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High-Profile Office Portfolio Sales Highlight Sharpening Investor Appetite for Suburban Assets

In Some Metros, Office Properties On Outer Fringes Surpass Rent Growth and Transaction Activity Seen In Trendy CBDs

By **Randyl Drummer**
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Sales such as the $103 million trade of eight buildings in the Cincinnati market by Duke Realty suggest that suburban assets are back on investors' radar.

It appears the long-suffering suburban office is finally getting its day in the sun as unabated capital flows earmarked for real estate investment and strengthening rents during the second half of 2015 prompt more investors to return to this property segment, which has largely languished since the recession.

Liberty Property Trust (NYSE: LPT), nearing the close of a multi-year strategy to shift out of suburban office, is selling into a strengthening national suburban office market that is recording post-recession highs in sales volume. This week Liberty said it has sold $550 million of such assets so far this year, and this week disclosed plans to dispose of another 8.5 million square feet of office properties in 2016. With those sales, the REIT said it will complete its strategic portfolio repositioning, exiting Tampa, South Florida, Minnesota and Northern Virginia in the process.

The Malvern, PA-based REIT expects to its final round of suburban assets will bring between $900 million and $1.2 billion on the market. It plans to use the proceeds to finance future acquisitions and plow $500 million to $700 million in new development projects slated to kick off next year, the company said as it revealed earnings guidance for 2016.

The planned dispositions follow $550 million in suburban dispositions by Liberty so far this year, including the $245.3 million sale earlier this month of its 41-property, 2.4 million-square-foot office and flex portfolio in Horsham, PA, to privately held Workspace Property Trust (WPT).

Other large recent portfolio trades include Brookwood Financial Partners' purchase of a 29-building, 1.6 million-square-foot portfolio in the Philadelphia area from Brandywine Realty Trust and DRA Advisors for $184.25 million, or $114 per square foot.

Two big portfolios have traded recently in the greater Cincinnati area, including the $103 million purchase of six Duke Realty Corp. office properties by a fund managed by Apollo Global Management LLC. Also in Cincinnati this past week,a fund sponsored by Birmingham, AL-based investment firm Harbert Management Corp., in its second acquisition in partnership with Brentwood, TN-based Smith/Hallemann Partners, purchased a 730,000-square-foot, five-building suburban office portfolio.

Rising Suburban Rents Get Investors' Attention

Investment sales momentum in many secondary suburban markets of the country, notably Philadelphia, Atlanta and Orange County, CA, have pushed investment totals to a national post-recession high, more than doubling comparable 2014 figures, according to JLL's third-quarter 2015 office investment outlook.

While core institutional investors have diversified into top high-barrier-to-entry, transit-oriented suburban submarkets, the most active buyers were opportunistic and value-add private equity investors, such as

Starwood Capital and Lone Star Funds. Nearly 40% of third-quarter 2015 activity was driven by portfolio acquisitions, particularly in the Phoenix, Philadelphia and Orange County markets, JLL's research found.

Rental rate growth is driving the rally. Suburban office market rents, while growing at a slower rate than CBDs, posted gains of 2.7% in the third quarter, led by high-growth suburbs in Minneapolis and Fort Lauderdale, FL, and spillover growth from San Francisco in Oakland, CA, according to JLL. Across all U.S. markets, suburban submarkets also logged higher rates of net absorption in the quarter.

With office rental rates in CBDs and secondary business districts already more than 5% above their long-term averages -- and prime suburban assets hovering just below their averages -- the rent gap between suburban and urban office assets, which has averaged 200 basis points for the last four years, will narrow and close by the end of 2016, according to a recent forecast by CoStar Portfolio Strategy. Urban rent growth should decelerate from this year's 5.5% to 4.5%, while suburban rents should continue to accelerate slightly to 4.2%, according to the CoStar forecast.

Not All Millennials Want to Live In Downtown Lofts

Some investors believe a desire for shorter commutes, access to transit and a flexible work schedule, which were rated of highest importance by millennials in recent survey of young professionals aged 20 to 37 in the greater Boston area by the Boston/New England chapter of the Urban Land Institute (ULI), may drive demand for well-located suburban property, where pricing still lags office properties in CBDs.

However, "This does not suggest that we will see an exodus away from urban centers over the next decade," says Paul Leonard, senior real estate economist at CoStar Portfolio Strategy. "Rather, it suggests that the suburbs - particularly well-located suburbs with good demographics and a supply of quality office stock - should not be written off."

Investors being priced out of CBDs and secondary business districts should consider expanding their search to prime suburban submarkets, Leonard added.

Pricing is 15% to 30% above the 2006-07 peak in CBDs and secondary business districts, respectively, pricing in prime suburban submarkets is just now reaching the previous peak, Leonard said.

At the same time, new supply in urban submarkets is catching up with office development in the much larger suburban office inventory. A total of 32.9 million square feet in urban new supply is forecast to follow new apartment rooftops in 2016, compared with 32.2 million square feet in suburban submarkets, a trend expected to accelerate through 2017-18.