Office Investment Outlook

United States | Q4 2016

OFFICE

Following a year of moderate declines, office dynamics well positioned in 2017

U.S. Office property market	
-20	1.0%
12-month change in total vacancy (bps)	12-month net absorption (as % of inventory)
1.1%	3.6%
12-month completions (as % of inventory)	12-month rent growth (p.s.f.)

U.S. Office investment	
$143.0	-0.6%
Investment sales (FY, billions of $US)	FY investment sale growth
4.3%	-26
Average cap rate	12-month change in cap rate (bps)

Incremental growth of office fundamentals expected as workforce constraints emerge and absorption decelerates. Near full employment markets and a shortage of skilled talent are restricting expansionary activity in several major technology hubs, a factor in decelerating leasing velocity and moderating occupancy growth. Broader economic trends appear favorable heading into 2017, with increased optimism toward business conditions, personal finances and employment. The shift in public policy will be a key factor to watch.

Following a year of uncertainties, office liquidity outlook improving for 2017. Despite U.S. investment volume declines in 2016 at-large, the office sector sustained stable activity, reaching $143.0 billion of full-year transactions. However, office pricing remains under pressure as investors adopt more selective, targeted acquisition strategies, impacting liquidity in parts of the market. Moving into 2017, investor sentiment continues to improve with sustained cautious optimism.

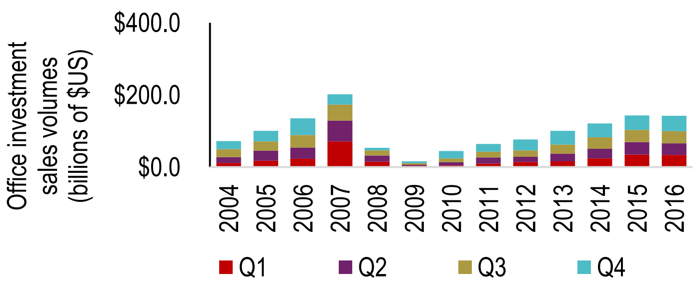
Pent-up demand for scale to benefit office investment into 2018. Lagging portfolio and entity-level transactions this cycle are expected to shift in 2017. Investor appetite for scale, built-up value by national to regional real estate platforms and underperforming public markets are factors in this outlook.

As secondary market investment increases, outperformers emerging across CBDs and suburbs. After a modest setback at midyear, secondary market momentum has been reenergized, with these markets seeing their most active relative year of the cycle in 2016. Atlanta, Dallas and Philadelphia are leading this activity, with drivers divergent across CBD and suburban submarkets.

Offshore office investment remains the norm, with German and Asian buyers now leading. With more than $20.0 billion of foreign office acquisitions in 2016, the sector continues to be a primary beneficiary of offshore capital demand. This is increasingly being driven by German and Asian capital. While three-fourths of this capital remains focused on primary markets, modest gains are being seen in multitenanted, core assets in select secondary markets.

Office investment sales

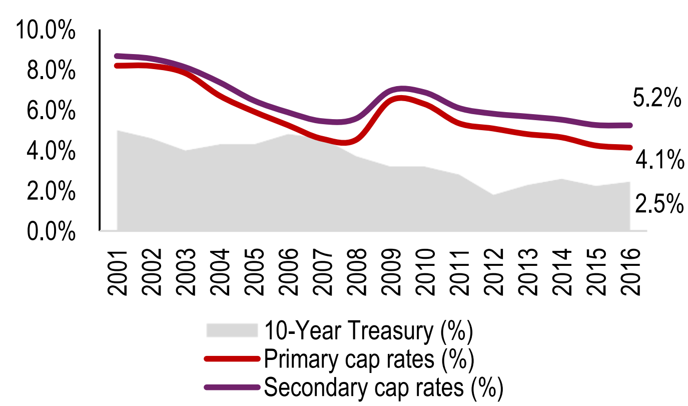
While up 7.4 percent in the fourth quarter, year-to-date office investment sales stable over 2015 levels with a modest 0.6 percent decline at year-end



Source: JLL Research, Real Capital Analytics (Transactions larger than $5.0M)

Despite year-over-year compression, office cap rates plateauing

With recent gains in interest rates, the spread between office cap rates and the 10-Year Treasury has also tightened. However, spreads remain healthy with room for further compression



Source: JLL Research, NCREIF, Board of Governors of Federal Reserve

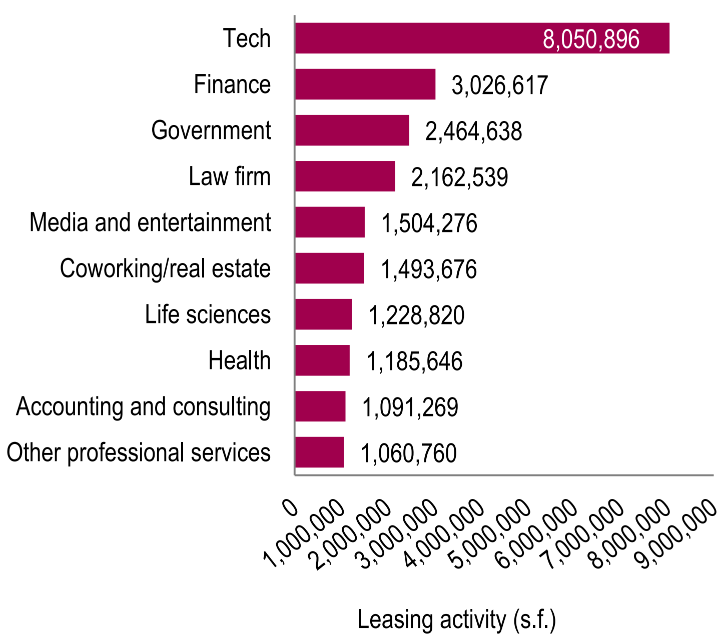
TOP 5 OFFICE THEMES

1 Incremental growth of office fundamentals expected as workforce constraints emerge and absorption decelerates

A combination of decelerating leasing velocity and a lower level of "mega leasing" in the fourth quarter resulted in the lowest level of occupancy growth in the U.S. office market in 24 months. This comes as markets near full employment and a shortage of skilled talent restricts expansionary activity in several major technology hubs. However, the tech sector remained the office market's primary demand driver, representing 24.4 percent of national leasing activity and helping offset suppressed tenant demand in the legal and financial services sectors. Within the major tech markets, the pace of San Francisco's growth is slowing—decelerating from 2.9 to 1.1 percent occupancy growth from 2015 to 2016, respectively, but sustained, robust expansionary activity in hubs such as Austin, Seattle-Bellevue and Silicon Valley are counteracting this, with each recording annual occupancy gains of 2.0 percent or greater.

Leasing by industry

Tech remains by far the leader in leasing activity, even as the industry faces a talent shortage



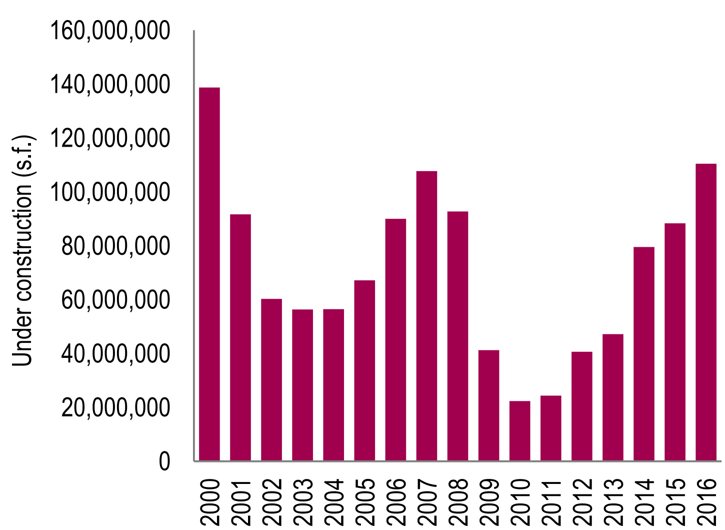
Source: JLL Research (leasing activity > 20,000 s.f.)

Despite the moderation in leasing demand, construction volumes rose once again and now stand at a cyclical high of 110.5 million square feet. Completions for 2017 are expected to exceed demand for the first time in the current cycle, with construction anticipated to peak and new groundbreakings to ratchet back in 2017. The risk of future oversupply is most acute in major gateway markets, including New York and Washington, DC, in which a surplus of quality new space or challenging prospects for backfilling second-generation space may materialize over the next 24 months.

Heading into 2017, broader economic trends appear favorable for the office sector, with consumer confidence recently rising to a 13-year high, suggesting increased optimism toward business conditions, personal finances and employment. The broader shift in public policy will be a key factor to watch. Prospects of policies favoring deregulation and lower taxation may serve as a catalyst for select industries which have faced increased regulatory pressures over the past eight years.

Under construction

2016 ended the year at 110.5 m.s.f. of development activity, surpassing the previous cyclical peak



Source: JLL Research

2 Following a year of uncertainties, office liquidity outlook improving for 2017

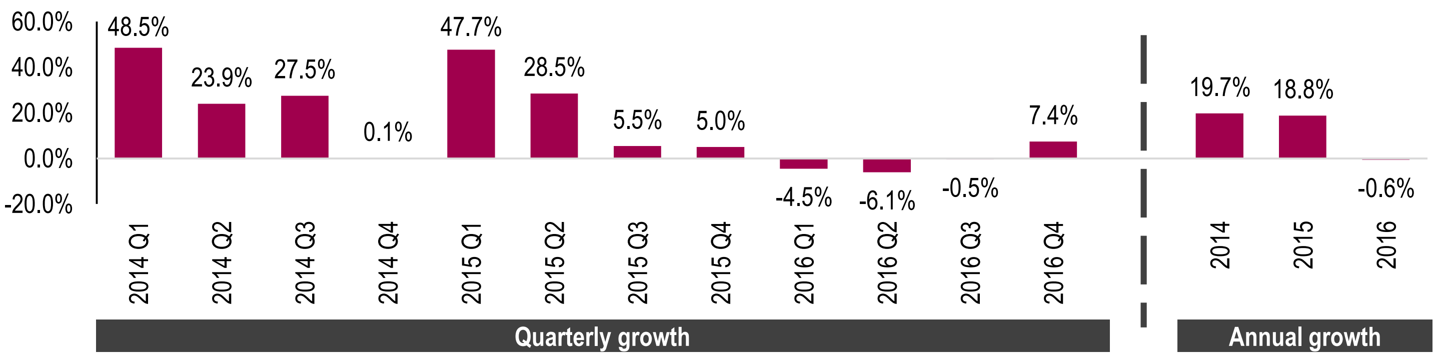
Despite U.S. investment volume declines in 2016 at-large, the office sector sustained stable activity, reaching $143.0 billion of full-year transactions. This represented a modest annual decline of 0.6 percent. The fourth quarter was a key driver of year-end activity: $43.2 billion of office transactions represented the largest quarterly figure of the cycle, and with quarterly gains of 7.4 percent, this represented the highest level of quarterly gains since the second quarter of 2015. This further supports that investor sentiment is stabilizing with increased optimism heading into 2017.

On the heels of an uncertain global investment environment over the past 18 months and sustained record-low cap rates, office pricing remains under pressure as investors adopt more selective, targeted acquisition strategies. With this, the liquidity landscape for office product weakened in 2016, negatively impacting low-growth, non-CBD, suburban office submarkets. The liquidity for core, urban office transactions similarly weakened, though it fared well relative to the aforementioned suburban product. These dynamics have translated into plateauing office cap rates with signs of softening emerging in select secondary markets. In 2015, a minor 6.0 percent of tracked office markets experienced softening; in 2016, this metric expanded to 25.0 percent, the highest level seen since 2010. With this, the gap between primary and secondary market cap rates remains at record levels, averaging 111 basis points, compared to the long-term average of 75 basis points.

Looking ahead, following a year of uncertainties and resulting shifts in the office capital markets, investor dynamics have already exhibited signs of improvement in the beginning weeks of 2017. For core investments, the outlook has improved. With active sources of offshore capital and increased activity expected from domestic institutional players this year, dynamics are expected to benefit gateway market opportunities and a select few secondary markets. For value-add and opportunistic opportunities in desirable urban submarkets, liquidity remains very strong and at the highest levels seen yet in select markets. As activity proceeds at more normalized levels, pricing will be a key factor to watch, with high-growth, high-barrier-to-entry markets expected to be more resilient.

Strong fourth quarter a precursor of 2017 investor sentiment

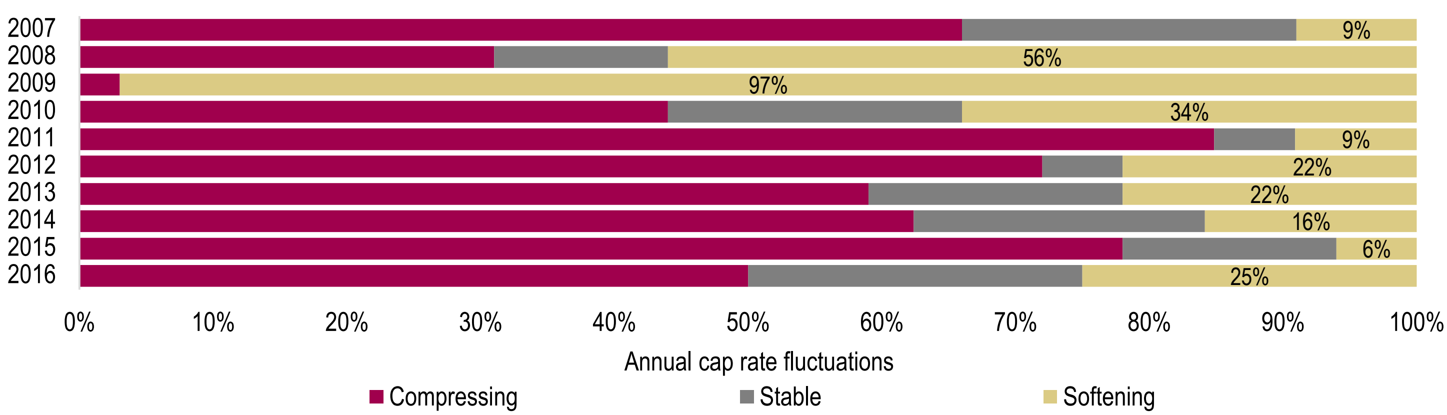
The office sector sustained stable activity in 2016 with a modest 0.6 percent decline. This was driven by a strong fourth quarter—the largest of the cycle—with the highest quarterly gains since Q2 2015



Source: JLL Research, Real Capital Analytics (Transactions larger than $5.0M)

Overall office cap rate fluctuations

While 50.0 percent of markets are seeing cap rates compress, signs of plateauing are beginning to emerge, with 25.0 percent of markets seeing a year-to-date softening of cap rates



Source: JLL Research, NCREIF. Includes 32 major office markets; Stable defined as markets seeing fluctuations within 10 basis points year-over-year.

3 Pent-up demand for scale to benefit office investment into 2018

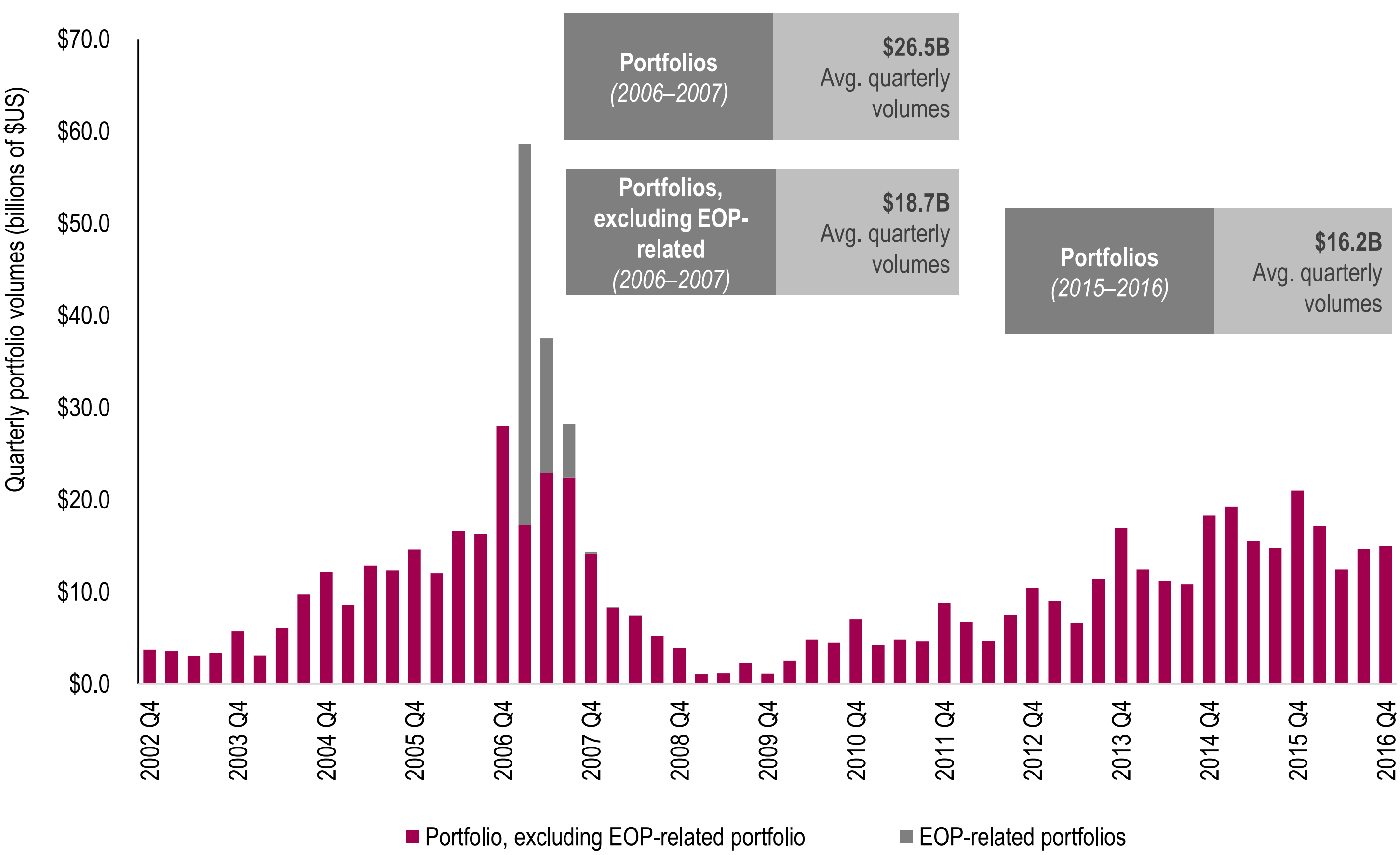
A balance between single-asset and portfolio or entity-level transactions remains the norm in the office capital markets today, with single assets primarily driving office deal flow, exceeding portfolio volumes year-to-year and averaging 58.0 percent of annual transactions since 2010. When comparing this to activity in the prior cycle, it points to pent-up demand for portfolio and entity-level transactions within the office sector. In 2006 to 2007, these transactions drove activity, with single-asset sales accounting for a minority 49.0 percent of activity on average. This average excludes the outsized impact of the Equity Office (EOP) acquisition and subsequent Blackstone dispositions of Equity Office assets in 2007, the total transaction values of which are estimated to have exceeded $60.0 billion. Excluding EOP, quarterly portfolio volumes over the last eight quarters are between 13.0 and 14.0 percent below the prior cycle peak, set in 2006 and 2007. As a result, portfolio volumes are lagging prior cycle levels by $2.5 billion on average each quarter. Despite this lag, national and regional portfolio opportunities have been rising with three $1.0 billion+ transactions closing this quarter alone:

- Cousins Properties closed on its merger with Parkway Properties in an office, entity-level transaction valued at $1.95 billion.
- Blackstone closed on a national, multisector portfolio from Alecta, a Swedish occupational pension manager, for $1.7 billion. While diversified, the portfolio contained a strong core of high-quality office assets, accounting for 40.0+ percent of total portfolio value.
- Spurred by Hines's plan to liquidate and dissolve its global REIT, Blackstone also closed on the acquisition of 3.0 million square feet of West Coast office assets for $1.2 billion.

Considering these facts, the built-up value by national to regional real estate platforms and underperforming public markets, increased portfolio and entity-level activity are expected to drive office investment into 2018 given pent-up demand from existing platforms, as well as a strong desire for scale from dry powder focused on U.S. markets.

Pent-up demand for scale to benefit office investment into 2018

Excluding the impact of EOP-related investments in the prior cycle, quarterly portfolio volumes remain below historic norms; average quarterly volumes lag prior cycle by $2.5 billion



Source: JLL Research, Real Capital Analytics (Transactions larger than $5.0M)

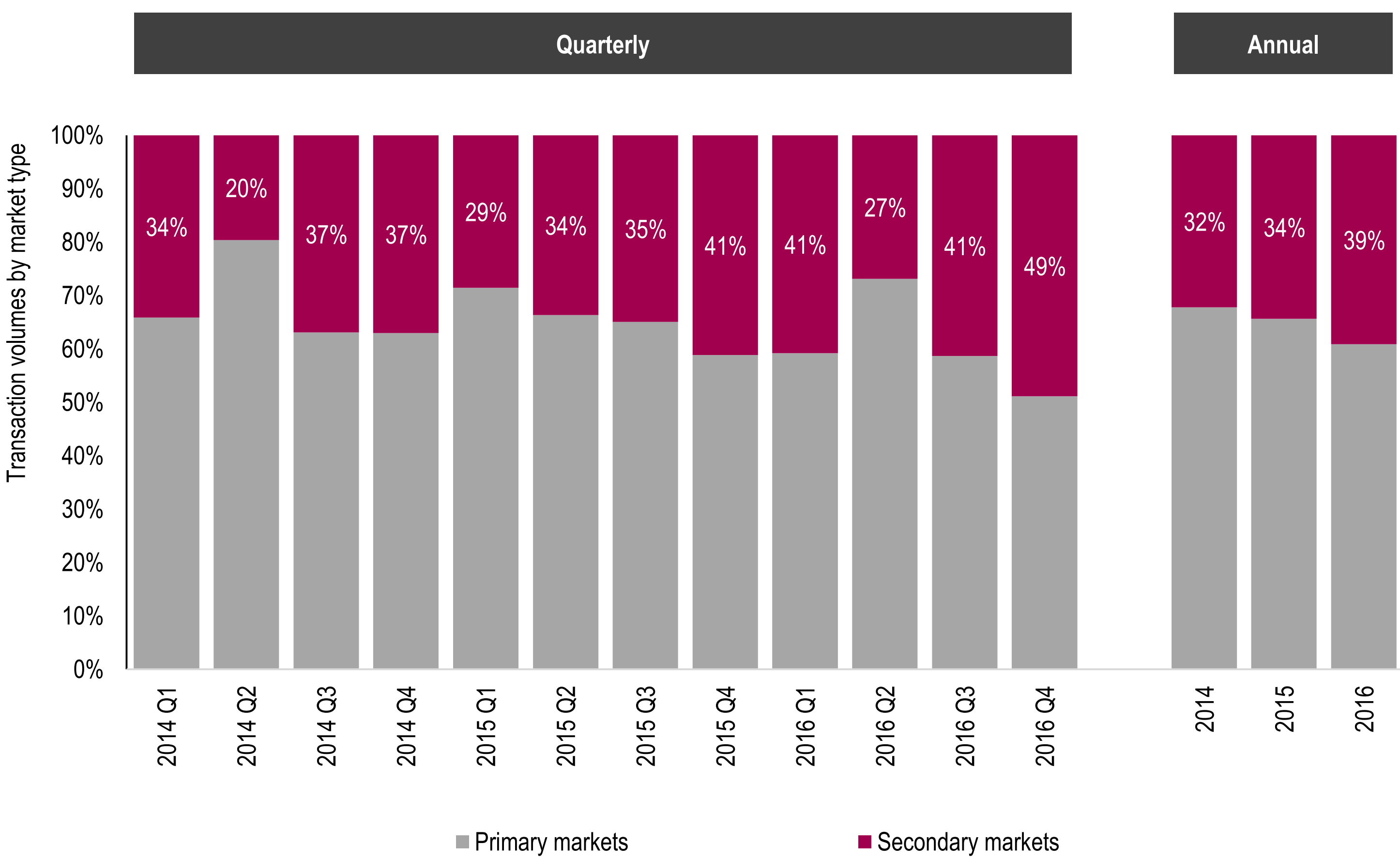
4 As secondary market investment increases, outperformers emerging across CBDs and suburbs

Following up on rebounding momentum during the third quarter, secondary market office investment continued to rise in the fourth quarter, reaching $10.4 billion of transactions. This represented the second most active quarter for this segment of the current cycle. As a result, secondary market office investment accounted for nearly 50.0 percent of fourth-quarter deal flow and 39.0 percent of full-year 2016 activity. Atlanta, Dallas and Philadelphia remain the largest drivers of volumes, each of which have seen office volumes exceed $2.0 billion in 2015 and 2016. Atlanta continues to outperform with annual volumes consistently exceeding $4.0 billion, accounting for four of the ten largest single-asset secondary transactions of the quarter and making it one of the five most active office investment markets in the United States at year-end. In Atlanta's largest deal of the quarter, Starwood Capital Group acquired One Atlantic Center from Hines for $318.1 million, or $289 per square foot.

Consistent across all three is a blend of transactions across CBD and non-CBD submarkets. However, while a 35.0+ percent growth in non-CBD transactions in Philadelphia in 2016 was the primary driver of activity, both Atlanta and Dallas are being driven by urbanization momentum: The markets each experienced $1.0 billion+ of urban office investment in 2016, with Atlanta seeing growth of 37.2 percent and Dallas at 92.6 percent year-over-year. Lagging urban investment is similarly catching up in smaller markets such as Indianapolis, Austin, San Diego and Minneapolis—each of which saw annual CBD office investment growth exceed 40.0 percent. Similarly, lagging suburban investment is catching up in Portland and Oakland–East Bay. While market and submarket selectivity remains the norm, a heightened focus on near- and midterm economic, demographic and fundamental strength will be a critical determinant in driving domestic capital flows in 2017. Those secondary markets exhibiting sustained strength in fundamentals and investment performance will further benefit from a diversifying investor base and thus sustained liquidity and pricing.

Investment sales volumes by market type

Second-half momentum pushes secondary markets to cyclical high on a quarterly and annual basis compared to primary markets, accounting for nearly 50.0 percent of fourth-quarter transactions

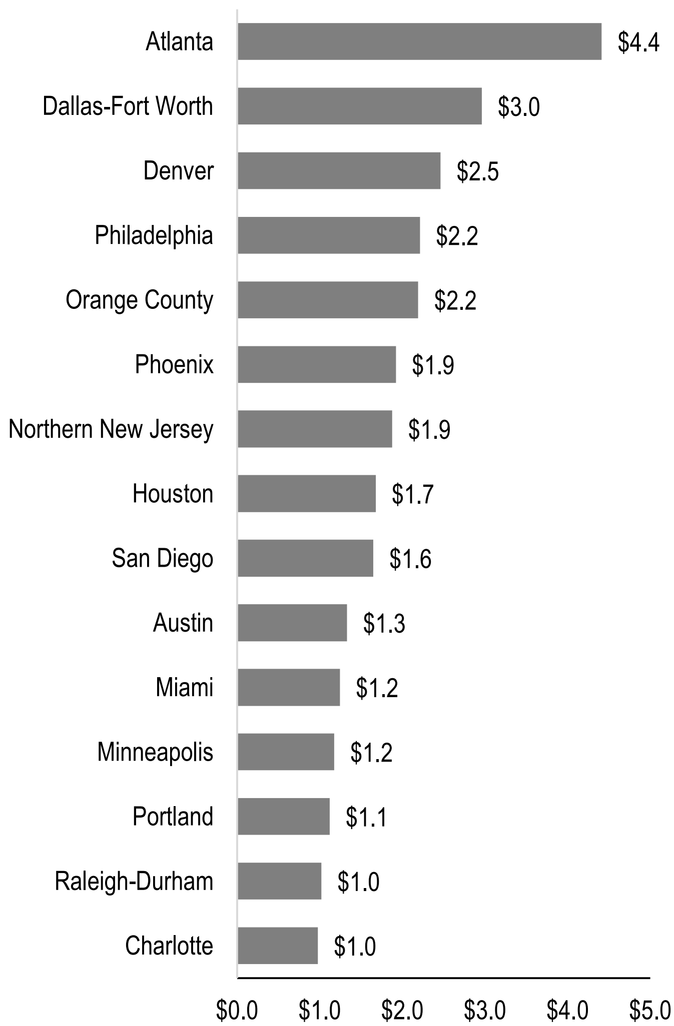


Source: JLL Research (Assets larger than 50,000 s.f.)

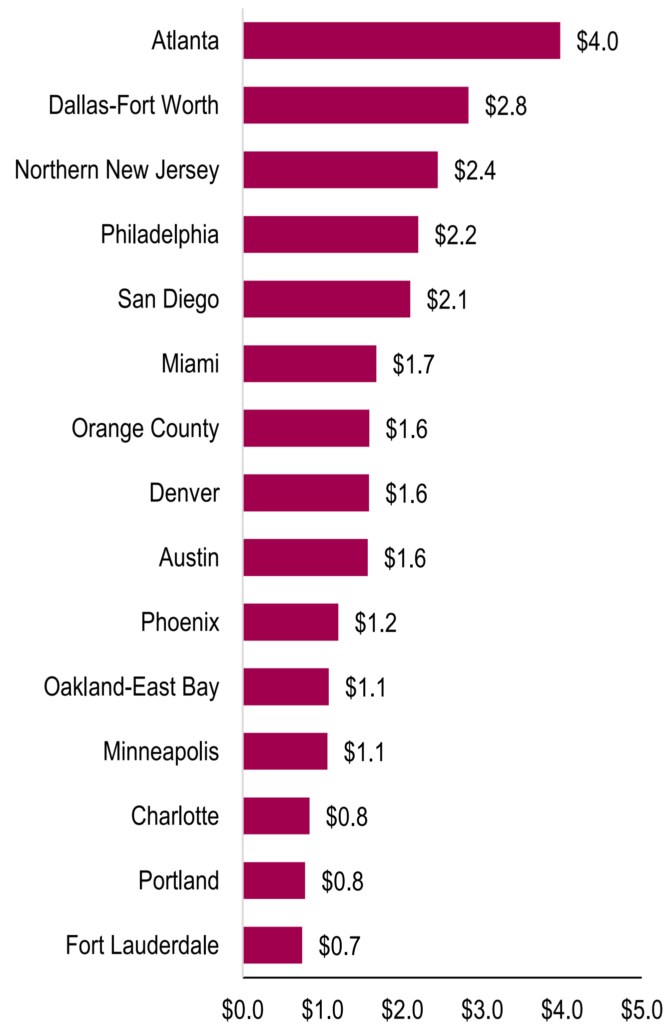
Who is leading secondary market volumes?

Atlanta, Dallas–Fort Worth and Philadelphia each consistently seeing office volumes exceed $2.0 billion annually

Leading secondary market volumes *(FY 2015, in billions)*



Leading secondary market volumes *(FY 2016, in billions)*



Source: JLL Research (Assets larger than 50,000 s.f.)

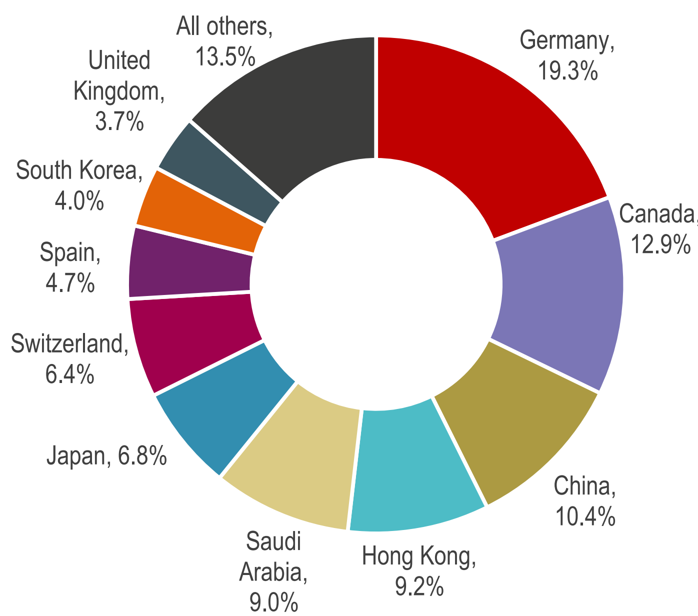
5 Offshore office investment remains the norm, with German and Asian buyers now leading

When analyzing foreign investor trends, office continues to outperform peer sectors and at a sustained, structural pace relative to the prior cycle. In 2016, foreign office investment exceeded $20.0 billion and accounted for 16.0 percent of overall acquisition activity for the second consecutive year—record levels on both indicators. As this remains the norm, the profile of offshore buyers continues to evolve. While Canadian groups have historically been the most active, the reemergence of German capital and emergence of Asian capital is now exhibiting its impact. Nearly 40.0 percent of all inbound investment came from European buyers—led by the Germans, followed closely thereafter by Asian (30.8 percent) and Middle Eastern (16.8 percent) capital sources. This is further reinforced when looking at the most active countries of origin. Following German buyers, which were the most active at year-end, Asian buyers were four of the ten most active countries of origin, with Chinese and Hong Kong buyers in the top five. In two of the largest offshore deals closed in the fourth quarter, Israel-based Global Holdings acquired 1250 Broadway in New York for $565.0 million, or $875 per square foot, and Spain-based Ponte Gadea acquired Southeast Financial Center in Miami for $516.6 million, or $422 per square foot.

With this sustained level of offshore active capital focused on the office sector, there is more evidence of the diversification of this capital into secondary markets: Of the ten largest offshore office acquisitions in the fourth quarter, five were in secondary markets, with four of those being multitenanted yet core and stabilized properties. While these opportunities are slowly increasing for top-performing secondary markets, three-fourths of this capital is expected to remain focused on those gateway markets.

German, Asian capital leading offshore office acquisitions in 2016

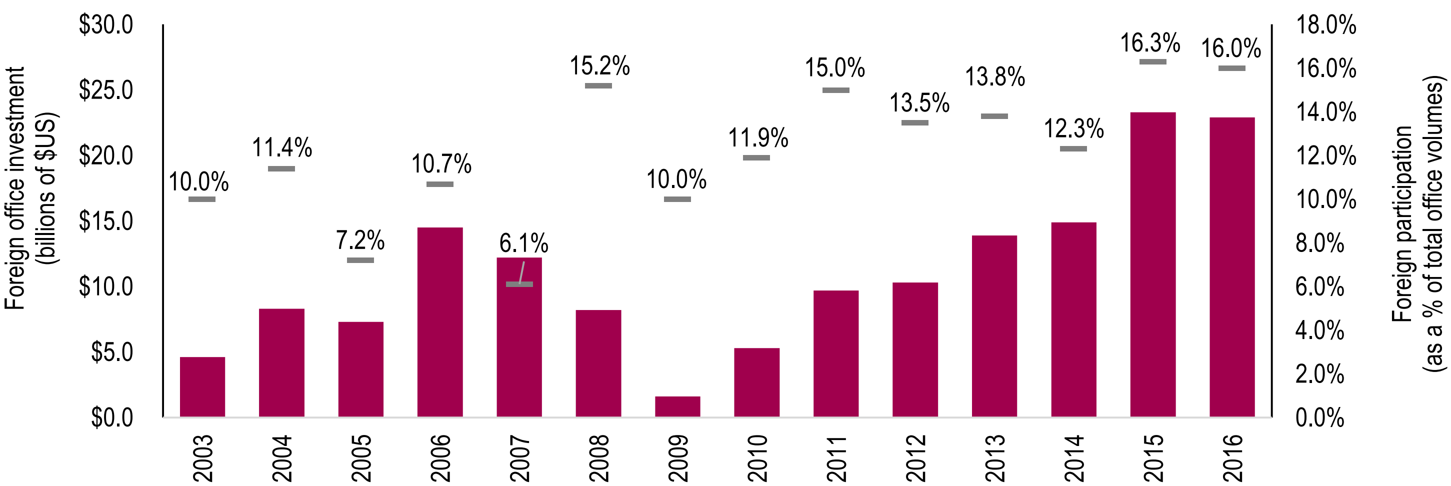
The foreign acquirer landscape took a shift in full-year 2016, with German capital surpassing Canadian as the most active and Asian investors accounting for four of the ten most active.



Source: JLL Research, Real Capital Analytics (Transactions larger than $5.0M)

Foreign office investment stable at elevated levels

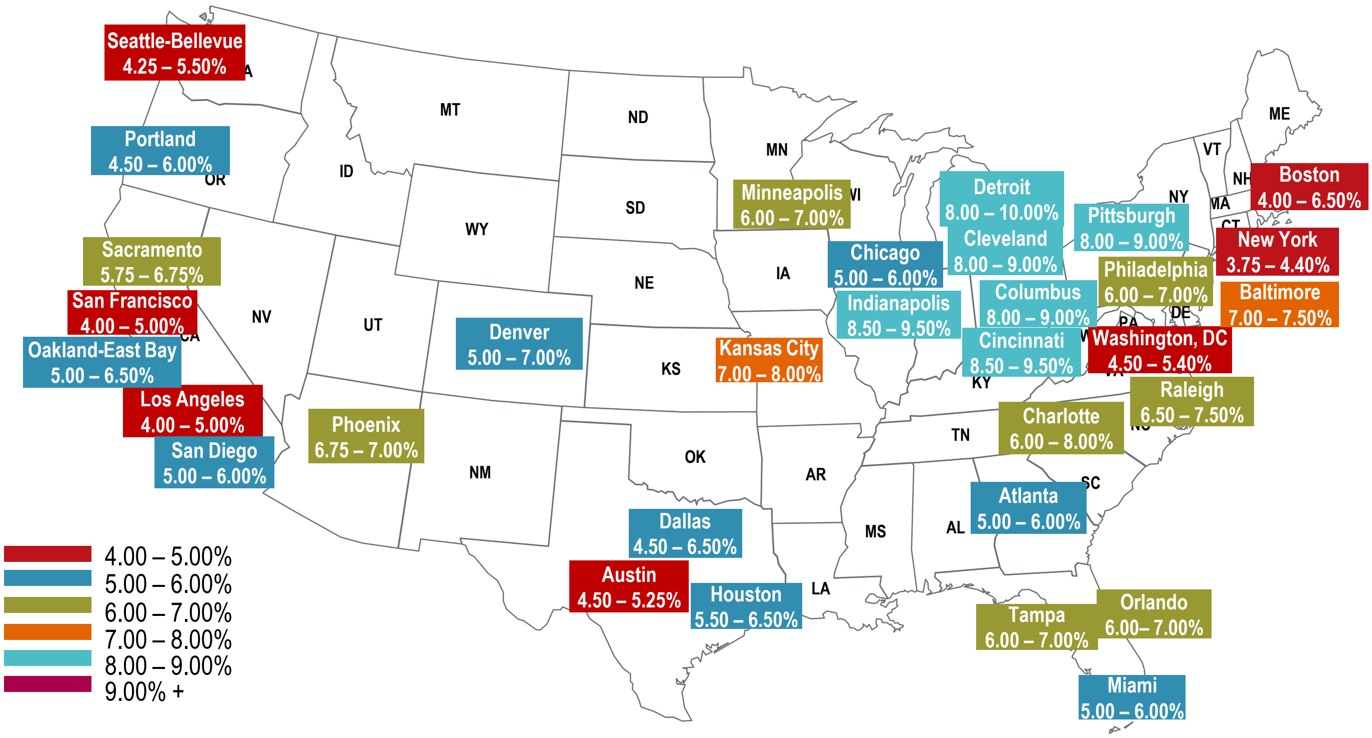
Office continues to outperform peer sectors and at a sustained, structural pace relative to prior cycle: 16.0 percent of full-year 2016 acquisitions by offshore investors



Source: JLL Research, Real Capital Analytics (Transactions larger than $5.0M)

Core CBD office cap rates

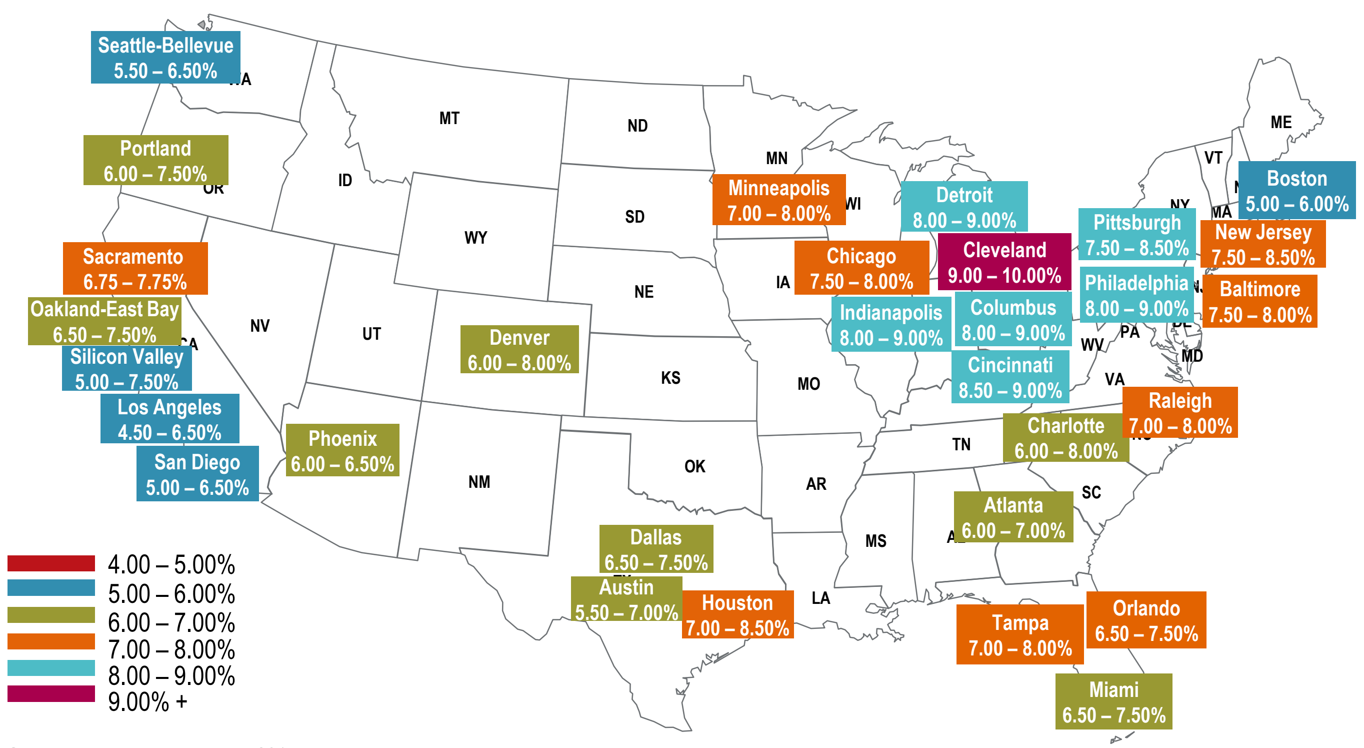
Coastal, primary markets are now all seeing Core product transact at sub-5.0 percent levels



Source: JLL Research, January 2017

Core suburban office cap rates

Suburban cap rates generally stable, with best-in-class product in high-growth secondary markets seeing assets transact as low as 5.0 percent to as high as 8.0 percent



Source: JLL Research, January 2017

Notable primary market transactions, Q4 2016

Market	Property	Buyer	Seller	Price ($)	Size (s.f.)	Price (p.s.f.)
Boston	One Kendall Square	Alexandria	DivcoWest	$725,000,000	644,771	$1,124
New York	1250 Broadway	Global Holdings	Jamestown / MHP / David Werner	$565,000,000	645,977	$875
San Francisco	One Front Street	Paramount	Invesco / State of Florida	$521,000,000	651,732	$799
Los Angeles	The Bluffs at Playa Vista	Minskoff	JPMorgan Chase	$413,000,000	500,943	$824
Los Angeles	Lantana Entertainment Media Campus	Brightstone	Jamestown	$403,000,000	482,377	$835
Washington, DC	Two Independence Square	KTB / Kiwoom / Meritz	Piedmont	$385,600,000	579,000	$665
San Francisco	Foundry III	American Realty Advisors	Tishman Speyer / JPMorgan Chase	$349,893,786	291,093	$1,202
Los Angeles	Citigroup Center	Coretrust	Thines	$336,000,000	891,056	$377
New York	441 9th Avenue	Cove / Baupost Group	EmblemHealth	$330,000,000	350,000	$943
San Francisco Peninsula	Genentech South Campus	Genentech	HCP	$311,300,500	456,788	$682

Notable secondary market transactions, Q4 2016

Market	Property	Buyer	Seller	Price ($)	Size (s.f.)	Price (p.s.f.)
Dallas–Fort Worth	State Farm Campus	Mirae / Transwestern	State Farm	$825,000,000	2,200,000	$375
Miami	Southeast Financial Center	Ponte Gadea	JPMorgan Chase	$516,600,000	1,225,000	$422
Orange County	Park Place (6 properties)	Allianz (45% interest)	LBA Realty / Principal	$338,680,233	1,910,210	$394
Atlanta	One Atlantic Center	Starwood Capital Group	Hines	$318,100,000	1,102,246	$289
Minneapolis	City Center	HNA Group	Shorenstein	$315,000,000	1,617,888	$195
Atlanta	191 Peachtree Tower	Banyan Street Capital / Oaktree Capital	Cousins Properties	$268,000,000	1,209,721	$222
Orange County	Google Center	Jacaranda Holdings	Scholle Corporation	$260,000,000	573,000	$454
Austin	100 Congress	Invesco	MetLife	$230,460,160	411,536	$560
Atlanta	Atlanta Financial Center	Sumitomo Corporation of Americas	Hines	$222,500,000	908,659	$245
Atlanta	Three Ravinia	Preferred Apartment Communities	CBRE Global Investors	$210,100,000	813,145	$258

Notable portfolio transactions, Q4 2016

Market	Property	Buyer	Seller	Price ($)	Size (s.f.)	Price (p.s.f.)
National	Parkway Properties Portfolio	Cousins Properties	Parkway Properties	$1,950,000,000	-	-
Naitonal	U.S. Alecta Multisector Portfolio	Blackstone	Alecta	$1,700,000,000 (overall)	-	-
National	West Coast Hines Global REIT Portfolio	Blackstone	Hines Global REIT	$1,162,000,000	3,000,000	$387

For more information, please contact:

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