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SPRING 2008

(l to r) Fran Sullivan, Rick Page, Larry Pflughoeft, Paul Suzman, Tom Baker (Don MacLaren still telemark skiing)

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Commercial Real Estate Planning
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2008: OUTLOOK, A LESSON, AND NON PROFITABLE THINKING.

I returned recently from a trip to visit friends and remaining family members in South Africa.

And used the 22 hours of return flight time to jot down a few thoughts about the past year and trends and opportunities for this one.

A landlords' market; but for how long?

While revisiting the 'Hysteris Loop' (see adjoining column) we realized that until the nation's economy sorts out itself, and its wild mood swings, we would **really** be guessing what the next 'loop' might look like. That said, in the Seattle and Eastside markets we anticipate a modest increase in actual rates. And most leases also have some escalation built into them. Commercial real estate is a lagging indicator in that, for the most part, medium to large businesses, if they do not own their buildings, lease spaces for 7-10+ year periods. (Smaller tenants usually take shorter lease terms) And there are few leases which enable a tenant to give back significant amounts of space when, for example the economy slows or the Dow Jones dips. On average such leases only turn over at 10+% per annum outlasting most business cycles and tenants have to predict out growth and decide whether to expand or contract each time around. Not an easy task. So is the market becoming overbuilt……?

Cranes: one only has to drive up I5 or down I405 to see why some regard the crane as King County's official bird. There are some 34 buildings actually under construction on either side of Lake Washington which include commercial office space. (This flock of cranes is further augmented by those towering over new condos or hotels). Over **2,000,000 SF** in Seattle of which less than 20% is pre-leased. And over **4,000,000 SF** on the Greater Eastside of which almost 65% are preleased. And there are several other permitted structures waiting to get engaged to eligible tenants before taking the plunge. And like cranes, construction costs have soared in recent years although recently, according to Turner Construction forecasts, these increases have flattened out somewhat. 5% increase Q4 '07 through Q4' 08 versus over 7% the previous year and over 10% cost rises the year before that! All that steel and concrete feeding China's renaissance.

So, some might argue that patient capital will risk unpredictable business cycles to get buildings out of the ground knowing that they should, ultimately, have a cost advantage. Takes a strong stomach though!

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HYSTERESIS LOOP REVISITED

Four years ago in February at the end of the last recession, we forecast Seattle Downtown* average rental rates through the year 2010. We applied the Hysteresis Loop concept which says that the rate at which rental rates recover as vacancy rate declines, is slower than the rate of decline as vacancy rate increases. We used past Seattle Downtown* average rental rate history from OfficeSpace.com online to define the curve shown in Figure 1. The forecast indicated that rents would slowly increase from about $25/RSF/yr at the then15% vacancy rate to about $30 at 3-4% vacancy and then increase steeply as vacancy fell further.

To predict what vacancy rates might be in the future, we had to also predict increasing future demand for existing space plus new buildings coming on line. We used UBS data showing the relationship between business and service job growth in the four year period following the previous three recessions. As shown in figure 2, vacancy was predicted to fall from about 15% at the end of 2003 to 2-3 % at the end of the decade. The figure for early 2008 was about 5%.

The actual current vacancy rate of 8.6% and the current estimated Downtown* average rent of $30.60 /RSF/yr are shown on both figures. We predicted that vacancy rate would fall faster, but that rents would rise more slowly. Due to the law of compensating errors our $30.00 average rate forecast was not far off the mark. Interestingly, Greater Bellevue currently enjoys slightly lower vacancy and approximately $2.00 higher average rents.

(*Note: average Seattle Downtown rental rates used to make this prediction cover Lake Union to Pioneer Square and Waterfront to Capital Hill. CBD rates are higher, at an average of $35.40)

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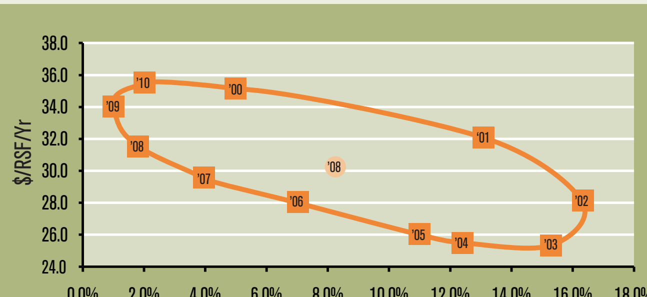

figure 1

figure 2

FOREIGN INVESTMENT IN U.S. REAL ESTATE

Unlike some other countries, the United States places few restrictions on non-U.S. citizens or institutions investing in domestic real estate. When combined with the usual investment parameters, the ease of investment has been one of the factors that has resulted in the United States being a favored haven for foreign real estate investors.

According to the latest annual survey of its members by the Association of Foreign Investors in Real Estate (AFIRE), the U.S. is considered to be the most stable and secure country for real estate investment. Consequently, New York City, as would be expected particularly for institutional investors, ranked number one globally. Seattle has become increasingly attractive to foreign investors and came out fifth in the survey among U.S. cities, after New York, Washington D.C., Los Angeles and San Francisco.

Individual Foreign Investors:

Although the vast majority of foreign investment in U.S. real estate is made by institutions and other multi-member entities, the extent of investment by individuals is increasing. Although much of individual investment is in single family homes and condominiums, there is increasing interest by non-U.S. citizens in acquiring income producing property, either individually or by partnering with others from the same country.

Before taking any steps to buy U.S. real estate, it's critical that a foreign investor meet with appropriate advisors to obtain information on any requirements that apply to such investments, such as the Foreign Investment in Real Property Tax Act (FIRPTA), which was passed in 1980, and the best type of vehicle with which to use for the acquisition.

The purpose of FIRPTA is to ensure that a tax is paid on any gains when a foreign person sells real property in the U.S. It requires the buyer to withhold 10% of the purchase price at closing and send it directly to the Internal Revenue Service. It's applied to the actual tax obligation arising from the sale, which is determined when the seller files the required income tax return for the year of the sale.

There are some exceptions to the withholding requirement, which can be described in detail by the seller's advisors.

Ownership Vehicle:

Foreign investors may not be knowledgeable about all of the alternative entity types that may be used to acquire real estate and which ones offer the most advantages. A Limited Liability Company (LLC) has become the most common ownership vehicle in Washington and most other states due to having the legal protection of a corporation combined with certain tax advantages for its members. The investor's advisors can provide information on the advantages and disadvantages of each type of entity. The differences are significant and can trap an unwary investor if the wrong type of entity is used to acquire and own the real estate.

The reputation of the U.S. Internationally may not be at a high point, but the stability and long term returns from income producing property here remain attractive to investors throughout the world. The extent of foreign investment will continue to increase as wealth and attendant investment capital increases in many other countries.

Proper advice before starting the search for the right properties is critical to the success of the investment.

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2008 OUTLOOK…

Continued from Page 1

"It is in my job description…."

I wanted to identify the appropriate person at a corporate services firm HQ with whom to talk about a technology application (for a small company on whose board I serve). After ignoring initial voicemail and emails, finally. *"It's **not** in my job description to identify such individuals in the firm"* I was advised in an email. An embarrassed executive gave me the name I needed shortly thereafter. But more importantly, I was reminded what service means. The urban legend of a salesperson at Nordstrom accepting the return of an automobile tire is a powerful symbol of commitment to customer service no matter what. Occasionally people will take advantage, but everyone remembers courtesy. Especially when people go beyond what is expected. To a sole practitioner, his or her 800 square foot office is just as important as is the 45,000 square foot office to the 25 partners of a professional firm. And both deserve, not equal time but certainly equal respect. The oak tree starts with a single acorn.

Thinking non profit.

Increasingly the management of non profits includes those who are financially independent and want to 'give back'. And boards include bright, community minded volunteers, very aware of their responsibilities.

Over the long term, board policies often means that a different set of directors/trustees will be living with consequences of any earlier lease/purchase decisions. Non profit board protocol, (Sarbanes Oxley requirement that decisions need to pass a higher test of impartiality and due diligence) often results in the real estate planning process taking longer than for commercial enterprise. Our advice; start the process earlier than you might think you need to.

Seattle is fast becoming, thanks to the likes of The Gates Foundation and UW, a hotbed (if you'll excuse the term) of global health + technology. And microfinance ventures. People increasingly realize that the health and welfare of others in our global village ultimately impacts all of us. Seattle is incredibly fortunate to be a vector for this area of enterprise which attracts the best and brightest. Serving the interests of such organizations is an adventure and a privilege.

So a checklist for the rest of 2008:

Remember our job description + avoid those who forget theirs, learn more about creative non profits active in our town, and appreciate consummate professionals irrespective of which side of the table they sit.

As always your comments are welcome.

Paul Suzman pauls@officelease.com

TULIPOMANIA

With talk of recession, The possibility of $5 per gallon gasoline (welcome to Europe) and the dollar falling to new lows against the Euro, Seattle's economy has often tended to be out of sync with much of the rest of the country. Seattle's housing market, for example, has not fallen victim to the sub-prime mess as have other areas of the country. . And Seattle is regarded as one of the top commercial markets in the US. Western Washington is enjoying low unemployment, and is home to a headquarters pantheon of well run national and multi-national corporations. So what does recession mean and how does it affect Puget Sound businesses' ability to plan for the future?

Financial cycles would seem to evolve from excessive optimism. That is, credit expansion, which feeds into asset prices, which lowers the cost of capital, which leads to more investment, which leads to a boom. Eventually, the investments are found not to be sustainable in that they do not generate profits. Profits are the central factor in this cycle: if over-investment cannot generate profits, the whole structure collapses, moving from boom to bust. —William White, Economic Advisor for the Bank of International Settlements

So, ever since the great Tulip bubble burst in the 17th Century the World economy has swung through a series of such cycles (in fact it's still referred to as Tulipomania!). Boom to bust to boom to bust. The last being the dot.com implosion

So in anticipation of, or perhaps despite, these cycles, business owners often engage in strategic or contingency planning during which they guess at the future. Which is often easier said than done; and requires considerable discipline as one has to set time aside from the daily exigencies of running your business day to day.

Commercial real estate cycles usually lag financial cycles. And in part because of the long lead time involved in planning, permitting (except perhaps in China) pre-leasing and construction developers have to anticipate the market. Real estate planning is an extension of strategic planning but as real estate takes a long time to acquire and dispose of (you cannot simply hire or fire bricks and mortar or rewrite it) it really does require a leap of faith as one guesses at future space requirements about which you are never quite sure. But there is one thing that you do know. And that is the terms of your current lease. Or, do you?

- Expiration date
- Extension/holdover clause
- Renewal/expansion options
- Termination rights/demolition clause

Are the terms of your lease comparable to current market?

Do you know your landlord's plans? Do they have plans to sell the building?

What are your contingency plans to contain growth, contraction or acquisition?

OfficeLease can help you work through these issues and prepare for the next cycle that is on its way. Talking with us about Tulipomania, your office space needs and your current lease over lunch, it can be as painless as, well, a free lunch! Let us know if we can help.

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LATENCY AND TWO DAM REDUNDANCY

Is your company looking for a way to significantly reduce power costs and your carbon footprint? Look no further than Central Washington and the cities of East Wenatchee and Quincy, in Douglas and Grant Counties respectively. Microsoft, Intuit, Yahoo and T-Mobile have located their data centers to the middle of the State, Why? Part of the story is the "2 Dam Redundancy". i.e. a power source that is not only green and sustainable but offers 2 separate hydro electric dams as the main power source.

When comparing locations for a server farm or other such intensive power user, there are always several factors that go into making the right choice. Overall costs, ambient climate, attracting and retaining employees, cost of living, strong local community, good schools and recreational environment. And in considering locations for a client based in Southern California, there is latency!

This is essentially the amount of time it takes a packet of data to move across a network connection. When a packet is being sent, there is "latent" time, when the computer that sent the packet waits for confirmation that the packet has been received. Latency and bandwidth are the two factors that determine your network connection speed. (Remember this when you are tapping your fingers wondering why YouTube is taking so long to load!)

Bandwidth is just one element of what a person perceives as the speed of a network. Latency is another element that contributes to network speed.

The term latency refers to any of several kinds of delays typically incurred in processing of network data. A so called low latency network connection is one that generally experiences small delay times, while a high latency connection generally suffers from long delays.

We are talking about milliseconds here, for example the speed of light is about 186.3 miles per millisecond. A photon traveling the 2,787.7 miles from the corner of Sunset and Vine in Los Angeles to Wall Street in lower in lower Manhattan would arrive in 14.96 milliseconds. That's in a vacuum. In the real world, data latency would slow that trip to around 35 milliseconds, according to a new report from TABB Group. Most companies want to have their data centers located in an area where they can achieve a latency time of 5 to 11 milliseconds. This is the reason the Northwest is a great location for west coast companies looking for data center space.

While some communities across the country boast of inexpensive solutions for data centers due to tax incentives, low cost of real estate and competitive power rates, most of such power comes from coal which depletes natural resources (not sustainable) and is clearly not good for the environment (think acid rain among other side effects!)… Our neighbors to the East make a compelling case with their sustainable 2 Dam Redundancy and the chart below illustrates Douglas County's power rates compared to those in other other markets. It's a great deal. Dam It!

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Utility	Energy Rate ($/kWH)	Demand Rate ($/kWH)	ROM Annual Cost ($) at		Annual Savings for Douglas County AT 10MW
			5MW	10MW	
Douglas County PUD	0.0185	1.00	870,300	1,740,600	-
Pacific Gas & Electric	0.12584	11.54	6,204,192	12,408,384	(10,667,784)
Seattle City Light (Tukwila)	0.0452	0.080	2,027,760	4,055,520	(2,314,920)
Silicon Valley Power	0.07175	7.59	3,598,050	7,196,100	(5,455,500)
Dallas	0.095	6.90	4,575,000	9,150,000	(7,409,400)
Xcel Energy (Colorado)	0.02846	11.91	1,961,348	3,922,696	(2,182,096)

This table is provided courtesy of The Sabey Corporation based upon data sourced from publicly available information subject to frequent market changes

FINANCING COMMERCIAL REAL ESTATE IN 2008

Credit Crunch…Liquidity Crisis… Recession…Depression…?

It's enough to cancel my Wall Street Journal subscription!

As the economy goes, so goes the commercial real estate mortgage business but maybe a little hindsight would be helpful in explaining our current situation.

For that last 10 years the commercial real estate finance market saw increasingly aggressive loan underwriting and tighter spreads. There was no, or very little, premium factored in by the lending market for risk, amortization became an option, average 'loan to values' went up as spreads went down, deals with big tenant rollover risk, with high vacancy, with high PML's were transacted as lenders were willing to overlook or structure around any perceived risks. Too much money was chasing too few deals. The same can certainly be said for the equity side of the business as well. Cap rates continued to fall and investors stretched beyond traditional 'core' assets to buy or they convinced themselves that what they were buying was 'core'.

As example, two deals I worked on in late 2005. One was for the acquisition of a medical office building in Yakima, Washington. An 80% loan to value financing on a secondary product type (Medical Office) in a tertiary market with the loan priced at 100 points over Treasuries. The second, a high end retail project in Seattle was a 55% loan to value refinance on one of the highest quality projects in the region and it was priced at 95 over treasuries. Only a 5 basis point difference for an 80% loan on a medical office building in Yakima and a 55% loan on a high end retail project in Seattle ? Something was wrong with that picture and there are many other such examples.

Today's picture is quite different. In 2007 the CMBS or "Conduit" market accounted for about $230 billion worth of business. In 2008 it may be 1/10th of that. A huge amount of capital no longer available to the market. Life insurance companies, pension funds and banks are filling some of the void but all have limited supplies of funds available for commercial real estate finance and, as the financial markets continue to contract I suspect these sources of funds will start to dry up. Many of the life companies and pension funds have already pulled entirely out of market and many, if not most, others are being very selective in the transactions they will consider.

A year ago obtaining a loan of 75% to 80% of value was pretty straightforward and we'd see several lenders trying to 'win' each financing opportunity. With such a restriction on the supply of capital the lenders have become significantly more conservative with very few doing financings of more than 65% LTV. Spreads have also widened dramatically from 100+ over for most deals a year ago to up to 300 over today. On the bright side the Treasuries have fallen enough so that the all-in rates aren't that much different than they were a year ago. So money is cheap….you just can't have any!

So where are we headed?

Let's focus on the laws of Supply and Demand. We've had an oversupply of capital/credit for the past few years and it has driven investors to accept risks and/or to make loans that perhaps they would normally not have made. Now that oversupply has turned into undersupply. When financial institutions and investors finally feel that the worst is behind us we'll likely see more capital returning; but when? If we are lucky, before the end of 2008. But we should not hold our collective breaths..

So if you are looking for debt on commercial real estate…..

- Expect that more equity will be required than in previous years.
- Initiate financing as early as possible in advance of loan maturities.
- To find the best financing be prepared to spend more time shopping the market
- Explore the extension of your existing bank loans now.

We've seen similar recent market disruptions in 1998 and 2001 both of which were relatively short lived. The current pull back started in the Summer of 2007 so we are already into this cycle longer than the two previous downturns. I'd like to say that we will never again see the markets as overheated as they were over the past few years; but I've been wrong about that before and am sure I would be again..

Michael S. Taylor –
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A Client Comments:

"Kennedy has over $9 billion of real estate under management. Our firm has extensive experience in negotiating leases. Still we recognized that our own search for space could be made more effective by making use of an experienced local tenant representative…We spoke to several brokerage firms, and ultimately engaged OfficeLease to act as Kennedy's advisor and representative. We considered alternatives, from purchase of existing buildings to leased space in projects still on the drawing boards…, They did a good job of introducing new ideas and space proposals and maintained a consistent and diligent focus on communications with our management team and helped push the selection process to a timely completion. OfficeLease is financially sophisticated and were good at communicating with our own numbers-oriented management. Paul Suzman in particular acted as a key member of our team and was effective at maintaining open and effective communications with the landlord during the negotiations process".

Steve Bremner, CFO, Kennedy Associates Real Estate Council 206.623.4739