

# Office March '10 Update - Summary

March 31, 2010

DJIA: 10,857 | RMZ: 671 | 10-Year T-Note: 3.83%



## Relative Pricing of High- and Low-Barrier Markets is Reasonable

**Three Elements, Three Messages:** The three most important elements of the office real estate business are at distinctly different phases of their own cycles. First, underlying market fundamentals (i.e., M-RevPAF as a proxy) are still in decline, but at a far slower rate than in '09, and should begin to reach their trough by the end of '10 or early '11 as office demand eventually re-emerges. Second, cash flow (NOI as a proxy), which lags changes in fundamentals, is likely to have its worst year in this cycle during '10. Growth in NOI is unlikely to resume until '12, and even then, growth prospects appear unexciting. Third, and perhaps most notably, private-market building values (measured by expectations of cap rates and/or values per sq. ft.) for top urban markets have recently mounted a noticeable increase as buyer risk appetites grow amid a low interest-rate environment.

**Relative Return Expectations in the Private Markets Make Sense:** Since late '09, Green Street's cap rate estimates for office REIT assets in top markets (e.g., Midtown Manhattan) have been reduced by >100 bps, which is much greater than in low-barrier markets (e.g., Atlanta), where values have not rebounded as quickly. This begs the question: is there a disparity in return expectations across high-barrier and low-barrier markets? Based on our analysis, expected returns appear to be roughly on par, despite the wider cap rate spread. Incorporated into this conclusion is the assumption that a spread of about 250 bps in the perpetual NOI growth estimates used for high-barrier vs. low-barrier markets is warranted. This represents a wider differential than what we had been employing.

**High-Barrier vs. Low-Barrier in the Public Market:** An analysis introduced in this report links the observed implied cap rate spreads between high-barrier and low-barrier office REITs with corresponding forward 12-month total returns. Although implied cap rates represent an imperfect shorthand for an expected returns analysis, this metric has proven that it can provide a useful "first pass" at answering the high-barrier/low-barrier question. Not surprisingly, high-barrier office REITs have outperformed more often than not, and sometimes by a landslide. Yet, there have been times when an above-normal implied cap rate spread on low-barrier did translate into future total return out-performance. Because current expectations for '11-'15 NOI growth are roughly similar, on average, for high-barrier/low-barrier REITs, the appropriate implied cap rate spread should be lower than during a time of robust differences in the prevailing outlook. At present, the public pricing of high- and low-barrier companies falls into the "neutral" range (implied cap rate spread: ~160 bps).

**Recommendation:** From a sector-level valuation perspective, office remains the most expensive among the major property types (see 3/1/10 *Property Sector Valuation* report). Individual recommendations are presented below, with arrows noting directional change. Labs (ARE/BMR) and data centers (DLR) are also included, although both sectors have separate pricing models from the office group (i.e., labs are priced relative to each other; DLR is now priced relative to all REITs).

**BUY:** ARE, CLI (↑), DEI, SLG (↑), VNO  
**HOLD:** BDN, BMR, BXP (↓), CUZ (↓), DLR (↑),  
DRE, KRC, OFC, PDM (↓)  
**SELL:** BPO, HIW, LRY, WRE (↓)  
**NOT RATED:** MPG

Michael Knott  
John Stewart  
Enrique Torres  
Lukas Hartwich

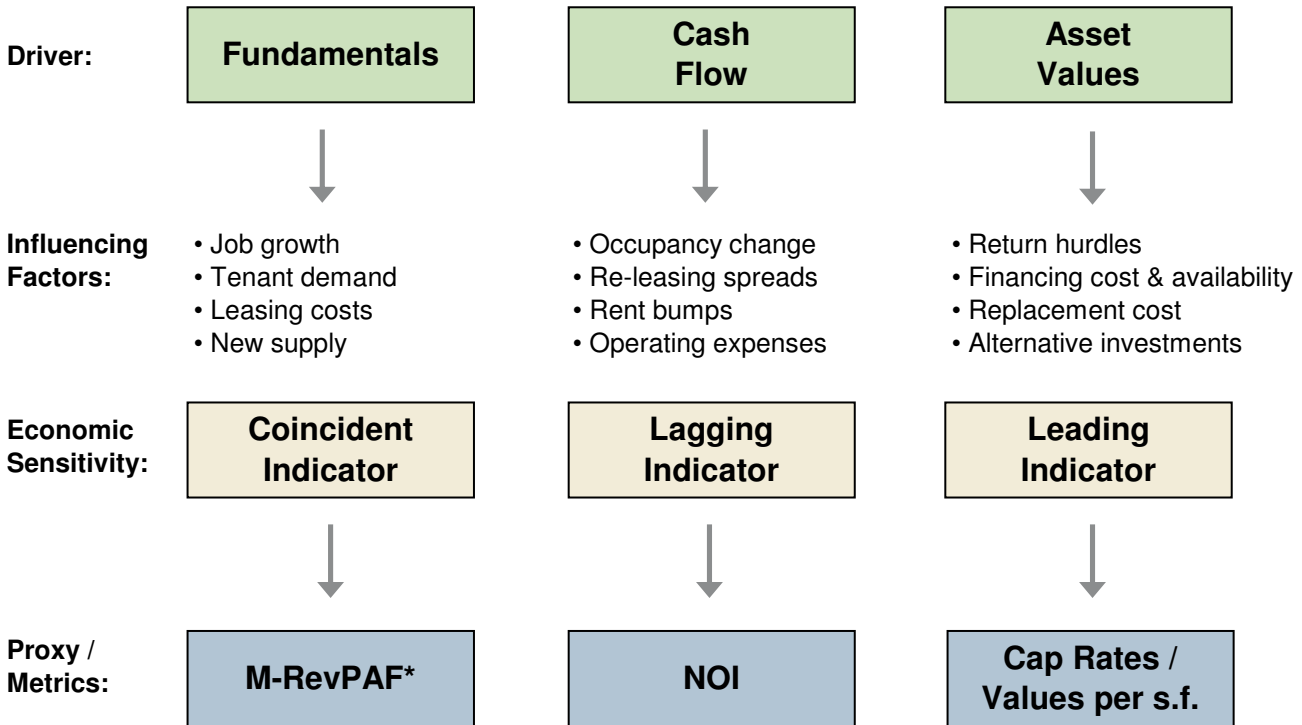
## Office REITs: March 2010 Update

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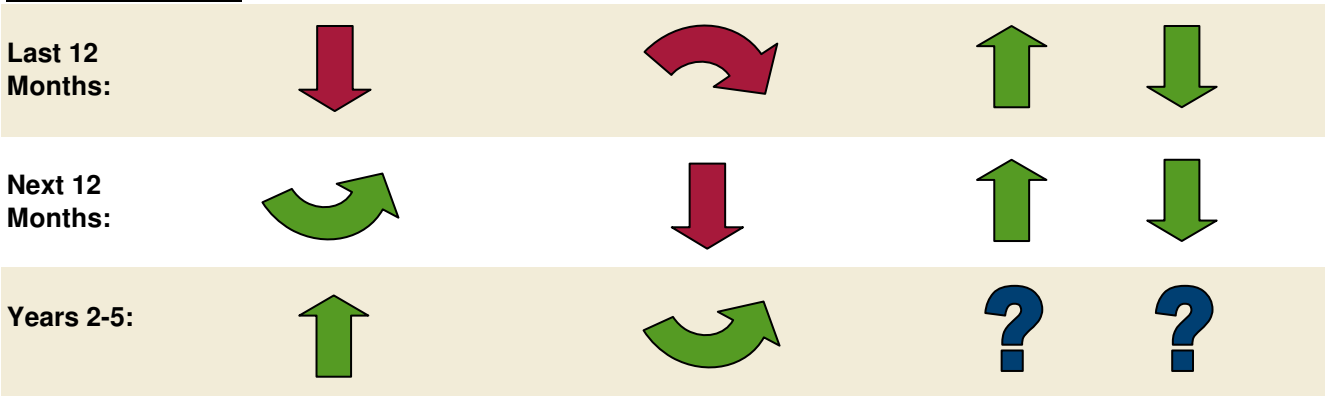
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**I. Office Sector Executive Summary**

**Three Key Drivers:** Discussions of the state of commercial real estate often confuse three important but very distinct concepts: fundamentals (i.e., prevailing market rent/occupancy levels dictated by the interplay of supply and demand), cash flow growth (NOI is a proxy), and valuations. As a result, our objective is to clearly delineate between these three concepts. The following snapshot of these factors shows that office fundamentals are expected to bottom by year-end; cash flow is expected to bottom in '11 before slowly rising; and building values are on the rise, particularly in top CBD locations.



**History & Outlook:**

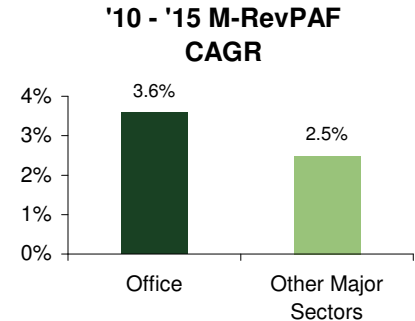
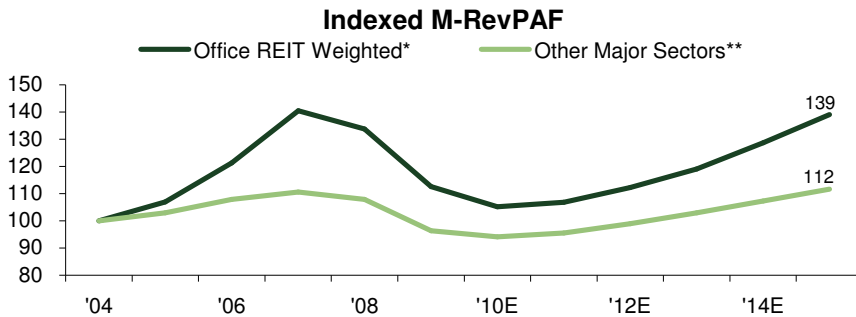


<b>Comments:</b>	<ul style="list-style-type: none"> <li>• Bottoming in '10</li> <li>• Down 20% peak to trough</li> <li>• Need job growth</li> <li>• Minimal new supply</li> </ul>	<ul style="list-style-type: none"> <li>• Declines in '10-'11</li> <li>• Mediocre growth '12-'15</li> </ul>	<ul style="list-style-type: none"> <li>• Values rising in top CBDs</li> <li>• Office chronically overpriced in the private market</li> <li>• 5% annual returns since '86 per NCREIF</li> </ul>
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\* M-RevPAF is the product of market occupancy and market effective rents; this provides a single metric for observing changes in market conditions.

**I. Office Sector Executive Summary (cont'd)**

**More Volatile Fundamentals:** M-RevPAF for the office sector – disproportionately weighted by important office REIT markets, such as Manhattan and D.C. metro – tends to be more volatile than in other property sectors. The decline in this measure has been more severe than for other property types, but the '11-'15 rebound is expected to be stronger.

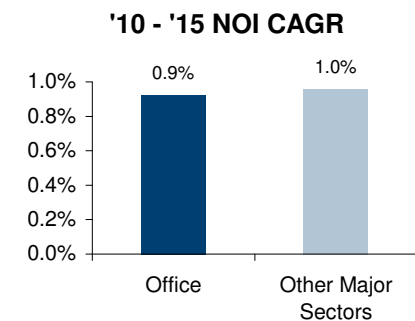
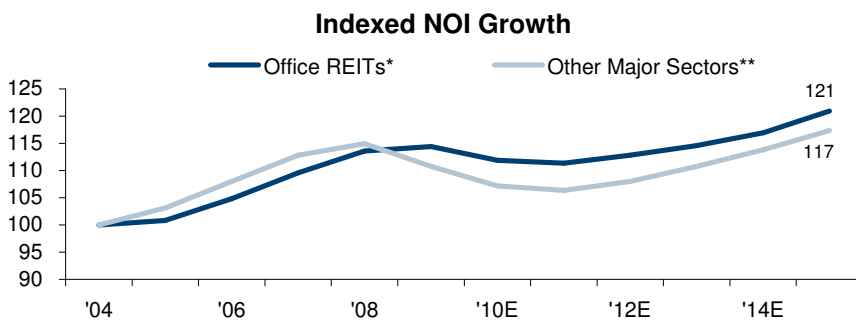


\* Based on individual market forecasts weighted by REIT asset values, which are concentrated in top markets, i.e., Manhattan, D.C. Metro, and LA = nearly 60%.

\*\* Average of Apartments, Industrial, Malls, and Strip.

Source: Reis, Green Street Advisors

**Unexciting NOI Growth Prospects:** Office NOI lags changes in M-RevPAF, but it is still a positive surprise that office REITs reported flat same-store NOI in '09. This is due to long lease terms, especially in Manhattan, a market that benefited from unprecedented federal support for the city's finance engine. Office NOI is expected to decline in '10, while growth prospects between '12-'15 are unexciting due to a lag with improving M-RevPAF.

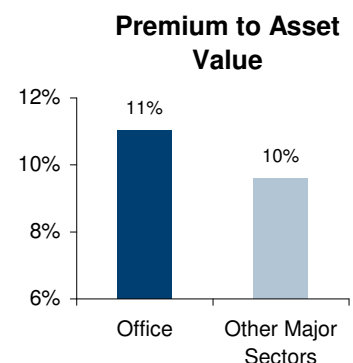
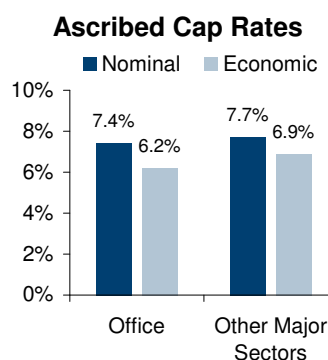
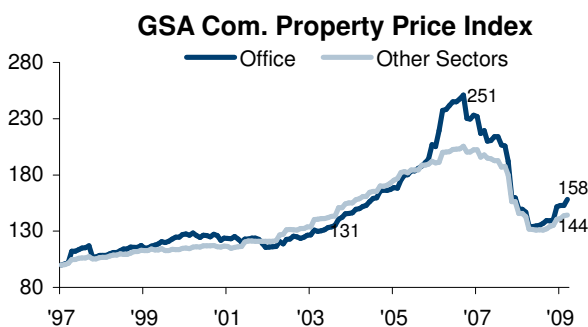


\*Weighted by REIT asset value. Excludes DLR and MPG.

\*\* Average of Apartments, Industrial, Malls, and Strip.

Source: Green Street Advisors

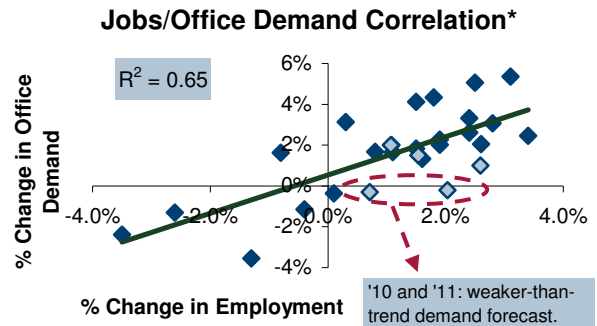
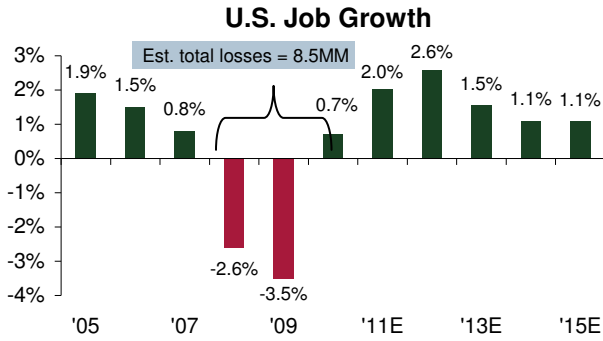
**Values Fell Hard, but Back on the Rise:** Despite the office sector's relative NOI stability, sharp M-RevPAF declines and the seizure in capital markets caused asset values to decline precipitously. However, in recent months, expectations of building values have risen, especially in top markets, causing a sharp rise in the values ascribed in Green Street NAV estimates.



Source: Green Street Advisors

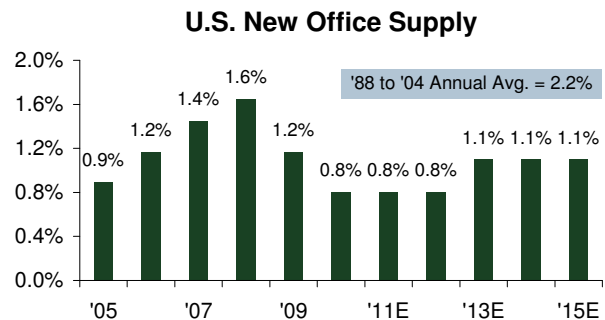
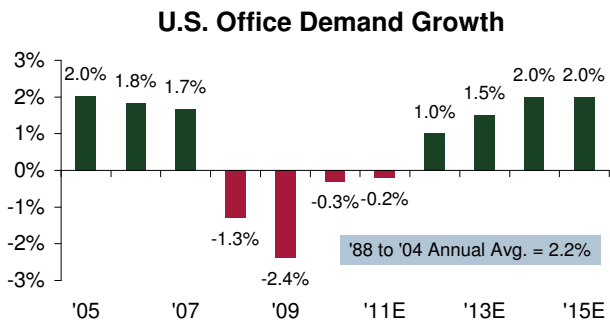
**II. Key Macro Assumptions**

**Changes in Jobs Drive Office Demand:** After two terrible years on the U.S. employment front (and a pretty awful decade, to boot), the outlook calls for moderate job growth by the end of '10. While some pundits expect outsized job growth to follow because that is what historically follows severe contractions, there is also a good case for more muted employment growth (e.g., anti-business policies from Washington, the prospect of a weak economic environment wrought by de-levering, etc.).



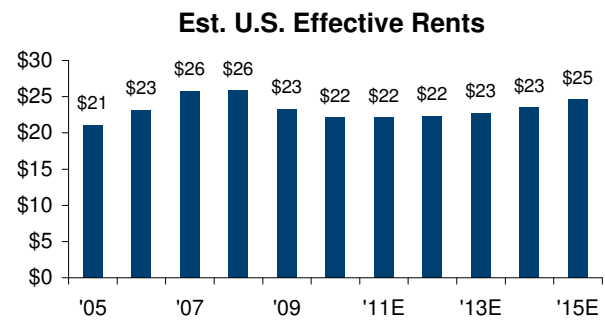
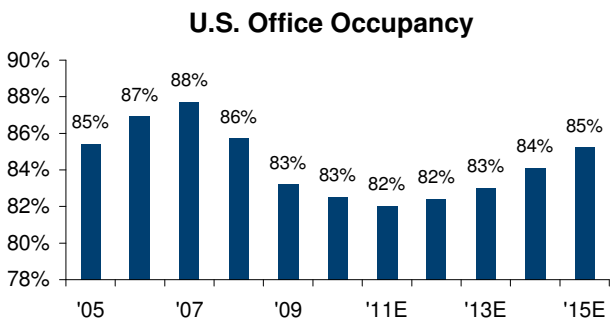
\* Plots annual changes in jobs and office demand (i.e., net absorption) from 1988 through the 2010-2015 forecast period. Correlation based on data through 2009. Source: IHS, Reis US Top 50, Green Street Advisors

**Weak Office Demand Through '11:** Declines in U.S. office demand to date (-4%) have been less severe than the '01-'03 cycle (-5%). While space givebacks in the last cycle were inflated by tenants coughing up space leased speculatively from '98-'00, this cycle has been defined by historic job losses of 6% of the peak employment base. As a result, office tenants probably have excess leased space that will limit additional near-term demand even as hiring resumes in '10 and into '11.



Source: Reis US Top 50, Green Street Advisors

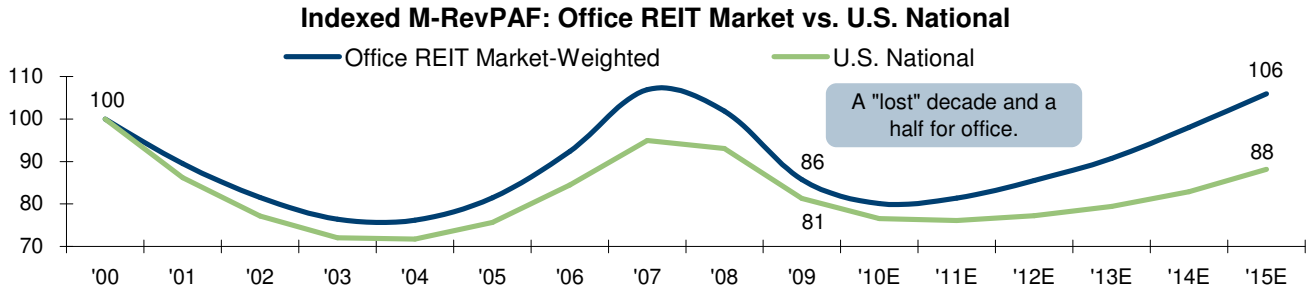
**Lower U.S. Occupancy than Last Cycle:** U.S. office occupancy is expected to bottom in the low 80% range, which is slightly worse than the last cycle, despite a lack of new supply. This is due to the fact that the vacancy at the onset of this recession was much higher than in the '01 time period.



Source: Reis US Top 50, Green Street Advisors

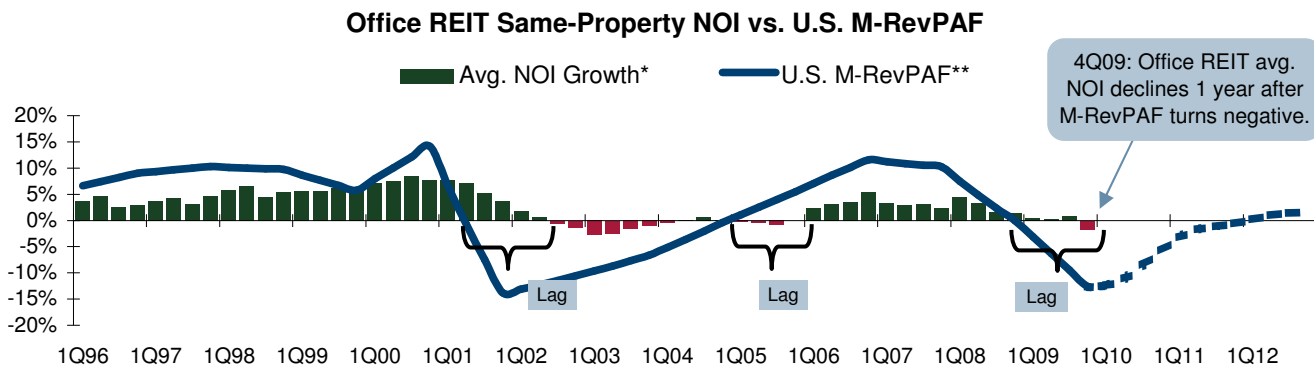
**III. Office REIT Fundamentals Update**

**Office REIT Markets More Volatile than U.S.:** As a group, office REITs are overweight top markets such as Manhattan and D.C. Because these markets tend to experience more dramatic swings in fundamentals, an M-RevPAF time series weighted by REIT markets shows more volatility than the U.S. as a whole. Over the next few years, key REIT markets should benefit from fundamentals that improve more rapidly than the U.S. average.



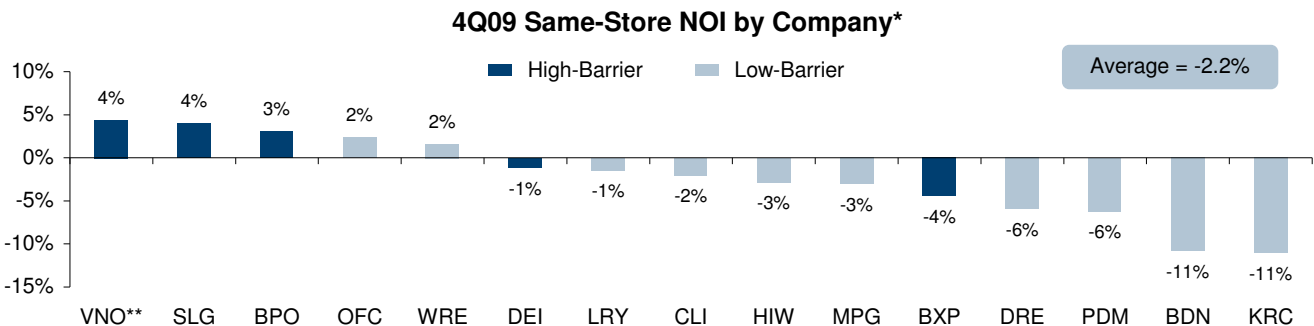
Source: Reis, Green Street Advisors

**Office REIT NOI Growth Finally Dips into the Red:** During 4Q09, office REIT NOI growth turned slightly negative, which is consistent with the historical four-quarter lag typical with U.S. M-RevPAF. Further NOI declines are expected in '10-'11.



\* Based on the average of all office companies covered by Green Street Advisors at that time where data is available. Excludes DLR & PDM.  
 \*\* U.S. M-RevPAF used instead of office-REIT weighted M-RevPAF because the U.S. version goes back further and offers a quarterly time series.  
 Source: Company disclosure, Reis, Green Street Advisors.

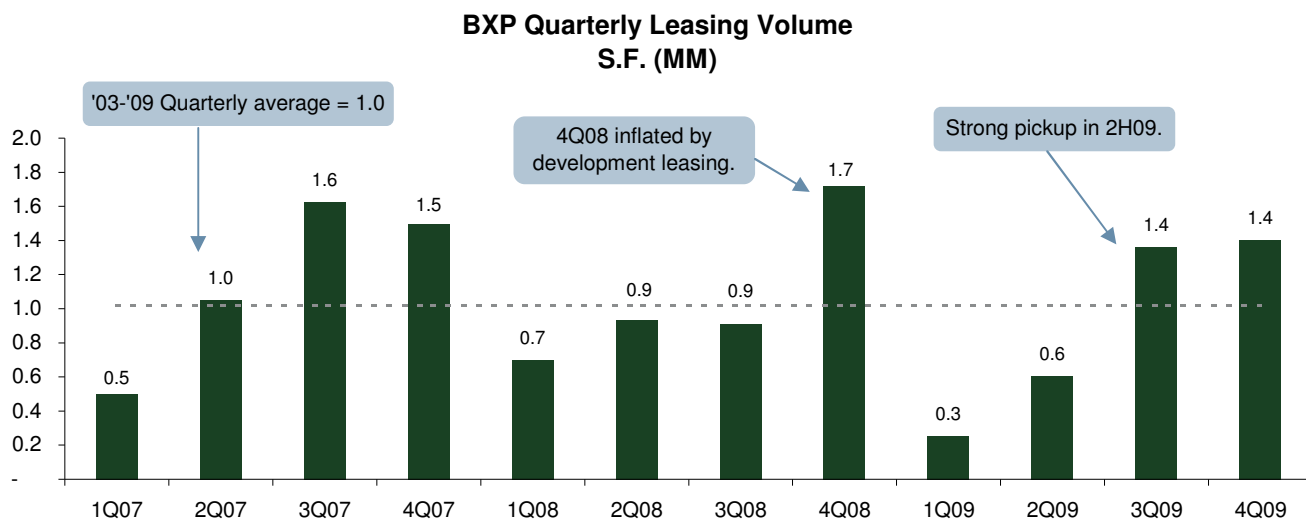
**Same-Store NOI Declines:** Same-store NOI performance declined across most companies during 4Q09 and the sector average fell into negative territory for the first time this cycle. Relative to low-barrier companies, long lease-terms continue to help high-barrier names preserve NOI. The worst performers are feeling the pain from large occupancy losses earlier in the year.



\* Excludes CUZ & DLR because data not provided or not meaningful. \*\* VNO reports only a cash same-store EBITDA metric.  
 Source: Company disclosure, Green Street Advisors.

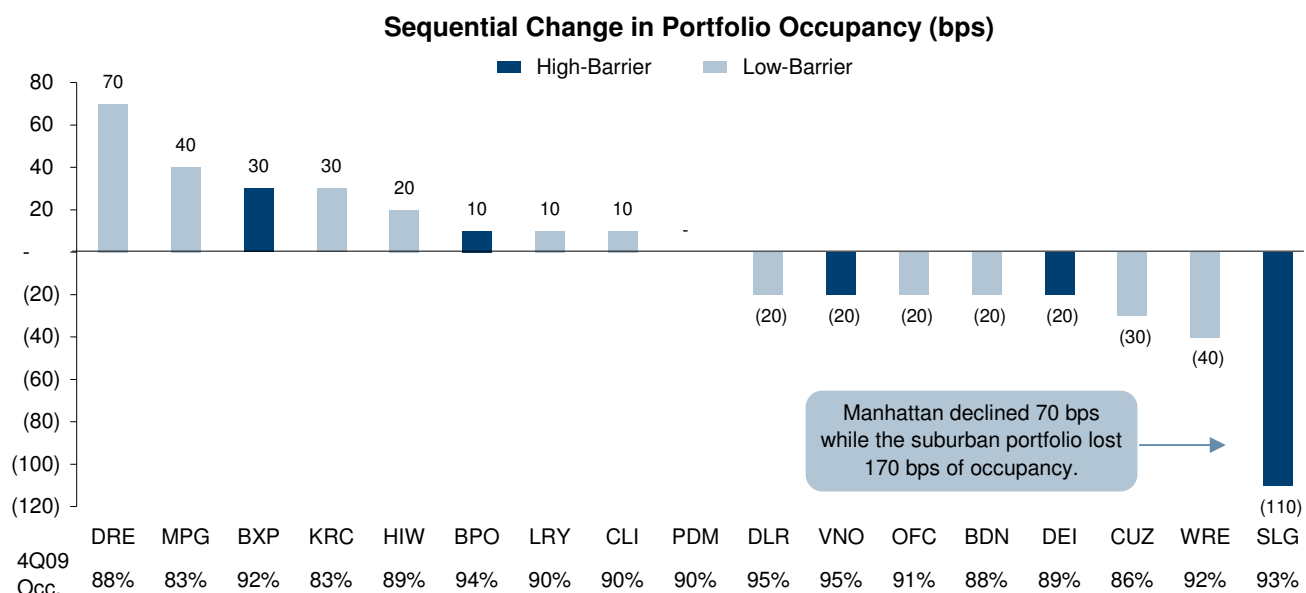
**III. Office REIT Fundamentals Update (cont'd)**

**A Sign of Improving Demand -- BXP Leasing Volume Turns Up:** Boston Properties (BXP) is a bellwether office REIT that owns high-quality properties in top markets. The company's leasing activity plummeted during the worst of the financial crisis in early '09, but has since rebounded sharply. While this reflects tenants acting on the favorable leasing economics now available, the pick-up is also a positive sign that decision-making paralysis has lessened and that fundamentals (i.e., M-RevPAF) may be nearing bottom.



Source: Company disclosure; signed leases for '08-'09; '07 is for leases commenced.

**Some Office REITs Pick Up a Bit of Occupancy:** As office demand starts to show a little more life, some REITs are beginning to make a dent in recovering from recent occupancy losses. However, the gains are not universal and are only marginal. Because the below data is portfolio occupancy, some of the bigger gains (e.g., DRE) reflect lease-up in unstabilized assets, along with ever so slight gains on a same-store basis.



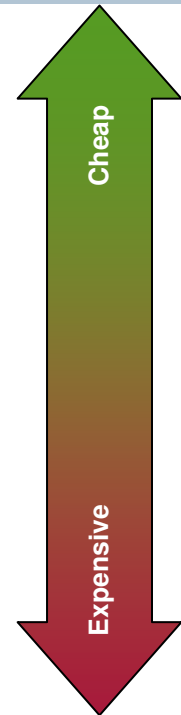
Source: Company disclosure, Green Street Advisors.

**IV. Private Market Return Expectations**

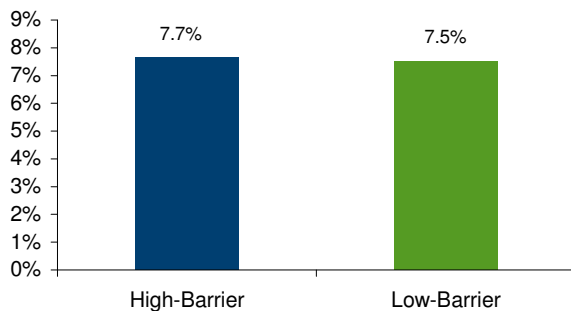
**A Look at Expected Returns by Market:** With recently reduced cap rates for certain high-barrier markets, a key question emerges: is this appropriate in the context of expected returns for individual markets? Based on estimates of cap rates, near-term cash flow growth, and long-term growth, our conclusion is that current cap rates produce roughly equal expected total returns, on average, between high- and low-barrier markets. Some of the cheapest markets include Houston and D.C. while Orange County and Downtown Los Angeles are relatively expensive.

**Unlevered Return Expectations for Top REIT Markets**

Market	Econ. Cap Rate*	IRR**
Houston	6.0%	8.5%
D.C.	5.6%	8.1%
Austin	6.9%	8.1%
Sub. VA	6.3%	8.0%
West LA	5.6%	8.0%
NY-Midtown	5.3%	7.9%
Tampa	7.1%	7.7%
Philly	6.8%	7.6%
Raleigh	7.1%	7.5%
Orlando	7.1%	7.5%
Suburban MD	6.5%	7.5%
Boston-CBD	5.7%	7.5%
NY-Downtown	6.5%	7.4%
San Fran.	5.8%	7.4%
San Diego	6.3%	7.4%
Boston-Sub	6.9%	7.3%
Northern NJ	7.0%	7.3%
Indy	7.2%	7.2%
Atlanta	7.3%	7.2%
Nashville	7.2%	7.1%
O.C.	6.8%	7.0%
LA-Downtown	5.8%	7.0%



**Unlevered Return Expectations**

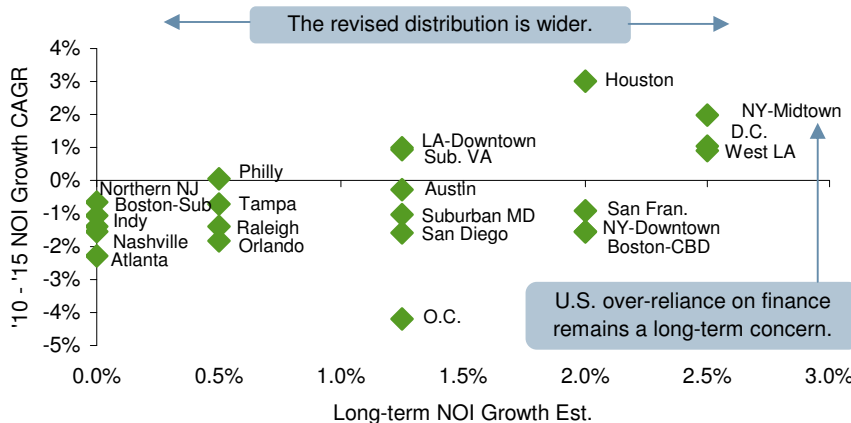


Source: Green Street Advisors.

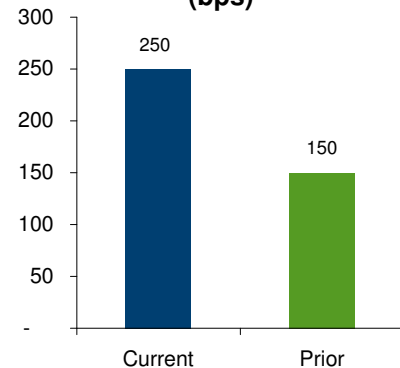
\* Roughly based on cap rates used for these markets in Green Street NAV estimates. \*\* "Market" models used to forecast near-term cash flow growth.

**Long-Term NOI Growth Expectations Widen:** Pegging near-term and long-term NOI growth expectations by market, as shown below, is a key part of the expected return analysis. The estimate for long-term NOI growth (i.e., into perpetuity) is especially important, and our assumption for the spread between the best and worst markets has been increased significantly, to 250 bps/year (e.g., Midtown Manhattan vs. Atlanta). It is no surprise that high-barrier markets offer superior long-term performance, but setting an appropriate betting line is more challenging. Office REIT NOI history (nearly 300 bps/yr better for high-barrier companies) and NCREIF data (better returns/NOI growth for CBD office vs. suburban) suggest a wide spread is warranted.

**Green Street Estimates of Near- and Long-Term NOI Growth by Market**



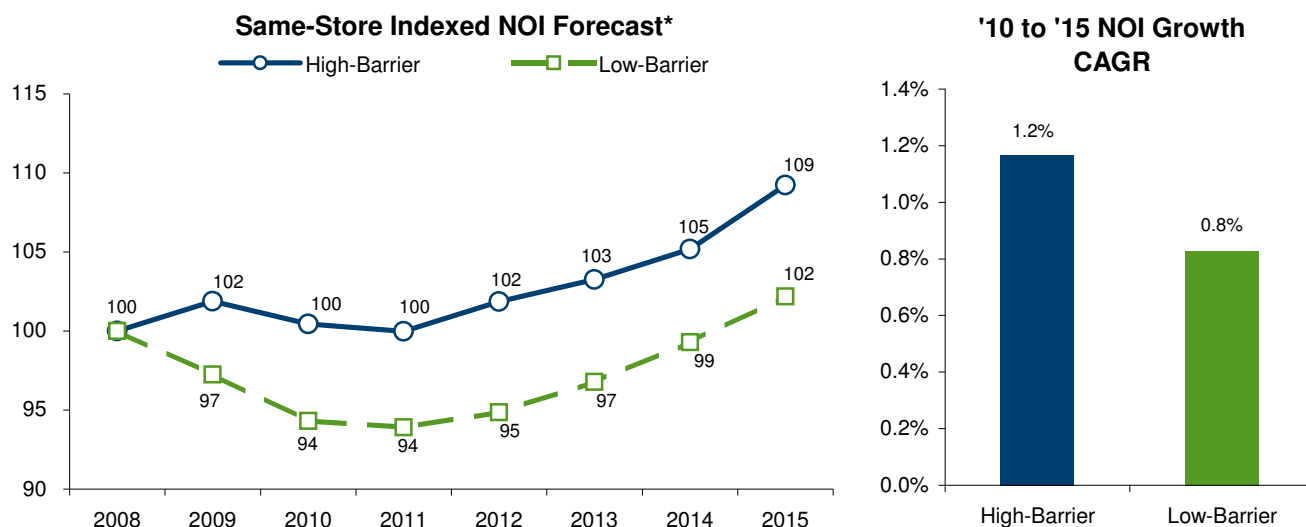
**Long-Term NOI Growth Estimate: Spread between Top and Bottom Markets (bps)**



Source: Green Street Advisors.

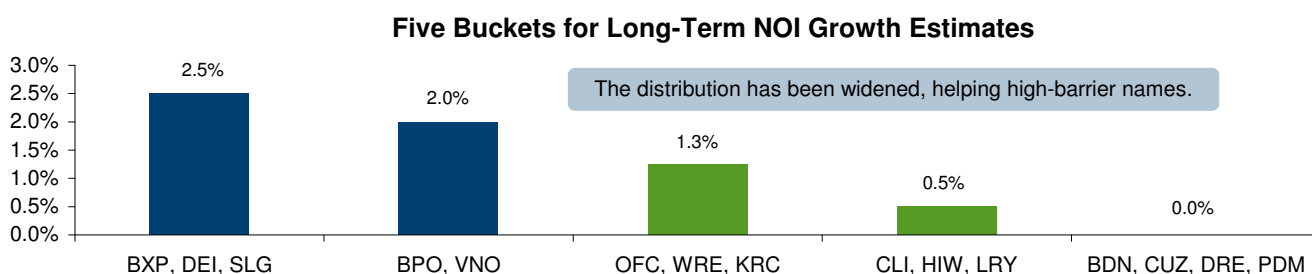
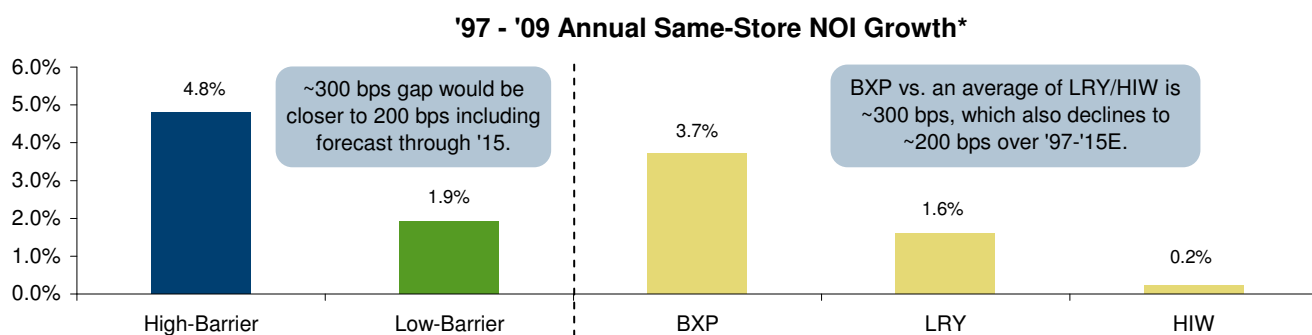
### V. High-Barrier vs. Low-Barrier

**NOI Forecast Summary:** Low-barrier NOI declined in '09, while high-barrier NOI staged a surprising increase. Current forecasts for high-barrier office REIT NOI growth over '10-'15 call for a modest advantage over the low-barrier peer group.



\* High-Barrier average includes BPO, BXP, DEI, SLG, VNO. Low-Barrier includes BDN, CLI, CUZ, DRE, HIW, KRC, LRY, OFC, PDM, WRE. Excludes MPG. Source: Green Street Advisors.

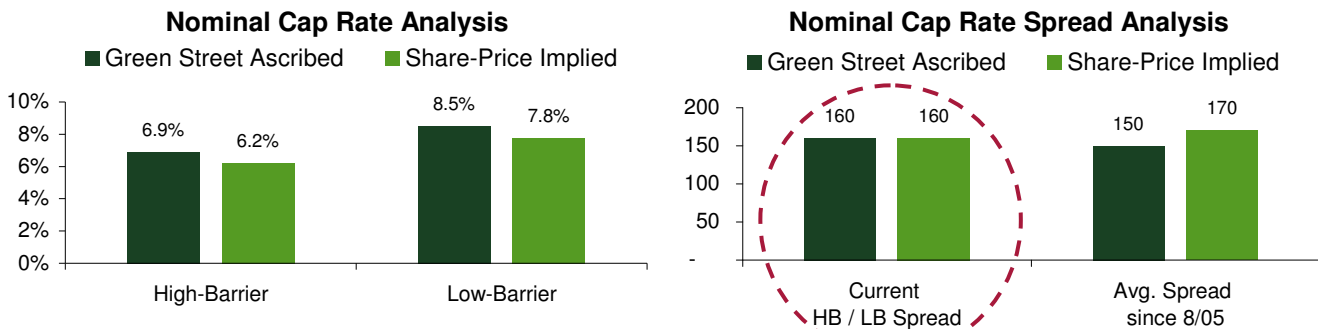
**The Long-Term Outlook Seems Better:** Over a dozen years in the public markets, high-barrier office REITs have delivered NOI growth that, on average, is superior to low-barrier companies by nearly 300 bps per annum. This suggests an increase in the long-term NOI growth estimates for these companies is warranted, similar to that shown for high-barrier markets on the prior page. The practical relevance of such a conclusion is that it provides economic justification for a greater cap rate spread between these types of companies, all else being equal.



\* High- and Low-Barrier CAGRs based on annual averages of office REITs covered by Green Street at the time weighted by asset value. Source: Company disclosure, Green Street Advisors.

**V. High-Barrier vs. Low-Barrier (cont'd)**

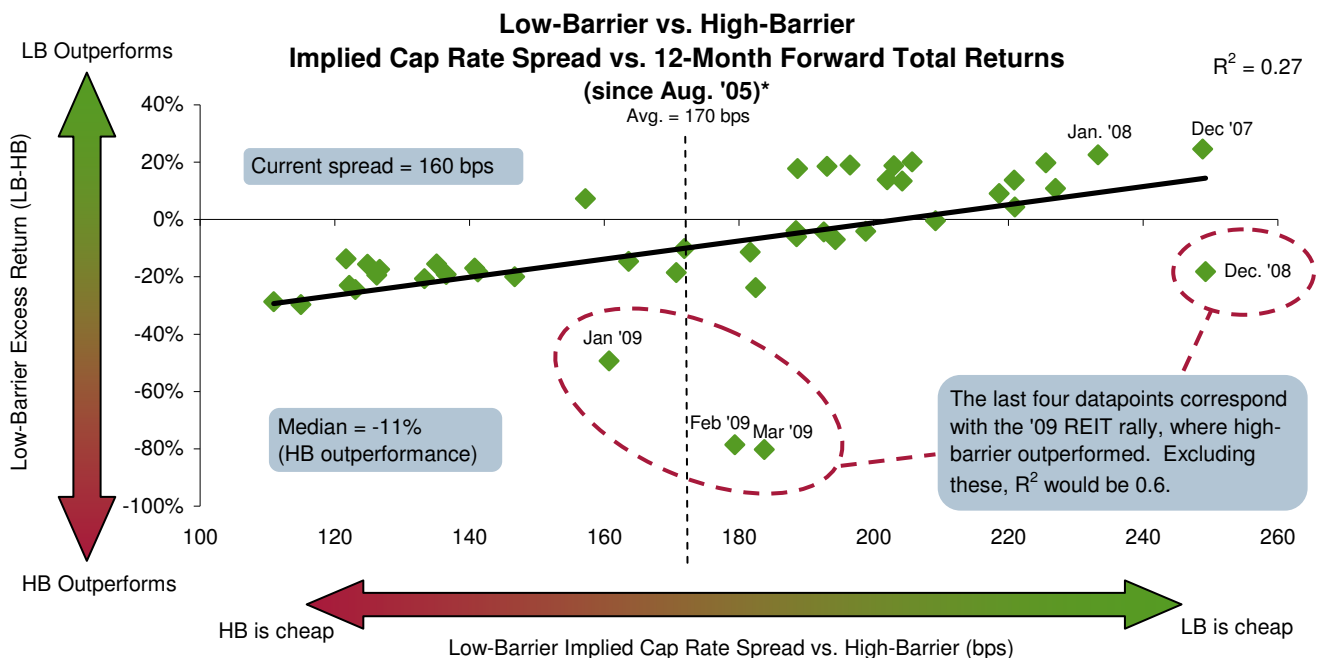
**Ascribed / Implied Cap Rate Summary:** Both high-barrier and low-barrier office REITs trade at premiums to asset value (i.e., implied cap rates < ascribed cap rates). The current share-price implied cap rate spread between the two groups approximates that used in current Green Street NAVs, and is in line with its five-year average.



Note: Each company only included since coverage initiation. Most recent additions: OFC ('07), DEI ('06), BDN ('06), BPO ('05), SLG ('05). Excludes DLR and MPG.  
 Source: Green Street Advisors

**Low- and High-Barrier Implied Cap Rates vs. Future Returns:** Given the choice, drivers prefer a BMW over a Kia. But, at some price, the BMW becomes too expensive on a relative basis. Office REIT investors face a similar challenge: the BMW (high-barrier) is preferred over the Kia (low-barrier), but when is the BMW too pricey?

Insight into the question can be derived by plotting implied cap rate spreads with corresponding forward 12-month total returns. Although implied cap rates are imperfect shorthand for an expected returns analysis, this metric has proven that it can provide a useful “first pass” at answering the high- vs. low-barrier question. Not surprisingly, high-barrier names have outperformed more often than not. Yet, there are times when an above-normal implied cap rate spread on low-barrier did translate into future total return out-performance. Because current expectations for high-barrier/low-barrier NOI growth over '11-'15 are roughly similar, on average, the appropriate implied cap rate spread should be lower than during a time of robust differences in the prevailing outlook. At present, the valuation gap appears neutral.

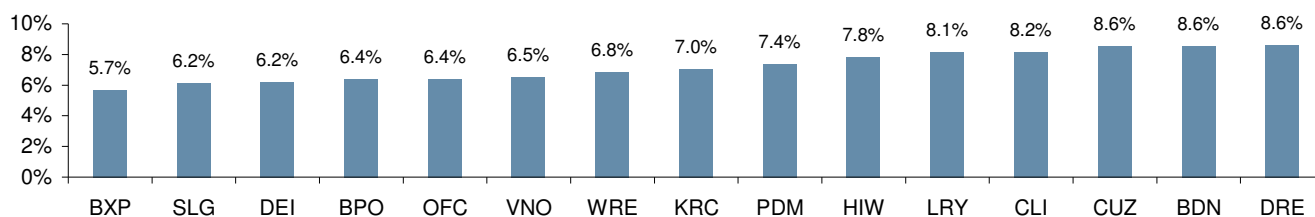


\* August '05 start date chosen because SLG and BPO had recently been added to our coverage universe.  
 Source: Bloomberg, Green Street Advisors

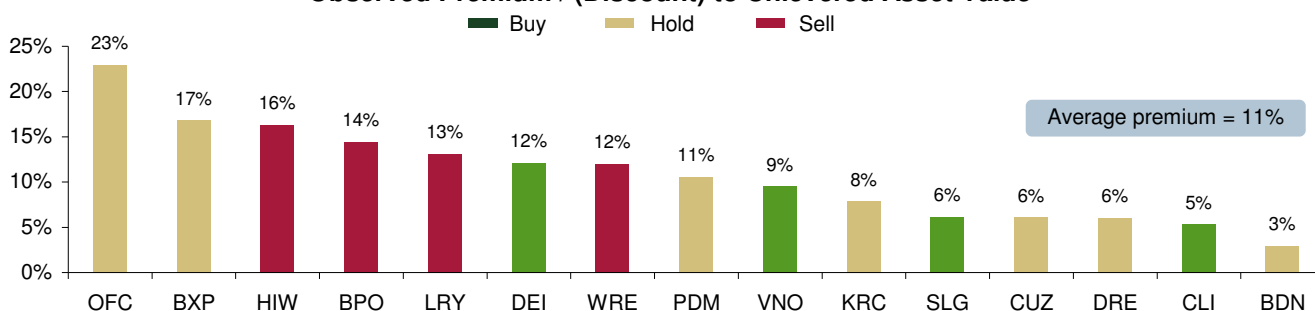
## VI. Valuation and Recommendation

**Valuation Summary:** Office implied nominal cap rates range from the mid-5%'s to nearly 9%. The sector trades at a premium to unlevered asset values in our current NAV estimates. A qualitative summary of Pricing Model variables for each company is presented below. These variables are both objectively and subjectively derived. The result is a “warranted premium to asset value” (unlevered) for each company that determines warranted share pricing. The *warranted* premium distribution is always centered on *observed* public pricing (i.e., avg. observed premium = avg. warranted premium). By assuming that office REITs are priced properly, recommendations are focused on relative value.

### Implied Nominal Cap Rate\*



### Observed Premium / (Discount) to Unlevered Asset Value\*



Source: Green Street Advisors

### Valuation and Recommendation Summary\*

Relative Variable Rankings (++ Good + Above-Average • Average - Below-Average -- Poor)

Ticker	Franch. Value	Over-head	Corp. Gov.	Share Liq.	Balance Sheet	Warr. Prem. to Assets	NAV		Recommendation	
							Current	% Δ	REC	Δ
OFC	++	•	++	•	-	23%	\$25.50	-	HOLD	-
BXP	++	++	•	++	+	19%	\$56.50	1%	HOLD	▼
DEI	•	+	++	-	--	14%	\$11.25	-	BUY	-
HIW	+	--	-	•	+	14%	\$23.75	1%	SELL	-
BPO	+	+	-	•	-	13%	\$10.75	-	SELL	-
VNO	+	-	--	++	•	12%	\$62.50	8%	BUY	-
PDM	-	•	•	--	++	11%	\$17.00	-	HOLD	▼
LRY	+	-	•	+	++	11%	\$26.75	1%	SELL	-
WRE	•	++	-	-	+	10%	\$25.00	1%	SELL	▼
SLG	•	-	--	++	--	8%	\$48.75	7%	BUY	▲
CLI	•	•	--	•	++	8%	\$32.00	-	BUY	▲
KRC	-	--	+	-	+	7%	\$26.50	-	HOLD	-
CUZ	--	--	+	--	+	7%	\$7.25	-	HOLD	▼
DRE	--	++	++	+	•	6%	\$10.25	(7%)	HOLD	-
BDN	--	+	•	--	-	3%	\$11.25	2%	HOLD	-

\* Excludes MPG, which is "Not Rated", as well as labs and data centers. Table sorted by warranted premium to asset value.

## VII. Company Specific Investment Attributes and Recent News

### Boston Properties (BXP): Patience is a Virtue

#### Company Background

BXP owns and develops top-quality assets primarily in four major markets (Midtown Manhattan, Boston, Washington, D.C., and San Francisco). The company has produced stellar total returns since its '97 IPO and is the "blue chip" office REIT.

#### Key Investment Themes

- + Healthy Balance Sheet:** BXP's balance sheet is well positioned from the standpoint of both leverage (46% versus average of 54%) and liquidity (\$1.5 billion of cash).

**+ High-Quality Portfolio:** BXP owns arguably the most desirable portfolio in the sector and is currently benefiting from a flight-to-quality within its markets.

**+ Modest Lease Expirations:** BXP faces lease expirations of just 7%/year through '12.
- + High-Barrier Focus:** BXP's portfolio sports above-average long-term expected growth. The near-term outlook for Manhattan has brightened as leasing activity has picked up.

**+ Top-Notch Management:** BXP's management has an impressive track record of creating shareholder value. Despite the sad recent passing of CEO Ed Linde, BXP has a deep bench that can be expected to carry the torch.

**● No Deals Yet:** Attractive acquisitions have been, and are expected to be, slow to emerge.

#### Recent News

Prior tenant blowups (e.g., Lehman) continue to impact BXP's same-property results, resulting in a 4% decline in 4Q09 cash NOI. While conditions remain tough, sentiment in BXP's markets has improved significantly, especially Manhattan. Same-store NOI growth is expected to remain negative in '10 before turning flat in '11, as a weak job outlook remains a cloud over intermediate growth. Management is confident that investment opportunities will eventually emerge, although that process may take longer than most expect.

**Current Recommendation: HOLD**

### Brandywine Realty Trust (BDN): Taking the Pain Early

#### Company Background

BDN is a suburban office owner and developer with a primary market concentration in the Mid-Atlantic. The company expanded beyond its traditional suburban Philadelphia home base with the '06 acquisition of Prentiss Properties, in what proved to be an ill-advised allocation of capital. BDN has subsequently exited most of the Prentiss markets, and retrenched to its Mid-Atlantic, suburban office roots. BDN's long-term total returns significantly trail its peers.

#### Key Investment Themes

- + Two Out of Three Isn't Bad:** BDN generates two-thirds of NOI from suburban Philadelphia and metropolitan Washington, D.C. Given the continued expansion of the U.S. government, BDN's mid-Atlantic markets appear poised to remain among the healthier office markets for the foreseeable future.

**● Portfolio Positioning:** Tom Wirth, recently appointed EVP, Portfolio Management, has been charged with developing a long-term business plan for every asset in the portfolio. In particular, BDN needs to decide whether to fish or cut bait in California and Austin, two "growth markets" BDN inherited with the '06 Prentiss acquisition.
- Leverage Remains High:** Near-term liquidity concerns have been addressed, but leverage remains worse than average. Management intends to reduce leverage over time, but the timing and magnitude remain in question. The recent addition of a continuous equity program is a step in the right direction.

**- Same-Store is U-G-L-Y:** BDN posted -11% cash same-store NOI in 4Q09, tied for worst in the office sector. Snow removal costs will likely pressure results in 1Q10, and cash same-store NOI is projected to drop 6% for FY10, placing BDN near the bottom of the office pack.

#### Recent News

BDN's 4Q09 headline results masked a weak core -- management used debt buyback gains to raise '10 guidance by \$0.02/sh, but same-store occupancy was down nearly 400 bps year-over-year to 88.5%, and cash same-store NOI dropped 11%. BDN's 4Q09 core results were disappointing, given the perceived relative strength of the company's largest markets. BDN recently hiked its annual dividend pace by 50% to \$0.60/sh, unwinding an emergency liquidity preservation measure enacted during the credit crunch, and restoring the payout to a level commensurate with projected taxable income. In March, BDN filed an 8-K detailing a 15 million share continuous equity program (\$175-\$200 million in potential proceeds).

**Current Recommendation: HOLD**

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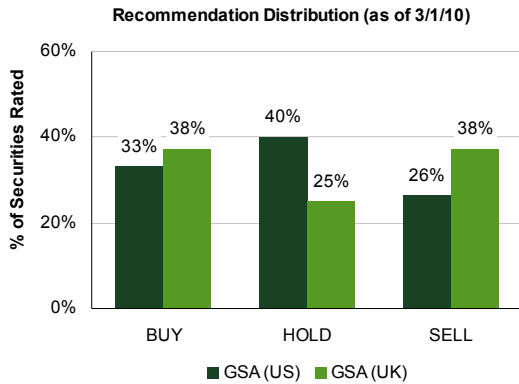
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**Total Return of Green Street's Recommendations<sup>1,2</sup>**

Year	Buy	Hold	Sell	Universe <sup>3</sup>
2010 YTD	4.8%	1.5%	3.1%	2.8%
2009	58.8%	47.6%	6.2%	37.9%
2008	-28.1%	-30.9%	-52.6%	-37.3%
2007	-6.9%	-22.4%	-27.8%	-19.7%
2006	45.8%	29.6%	19.5%	31.6%
2005	26.3%	18.5%	-1.8%	15.9%
2004	42.8%	28.7%	16.4%	29.4%
2003	43.3%	37.4%	21.8%	34.8%
2002	17.3%	2.8%	2.6%	5.4%
2001	34.9%	19.1%	13.0%	21.1%
2000	53.4%	28.9%	5.9%	29.6%
1999	12.3%	-9.0%	-20.5%	-6.9%
1998	-1.6%	-15.1%	-15.5%	-12.1%
1997	36.7%	14.8%	7.2%	18.3%
1996	47.6%	30.7%	18.9%	32.1%
1995	22.9%	13.9%	0.5%	13.5%
1994	20.8%	-0.8%	-8.7%	3.1%
1993	27.3%	4.7%	8.1%	12.1%
<b>Total Return</b>	<b>4195.1%</b>	<b>372.3%</b>	<b>-35.0%</b>	<b>427.2%</b>
<b>Annualized</b>	<b>24.6%</b>	<b>9.5%</b>	<b>-2.5%</b>	<b>10.2%</b>

Year Ending December 31:

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