Author

Tony Beck
Vice President - Southern Virginia
First Potomac Realty Trust

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General Overview

Despite the ongoing debate whether the United States government has a spending problem versus a cost reduction problem, in addition to the unknown of the European financial turmoil related to the debt crisis, the US commercial real estate investment market continued to recover in 2012 with multifamily leading the charge again. Historically low interest rates and increased lender confidence supported by Freddie Mac and Fannie Mae made this sector the most active over the past year.

Of the five different asset classes, all have shown a positive trend over the past year with office, industrial, retail, and lodging all falling in behind multifamily. The Class A office product in primary markets (i.e. New York; Chicago; Atlanta) has been an area where investors have focused. These properties have offered higher yields; however, the slow job market recovery has hampered occupancy and the lingering 2007 debt on distressed properties in the primary markets has prompted investors to start to broaden their search for Class A properties in the secondary and tertiary markets.

The retail sector is in recovery with investment into malls, power centers, and specialty retail anchored by national tenants leading the way. With limited new development in this sector, investors are looking for quality locations with redevelopment opportunity being the trend for the coming year. The hotel and lodging sector leveled off in 2012 with the fear of the economy dropping back into recession. The overall operating fundamentals remained strong and the access to equity and lower cost of capital will assist in a gradual recovery in 2013 and beyond.

The commercial mortgage-backed securities (CMBS) market continued to have the cloud of the 10 year loans that were originated in 2006 and 2007. There is currently just under $1.0 trillion in securitized and non-securitized commercial real estate (CRE) loans that will mature in 2016 and 2017. If these loans were to come due now it would be difficult, if not impossible, to refinance unless the underwriting standards were relaxed and the net operating income of these properties improved or the current loan to value ratio were reduced.

US SALES VOLUMES

There continues to be a flight to cash flow, quality, and security of the more institutional grade assets with pricing reaching near 2006 levels. The multifamily and retail (mall) sectors are seeing purchase prices above any previous years high. Apartments and mall properties are up 10% and 8%, respectively from the previous 2007 high and retail (anchored strip centers), industrial, office, and lodging are all showing increase from the lows of 2009 and 2010, but still down 3% from the 22% high of 2006.
Based on transactions of $25 million and over, the investment sales market continued to see growth in all commercial sectors in 2012 with an approximate increase in sales volume by 19% or total growth of $182 million from 2011 to 2012. Again, as trophy property inventory in primary markets decreases for institutional grade investors, this creates a growing appetite for assets as many investors are looking to profit from the Class A assets into secondary and tertiary markets.

Since early 2010, real estate investment trusts (REITs) have outperformed the S&P and NASDAQ and have increased the investment in all market segments. Their balance sheets are as strong as ever and with access to equity through the sale of common shares and preferred equity, balance sheets will continue to grow in 2013 and beyond. As the overall market crashed in 2008, most REITs focused on re-capitalizing through the issuance of common stock which, in turn, lowered their ratios. This put most REITs in a strong position in 2012. More acquisitions in the primary markets on trophy properties will continue to follow suit in 2013.
HAMPTON ROADS IN REVIEW

Like the national trend, Hampton Roads saw an increase in investment activity with multifamily providing three of the top five transactions in 2012, with the anchored retail and the medical office sale rounding out in the top four. Activity and interest continues into the 1st quarter of 2013 with early announcements of multifamily, office and industrial portfolios being marketed for sale.

<table>
<thead>
<tr>
<th>Property Name</th>
<th>Property Type</th>
<th>Purchase Price</th>
<th>Size per ft/unit/room</th>
<th>per ft/unit/room</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tapestry Park Apts</td>
<td>Multi-Family</td>
<td>$29,600,000.00</td>
<td>190</td>
<td>$155,789.47</td>
</tr>
<tr>
<td>Fort Norfolk Plaza - MOB</td>
<td>Medical Office</td>
<td>$29,200,000.00</td>
<td>195,890</td>
<td>$149.06</td>
</tr>
<tr>
<td>Haygood Shopping Center</td>
<td>Retail</td>
<td>$28,000,000.00</td>
<td>174,410</td>
<td>$160.54</td>
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<tr>
<td>The Ashton Portfolio</td>
<td>Multi-Family</td>
<td>$26,640,000.00</td>
<td>370</td>
<td>$72,000.00</td>
</tr>
<tr>
<td>Steeplechase Apts</td>
<td>Multi-Family</td>
<td>$25,570,000.00</td>
<td>220</td>
<td>$116,227.27</td>
</tr>
<tr>
<td>Lillian Vernon Building</td>
<td>Industrial</td>
<td>$18,200,000.00</td>
<td>868,506</td>
<td>$20.96</td>
</tr>
<tr>
<td>Patrick Henry Corp Cntr</td>
<td>Office</td>
<td>$14,100,000.00</td>
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<td>$142.28</td>
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<tr>
<td>Williamsburg Marriott</td>
<td>Hotel/Lodging</td>
<td>$12,000,000.00</td>
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<td>$40,677.97</td>
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<td>Indian River Dist Cntr</td>
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<td>ATK Blackhawk Building</td>
<td>Office</td>
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<td>$163.30</td>
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<td>Muller Martini Building</td>
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<td></td>
<td></td>
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<td>$282,010,000.00</td>
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The Hampton Roads area is unsettled more than most regions nationally due to the pending government cutbacks in defense spending and the long running saga of the longshoreman’s strike looming over the region. Even with those challenges, the overall local economy made gradual progress with Gross Regional Product expanding at 1.63 percent and regional unemployment of 6.4 percent by year end 2012. The Port of Virginia saw increases in general cargo tonnage and TEU’s at 12.2 percent and 9.8 percent, respectively.

2013 will see continued investment activity in the region with the larger institutional investors finding it more difficult to acquire stabilized, trophy assets in primary markets. Hampton Roads may benefit from the need of these institutional investors for placement of cash. If rental and vacancy rates are perceived to have bottomed out in the region, this may be viewed as an opportunity for value adds play in Hampton Roads.

The real challenge for the overall region will be the decisions made on government spending. It is widely anticipated that impending defense spending cuts, as well as reductions in government contract spending, will have a dampening effect on office investment sales in Hampton Roads.
INVESTMENT - A WORD ON CAP RATES

“CAP RATES ARE REALLY, REALLY LOW BECAUSE SO MANY INVESTORS IN THE WORLD SAY “I’M TIRED OF TAKING RISK, I WANT TO GO BUY HARD ASSETS.””
- Tony James, President and COO of Blackstone Group, LP, December 2012.

Discussing cap rates can be a dangerous occupation, for many reasons, but the risk can be summed up in a quote from a prominent local Hampton Roads appraiser, who says that cap rates will all come down to what you are capitalizing. Capitalizing fairy tale income will get you fairy tale values. Cap rate statistics are generally averages of averages, pulled from thousands of actual transactions across the country or maybe just a few actual sales in our local market. One hopes that those transactions are arrived at by rational buyers and rational sellers, but, as in most things, rationality cannot be guaranteed, even in real estate sales.

Nevertheless, there are lots of cap rate statistics out there, and there are rational buyers and sellers watching them closely. Over the last year, they have watched them trend lower or hover at historically low rates, as indicated in Mr. James’ quote above. Below are some indications of recent national and local cap rates, derived from a number of credible sources, but remember, they are indications, (averages of averages) and rationality is not guaranteed. One factor to note: major studies of cap rates focus on cap rates from institutional grade sales in major markets; Hampton Roads sales are typically non-institutional grade and thus will tend to range from 50 to 100 basis points higher than these.

Multifamily: The popularity of multifamily investments has pushed these cap rates to the lowest of any real estate asset class. Those institutional deals are averaging about 5.75% according to a recent national survey; locally, some Class A apartments have traded at cap rates in the low 6’s, but more seem to have sold in the high 6’s to low 7’s.

Office: Which flavor of office would you like? National CBD? National Suburban? Secondary Market? Flex Warehouse? Depending on how appealing the property, these cap rates are averaging from about 6.7% to 8%; recent sales in Hampton Roads indicate we are solidly at the Secondary Market average of 8%.

Retail: While the numbers for retail are different than office, the pattern is the same: institutional quality regional malls, power centers and strips are trading in the high 6’s to low 7’s, respectively, while recent sales in Hampton Roads show cap rates from mid-7’s to low 8’s; although, there was a sale last year of a grocery anchored center at a 9.5% cap rate – perhaps a little irrationality in that last one? Whatever you do when trying to bring national or local average cap rates to bear on an individual property, remember the appraiser’s disclaimer cited above: “It all depends on what you are capitalizing!”

Tom Dillon
Senior Vice President, Real Estate Financial Services
StellarOne