and for which assets investors are willing to stretch their underwriting in order to make purchases, where and for which assets more conservative underwriting will prevail, and for which markets and assets investment consideration will still be absent. Now that the trough in leasing markets has been realized and as more idle investment capital aggregates, the range in investment quality—comprised of a combination of market quality, location uniqueness, building quality, and tenancy—for which investors are willing to stretch, should further expand in 2011. The return to investment in commercial real estate for risk diversification and safety, which has been the driving factor in the current investment market recovery, should continue to guide the speed and degree at which further progress will occur in 2011. The window for matching low rate, fixed-term debt with longer term hold expectations in an accretive manner should continue in 2011, providing a fertile environment for continued pressure on capitalization rates, and should also expand the range of assets investors view as suitable for acquiring. Supply-constrained California markets are poised to benefit the most from this confluence of positive investment market factors, which has been the case in the last two market cycles, as they have been among those markets to decline the least and improve the most.