

KORPACZ REAL ESTATE INVESTOR SURVEY[®]



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Making News This Quarter



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average initial year market rent growth rate assumption (except Southeast Florida, which held steady). On a year-over-year basis, this assumption increased in all but the Northern Virginia market. The average year-over-year increase was 113 basis points.

Sensing that many investors are eager to capitalize on rising rental rates, the volume of new offerings remains robust in the office sector. According to Real Capital Analytics, Inc., new offerings in the office sector totaled \$55.7 billion for the first eight months of 2006, 12.0% higher than the same period in 2005. Despite this slew of offerings, transaction volume was 27.0% lower in July 2006 than in July 2005. Nevertheless, the number of transactions has increased monthly since May 2006. One reason for the year-over-year drop in sales volume is that “all the good stuff has been sold.” Nevertheless, investors continue to purchase both core and opportunistic assets. “We pick CBD assets over suburban, as well as stable assets over partially leased ones,” shares a participant.

Unfortunately for investors looking for core, stable assets, prices remain very high and returns remain very low. “Overall capitalization rates are still compressed for the best office assets up for sale even though interest rates have increased slightly,” states a participant. In order to maximize their returns, some investors are opting to construct new office properties in both established and emerging office markets. “We will do development deals either alone or with a joint partner over the near term because rental rates warrant new construction, and we can achieve higher returns,” reveals a participant. “Many markets are short on supply, especially for large tenants,” comments a participant.

Barring another terrorist attack or devastating natural disaster, the U.S. economy is expected to continue to grow at

a steady pace and provide adequate demand for all sectors of the real estate industry. The end result is a positive influence on rental rates, net operating income, and property values that should continue to offer investors diverse investment opportunities.

USEFUL WEBSITES

Websites of interest are summarized below.

www.greenbiz.com: This website provides news and resources to assist companies in integrating environmental responsibility into profitable business practices. This site features daily news feeds, electronic newsletters, briefing papers, and links to additional websites – all at no cost to users. Top news headlines are added to this site by outside businesses, nonprofit groups, consultants, and federal organizations.

www.greenerbuildings.com: This resource is a free guide to understanding and addressing building design, construction, and operation related to environmental responsibilities. This site contains hands-on tools, action steps, and other resources that address underlying issues and promote cost-effective practices in order to improve the environmental performance of buildings. The information is divided into eight main topics that reflect the process most companies go through in addressing green-building issues.

www.usgbc.org: The U.S. Green Building Council (USGBC) is the nation’s foremost coalition of leaders from across the building industry working to promote buildings that are environmentally responsible, profitable, and healthy places to live and work. Council members work together to develop LEED® products and resources, the annual Greenbuild International Conference and Expo, policy guidance, and educational

and marketing tools that support the adoption of sustainable building. Becoming a member of USGBC via this website provides access to research and publications focused on sustainable growth. Users can also sign up to receive a free magazine exclusively covering the rapidly growing green building industry.

www.imt.org: The Institute for Market Transformation (IMT) promotes energy efficiency and environmental protection in the United States and abroad. The organization’s activities include technical and market research, educational outreach, and creation and coordination of program initiatives. There are a variety of publications available for downloading, as well as links to continuing education courses that address energy efficiency and commercial real estate for real estate professionals.

VALUATION ISSUES

RENT SPIKES

A rent spike is an increase in market rent that is markedly higher than the general inflation rate. For example, if inflation is 3.0%, one might expect a spike to be at least 50.0% to 100.0% higher, or say 4.5% to 6.0%. According to participants, rent spikes typically occur during the first five years of a ten-year forecast. Although they are most often applied in a series of years, an unusually high spike may be applied for a single year only.

Participants who apply rent spikes maintain that they are both extremely property specific and heavily dependent on submarket conditions. Specifically, they are used “where and when appropriate” in markets where hard evidence exists that rents will increase substantially in the future. Such evidence includes a diversified economic base, strong job growth, and an above-average rate of absorption. Furthermore, since many participants time the use of rent spikes according to anticipated supply-

Green Building Macro Trends – What You Need to Know

By Dan Winters, Managing Principal of Evolution Partners

GREEN BUILDING HAS ARRIVED ON THE SCENE IN REAL ESTATE CIRCLES NATIONWIDE AS ENERGY COMMODITY COSTS HIT NEW HIGHS AND GLOBAL WARMING CONCERNS MAKE HEADLINES. Trade organizations, including the ULI and NAIOP, now hold national and local conferences dedicated to green building. Both organizations have witnessed huge attendance growth at these conferences over the past several years, have published extensive texts on green development, and have annual green building awards presented to leading developers. Furthermore, the U.S. Green Building Council has seen its membership swell tenfold from 570 companies in 2000 to over 6,300 today.

It's clear green building is here to stay as the economics and political realities are enticing more developers, building owners, and savvy investors to embrace green building techniques within their investment decision processes. Many companies have made commitments to green buildings, including PNC Bank, Starbucks, REI, Whole Foods, SC Johnson, Target, Bank of America, Goldman Sachs, Adobe Systems, and Genzyme. Some do it for brand value. Others do it because green buildings attract and retain employees, reduce sick time, and in case study after case study provide the platform for companies to achieve ever higher productivity from their employees.

Leading developers, such as Douglas Durst, developer of both Four Times Square and Bank of America Tower at One Bryant Park in New York City, follow green building processes in their development practices as a matter of normal course. Durst was recently quoted in the August 13, 2006 edition of *The New York Times* as saying, "We think it's important to do, and we think that other buildings that don't do this will become obsolete and our buildings will continue to maintain their value."

A number of other large real estate development firms tuned into their clients' needs are building green buildings with design features and systems that save on energy and occupancy costs. Developers, including Hines, Forest City Enterprises, Louis Dreyfus Property Group, Corporate Office Properties Trust, and Liberty Property Trust, are building green buildings to satisfy tenant demand, reduce obsolescence risk, and assert market leadership over their competitors.

Green building investment is increasing as well. CalPERS, the nation's largest pension fund managing a \$211.0 billion retirement investment portfolio for over 1.4 million California public employees, is busy implementing the state's Green

Wave mandate passed in February 2004. This mandate calls for CalPERS and its sister fund CalSTRS to commit \$1.5 billion to investments in cutting-edge technologies and environmentally responsible companies. The goal is to improve the fund's long-term financial returns through investments with an environmental technology focus, while at the same time reducing pension fund investment risk exposure to corporate environmental liabilities and increasing energy costs.

This initiative packs significant impact with far-reaching effects. In late 2004, CalPERS adopted an Energy Efficiency Plan which proposed a 20.0% energy use reduction goal for its core real estate portfolio within five years. They also undertook a comprehensive audit of their current real estate investments in order to determine whether their third-party investment managers maximize opportunities to use clean energy, achieve superior energy efficiency, and implement green building standards and practices. Most importantly, these measures are being incorporated into their investment-manager selection process and investment-decision metrics going forward, and other pension funds are taking notice and pursuing similar tracks.

WHAT IS GREEN BUILDING?

At its core, the philosophical underpinnings of green building are based on minimizing the amount of resources used to construct and operate a building. A formal definition from the Office of the Federal Environmental Executive defines green building as, "The practice of 1) increasing the efficiency with which buildings and their sites use energy, water, and materials, and 2) reducing building impacts on human health and the environment through better siting, design, construction, operation, maintenance, and waste removal through the complete building life cycle."

Ultimately, green building has become the shorthand term for the concept of sustainable development as applied to the building industry. Also known as "high performance buildings," green buildings are intended to be environmentally responsible, energy efficient, economically profitable, and healthy places to live and work.

LEED® AS A GUIDE

The US Green Building Council (USGBC), a trade organization founded in 1993, developed and released the Leadership in Energy and Environmental Design (LEED) Green Building Rating

System® in 2000. The development of the rating system resulted from a seven-year, consensus-based process that involved all private and public sector USGBC members. LEED is a points-based system that defines green building with specific prerequisites that mandate certain processes such as energy performance, indoor air quality, and onsite recycling.

The LEED standard defines green building by establishing a common standard of measurement, promoting integrated design practices, recognizing environmental leadership in the building industry, and ultimately transforming the building market. LEED has grown to encompass several applications, including new commercial construction, existing buildings, commercial interiors, and core and shell. LEED applications currently in the pilot phase include homes, neighborhood development, and retail.

Under the LEED 2.0 system, a project is awarded up to 69 points based on six criteria –

1. Sustainable Sites
2. Water Efficiency
3. Energy and Atmosphere
4. Materials and Resources
5. Indoor Environmental Quality
6. Innovation

Commissioning, an independent, post-construction quality assurance process, is an important LEED prerequisite as it lowers ongoing operating costs and risks. Commissioning ensures that all designed building features and operating equipment are installed and functioning as intended. The commissioning experience corrects a surprising number of material failures stemming from the design and construction process that has a material impact on current and future asset value, particularly as systems become more technologically complex.

As buildings accumulate points for implementing green measures such as low-flow water faucets, expanded daylight, energy performance optimization, indoor chemical and pollution control, etc., its level of greenness increases. The LEED rating system awards different levels of achievement based on the number of points earned –

Certified - 26 to 32 points

Silver - 33 to 38 points

Gold - 39 to 51 points

Platinum - 52 to 69 points

As of midyear 2006, approximately 560 million square feet of commercial building space has been registered or certified under LEED. Since LEED's inception, the project registration growth rate has increased between 50.0% and 75.0% annually with LEED projects in all 50 states and 12 countries. LEED is licensed in Canada and India, and license agreements are being negotiated for Mexico and Brazil.

GOVERNMENT LEADERSHIP

Federal, state, and local municipalities have embraced green building mandates for their projects. Over 40 municipalities, including the major North American cities of Atlanta, Boston, Chicago, Dallas, Honolulu, Kansas City, Los Angeles, New York, Portland, Sacramento, San Francisco, San Jose, and Seattle, require LEED certification at various levels for public building construction. In many cases, these requirements have spilled over into the private market. As an example, to build anything over a 5 FAR (floor area ratio) in Seattle's central business district, a developer must submit plans consistent with achieving a LEED Silver rating in order to receive project approvals through the Seattle planning commission.

New legislation in Congress would result in the federal government adopting green building standards across all agencies. Senator Jim Jeffords (I-VT) and Representative Mike Doyle (D-PA) recently introduced companion bills in the Senate and House of Representatives that would create an Office of High-Performance Green Buildings within the General Services Administration (GSA). The objective is to develop uniform sustainable design standards and procurement policies for all federal agencies.

The GSA and EPA (Environmental Protection Agency) policies require new buildings to achieve a LEED Silver rating. In January 2006, 17 federal agencies – including the GSA and EPA – signed a Memorandum of Understanding “commit(ing) to federal leadership in the design, construction, and operation of high-performance and sustainable buildings.” This is an important market driver since the GSA alone owns and operates more than 3.0 billion square feet of office space nationwide. The incorporation of green building standards into government policy will have a significant effect on the price, selection, and availability of green products leading to a continued decrease in prices of many green building components.

GREEN BUILDING BENEFITS

The benefits of green building are significant. Green buildings have become synonymous with high performance buildings – some circles have started referring to these buildings as “Super Class A.” Well-designed and commissioned high-performance buildings result in superior NOI (net operating income) levels relative to market peers through higher rents, faster lease-up, lower operating costs, and lower turnover rates. Case study after case study has shown the following –

- Greater revenue through top-of-market rents
- Faster lease-up relative to market
- Lower re-leasing expenses and vacancy downtime due to higher tenant retention rates

- Lower loan default risk due to financially strong tenants
- Lower operating costs primarily on energy and water
- Lower exposure to energy price volatility and cost escalation
- Lower replacement reserves and reduced maintenance

Furthermore, green buildings that achieve certain indoor air quality LEED points minimize an owner's and lender's exposure to default risk stemming from reduced mold and indoor air problems, both of which are uninsurable liabilities.

REAL ESTATE - IT'S ALL ABOUT THE TENANTS

Missing from the benefit equation is the opportunity for tenants in green buildings to achieve productivity gains from their workforce. From a true occupancy cost standpoint, the impact of human capital on a company's profit-and-loss statement is immense as payroll and benefits typically account for 35.0% to 40.0% of operating expenses. In sheer volume terms, improvements in human capital efficiency can have a dramatic bottom-line impact.

Green building tenants have been experiencing numerous human capital gains primarily related to recruiting and retention, absenteeism, self-reported productivity gains, and overall morale. For example, all-in recruiting costs typically run 15.0% to 20.0% of salary (exclusive of recruiter fees), and it generally takes at least six months for a new hire to "get up to speed." In addition, management time and resources are devoted to training and integrating the new hire into the organization. Factor in the costs when an employee departs, which can include lost client relationships, dropped responsibilities, lost business development initiatives, and ideas, etc., and the cost of turnover can be very significant. Any reduction in this metric alone flows straight to the bottom line.

Case in point, PNC Bank experienced a 30.0% reduction in staff turnover after moving into its new LEED Silver Operating Center on top of a 20.0% energy use reduction. This was a decisive factor in PNC Bank's decision to make all of their new buildings going forward LEED certified. Their current bank branch prototype is built for \$150,000 less than their competitors' non-green branches, delivered 4-5 weeks faster, and consumes 40.0% to 50.0% less energy than a typical bank branch.

Separately, but equally important, thermal comfort is an issue not to be taken lightly. An eight hour workday is comprised of 480 minutes. A person who either spends six minutes per day going for a walk to warm up because they are too cold or breaks/refocuses their concentration when the HVAC system overhead kicks in wastes 1.25% of their day. The "too hot/too cold" complaint is the largest occupant issue, according to The BOMA Foundation (BOMA – Business Owners and Managers

Association). Eliminating or reducing this distraction can have an immediate productivity boost.

When a tenant moves into a facility that supports its workforce through design features, such as higher indoor air quality, daylight harvesting, raised flooring, and an efficient layout supporting communication and workflow, it follows that the firm will have a greater chance of attaining a more productive and loyal workforce. In turn, this workforce can churn out higher quality products which will likely lead to higher degrees of satisfaction with its customer base, resulting in higher profitability, market share, etc. – all characteristics that translate into higher firm value.

Under this scenario, it follows that the tenant's credit rating would increase, resulting in a more secure credit tenant underlying the real estate lease contract – it becomes a self-reinforcing loop. High-quality credit tenants are rewarded in the real estate debt and equity markets through lower borrowing costs and lower overall capitalization rates upon sale. While many management factors affect this equation outside of the real estate realm, buildings that don't have these features will understandably find it significantly harder to engender such a scenario.

It takes an insightful CFO to understand the benefits of a green building on their company's overall cost structure, particularly when these buildings command top-of-market rents. However, it only takes one negative experience to demonstrate the impact on an organization's bottom line. For example, a major Dallas law firm lost 30 professional staff that comprised over \$6.0 million in billings in a 12-month period primarily because of poor-quality office space.

By applying a critical eye to an organization's overall occupancy costs through a holistic approach, the case for occupying a green building becomes obvious. Since leading companies seek competitive advantages in every area, there is an increasing demand for high-performance green buildings.

ENERGY SAVINGS AND EMISSIONS REDUCTION

Beyond the ongoing operational cost savings and positive NOI impacts achieved by energy efficient buildings, energy savings by the real estate industry overall is a critical issue. The U.S. Department of Energy reports that buildings account for over 39.0% of U.S. energy consumption with 50.0% of this consumption going to heating, cooling, and lighting of buildings. Roughly two-thirds of this energy comes in the form of electricity with natural gas and petroleum-based systems comprising the balance. In the United States, 50.0% of the electricity generated comes from coal, a significant contributor to CO₂ greenhouse emissions and SO₂ acid rain emissions.

Besides negative environmental impacts from coal-fired elec-

tric plants, economic impacts are being felt across the board. Coal spot prices have increased significantly since 2003 along all grades with price volatility at 2x multiples over a trailing three-year period. Couple this with the numerous utilities experiencing price deregulation in 2006 and 2007, and electricity consumers in a number of regions are being hit hard.

Economic texts routinely refer to pollution, such as CO₂ and SO₂ emissions, as “negative externalities.” The benefits from the emission-inducing activity accrue to a few, while the costs are thinly spread to others. This is highly likely to change as emissions caps and trading has taken hold in Europe – both are near on the horizon in North America. Once emissions are priced into energy production, costs will only increase. Insulating one’s company from this eventuality is smart business.

FINANCE AND INVESTMENT

The real estate capital markets have been awash in capital since 2000. Private equity funds actively compete with TIC (tenant-in-common) investors, foreign capital, REITs (real estate investment trusts), and private buyers with different yield and investment horizons. CMBS issuances are at record highs. Yet behind the scenes, a shift is taking place in how certain investments are made. There are important additional dynamics getting major traction in institutional circles – call it the “proverbial pebble in the pond.”

One of these dynamics is the Carbon Disclosure Project (www.CDProject.net) which is supported by 155 institutional investors with assets of more than \$21.0 trillion, including Allianz, Axa, CalPERS, Ixis, New York Common Fund, and the majority of large European and Asian investment banks. It was launched in 2003 in order to provide a forum for the world’s largest institutional investor collaboration on the business implications of climate change. This year, over 1,900 of the largest companies worldwide were sent a request for information disclosure on greenhouse gas emissions throughout their entire supply chain. Last year’s questionnaire was sent to the top 500 companies worldwide; it received an 89.0% response rate with 71.0% of the companies responding in full.

This is a big deal as the “ripple” effect is at least twofold. First, companies are now being judged on their environmental track records by investors that represent roughly 10.0% of the global capital markets. This has a major effect on how companies operate today, the types of products in the R&D lab, and future corporate policy decisions. Second, companies are taking action to reduce their carbon impacts; one of the ways they can do this is by occupying a green building. Goldman Sachs and JP Morgan are among several financial institutions adopting financing policies in response to global warming con-

cerns (carbon risks, location risks, and regulation risks).

In April 2006, the Senate Energy and Natural Resources Committee on Capitol Hill heard testimony by executives from eight large energy companies, including Shell, General Electric, Exelon, and Duke Energy. Six of the eight executives said that they would either welcome or accept mandatory caps on carbon emissions. Wal-Mart also spoke out in favor of a cap. The outspoken stance taken by big businesses is partly in response to initiatives like the Carbon Disclosure Project and the Global Reporting Initiative (www.GlobalReporting.org).

REDUCING INVESTMENT RISK

Global investment risks are increasing from long-term rising energy costs and intensifying climate changes. Swiss Re and the Reinsurance Association said its industry incurred \$40.0 billion in climate-related damages in 2004 and \$80.0 billion last year. Risk analysts are concerned about outlier events that could increase in frequency, such as the recent hurricane in Spain.

U.K. Treasury Secretary Brown told the U.N. General Assembly that climate change damages in five to ten years are likely to be 2.5% of global GDP. These damages will substantially increase if large emission reductions are not made soon and global warming continues. Investment instruments reducing these risks will have greater value since they will be less subject to economic harm from increased regulatory and liability risk. Many green building attributes greatly reduce these impacts and are a major reason why so much macro attention is focused on this sector.

At the asset level, exposure to energy volatility, legal risk from mold claims and other indoor air quality issues, and functional obsolescence risk reduction all drive the case for green building. Green buildings are superior assets, achieve superior financial results, attract strong tenants, and deliver risk reduction on various measures – compelling reasons to build and occupy green buildings. Ultimately, green building is a compilation of a series of disruptive technologies that challenge the status quo. Change can be difficult, but change is necessary in order to both progress as a society and address economic and environmental realities. ♦

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