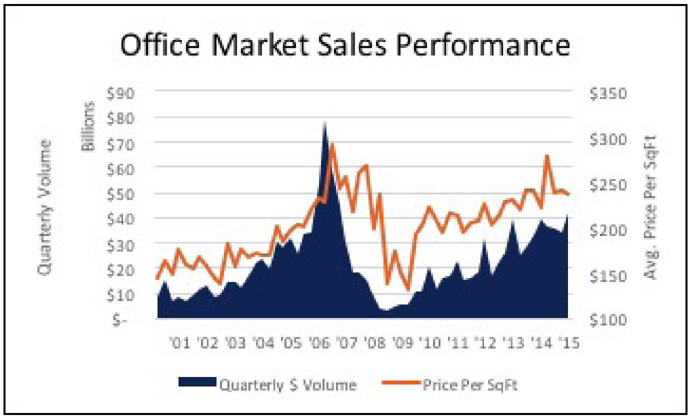
SVN
COMMERCIAL REAL ESTATE ADVISORS

OFFICE
Market Outlook

SLOW GROWTH AND STEADY GAINS

With many key office-using sectors of the economy in expansion mode, the office space market appears relatively healthy and poised for growth in 2016 and beyond. The space market is improving with overall asking rents growing at over 3% and vacancies falling slightly nationwide, according to commercial real estate research firm REIS®. These factors combined with still relatively low levels of new supply projected should mean growth in fundamentals for most of 2016.

The office sector transaction market has experienced steady growth in volume and pricing since the recession with 2015 being the best year since 2005 at over $148 billion in sales, according to Real Capital Analytics (RCA). In fact, the average price per square foot sold in 2015 was $248, extremely close to the record set in 2007 of $256. Given that Net Operating Incomes are likely to rise and cap rates to remain flat in 2016, it is highly plausible to see nationwide record pricing and sales volume this year. Many markets, especially the large 24/7 cities, have already experienced record pricing in past years.



Source: Real Capital Analytics®, Lakemont Group

While office properties in Central Business Districts (CBDs) remained popular in 2015 with 8% year over year growth, suburban property sales grew at 28% year over year to actually beat CBD sales, with $80.2 billion in volume compared to $68.5. This increase in suburban demand was, no doubt, influenced by the all-time record price per square foot of $377 for CBD compared to the near record, relatively more modest, price of $190 per square foot in the suburbs. The suburbs also offered potential higher income yields with cap rates averaging 7.0% versus 5.8% in the CBDs.

Investments in the medical office sector also grew in 2015 according to RCA. This sub-specialty saw over $11.1 billion in volume in 2015 which represented a 13% year over year gain. Medical office properties traded at a respectable 7.0% average cap rate, equal to that of the suburban properties. Given the demographic shift of the United States population towards being ever older and thus demanding more medical care, it is highly likely that investments into this sector will increase at a growing rate. Overall, it is expected that sales in all office sectors and types will increase in 2016, with cap rates remaining fairly flat, as interest rates are not likely to increase substantially and may even fall slightly.

MARKETS TO WATCH

- ATLANTA
- CHICAGO
- CINCINNATI
- DALLAS
- DENVER
- FT. LAUDERDALE
- HOUSTON
- MINNEAPOLIS
- SAN ANTONIO
- SAN FRANCISCO

Economic Projections - Office

- GDP Growth
- Prv. Fixd. Invest.
- Office Employ
- Unemployment
- Corp. Profits
- Interest Rates

Real Estate Market Projections - Office

- Rental Rates
- New Construction
- Occupancy
- Net Absorbtion
- Prices
- Transaction Vol.

Office Market Statistics

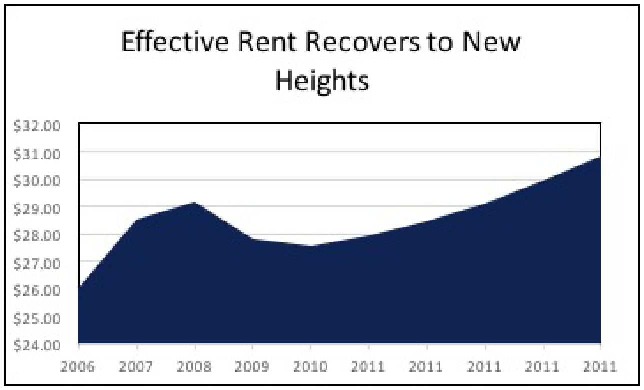
RECORD RENTS AMIDST STILL HIGH VACANCIES

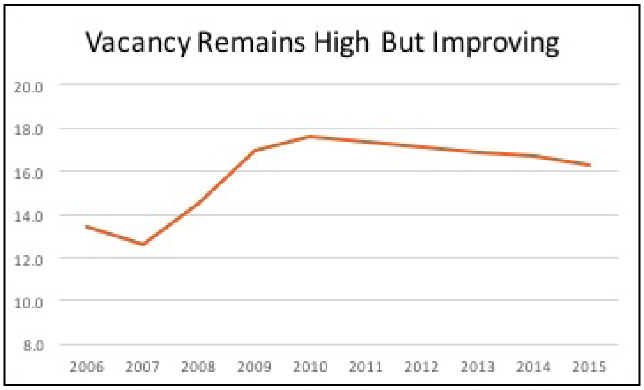
Average asking rents per square foot set a record high in 2015 according to REIS®, by achieving the level of $30.86 nationwide. This marks the first time average national office rents broke the $30 level. Of course, concessions and rent abatements are still possible in many markets with above average vacancies, but even those are seeing real improvements. REIS® forecasts office asking rents to grow at levels above 3% for the next several years, as they have done since 2014, given that much of the economic growth in the United States is expected to come from office-using sectors. This is a logical conclusion.

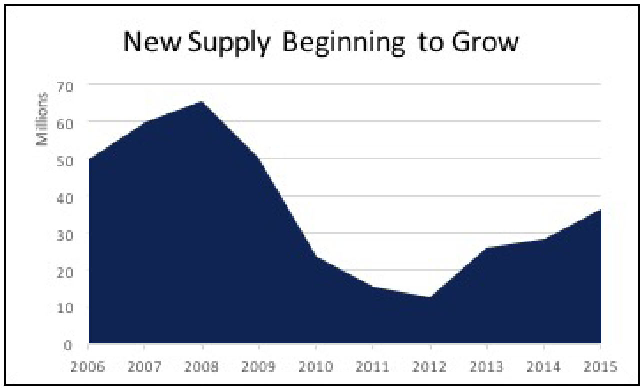
While asking rents sit at all-time highs, the national vacancy rate sits at 16.3%, which is still substantially above the 90s tech boom lows of sub-10% and the 2007 low of 12.7%. We believe this paradox can be explained by the trend of office-using firms demanding denser and denser working environments as they embrace new "open work" and "co-working" concepts. These new spaces feature a higher concentration of square feet per employee. Properties that can accommodate such demands (i.e., have adequate parking or mass transit linkages) can command a premium, while those that cannot suffer a discount or, frankly, just persistent vacancy. Thus, it is the case that some of the vacancy in the statistics is in space that is functionally obsolete and not truly competitive anymore. Owners and managers of such properties should seek ways to modernize their space, which may include radical redesigns and physical modifications.

Additionally, the level of completions of new office space remain substantially below pre-recession peaks and, while forecast to grow by REIS®, it is still not likely to produce an oversupply in the foreseeable future. In 2015, net absorption surpassed 43.6 million square feet versus 36.6 million square feet of completed new office space. This trend is forecast to continue and, thus, overall vacancy should fall for the next several years. Further, as the construction process tends to be long from announcement to delivery, pressure on rents should be substantially positive.

Finally, it is worth noting that the trend of office users desiring downtown/CBD locations over suburban ones is likely to continue. While each market has its own unique gradient of CBD to suburban rents, it is expected that this premium will grow larger as many CBDs run out of quality vacant space to lease.







Source: REIS®, Lakemont Group

Office Market Statistics - Class Focus

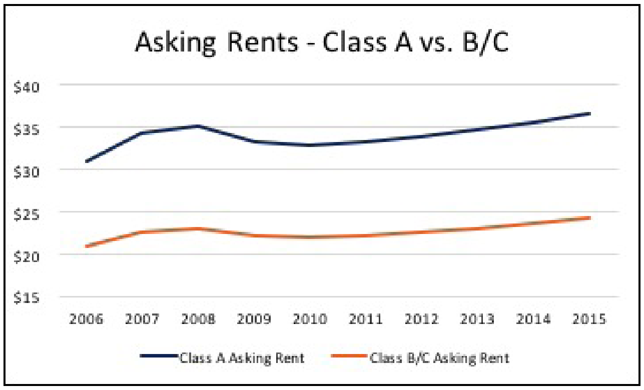
'B/C' HOLDS STEADY WHILE 'A' GAINS

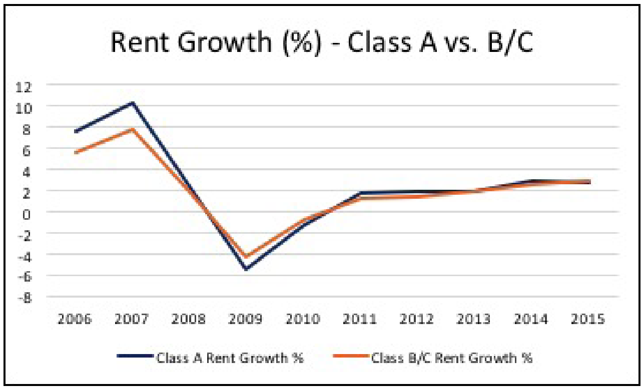
The internal statistics of the office market offer some meaningful insights into the dynamics at play. As always, Class B/C properties offer a substantial discount in occupancy cost to their newer/nicer Class A competitors. The gap between A and B/C rents is over $12 per square foot according to REIS®, which is slightly larger than average, but B/C asking rents actually grew faster (3.0% versus 2.8%) in 2015. In fact, as the chart graphically depicts, Class B/C rents have actually exhibited greater stability during the downturn and after, compared to Class A.

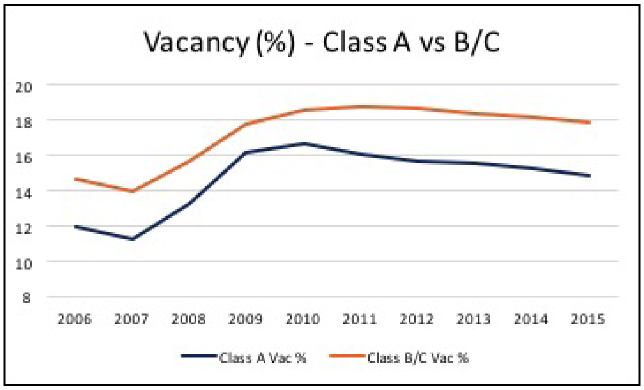
Still, this slight edge in rent growth by Class B/C properties is not necessarily going to persist, as the overwhelming amount of net absorption is occurring in Class A (38.8 million square feet in 2015 versus 4.8 million in Class B/C) and overall trends suggest that Class A should have the advantage, given the strength of the economy. This is more plainly observed in the vacancy statistics; Class A has fallen over 2% from 2011 to 2015 to sit at 14.9% nationally while Class B/C fell slightly less than 1% to 17.9% over the same time period. The reason rent growth is not substantially higher in the Class A segment is the moderating effect of new supply additions (by nature, all new supply is Class A as age is the dominant factor in determining a building's class).

From an investment standpoint, Class B/C actually offers relatively good stability of fundamentals and is typically priced at much lower prices per square foot with higher cap rates. All else being equal, an investor may be able to generate substantially better income yields from Class B/C than Class A. Of course, Class A typically benefits from lower operating costs from sources such as more energy-efficient construction and systems.

Given the demand for Class A and relatively low levels of new supply discussed earlier, there exists an opportunity to convert older Class B/C buildings to more modern facilities better capable of competing with the newer constructed Class A facilities. Tenants, who increasingly bear the risk of increases in operating costs, will likely value the addition of energy saving measures and other capital expenditures that add amenities and lower the risk.







Source: REIS®, Lakemont Group

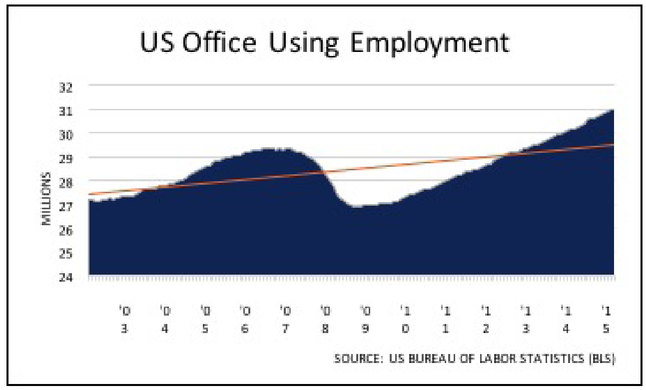
Office Economic Statistics

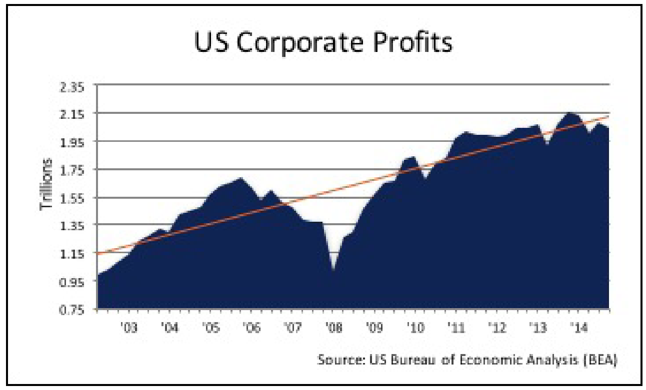
DOMESTIC STRENGTH AND GLOBAL UNCERTAINTY

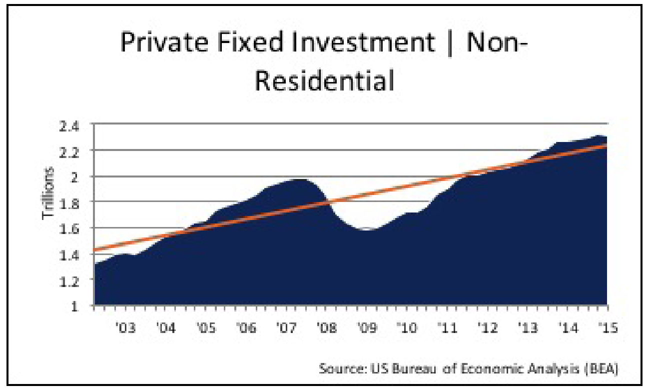
Overall, the United States' economy is fairly healthy and maintaining a slow, persistent growth trend with rising GDP and steadily falling unemployment. The most critical economic factor in influencing office market fundamentals is office-using employment, whose levels have steadily posted new all-time record highs almost every month continuing into 2016, according to the U.S. Bureau of Labor Statistics. This measurement includes employment in sectors such as Information and Professional and Business Services, which have resumed hiring in earnest. This measure grew at 2.09% in 2015, slightly beating growth in total employment of 2.05%, and is expected to continue growing at similar rates for the next few years. This alone should translate into increased demand and net absorption of office space.

The reason for the growth in office-using jobs and total employment comes, in part, from the health of the business sector, which is partially proxied by measures such as corporate profits and private fixed investment (non-residential) that are graphically depicted herein. Corporate profits of domestic firms have risen substantially over the last several years, according to the U.S. Bureau of Economic Analysis (BEA). The rate of growth slowed in 2015, in part due to slightly higher interest rates, and rising costs of labor due to the sustained growth in the macro economy. Still, it appears that firms are increasingly willing to invest domestically, as private fixed investment continues to grow with annual rates setting new record highs for the past several years, according to the BEA. This trend should force more office sector hiring and thus the need for office space.

There is, of course, a countervailing trend in global economics with risk and pain from Asia and Europe. As the United States trades with these regions, a global slowdown or recession could turn these trends flat, or even negative, and thus cause pain in the U.S. office market. At present, the United States appears to be one of the healthiest economies in the world, but the risk is real and bears attention. Still, these risks appear to pose greater threat to other real estate sectors such as industrial and hospitality. The trend of "offshoring" office jobs from the United States to countries such as China and India has actually declined in many industries, as those countries' labor costs have risen and the realization of negative externalities (theft of intellectual property and poor customer service for example) have even caused some firms to "onshore" or "reshore", especially in their office-using employment hubs.



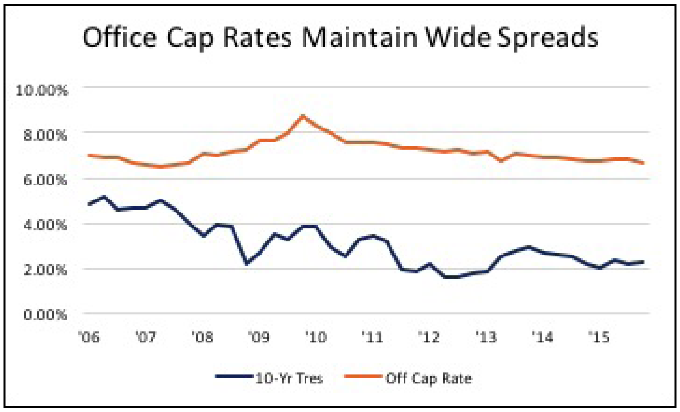




Office Capital Markets Outlook

WIDE SPREADS INDICATE LOW RISK

The office sector has increasingly become a popular one for global real estate investors at an increasing rate. This trend began in the international mega markets (i.e., New York City and San Francisco) but has broadened to many secondary markets across the nation. As such, average office cap rates have continued to fall in recent years to an average of 6.8%, according to Real Capital Analytics. Long-term interest rates remain low and are now widely expected to remain as such for 2016 and possibly 2017. The net result is the relatively wide spreads between office cap rates and interest rates should sustain. Thus, with respect to the office market, we do not see any immediate signs of a bubble or imminent reversal of cap rates upwardly. If spreads begin to compress or interest rates jump suddenly, pricing of office assets could fall, but this is not forecast on the horizon. To the contrary, the global economic fears and low interest rates and equity returns should actually fuel increased investments in office properties in 2016.



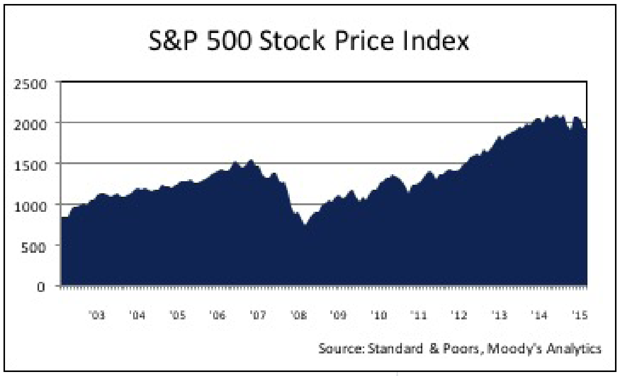
Source: Real Capital Analytics®, Lakemont Group

Office Market Trend Watch

RETURN OF THE PRIVATE OFFICE IS POSSIBLE

It is often said that the only constant in business is change. This fact is readily observable in the United States' office space market. As firms experienced precipitous declines in revenues due to the last recession, they were forced to find means of cutting costs. These cost cutting and efficiency moves allowed the U.S. corporate sector to recover relatively quickly, and helped drive, amongst other things, new highs in domestic equity markets (such as those proxied by the S&P 500). Many of these efficiencies related to using less office space per employee and employing fewer full time, permanent staff (home office independent contractors helped fill the void). Now that firms have seemingly exhausted the gains from such moves, the logical question to ask is what is next? There are a few possible moves. First, further deepen the office/employee reduction paradigm and reduce space in favor of "virtual workplace solutions" which would, in essence, be a play on the trend of Millennials and others desiring to work flexibly and from home. Or, and perhaps more counter-intuitively, some may reverse trend and reembrace the "private dedicated office".

Competition for talent may make such an effective weapon in hiring wars as top performers and skilled team members desire natural comforts of a dedicated office where they can display personal belongings and not have to share a crowded work table as they attempt to complete creative work. While this sounds implausible, it is worth noting that trends of lower square foot ratios per employee have reversed after past recessions. Thus, it is a possibility.

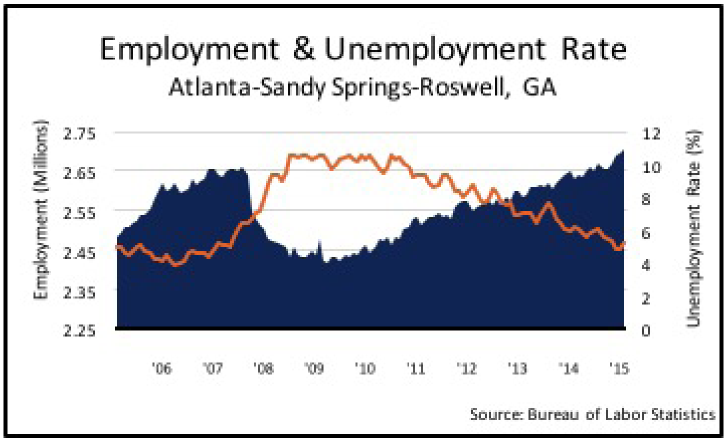


MARKETS TO WATCH

Not necessarily the largest or the most actively contested markets, the 2016 Office Markets to Watch are each at an important juncture that presents unique opportunities for investment. Together, they reflect the diversity of trends that is driving the economy and commercial real estate performance in markets across the country.

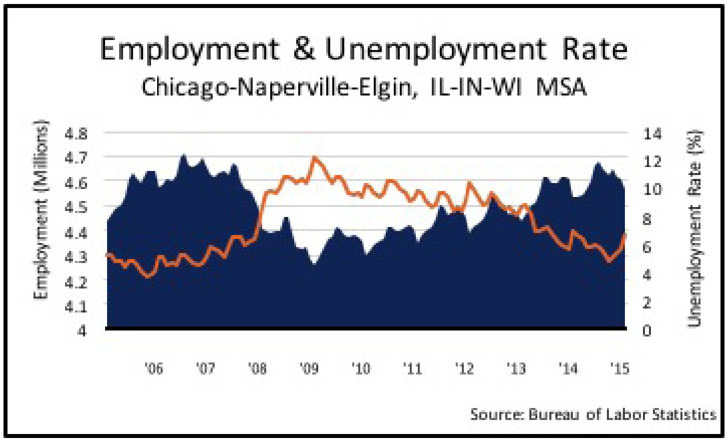
ATLANTA, GA

Atlanta has experienced strong gains in total employment and is setting record highs as of January '16, according to the Bureau of Labor Statistics, with unemployment at 5.2% and new job creation at an annualized rate of 3.5%. This includes growth in key office-using sectors including Professional and Business Services, Financial Activities, and Education and Health Services, which grew at annualized rates 5.0%, 2.0%, and 1.8%, respectively. In addition, Construction employment is growing at a 7.4% annualized rate, indicating further overall economic growth is projected to occur in Atlanta in 2016 and beyond. According to Georgia Trend, many high impact industries are likely to accelerate growth in Atlanta including life sciences and technology. These forces should cause rising rental rates and falling vacancies in the metro region, with downtown/midtown potentially poised to gain in the overall trend of urbanization affecting cities such as Atlanta.



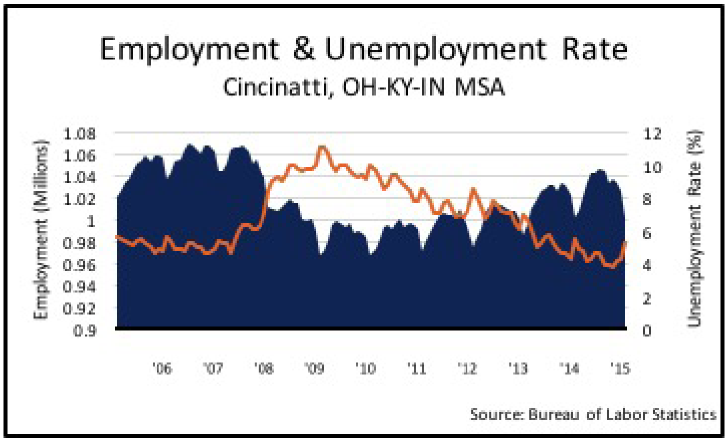
CHICAGO, IL

Chicago started 2016 with an upward move in unemployment to 6.7% in January from 4.9% in September of 2015, according to the Bureau of Labor Statistics. Overall, Chicago recovered from the recession but employment levels still remain below their pre-2007 levels. The office sector has remained fairly flat with gains in employment registering annualized rates of growth of 1.1%, 0.5%, and -0.3% for Information, Financial Activities, and Business and Professional Services, respectively. Still, Chicago remains an international hub for business activities, and demand for office and other real estate investments has reached record highs, according to Real Capital Analytics®. They report that in 2015 over $8.5 billion in office properties transacted, an increase of 34.3% from 2014. Chicago's economic diversity should serve the office market well, especially in the downtown core in 2016 and beyond.



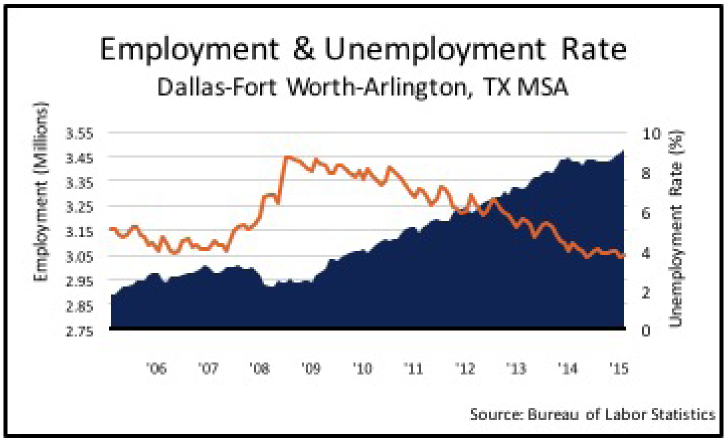
CINCINNATI, OH

Cincinnati's economy is still struggling to find a consistent growth trend as unemployment started the new year at 5.2%, up from 3.9% in August of '15, according to the Bureau of Labor Statistics. Positive signs for the office market can be seen in Financial Activities and Information, which are growing at annualized rates of 3.6% and 2.2%, respectively; however the key office-using sector of Professional and Business Services is losing ground with –1.6% growth. Overall, the run of consolidations in industries such as banking, legal firms, etc. has still left Cincinnati with relatively high vacancies and lower lease rates. As the national economy grows, these relative pricing advantages should position Cincinnati to gain new tenants and users looking to locate in the region.



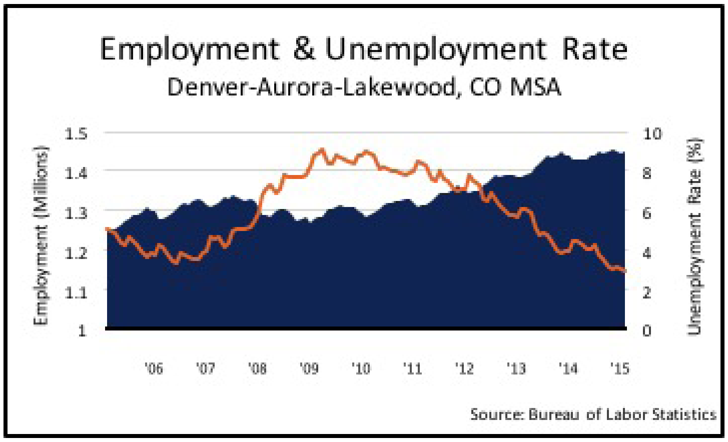
DALLAS, TX

Dallas remains one of the fastest growing employment centers in the nation, even with the energy price declines of 2015. According to the Bureau of Labor Statistics, the unemployment rate sits near record lows at 3.8% as of January '16, with the city creating over a half million new jobs since the recession. The office markets have fared well, as key office sectors of Financial Activities and Professional and Business Services have grown at strong annualized rates of 4.8% and 2.3%, respectively. Information has remained fairly flat at 0.4% annualized growth. As Dallas has become a modern international city with the help of the DFW airport, it is perhaps the best positioned market in the oil producing region of the U.S. to weather any pain from the petroleum industry. The office market should remain stable and growing in 2016 and beyond.



DENVER, CO

Denver remains one of the most rock-solid metropolitan economies in the nation with 3.0% unemployment in January '16, according to the Bureau of Labor Statistics, while maintaining steady, slow growth that has total employment at record highs. The office market is equally steady with a relatively low level of vacancy and fair asking rents. This stability and growth should persist in 2016 for the office sector as key employment groups - Financial Activities, Professional and Business Services, and Information - are all showing strong-to-decent annualized growth of 3.9%, 3.2%, and 1.8%, respectively. Denver maintains a diversified set of economic base activities including aerospace, bioscience, and energy, just to name a few. As such, the office market is likely to withstand any negative impacts of global uncertainty and oil price declines for the foreseeable future.



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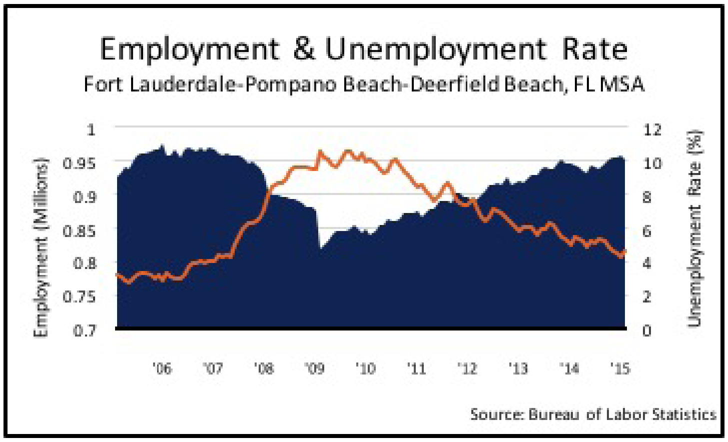
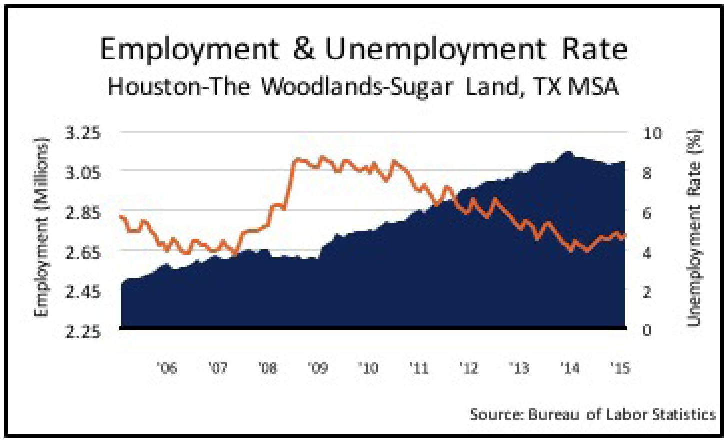
FT. LAUDERDALE, FL

Ft. Lauderdale has experienced significant recovery from the recession but still remains below pre-recession peaks in both total employment and lows in the unemployment rate. Still, the economy is quite healthy with a 4.7% unemployment measure as of January '16, according to the Bureau of Labor Statistics. As part of a multi-metro region, Ft. Lauderdale offers relatively lower office rents and higher occupancies, as well as an overall lower regional cost of living (especially compared to Miami) and thus is a rational place to grow and expand a business. Key office sectors are displaying strength with Financial Activities, Professional and Business Services, and Information all markedly positive with annualized growth rates of 4.5%, 4.3%, and 2.1%, respectively. The office market of Ft. Lauderdale should perform well in 2016.



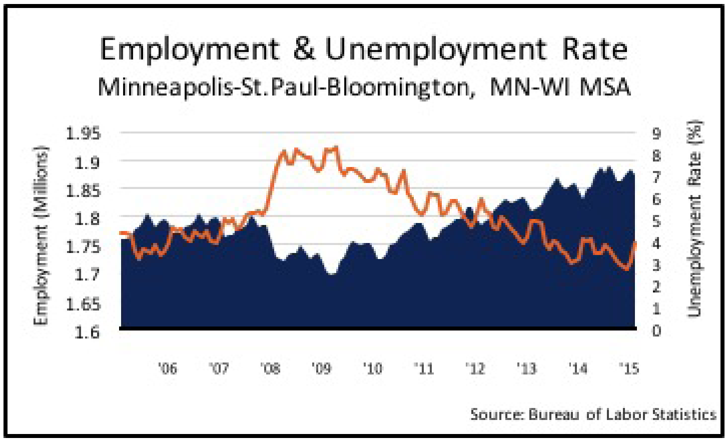
HOUSTON, TX

Houston is the hub of oil and energy production in the United States and, as such, is uniquely susceptible to the recent oil price declines that appear to have near-term persistence. It is likely that the office market in Houston will experience some pain in 2016 and beyond on a relative basis. Declines are already being felt in key office sectors with Information and Professional and Business Services declining at –2.5% and –1.8% annualized rates, respectively; however, Financial Activities is growing at 2.0% and thus should balance some of the negative effects. Overall, the Houston economy is actually fairly healthy with a 4.8% unemployment rate as of January '16 which has stayed near constant for much of 2015; thus, fears of the oil price declines may be overblown.



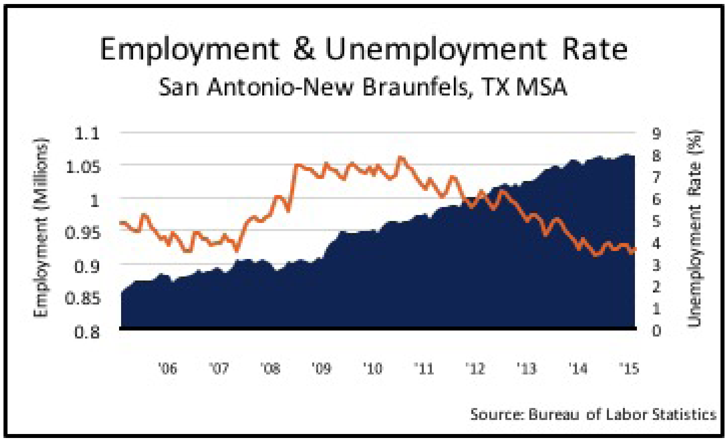
MINNEAPOLIS, MN

Minneapolis remains one of the strongest and most stable economies in the nation with 3.9% unemployment in January '16, according to the Bureau of Labor Statistics. The metro area has steadily gained total employment while only experiencing a modest decline during the past recession. The key office-using sectors are fairly stable with modest growth as Financial Activities and Professional and Business Services gain jobs at 1.6% and 0.9% annualized rates, respectively, while Information remains mostly flat at –0.3%. Given that Minneapolis is repeatedly cited as a good place to do business, its office market is likely to maintain stability and grow in 2016 and beyond. Further, Minneapolis is experiencing a long-term trend of re-urbanization, meaning that the CBD is likely to perform well for the extended horizon.



SAN ANTONIO, TX

San Antonio, like many Texas metros, has experienced significant economic growth with minimal impacts from the past recession. Overall, total employment is at near record highs and unemployment sits at 3.7% as of January '16, according to the Bureau of Labor Statistics. The metro's diversified economic base from trade and manufacturing to research and finance has left the office market relatively healthy and poised to grow in 2016 and beyond. All key office sectors are growing, including Financial Activities, Professional and Business Services, and Information, at annualized rates of 2.1%, 2.0%, and 1.0%, respectively. San Antonio does have significant exposure to industries such as automobiles and energy that could come under pressure in continued global slowdowns, but overall the risk to the office market does not appear significant at this time.



SAN FRANCISCO, CA

San Francisco remains one of the hottest office markets in North America, led by booms in the tech industry that are seeking urban locations over sprawling campus sites. As such, the Bay Area has some of the highest rents and lowest vacancies and this trend is not forecast to reverse anytime soon. The overall economy is very healthy for the size of this metro, with unemployment at 3.9% as of January '16, according to the Bureau of Labor Statistics. Office-using sectors are some of the fastest growing, with Professional and Business Services, Information, and Financial Activities growing at 5.4%, 4.8%, and 1.3% annualized rates, respectively. Affordability of office space, as well as overall cost of living and operating, are the biggest impediments to sustained growth; thus, expect the suburbs to grow and urbanize at increasing rates as well.