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General Overview

Commercial real estate showed signs of continued recovery in 2013 across all metrics. Vacancy rates across all property types decreased in 2013 and were substantially lower than their peaks during the recent recession. Interest rates remain near historic lows, and investors and lenders continue to show more confidence in the real estate sector. Raymond Torto, Ph.D., CRE, Global Chairman for CBRE Research, recently declared, “Commercial real estate is in a sweet spot right now. It is a highly sought after asset class with improving fundamentals, and for leveraged buyers, a big positive arbitrage”. While the economy still faces headwinds with uncertainty in our nation’s capital, rising health care costs, and other economic factors, tailwinds have been increasing from solid corporate financials, improving housing markets, and improving credit availability and accessibility.

National sales transactions for office, industrial, retail, and multifamily assets increased by nearly 20% year-over-year in 2013 and continued a steady annual increase since 2009 when the post-recession recovery began. The chart below shows that sales volume exceeded $350 billion in 2013.

PROPERTY SALES VOLUME ON THE REBOUND

![Graph showing property sales volume from 2009 to 2013](image)

Within Hampton Roads, 2013 proved to be a successful year in the investment sales market. CBRE tracked approximately $375 million in sales of assets $5 million or more in the office, industrial, retail, and multifamily property types. Multifamily represented 76% of total sales transactions. This total of sales excludes portfolio acquisitions with assets inside and outside of the Hampton Roads market.

The largest individual sale transaction in the Hampton Roads market in 2013 was the sale of the Bon Secours Health Center, a medical office asset, in Suffolk, Virginia, for approximately $46.5 million.
The health of the commercial real estate industry begins with the health of the overall U.S. economy. The below chart illustrates that the national economy as measured by Gross Domestic Product (GDP) has grown in 17 of the past 18 quarters. The painful reductions in employment experienced during 2008 and 2009 have begun to dissipate, particularly in higher growth industries such as technology, energy, and health care.

**NOW IN 5TH YEAR OF ECONOMIC RECOVERY**

Quarterly Change in Real GDP, Seasonally Adjusted Annual Rate

![Chart showing quarterly change in real GDP](chart1.png)


Even with the sustained positive trend in the economy, job growth has proven difficult and still has not returned more jobs in the four years of recovery than were lost during the two year recession. The below chart shows the relative comparison of job growth since 2010 versus the sharp and painful declines experienced during 2008 and 2009.

**STILL NOT WHOLE ON RECOVERY OF LOST JOBS**

Quarterly average of monthly changes, thousands of persons

![Chart showing quarterly average of monthly changes](chart2.png)


While job growth remains a critical measure of real estate market performance, this report will focus on four other factors which help buoy the interest and optimism today in commercial real estate investment.
1. REAL ESTATE AS AN ASSET CLASS GETTING MORE INVESTMENT FOCUS

Commercial real estate continues to be a highly sought after asset class relative to stocks and bonds. With improving fundamentals across all property types and limited new development, real estate is projected to remain a favorable investment class. The yield on traditional fixed income instruments remains near historical lows, and there are concerns of downside risk to bonds in the likely event of rises in interest rates. While stocks posted a phenomenal return in calendar year 2013, that return was more than double their 10-year average, and there are some concerns that stocks could be at bubble-level valuations.

As the graph below prepared by CBRE Global Research and Consulting shows, commercial real estate continues to post strong returns compared to other asset classes, particularly over a 10-year period. Leveraged real property returns have been over 12% on annualized basis over the last 10 years per the NCREIF Property Index.

ASSET CLASS RETURNS
As of Year End 2013

<table>
<thead>
<tr>
<th>Annualized Returns, %</th>
<th>34</th>
<th>29</th>
<th>24</th>
<th>19</th>
<th>14</th>
<th>9</th>
<th>4</th>
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<td>90-Day T-Bills</td>
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Note: Order based on 1-year returns.

Source: CBRE Global Research and Consulting, NCREIF Property Index, NAREIT Equity Index, S&P 500 Index, Barclays Capital Government Bond, Consumer Price Index, 90 Day T-Bills

Institutional investors now believe they are under-invested in real estate which could result in greater capital flows into the sector in 2014. According to Cornell University’s 2013 Institutional Real Estate Allocations Monitor Survey, institutional portfolios are 8.8% invested in real estate, nearly 100 basis points below their average target real estate allocation of 9.8%. A shift in institutional investment choices towards more real estate will help buoy the demand side of the equation for commercial sales.
2. IMPROVING LENDING ENVIRONMENT HELPS BUYERS MAKE MORE DEALS

The improving economy and fundamentals across all property types have played a significant role as lenders have showed a willingness to lend on properties in smaller markets and to all five major commercial property types. Borrowers have also been very cognizant that we are still blessed with a historically-low interest rate environment.

Commercial Mortgage Backed Security (CMBS) loans are non-recourse commercial real estate loans which provide a very important service to both borrowers and lenders in commercial real estate transactions. CMBS loans provide borrowers access to the large fixed income capital markets, often with non-recourse, fixed rate, and higher loan-to-value terms that are more advantageous than those available from traditional banks or insurance companies. For lenders, the CMBS structure allows loans to be moved off of the originator’s balance sheet which helps create more opportunity for additional lending that meets standard underwriting criteria.

CMBS issuance surpassed $85 billion in 2013, a 78% increase from the $48.4 billion in issuance recorded in 2012. According to a recent National Real Estate Investor article entitled, “CMBS Lenders Start Year on Optimistic Note”, some industry experts expect CMBS volume will reach the $110 to $120 billion range in 2014 which would be another annual increase of 30% or more.

Dramatic Increase in CMBS Issuance

Source: Commercial Mortgage Alert CMBS Market Statistics
3. INVESTORS MORE WILLING TO INVEST IN SECONDARY MARKETS

With most primary national markets having substantially or fully recovered in pricing relative to the 2007 peak, investor interest has shifted more towards secondary and tertiary metropolitan markets. Investor sentiment has moved from preferring only gateway markets to a broader set of leading markets nationally as investors have started seeking higher yield.

As seen to the left, 2013 sales prices are closer to the 2007 peaks across all property types in major markets, while pricing in secondary and tertiary markets has been climbing less dramatically.

Investors will tend to focus on assets located in markets (primary or otherwise) where demographics and job growth are most favorable and with high quality properties with strong credit tenants.

4. INVESTORS ARE WILLING TO TAKE ON MORE RISK

Investors have become more and more comfortable with the economic outlook and have shown a much greater appetite for risk within both primary and other markets. Pricing for high grade core assets has recovered substantially causing investors to search for higher returns by taking on more risk.

The graph to the right, prepared by Cornell University’s Baker Program in Real Estate, shows approximately 60% of institutions pursued higher-yield value-add or opportunistic strategies in 2013, well above the 43% of institutions who focused on lower-yield and less risky core strategies.

CONCLUSION

Randy Anderson, Ph. D., Head of Americas Research for CBRE, recently stated, “Economic momentum will prompt continued improvements in property market fundamentals, increase capital availability and fuel property transactions in 2014”.

Commercial real estate has established itself as a sound and strategic investment class, and we expect investment volumes to continue to rise both in Hampton Roads and across all national markets with all of the exciting factors underway that have been discussed in this report.

Source: Real Capital Analytics & Moody’s Investor Service

Source: Institutional Real Estate Allocation Monitor, Cornell University
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