2007 CORPORATE REAL ESTATE SURVEY
A SPECIAL RESEARCH REPORT

Expansion Continues

In spite of cautious economic forecasts, unexpectedly robust job growth fuels all property types in 2007.

While concerns persist that the economic expansion will slow in 2007, commercial real estate continues to ride the momentum of five consecutive years of investment gains and consistently solid market fundamentals.

"This is an economy that has lots of resilience," remarked Doug Duncan, chief economist for The Mortgage Bankers Association, during its annual commercial/multifamily convention last month in San Diego. Duncan pointed out that the economy in the last few years has fought off 9/11, a recession and global terrorism. Indeed, the economy grew at 3.5% in the fourth quarter of 2006, but if the housing and automobile figures are stripped away, real GDP for the quarter rose to a robust 5.8%.

This year, a conservative projection of 100,000 new nonfarm payroll jobs will be created each month, according to Grubb & Ellis. One-fourth of those jobs will be generated in office buildings, absorbing 55 million to 60 million sq. ft. of space in 2007. That would outpace office completions by at least 10 million sq. ft. and push the nationwide vacancy rate down to 13.2% from its current 13.6% — the fourth consecutive year the vacancy rate has declined.

"In virtually every market in the country and in every product type, we are moving from a recovery period into a period of expansion," says Rick Davidson, president and chief operating officer of Coldwell Banker Commercial. Five central business districts — in Seattle, San Francisco, San Jose, Calif., Miami and New York's Midtown — should post double-digit gains in Class-A asking rents in 2007, while 20 other CBDs will enjoy rate increases of at least 5%, compared to just nine CBDs last year.

Other forecasts are similarly optimistic. The National Association of Realtors believes overall office occupancy rates will rise 0.8% in 2007. Rent growth, meanwhile is expected to jump 5.2%, up from 4.3% in 2006.

Still, employers are cautious in hiring as they again ponder the possibility of a slowdown in 2007, says Ken Mayland, president of Ohio-based ClearView Economics. The triggers that would halt the current expansion — excessive inflation, inventories, and personal and company debt — have not yet been tripped, he says.

Survey highlights

Against this backdrop, National Real Estate Investor and Coldwell Banker Commercial queried developers, owners, managers and corporate real estate professionals in late 2006 to uncover the answers to key questions facing them: How will corporations balance portfolios with market conditions? What will be the greatest influences on site selection in the coming year? Among the findings:

• Corporate respondents indicate that they plan to be involved in more transactions in 2007 than in 2006. Some 71% of respon-

Survey Methodology

Data for the 2007 Corporate Real Estate Survey conducted jointly by National Real Estate Investor and **Coldwell Banker Commercial** was collected in December 2006. The purpose of the survey was threefold: to investigate which markets — primary or secondary — will experience the most growth over the next 12 months; to determine the commercial real estate usage or holdings of corporations and their near-term plans; and to assess potential opportunities for commercial real estate owners, managers and developers in these markets.

Both providers and users of commercial real estate were surveyed. An email link containing the survey questions was sent to **NREI** subscribers, including developers/owners/managers and corporate users. The results are based on responses from 294 industry professionals. This report can also be viewed online at www.nreionline.com.

NREI covers trends in commercial real estate with an emphasis on finance. Approximately one-third of the publication's 36,000 qualified readers are developers/owners/managers, while lenders, corporate users and brokers make up the balance of the readership.

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dents plan to purchase real estate in 2007, up from 49% in 2006. Similarly, 63% plan to sell commercial real estate this year, up from 40% in 2006. Moreover, 55% of corporate respondents plan to develop commercial real estate in the next 12 months, up from 36% last year [Figure 1].

• Approximately three-fourths of the developer and corporate respondents expect their real estate portfolios to increase in 2007. The median portfolio size of corporate respondents is 475,580 sq. ft. [Figure 2].

• Both groups who plan acquisition, leasing, development and disposition activity in 2007 say those efforts will be divided fairly evenly among the multifamily, office and retail sectors. [Figure 3].

• In the process of site selection, corporate respondents say their top four influences are occupancy costs (69%), the local economy (67%), cost of land (57%), and population growth (47%) [Figure 4].

• Some 57% of developer respondents say over half of their new development activity is speculative versus build-to-suit. Furthermore, 27% indicate that all of their new development is speculative.

Primarily positive outlook

Strong market fundamentals and capital flow are giving the market continued momentum, says Davidson of Coldwell Banker Commercial, but cap-rate compression has pushed some investors out of the acquisition equation and into the development arena.

Spot overbuilding is a possibility in 2007, but it is less of concern than in the past because capital sources are much smarter and more sophisticated. "A significantly larger percentage of investors have a more guarded approach to the market today," says Davidson. "I believe this dynamic will soften the future cycles of our industry."

Although still in relatively good health, the retail sector saw an increase in vacancy rates last year compared with improving fundamentals for all other product sectors. "Of all the product types, it's the most vulnerable," says Davidson. "Delivery of retail space in 2007 and 2008 is projected to be strong and could have a [negative] impact on rent growth and overall returns." In the wake of the housing slide, retail starts

FIGURE 1. 71% OF CORPORATE RESPONDENTS PLAN TO PURCHASE COMMERCIAL REAL ESTATE IN 2007

FIGURE 2. THE MEDIAN PORTFOLIO SIZE OF CORPORATE RESPONDENTS IS 475,580 SQ. FT. (LEASED & OWNED SPACE)

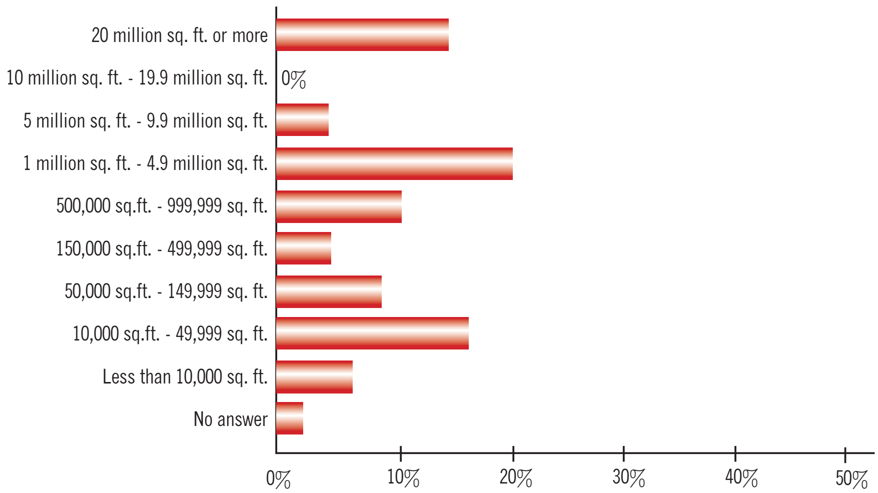
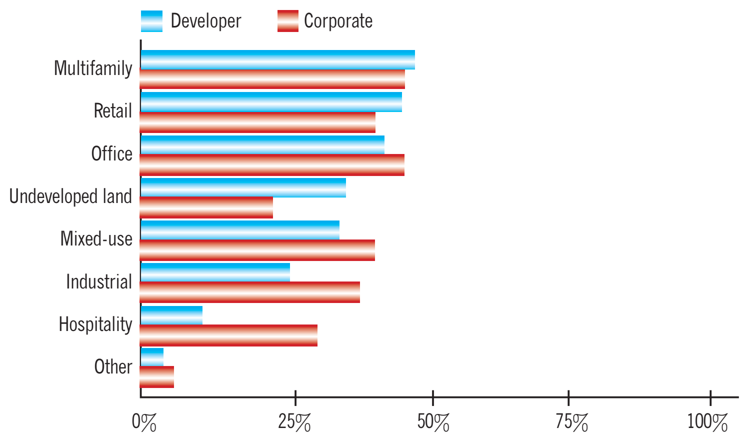


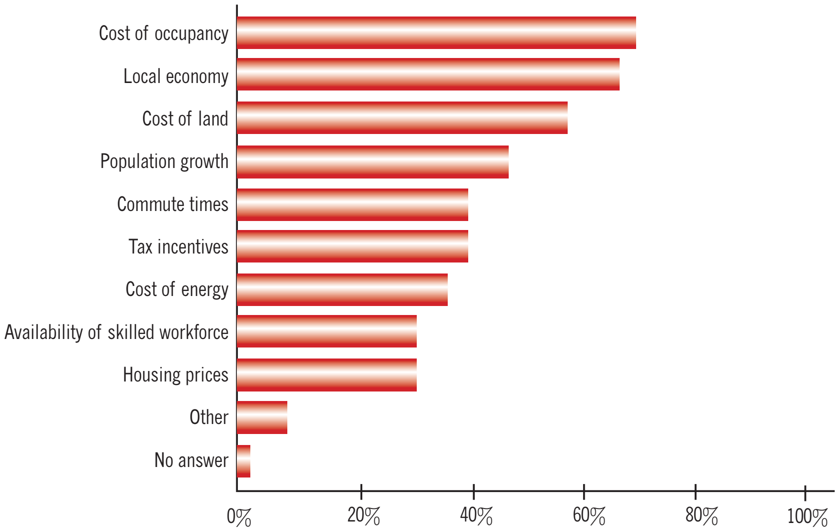
FIGURE 3. IN 2007, CORPORATE RESPONDENTS PLAN TO BE THE MOST ACTIVE IN THE OFFICE MARKET



dropped 2% to 300 million sq. ft. in 2006 and will drop to 278 million sq. ft. in 2007, according to a report from McGraw Hill Construction. That space is expected to come online over the next two years.

In contrast to the tepid retail sector, hotels were the darling of the investment party in 2006 and the witching hour isn't here yet. In fact, in the survey 29% of corporate respondents and 11% of developers indicate that they plan activity in the hospitality sector over the next 12 months. "The hospitality industry continues to improve," Davidson says. "Limited-service hotels especially have done very well. Revenue per available room [RevPar] growth is up across the board and the future fundamentals for this sector look good."

FIGURE 4. THE COST OF OCCUPANCY IS THE MOST FREQUENTLY CITED FACTOR IN CORPORATE SITE SELECTION



Sticker shock

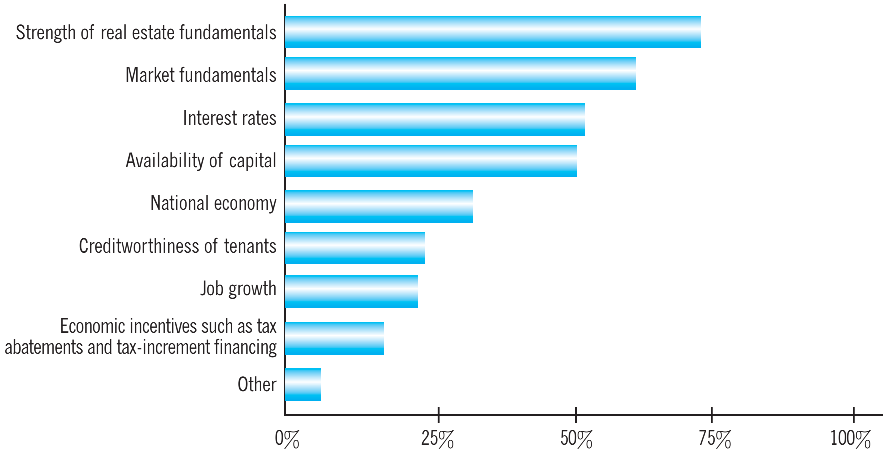
Overall, 59% of the 2007 survey respondents plan to increase holdings in secondary markets, while most of the corporate respondents (57%) and nearly half of the developer group (49%), say they'll increase their primary market holdings. "Sticker shock and cap rates in primary markets have pushed many investors into secondary markets," says James Costello, vice president and senior economist with Boston-based Torto Wheaton Research.

Nearly three-fourths (73%) of developer respondents in the survey said that real estate fundamentals, such as rental and occupancy rates, weigh heaviest in their decisions to develop, acquire or dispose of property. The next most frequently cited factor are market fundamentals (61%), followed by interest rates (52%), availability of capital (50%) and the national economy (31%). Creditworthiness of tenants (23%) and job growth (22%) landed near the bottom of the list [Figure 5].

"I am actually a bit surprised by this response, as the creditworthiness of a tenant is a key component in underwriting asset value," says Davidson of Coldwell Banker Commercial. "I think this speaks to the amount of capital in the market today and the appetite for investment."

Corporate respondents listed occupancy costs (69%) and the local economy (67%) as the top influences in site selection. Those concerns outweighed commute times (39%), tax incentives (39%), energy costs (35%), a skilled workforce (29%) and housing prices (29%).

FIGURE 5. FUNDAMENTALS ARE MOST LIKELY TO IMPACT DEVELOPER TRANSACTION DECISIONS



Commute times, a skilled work force and affordable housing should be ranked higher from a [corporate] site-selection mentality, according to Richard Kadzis, director of special projects for CoreNet Global.

Apart from those influences, concerns such as a city's existing business base and economic development reputation may be more significant overriding factors in site decision-making, says Kadzis. "Companies need reassurance they are making a good business decision. You don't hear them talking about things such as tax credits until they get to their short list [of cities]."

Green on radar

One potential cost-saving strategy — energy-efficient building design — registered with respondents, however slightly. A scant few companies — less than 10% among both corporate and developer respondents — say their portfolios include properties with energy-efficient designations [Figure 6]. However, 41% of developers and 38% of corporate users say they plan to own some properties with energy-efficient pedigrees — such as LEED certification or Energy Star — in the next three years.

"Environmentally sensitive development is still a relatively new phenomenon in our industry," Davidson says. "But as green designs are refined and green

FIGURE 6. LESS THAN 10% OF RESPONDENTS' PORTFOLIOS HAVE EARNED LEED CERTIFICATION OR OTHER DESIGNATION

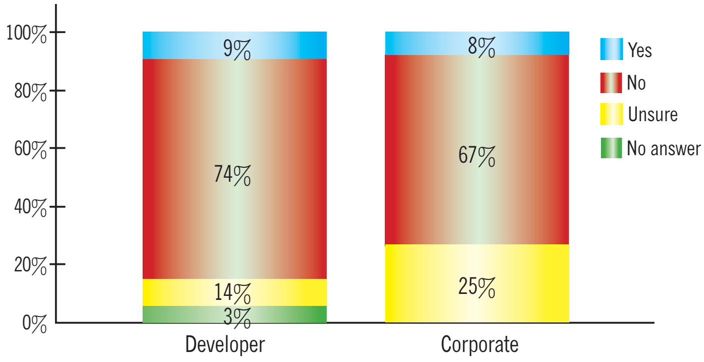
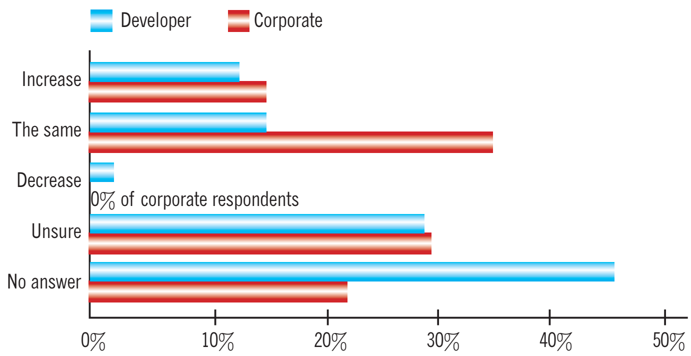


FIGURE 7. RESPONDENTS EXPECT SALE-LEASEBACK TRANSACTIONS TO REMAIN THE SAME OVER THE NEXT 3 YEARS



construction costs drop, we will see the industry migrate in this direction. Today's younger generations are far more environmentally conscious than generations of the past."

In roundtable discussions last year with corporate real estate managers from around the U.S., Torto Wheaton found that LEED certification is on companies' radar screens. "That could change if tenants begin clamoring for it," Costello says.

Cutting costs

As corporations look for ways to streamline operating costs, sale-leasebacks are one strategy to free up cash and get real estate off their books. In fact, the survey indicates that one-third of all respondents have entered into a sale-leaseback transaction, and 14% of corporate respondents and 12% of developers expect their use of sale-leasebacks to increase in the next three years [Figure 7].

That's no surprise to Larry Wilks, senior managing director in Cushman & Wakefield's capital markets group, who has seen a four-fold increase in sale-leasebacks in recent years. "Some companies see sale-leaseback as way to realign real estate to meet financial objectives, raise capital and fund business operations while still maintaining operational responsibility and control," he says. Though sale-leasebacks are more common between office tenants and building owners, a large part of retail branch-bank portfolios among Wachovia, Bank of America and similar banks are now on sale-leaseback terms.

Another corporate cost-cutting trend has been culling the actual square footage per employee. The survey indicates that more than half of the developer respondents (55%) did not know the total gross square footage that is occupied per employee in the properties they own, manage or develop, while 39% of corporate respondents did not know the figure.

"The 39% figure is actually a pretty good number," Kadzis says. "It's [an improvement] from 10 years ago." Large global real estate companies are tracking real estate metrics more aggressively these days, he explains.

Developers, unless full-service, are less apt to know square footage per employee because they operate more in a regional vacuum. "I think if you were to peel this statistic back, you would find it's just a matter of time until they're all pushed in that direction," says Kadzis. "And I suspect the [corporate] number will probably improve 5% next year."

Smooth landing?

In other projections, commercial real estate investment volume is likely to stabilize at a high level in 2007, particularly if interest rates and cap rates remain stable, according to Grubb & Ellis. Torto Wheaton's Costello adds that the 2007 office market has the best growth prospects relative to current prices because supply is fairly contained.

Ongoing softness in the housing sector has had minimal effect on commercial real estate properties with the exception of retail, where cuts in home improvement stores, furnishers and general merchandisers are likely to continue, according to Mayland of ClearView Economics. Job gains in hospitals, restaurants, engineering and architectural firms and government posts have compensated for job losses among retailers, home builders and the automotive industry, according to the Labor Department.

Some confusion has been caused by the department as a result of its frequent revision of initial job projections over the past year, actions Mayland attributes to "methodology nuances." The bureau's monthly survey of 400,000 businesses has proven to be less accurate than its monthly survey of 60,000 households, he says. That's because most new companies aren't part of the payroll survey, while the larger companies that are a big part of it have a greater tendency to cut jobs.

In all, the 2007 commercial real estate environment "is shaping up from a real estate underwriting standpoint, with more capital chasing a limited number of transactions," Wilks says. Attractive interest rates accentuated by pension funds reallocating capital into the real estate sector bode well for the coming 12 months. "The economy continues to do well and real estate fundamentals are strong."