



## 2011 Q4 Market Update

**Overview** – You may have noticed that we did not publish a Q3 update. We were unable to do so due to a dramatic change in our markets: actual deal flow. We experienced a spike in the inventory of for-sale value-add office product that perfectly fits our strategy of “manufacturing core” as well as other transactions that presented various compelling investment opportunities. Our intent was to build on the over \$300 million of value-add real estate we acquired last year. Unfortunately, largely for non-economic reasons, we were unable to acquire any of these assets, but we are encouraged by the fact that the assets that fit squarely within our “manufacturing core” strategy traded for prices that would have resulted in excellent risk adjusted returns had we been able to employ our time-tested, intensive asset management and repositioning efforts.

**Transactions** – Despite a substantial increase in our underwriting activity, overall transaction volume generally decreased across our markets during the second half of 2011 (please note, however, that as of the date of this update transaction data for December is unavailable). In retrospect, this is not surprising. Most of the trade volume earlier in the year consisted of core asset sales to buyers that were placing an enormous premium on cash flowing properties. Once the most aggressive core buyers “successfully” allocated their capital at historically low cap rates, demand began to return to equilibrium. We still have not seen the spigot open on the reservoir of underwater properties that are or soon will be owned by lenders and special servicers. We are pleased, however, to report that our markets experienced a significant uptick in sales of value-add properties.

**Debt** - Debt markets have been volatile over the past six months but appear to be settling down. Spreads widened at the beginning of last summer due to disruption in the CMBS market, but spreads have since narrowed due to a combination of (i) increased investor demand and (ii) a tightening of CMBS underwriting standards that has resulted in lower loan-to-value ratios (as pricing of the tranches over 70% LTV were most volatile). Year over year, the effect on interest rates has been somewhat muted as the increase in spreads was partially offset by lower swap and Treasury rates. CMBS and life companies continue to offer attractive debt for long term, fixed-rate financing on stabilized assets (*i.e.*, occupancy greater than 80%); banks and specialty finance companies are now offering attractive short-term floating-rate financing on these assets and recently these lenders have been tightening spreads and reducing LIBOR floors. With respect to non-stabilized assets (*i.e.*, less than 80% leased), available debt consists of loans from specialty lenders at higher interest rates; these rates, however, have also been declining as more lenders compete for business in this market.

**Real Estate Fundamentals** - At the risk of sounding like a broken record, fundamentals continue to bump along the bottom of the economic trough. With the exception of a couple of markets, absorption and rental rates remain flat and there is very little new development underway. We do not anticipate that fundamentals will strengthen appreciably until Q4 2012 at the earliest.

**Investment Opportunity** - There are two distinct trends emerging in today’s market concerning impending asset acquisition opportunities: one mundane and one dramatic. The former is simply that business is returning to normal for many owners in our industry. Among other catalysts, managers are winding down funds that are at the end of their lives and property investors are making tactical investment and disposition decisions. As a result, transaction volumes are beginning to return to pre-peak levels (*e.g.*, the first 11 months of 2011 experienced higher trade volume than each of 2002 and 2003). As an example, this past quarter, a large international real estate fund agreed to sell its entire U.S. portfolio. The buyer opted to spin off those assets that did not fit within their target markets, which resulted in over \$350 million of value-add office buildings trading in our markets last quarter.

The second, more dramatic trend is that the volume of REO assets and loans in special servicing has grown to such a degree (and is expected to continue to grow significantly in 2012 and 2013 as 2007 vintage CMBS matures) that lenders and special servicers will soon be forced to do something with their underwater loans. Their failure to address these issues sooner has already resulted in significant decreases in occupancy rates and net operating income and increases in deferred maintenance in their collateral. As a result, their overworked and undermanned asset management departments are in no position to perform the aggressive, arduous asset management duties that will be required to restore value to these assets. The idea of assigning this responsibility to third party providers will end up further diminishing their collateral value, as these property managers and leasing agents will not be able to compete against new owners of competitive buildings with fresh capital and a compensation structure designed to maximize equity appreciation as opposed to fee maximization. A cynic might suggest that special servicers are incentivized to keep these impaired assets on their books as long as possible to maximize fee income and then to sell them only after there are no fees to garner. If this is accurate, we can expect a steady flow of challenged assets to come to market.

The irony of the situation is that just as it has become clear that a double-dip recession is unlikely and that our economy should continue to expand at a modest clip, lenders and bond holders will be dumping properties into a fractured capital market and will achieve lower pricing than they would have in 2010-11. Clearly, the opportunity is here today.

**About Crocker Partners** - Crocker Partners is a vertically-integrated, real estate operator and equity manager that invests capital in office product located in primary submarkets in the Southeast U.S. and Texas. Our partners include some of the largest and most respected institutional investors in the world.