CLARION PARTNERS

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NATIONAL OFFICE MARKET PERSPECTIVE

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How do you feel about the current investment climate for office properties?

The current climate is more challenging than it has been for the better part of the current economic cycle. As the 2016 NCREIF Property Index (NPI) performance has demonstrated, core property returns are trending toward their long-term averages. With the cycle now in its eighth year, pricing for CBD assets in primary markets is 40% above prior peak. Investors now have to increase risk tolerance in order to pursue double-digit returns experienced through core acquisitions in gateway markets earlier in the cycle. As yields have compressed on competitively bid tier-one assets, many core investors stepped out into select secondary markets and scope of transaction risk, in search of yield premium. Investors are turning to value-add and opportunistic transactions to supplement yield expectations. However, at this point in the cycle, increased consideration should be given to whether sufficient time exists to execute an identified strategy before the next downturn. Generally, however, we believe office forecast fundamentals are balanced-to-favorable over the next several years.

How do your 2017 investment goals compare to 2016?

Clarion's current office portfolio consists of 117 office assets or 28.5 million square feet owned, valued at approximately $13 billion. Although Clarion Partners typically invests two to four billion annually, Clarion's primary investment goal is to strategically invest client capital where the potential for strong, outperforming returns is identified. The start of 2017 has seen transaction volume taper relative to last year reflecting a wider bid-ask spread due to uncertainty over the political and interest rate environment. Underlying fundamentals remain attractive however and thus Clarion's 2017 investment goals are similar to those in 2016 during which the firm closed transactions with a total gross asset value of approximately $3.7 billion through core, value-add and opportunistic investments. Clarion represents capital sources across the investment spectrum and as such seeks to deploy capital selectively across all asset types and risk tolerances. However, again similar to 2016, an increased demand exists across most of the Clarion Partners client capital base for retail and industrial assets as such asset classes are challenging to aggregate based on typical investment size and yield characteristics.

Where do you see the greatest opportunities? Where are you focused?

At this point in the cycle, we have little to no interest in speculative office development and pricing for high quality core office product in the top gateway markets is also challenging. Clarion's primary investment focus in the office sector is thus primarily centered on creative office redevelopment opportunities where we can buy below replacement cost in spillover markets, premier suburban submarkets, and select secondary markets. We prefer locations with a robust high-tech sector, durable employment prospects, strong demographics, and an established transit infrastructure with high proximal walkability as well as assets demonstrating strong tenant credit attributes. In addition, we are cautious about acquisitions in tech markets where tenant demand has waned following a pullback in early stage venture capital funding activity.

What are your views on investing in core markets vs non-core markets?

Both core and non-core markets offer valid opportunities if market-risk is priced correctly. Values in core markets have risen well-above pricing in non-core markets for good reason. Boston, Los Angeles, New York, and San Francisco have experienced tremendous job and population growth since the recession as compared to markets we approach more cautiously such as Chicago and Washington DC, for example. When we invest in non-core markets, we prefer those that are transitioning into substantial second-tier core markets that include Austin, Dallas, Denver, and Seattle. Many recent headlines have touted the outperformance of suburban office relative to CBD locations. There are certainly strong suburban office markets, and Clarion Partners looks to identify the best opportunities within those submarkets, however our research shows that suburban locations generally outperform their CBD counterparts only for brief periods of time, usually in the back half of a cycle, and not over the long-term. Therefore, increased consideration must be given to anticipated holding period and target strategy when contemplating investment in suburban or non-core markets.

What are your biggest concerns regarding the current office investment climate? How is the competitive landscape changing?

Office users are intent on maximizing space utilization especially in high rent markets. While business confidence has improved, many firms are still wary of financially overextending themselves. In certain markets, leasing big blocks of space has taken longer than expected even though office employment continues to expand as tenants work to find innovative ways to use less space. Many investors are wary of traditional office buildings because, on average, the office sector has underperformed the NCREIF property index for the past 20 years. However, newer and/or more creative, well amenitized properties targeting technology tenants for example, can often capture greater demand for space and thus potentially outperform. Additionally, a rising interest rate environment is expected to have a greater impact on long- term investment, as tenancy, credit, contractual rental rate increases, lease-rollover schedules, and lease renewal options for example can have dramatic impact on asset performance relative to initial yield and its progression over the holding period compared to market dynamics. Overall, the competitive landscape has been relatively stable for the asset class. Core returns are however decelerating slightly as a consequence of strong capital inflows and softer rent growth in certain competitive markets, and thus as a result, more capital is considering investment in the core plus to value-add space in order to enhance investment yields.

How do you see cap rates trending?

We believe fundamentals are sound with elevated business confidence, robust office employment, rising inflation, and the prospect of financial regulatory and tax reform all bolstering demand against a manageable supply forecast. In general, capitalization rates may be pressured to rise a bit in alignment with interest rate increases but will likely not move very significantly. Available capital is at a record high, and investors need to deploy capital at or above mandated yields. As such, we generally expect cap rates to remain relatively stable in primary markets for core product, and possibly compress slightly in some secondary markets as investors seek to supplement investment returns by identifying appropriate top-tier assets with strong long-term investment qualities to further enhance portfolio yields on a risk adjusted basis.

What industry sectors do you see most influencing office leasing activity in the U.S. in 2017?

Professional and business services, which includes many types of high-tech jobs, has been and are expected to remain the most significant office demand driver. Since 2014, government employment has been a positive driver for the office sector, however given the President's recent budget proposal, concerns about job cuts at the federal, state and local levels, excepting defense, have resurfaced, which could impact such tenancy and thus investments heavily dependent on the sector.

How do tenants' preferences in terms of office design and efficiency influence Clarion Partners' leasing strategies? What are the biggest trends influencing your building operations?

In general, we believe that many investments can benefit by integrating innovative, cost-effective, sustainable design or operation strategies. Physical improvements which reduce energy costs can contribute directly to bottom-line savings passed through to building tenancy, potentially increasing an asset's competitive position within its peer set. This ultimately can lead to increased asset value. Assets that incorporate these sustainability features may also see benefits in terms of meeting leasing requirements for an ever broadening tenant base mindful of incorporating sustainability practices into their office space leasing mandates. High sustainability standards can also benefit an asset through its retention of tenants, and ultimately increased rental rates by way of increased demand for such space and lower demonstrated operating costs relative to its competition. Clarion Partners implements such productive energy saving improvements throughout its portfolio, and conducts annual assessments utilized for identifying new opportunities relative to new technologies. A growing number of major tenants now demand some level of sustainable certification as a requirement for leasing, so assets that do not incorporate some level of "green" design are at a distinct disadvantage to those that do. All improvements to a property however, must always be considered against the backdrop of financial feasibility and potential return on investment.

The influence of the growing Millennial workforce has been much discussed. How is this cohort impacting your property operations?

Certain factors continue to push forward the evolution of the office sector such as increasing space efficiency, sustainability, desire for modern, amenitized space as well as more creative and open layouts. Increasingly, such location, design and operational factors provide an advantage to tenants looking to attract, secure and retain top talent from the growing Millennial workforce. Identifying acquisitions or improving office assets that will allow tenants to better capitalize on engaging the Millennial workforce is expected to positively impact demand for such space and thus allow increased opportunity to price such space accordingly, thus fostering improved real estate valuations over the long term.

What kind of changes have you implemented to improve energy performance and sustainability?

Clarion Partners has developed comprehensive assessment and operation protocols for implementation across its office portfolio as well as for use within its acquisition activities. Clarion Partners utilizes green building certification systems and energy rating programs throughout the entire lifecycle of investments it manages, beginning with the due diligence process for potential new investments. Clarion's acquisitions due diligence process includes considering Energy Star score, DOE Building Energy Asset Score, LEED feasibility and analysis by third-party consultants, and then projected costs to achieve LEED certification accompanied by analysis suggesting ultimate economic feasibility. Such items may include landscaping modifications, lighting improvements, or enhancing building mechanical equipment and systems for example. Through a pragmatic and adaptive approach, as of year-end 2016, Clarion's portfolio now includes 55 LEED-certified assets, up from only 38 in 2014, and 58 Energy Star-labelled office buildings (representing over 80% of Clarion's office portfolio).

What are your expectations for the office market in the coming year?

After several years of above-average rental rate gains, national rent growth slowed considerably in 2016. Given sound fundamentals we anticipate modest rent growth over the near-term. Geographically, we expect to see mixed performance with Western region markets outperforming other regions. The South should also do well relative to other markets. We see office rents in Houston bottoming over the next two years so are watching Houston for potential opportunistic prospects. In addition, it is worthy to note that it's potentially getting late in the economic cycle for large-scale, ground-up office development, so we would expect to see such endeavors moderating.