OFFICE REPORT

VIEWPOINT 2018 / COMMERCIAL REAL ESTATE TRENDS

By: Hugh F. Kelly, PhD, CRE

The Office workplace is at the nexus of powerful cross-currents. Pricing has made CBD acquisitions, especially in the gateway cities, almost exclusively the province of international and institutional investors. Meanwhile, signs of recovering suburbs – especially near-in markets with a small-town flavor – is providing a wider range of investors with opportunities. The much bruited co-working trend is evolving, but more attention is now being given to the right mix of traditional design and open space preferences. There is still abundant capital for this sector, but buyers are being increasingly selective in deploying funds.

The office sector posted another year of solid absorption. For all the popular chatter about "disruptors," the U.S. workplace continues to see demand from finance, professional and business services, as well as from start-ups utilizing co-working spaces. Unemployment for those with at least a bachelor's degree is now down to two percent, and the motivation for those carrying student debt to take jobs with solid income potential is particularly high. In most places, that means office work.

Future demand, however, may be attenuated. In the short run, 2018 must face the constraints of a 4.1% unemployment rate and an employment-to-population ratio of 60.1%, the highest since 2010. Beyond this year, offices are vulnerable if the finance and tech sectors face a down-cycle. Now is a good time for defensive planning.

Transaction Volume

The investment surge peaked in 2015, as buyer enthusiasm for office got out in front of the user markets, anticipating improvements in occupancy and in rent. Acquisitions made to capture future supply-demand tightening have largely found the properties fulfilling most reasonable projections. User-market fundamentals are generally solid as we turn into 2018, but transaction volumes have pulled back significantly.

Real Capital Analytics has noted falling deal volumes, especially for CBD properties, "at a pace reminiscent of the start of the downturn a decade ago." But we may advisedly bear in mind the observation of the 17th century polymath Leibnitz, "Nature has established patterns originating in the return of events, but only for the most part." Every cycle is distinct. Right now we do not see the over-leverage and bubble-inflating enthusiasms of a decade ago.

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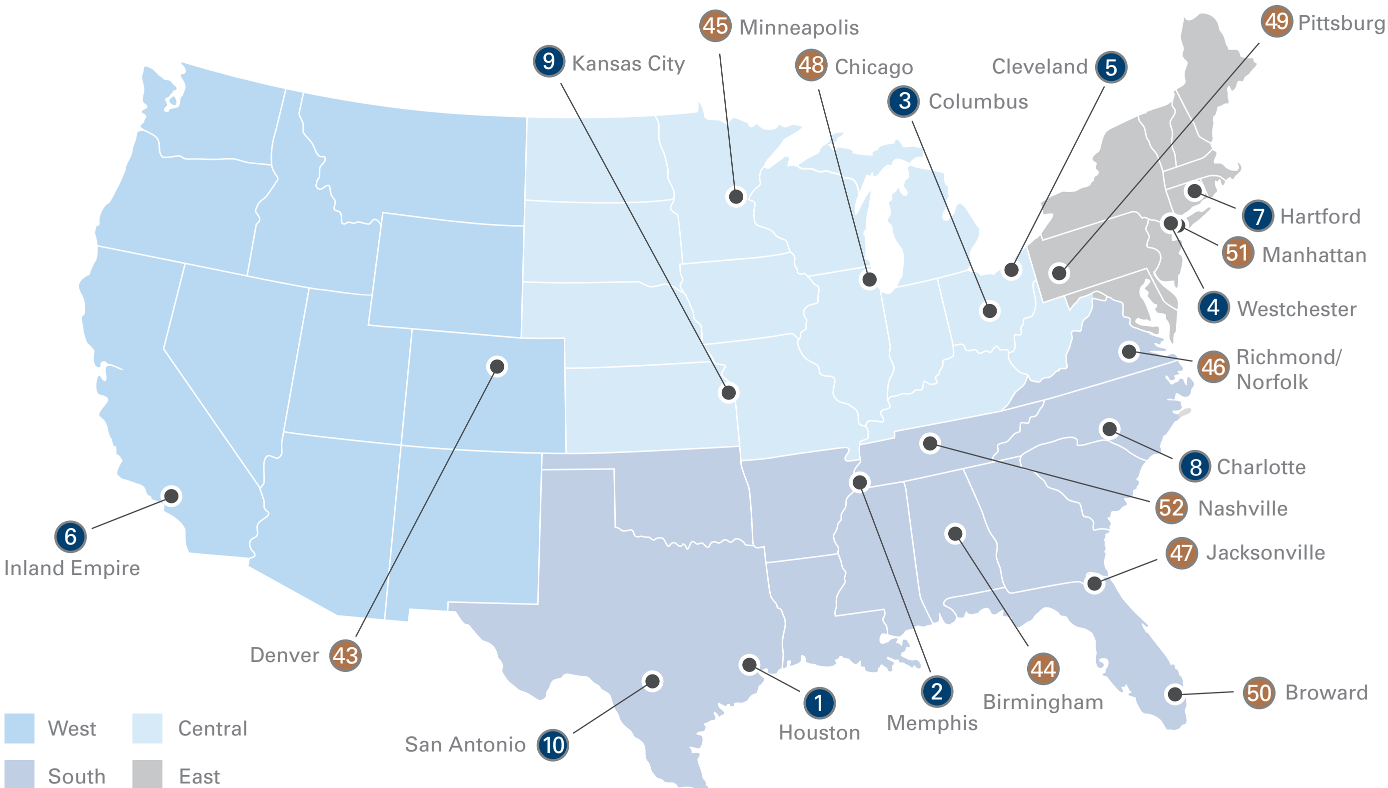
Indeed, the decline in volume, an overall drop of 6% to $94.5 billion through the first three quarters of 2017, can be taken as evidence of greater buyer discipline this time around. The shift from downtown office properties to suburban assets reflects a realization that CBDs have "for the most part" become fully priced, whereas suburban assets still represent opportunities for income growth and appreciation. In an important counter-trend, the number of properties traded is up 5%, to 4,129 assets, through the first three quarters of 2017, hardly a sign of a sclerotic market.

Suburban Office markets in Memphis, Westchester, and the Inland Empire have seen significant investor demand in 2017

TOP MARKETS BY OFFICE TRANSACTION VOLUME BASED ON YOY PERCENTAGE CHANGE



Bulls (Top 10)

YOY Rank	City	YOY Change	Total 4Q16-3Q17	Vol. Rank*
1	Houston	140.5%	$3,832.1 M	10
2	Memphis	118.6%	$269.6 M	51
3	Columbus	107.0%	$472.7 M	44
4	Westchester	104.1%	$603.3 M	40
5	Cleveland	90.5%	$457.0 M	46
6	Inland Empire	87.3%	$671.7 M	35
7	Hartford	83.9%	$159.9 M	52
8	Charlotte	79.7%	$2,375.0 M	16
9	Kansas City	78.7%	$962.4 M	29
10	San Antonio	76.7%	$719.7 M	34

Bears (Bottom 10)

YOY Rank	City	YOY Change	Total 4Q16-3Q17	Vol. Rank*
43	Denver	-27.4%	$1,730.1 M	21
44	Birmingham	-28.7%	$342.3 M	49
45	Minneapolis	-30.1%	$1,035.4 M	28
46	Richmond/Norfolk	-37.4%	$628.6 M	38
47	Jacksonville	-41.7%	$287.4 M	50
48	Chicago	-46.5%	$3,802.7 M	11
49	Pittsburgh	-46.9%	$347.3 M	48
50	Broward	-49.1%	$639.7 M	37
51	Manhattan	-51.9%	$12,773.8 M	1
52	Nashville	-53.6%	$468.7 M	45

* Volume Ranking is based on the overall transaction volume among 52 markets nationally

48.4%

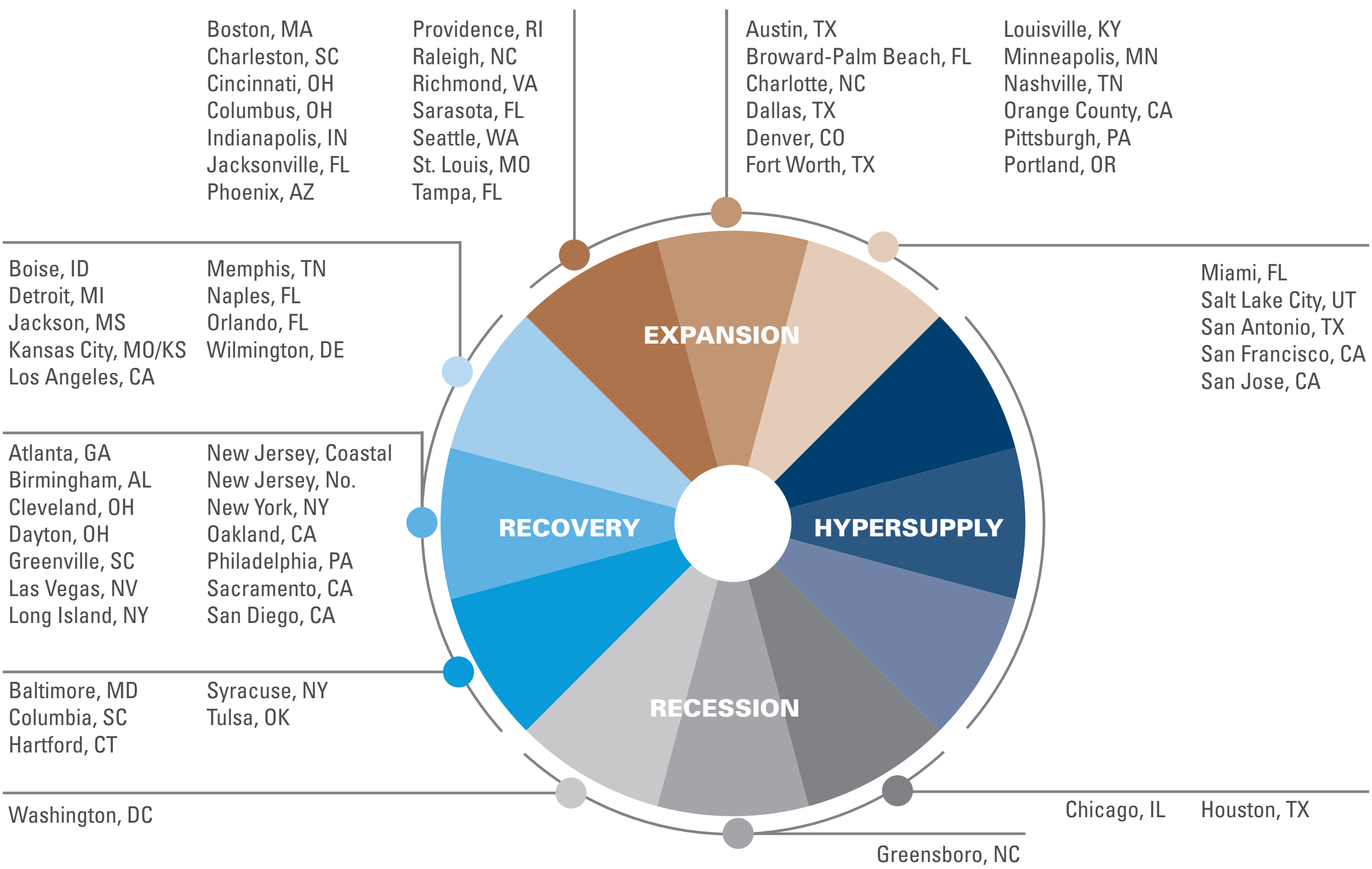
Heading into 2018, 48.4% of Suburban markets are in expansion, the highest since the financial crisis

Market Cycle

Relatively few markets are experiencing cyclical extremes. IRR's survey shows 51% of CBD markets in the expansion phase, and 44% in the upward movement of recovery. Only Houston and Jackson report downtown office recessions, while Denver is the sole market witnessing hypersupply. As shown in the chart below, the rebound in suburbs is significant. Just over 48% of suburban office markets are in expansion, while 45% find themselves in the recovery phase. A few markets, though, have local suburban market recessions: Chicago, Houston, Washington DC, and Greensboro.

Rents and construction volume are more important and sensitive indicators of cycles. Regionally, the West looks particularly strong, with CBD rental increases of 2.9% forecast for Class A office buildings, and a nearly-as-impressive 2.7% for

SUBURBAN OFFICE MARKET CYCLE



EXPANSION

Decreasing Vacancy Rates
Moderate/High New Construction
High Absorption
Moderate/High Employment Growth
Med/High Rental Rate Growth

HYPERSUPPLY

Increasing Vacancy Rates
Moderate/High New Construction
Low/Negative Absorption
Moderate/Low Employment Growth
Med/Low Rental Rate Growth

RECESSION

Increasing Vacancy Rates
Moderate/Low New Construction
Low Absorption
Low/Negative Employment Growth
Low/Neg Rental Rate Growth

RECOVERY

Decreasing Vacancy Rates
Low New Construction
Moderate Absorption
Low/Moderate Employment Growth
Neg/Low Rental Rate Growth

Class B downtown properties. These gains are on top of some of the country's highest rents. As for development, Denver is expanding its CBD inventory at 8.7% of its existing base, likely to benefit tenants looking for deals. Salt Lake City's suburbs are also seeing a 4.8% increase in its existing base, outrunning probable near-term demand.

Eastern metros present the unusual picture of higher anticipated rent growth in the suburbs than in the CBD. Downtown rents in cities like Boston, Manhattan, and Washington DC are so high that further upward movement is hard to achieve. So CBD rents are projected to grow 1.7%-1.8% for downtown properties, but about 2% for suburban assets whether they are Class A or B buildings. Philadelphia is forecasting the largest downtown increase in inventory, 2.8%. While Manhattan's skyline continues to add millions of square feet of offices, its installed base is enormous at 359 million square feet.

The Central region remains somewhat hobbled by high vacancy, in all office sub-sectors. Suburban rents are anticipated to grow sluggishly – 1.4% for Class A buildings and 1.3% for Class B offices. The prospects for CBD rents roughly track the Consumer Price Index at 2.0%-2.1%. While some construction is occurring in spots like downtown Dayton and suburban Indianapolis, additions to supply are unlikely to accelerate in 2018.

The South boasts many of the fastest growing metro areas in the country, many of which (like Nashville and Austin) are among the highly regarded "18-hour cities" and others (like Miami and Atlanta) are large established markets for investors. Despite having affordable rents vis-à-vis the major cities of the East and West, 2018 rental growth

REGIONAL RATES COMPARISON - OFFICE

	Cap Rate	Discount Rate	Market Rent ($/SF)	Vacancy Rate	4Q16 - 4Q17 Cap Rate
South Region					
CBD Class A	6.67%	7.97%	$27.76	13.32%	-2 bps
CBD Class B	7.62%	8.89%	$20.67	16.13%	1 bps
Suburban Class A	7.13%	8.43%	$24.90	12.22%	-5 bps
Suburban Class B	7.94%	9.10%	$18.99	14.08%	2 bps
East Region					
CBD Class A	6.53%	7.56%	$37.95	11.67%	-2 bps
CBD Class B	7.62%	8.65%	$28.16	15.14%	-3 bps
Suburban Class A	7.13%	8.09%	$27.35	14.16%	5 bps
Suburban Class B	8.08%	9.05%	$21.17	14.88%	3 bps
Central Region					
CBD Class A	7.95%	9.14%	$23.08	15.73%	-9 bps
CBD Class B	8.59%	9.64%	$17.38	14.50%	-9 bps
Suburban Class A	7.66%	8.82%	$22.85	14.75%	-11 bps
Suburban Class B	8.48%	9.55%	$17.56	16.82%	-2 bps
West Region					
CBD Class A	5.83%	7.59%	$39.98	13.11%	-6 bps
CBD Class B	6.49%	8.05%	$30.35	12.65%	-7 bps
Suburban Class A	6.31%	7.88%	$34.26	13.20%	-3 bps
Suburban Class B	6.87%	8.48%	$26.86	14.00%	1 bps
National Averages/Spreads					
CBD Class A	6.68%	8.01%	$31.79	13.38%	-4 bps
CBD Class B	7.53%	8.78%	$23.83	14.82%	-4 bps
Suburban Class A	7.04%	8.30%	$27.13	13.28%	-3 bps
Suburban Class B	7.83%	9.03%	$20.94	14.70%	1 bps

across submarkets/classes only range a projected 1.7%-2.0%. Markets with above-average outlooks include Miami and Dallas. Raleigh, Richmond, and Charlotte expect an active year for office development ahead.

Cap Rates & Values

With some local variation, cap rates should be reaching stability in the coming year. Very few office markets are believed to have further cap rate compression ahead. Such markets are either in the high-growth South, or are outliers with high cap rates (Orlando, Greensboro, Hartford, Indianapolis).

Cap rates in the major coastal cities are persistently the lowest both for downtown and suburban properties. This may be due to a "conservation of capital" emphasis for major investors who prefer to hold assets across cycles, yet like to know there is a reservoir of buyers available if and when they decide to sell. Higher cap rate markets tend to be smaller, with more volatile rents, where market timing is the investment key.

This does not seem to be a time where investors are willing to settle for "the best available building," but are determined to find properties that fit their own investment strategy.

Comprehensive Commercial Real Estate Market Research, Valuation and Advisory Services

About IRR

Integra Realty Resources (IRR) is the largest independent commercial real estate valuation and consulting firm in North America, with over 158 MAI-designated members of the Appraisal Institute among over 580 professionals based in our 49 offices throughout the United States and the Caribbean. Founded in 1999, the firm specializes in real estate appraisals, feasibility and market studies, expert testimony, and related property consulting services across all local and national markets. Our valuation and counseling services span all commercial property types and locations, from individual properties to large portfolio assignments.

About Viewpoint

IRR's Viewpoint represents the compilation and presentation of Commercial Real Estate (CRE) rates, market conditions, and forecast data. The rates, market conditions, and forecast data is generated via IRR's Viewpoint Survey. IRR's Viewpoint Survey requests market experts consisting of Appraisers and Consultants, each of whom have deep CRE expertise, to provide insights on over 60 U.S. markets. Viewpoint data is collected across five asset classes including Multifamily, Office, Retail, Industrial, and Hospitality.

Viewpoint's rates data (Cap Rates, Discount Rates, Reversion Rates, Vacancy Rates, etc.) reflects an expert's opinion based on recent market activity experienced in the past 6 months. Viewpoint forecast data represents a 12-month outlook based on current market conditions. The data in Viewpoint reflects rates data and forecasts based on stabilized properties in the respective U.S. marketplace. Where referenced, all regional and national averages are based on simple average calculations and are not weighted.

IRR's Viewpoint Survey is conducted through a proprietary data survey tool, and all data is checked both manually and by a specially designed computer editing procedure. While we do not guarantee that the survey is statistically accurate, the Viewpoint data provides, what we believe, is the best, clear-sighted insights into the CRE marketplace.

Sources

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Top Markets by Office Transaction Volume Based on YOY Percentage Change
Source: Real Capital Analytics

Market Cycle
Source: Integra Realty Resources

Regional Rates Comparison
Source: Integra Realty Resources