

### Market Overview

**Overview** – Deal volume is picking up significantly. Owner and lender capitulation has begun and the bid-ask spread has narrowed. Debt markets (CMBS and life companies in particular) have roared back to life for well-leased, stabilized assets, although debt remains scarce for properties under 80% leased. Leasing activity has spiked as tenants are rushing to lock in long-term leases in today's tenant friendly marketplace.

For the first time in over three years, Crocker Partners has placed a property under contract in a bid to reacquire a 1.2 mm SF Houston office project we sold in 2005. In addition, we have entered into a joint venture with an owner to provide rescue capital to buyout the existing mortgage at a significant discount and to recapitalize the asset. Moreover, we have been in the Best and Final rounds on three other value-add transactions during the past 60 days (prior to these deals, it had been over 60 months since we were in the Best and Final round on a widely marketed transaction).

**Coremania** – While we are seeing a significant uptick in transaction volume in our space (*i.e.*, value-add office) at pricing that will provide excellent risk-adjusted returns, we are surprised by the flood of capital chasing core properties and the effect it is having on core pricing and the definition of core. It is not unusual today to have 15 qualified buyers chasing a core asset (along with every life company and CMBS originator vying for the business), while a value-add property located down the street will be lucky to have three qualified buyers and a specialty lender in tow. As a result, we are seeing cap rates on core properties plummet to levels we have not seen since 2007, while value-add cap rates are more reflective of those seen during prior market downturns. Further, core buyers are already investing in markets that have not traditionally been considered primary core markets (such as Fort Lauderdale). It seems the term "core" now refers to any well-leased, Class A asset not located within a tertiary submarket.

As a result, we are observing an unusual inversion of risk in the market. Traditionally, core investments traded lower returns for lower risk (*i.e.*, return volatility), relative to value-add investments. The theory is that using conservative underwriting, a core investor could achieve an 8% return with some upside potential while avoiding net asset value ("NAV") risk. In effect, returns could deviate several standard deviations from the norm and the range of returns to the investor would nonetheless be between 4% and 12%. To the core investor, this return spectrum is preferred to that of traditional value-add investments, which may experience NAV risk within their return spectrum (*e.g.*, -10% to 25%), due to the use of leverage and the fact that most are initially poorly leased.

Today, however, core investors are upending this investment thesis. To win a marketed core deal today, an investor is required to use aggressive underwriting - we call these deals "priced to perfection," meaning that the 8% return becomes the best case scenario for the investor. As a result, the spectrum of returns to a core deal today is actually 0% to 8%. Alternatively, in the value-added space investors are generally underwriting acquisitions to

make a 15% leveraged return using conservative assumptions. Using this discount rate, properties are being purchased at very high cap rates, using moderate levels of leverage, and at significant discounts to replacement costs. These investors are demanding a significantly higher return to compensate them for taking lease up risk in this turbulent economic environment. Since these buyers do not generally underwrite rent increases during lease up, the pro forma return is driven almost exclusively by the pace at which the building's vacant space is leased. An extended lease up period, therefore, will result in a lower returns, but since the properties are acquired at such low prices, there will be negligible NAV risk. Rather, the return spectrum for value-add transactions today is 8% (delayed lease up) to 25% (accelerated lease up coupled with good news).

So, why would an investor choose to invest in a core (0%-8%) investment over a value-add (8%-25%) investment? First, investors are starved for yield and core properties have cash flow (which is arguably why so many REITs are trading at surprisingly high multiples). Second, in an effort to avoid a repeat of the substantial losses they suffered during the recent downturn, investors believe they are mitigating risk by allocating to core investments. Ironically, massive movement into core investments has increased the risk inherent in them while lowering the relative risk in value-add investments.

**Debt Markets** – Lenders continue to pursue well-leased assets. For instance, on our proposed Houston acquisition, we received competing offers from CMBS lenders to provide a 10-year, \$125mm loan (70% LTV) at a fixed interest rate below 5%. The market, however, is different for poorly leased assets. Last month, we were in the Best and Final round to acquire a 72% leased building and the only available financing came from a debt fund that would provide a 65% loan at 6.3% (which, although low by historical standards, is a significant spread over CMBS loans).

**Real Estate Market Fundamentals** – Real estate fundamentals have clearly bottomed out and in some of our target markets (mainly those in suburban DC) have shown signs of recovery. By and large, our submarkets are neither experiencing positive nor negative net absorption, rather they are bumping along the bottom of the curve. We are also seeing some good news in that leasing volume has spiked as tenants have weathered the worst of the Great Recession and now, believing that we are at the bottom of the real estate cycle, want to lock in favorable lease terms. All indications are that leasing markets will remain weak for the next 24 months, as office using employment slowly backfills the vacant and "grey" space (*i.e.*, space that is currently rented but is held for future expansion purposes).

### About Crocker Partners

Crocker Partners is a private equity fund manager that invests capital in office product located in primary submarkets in the Southeast U.S. and Texas. We are currently investing capital on behalf of Crocker Partners IV, a closed-end fund focusing on value-add and opportunistic office investments located within the Southeast U.S. Our investors include some of the largest and most respected institutional investors in the world.