Property Cycle Propelled By Suburban Second Wind

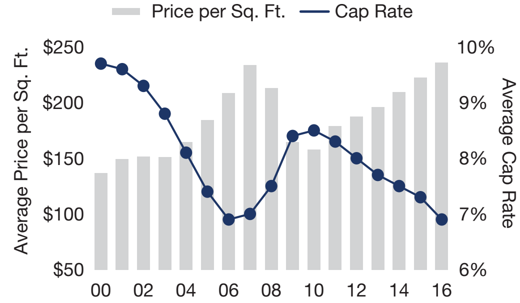
Solid asset performance tempers the overall climate of risks. As investors contemplate the year ahead, positive economic growth combined with solid office expectations must be calibrated with a rising interest rate environment. Additionally, the Trump administration's tax reform plan introduces some short-term uncertainty into the investment environment, which could slow decision-making. Though greater-than-expected upward pressure on long-term rates will likely increase investor caution and intensify risk assessment, historically cap rates have not moved in tandem with Treasuries. Additionally, the decline in vacancy and a projected rise in rent growth anticipated for 2017 could generate sufficient NOI growth to counterbalance the anticipated rise in interest rates. Still, opportunities will be more closely scrutinized in the new, more challenging investment environment.

Private investors active; capital flows to suburbs may accelerate. Transaction volume declined slightly last year, primarily reflecting fewer deals by REITs at higher price points. Private investors in the $1 million to $10 million price tranche dipped 3 percent compared to the preceding year's trend. Access to acquisition financing will sustain purchases in this segment of the market and offer additional opportunities to transact for owners seeking to monetize recent gains in property income. Heading into 2017, both the average price per square foot and cap rates are on par with their 2007 peak, though vacancies have yet to reach previous lows. The recent rise in long-term interest rates may slow the compression of cap rates, potentially bringing additional investors into the market. Arbitrage opportunities exist in trading out of CBD properties and into suburban assets that generally offer higher yields. As suburban assets continue to contribute a greater share of net absorption and vacancy rates compress, a greater flow of capital to the suburbs could ensue.

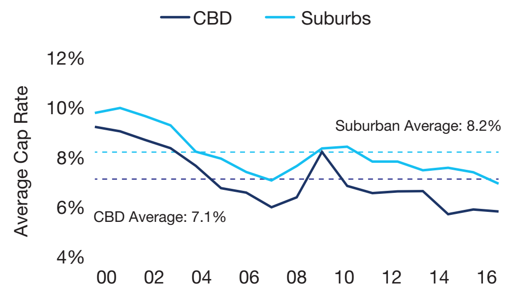
2017 Investment Outlook

- **Yields will become more critical.** As benchmark rates have risen at a rapid rate, investors have increasingly sought opportunities to preserve spreads. The higher cap rates in secondary and tertiary markets have enticed a growing cadre of investors. The cap rate spread between primary and tertiary markets stands at 80 basis points, down 30 basis points from 2015, and reflects the shift in momentum from classic trophy assets in primary CBDs.
- **Asset performance will be scrutinized.** Investor sentiment has become increasingly cautious, as a widening bid-ask spread has slowed transaction velocity. Though construction is expected to remain historically low, it is highly concentrated in CBD locations. Highly amenitized CBD deals have sparked less interest than in previous years, given heavier construction and slowing CBD rent growth.
- **Foreign capital targets will evolve.** Although traditionally institutional foreign capital has favored primary market CBD deals, some foreign investors are increasingly looking toward suburban properties in secondary markets to satisfy investment growth needs. The upturn in suburban property income growth should invigorate this trend.

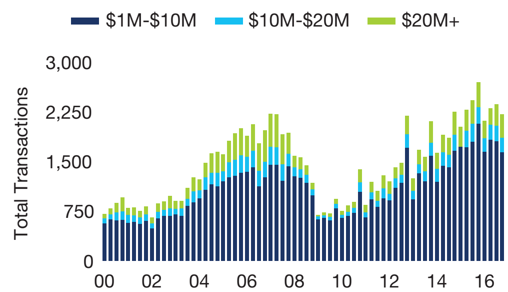
Office Property Price Trends



U.S. Office Cap Rate Trends By Location



Office Transactions By Price Category



Office Buyer Composition