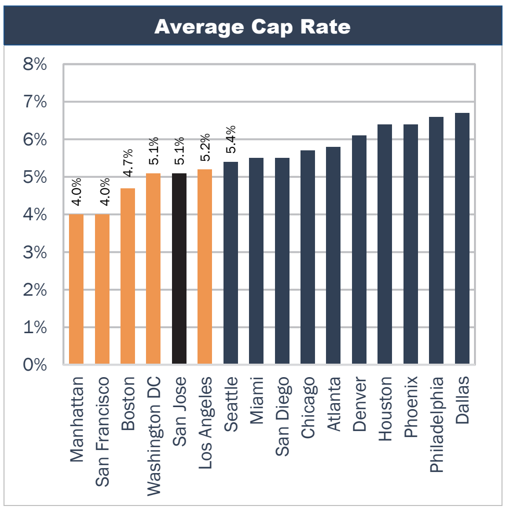
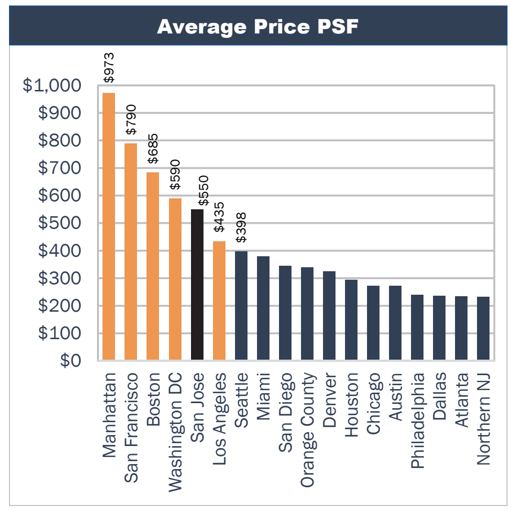
PCCP Market Commentary
Debunking the Myth of "Secondary" Markets
First Quarter 2016

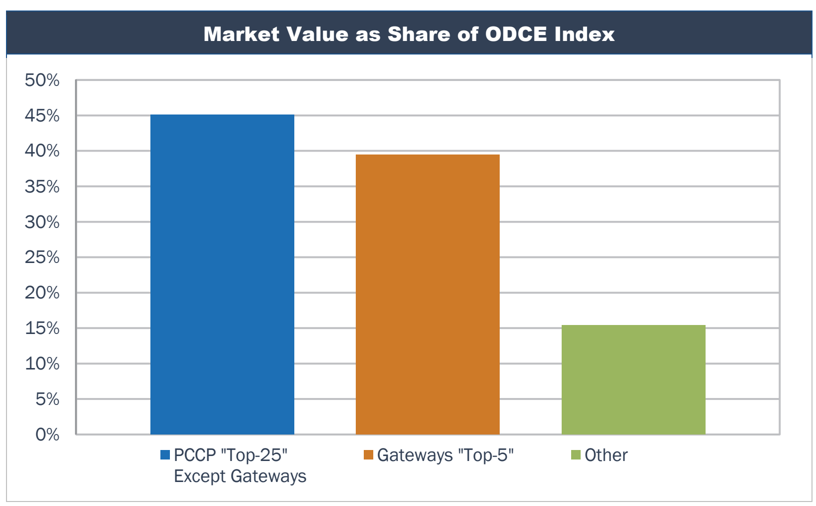
When investors talk about downturns in market cycles the phrase *flight to quality* is often used in terms of both tenants seeking better space and capital seeking more core-like assets in primary markets. This has created a perception in the investment community that in a downturn "secondary" markets might suffer more than gateway markets (New York, Boston, Washington D.C., Los Angeles, and San Francisco) in terms of both liquidity and price resiliency. For this reason the "gateways" generally are always in favor, with pricing driven exponentially higher in the latter part of market cycles when talk of a correction surfaces. This is not unlike what we are seeing today, as shown in the adjacent charts. Global capital has undoubtedly flooded gateway markets driving up pricing (note: to keep the analysis simple, we are analyzing only office property data).





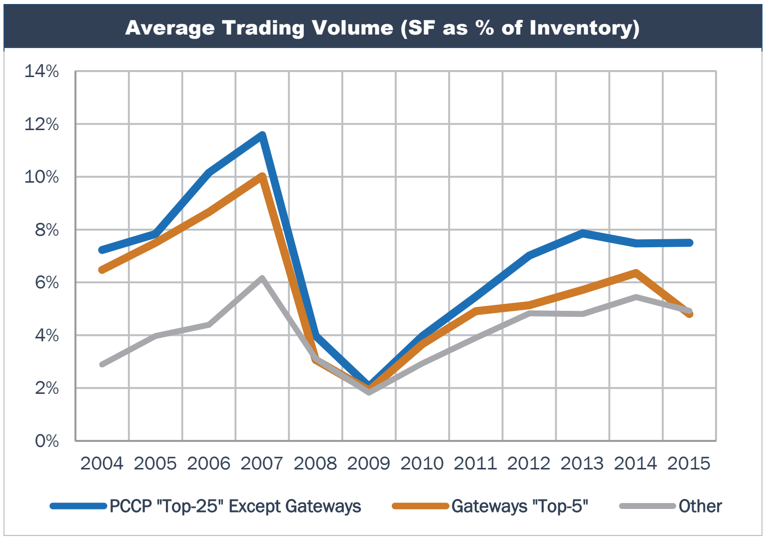
Source: Newmark Grubb Knight Frank, Real Capital Analytics.

But when you peel back the data, core capital is not confined to gateways and the so called non-gateway markets aren't exactly secondary. Just look at the NCREIF-ODCE index (Open End Diversified Core Equity "ODCE"), which is an index of 30 open-end commingled U.S. core funds[1]. One might expect this index to be concentrated in the gateway "top-5" markets. However, the data shows that almost half of these core investments are located outside of the gateways but within the "top-25" markets, as defined by market capitalization in terms of transaction



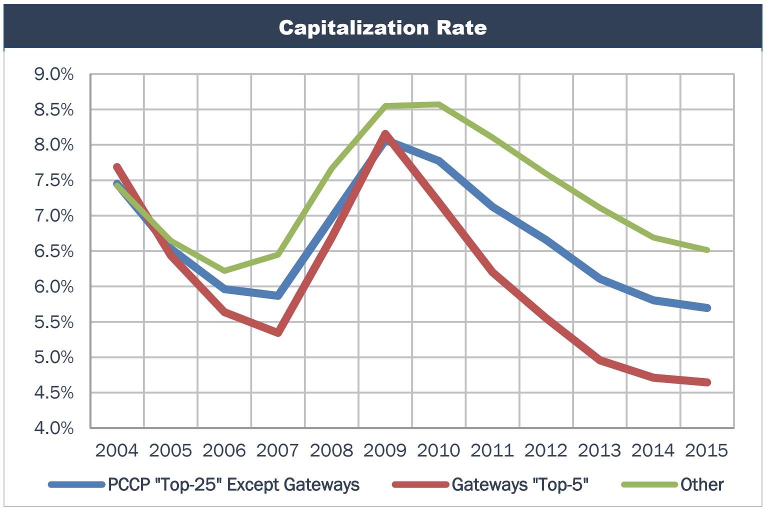
[1] *Note that at least 80% of the market value of net assets of ODCE funds must be invested in real estate, with no more than 20% in cash or equivalents. At least 80% of market value of real estate net assets must be invested in private equity real estate, at least 95% in U.S. markets, at least 80% in office, industrial, apartment and retail property types, at least 80% in operating properties (no more than 20% in (pre)development/redevelopment or initial leasing), and no more than 65% invested in one property type or region. No more than 40% leverage.*

volume[2]. Clearly, it is an investment myth that core assets are relegated to gateway markets. The reality is that they are heavily concentrated in the top-25 markets, which are often mistakenly referred to as secondary.



So why is there a stigma about these non-gateway top-25 markets? A fear of illiquidity and volatility? Taking a deeper dive into these 20 markets, the data proves otherwise. In the last downturn, these markets were actually as liquid as the gateways. The chart to the left shows average trading volume relative to each market's total inventory. Peak to trough, 2007-2009, the change in liquidity for the non-gateway top-25 fairly evenly mirrored the gateways. Similarly, with respect to price resiliency, cap rates increased more for the gateways from peak to trough. In other words, values decreased less for the non-gateway top-25 markets, showing less negative volatility.

So what does all this mean? As the herd of capital chases the idea of stability and safety in the over-heated gateways, opportunities can be widely found in the other top-25 markets. And in fact, these markets have proven to have liquidity and price resiliency in downturns. Further, as the ODCE index shows, capital has recognized the potential for core investment in this broader market set strengthening the case for value-add players to find and execute improve-to-core opportunities in the top-25 markets. Maybe these "secondary" markets should be considered primary.



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[2] The "Top-25" markets, as defined by PCCP, are the five "Gateway" cities New York, Boston, Washington D.C., San Francisco and Los Angeles, and Atlanta, Austin, Charlotte, Chicago, Dallas - Fort Worth, Denver, East Bay, Fort Lauderdale, Houston, Las Vegas, Miami, Minneapolis, Northern New Jersey, Orange County, Philadelphia, Phoenix, Portland, San Diego, San Jose, and Seattle.