PCCP Market Commentary

Safety in Core or Value Add?

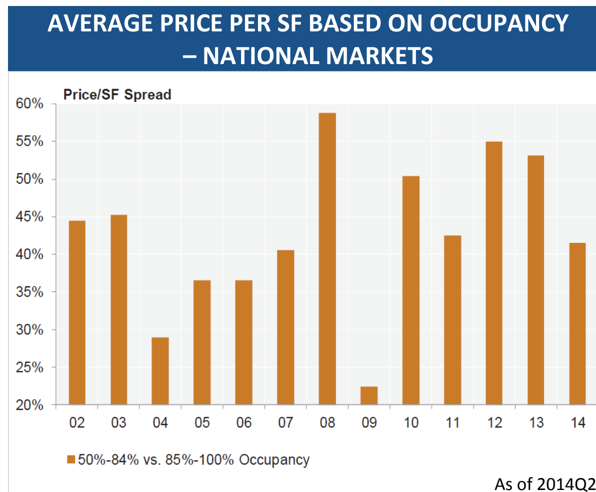
Fourth Quarter, 2014

Imagine two office buildings side by side. One is 95% leased with a diverse rent roll. The other is 50% leased. The anchor tenant just moved out. The first building is core, and trades very tightly. The second building is "value add" or higher on the risk scale. Which one is the safer investment?

CoStar's data confirms that occupancy challenged buildings trade at a significant discount to high occupancy buildings. This of course makes sense: the occupancy challenged building has the risk of not filling up, and poses different cap ex risks than the "core" building. But does the market price this difference correctly, especially in stable leasing markets where a functional building, over time, should capture its market share and fill up to market occupancy?

Our intuition is that if you think the market risk is expanding cap rates, then the core building is riskier. If you think the market risk is an economic downturn, then the value add building is riskier.

Here's one way to look at the math. For the value add building, we'll buy the occupied half for the same price per square foot as we would for the core building (say, a 5% cap) and we'll buy the vacant half for 50% of that price per square foot, which includes our leasing and capex costs. (This means we're buying the whole value add building for a 33% discount to the price of the core building, which is within the macro data to the right.)



Source: CoStar Portfolio Strategy

We ran a model to measure our potential return at this purchase price and, to keep things as simple as possible, assumed that capex and leasing costs are invested on day one, market rents grow at 3% annually, and the building is leased to 95% occupancy by the end of the 5-year hold.

If this building captures the leasing momentum of the market in real time and we achieve our business plan of 95% occupancy, our unlevered return is 13.4% if cap rates don't move and we sell at a 5.0% cap at the end of our hold period. Cap rates can expand by up to 430 basis points to 9.3% and we will still get our money back, even with a 10% drop in NOI. Anything wider means a loss.

VALUE ADD IRR						
Cap Rate / NOI	5.0%	5.5%	6.0%	6.5%	7.0%	9.3%
-10%	11.0%	9.2%	7.6%	6.1%	4.8%	0.0%
-5%	12.2%	10.3%	8.7%	7.2%	5.8%	1.0%
0	13.4%	11.5%	9.9%	8.4%	7.0%	2.1%

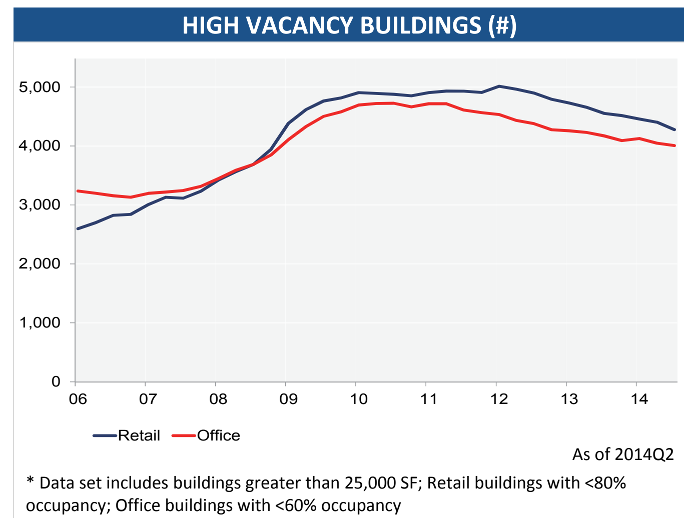
So, if you lease up the building before cap rates move, you make a lot of money, even if NOI falls a bit short of your projections. If you don't lease it up and cap rates expand, you are at risk of losing money, but the cushion from the 33% purchase price discount leaves you room for error. The success of value add business plans when cap rates look like they will expand in the near future depends on how long your lease up plan is and how stable the leasing market is.

Let's go back to the core building next door. We used the same model and assumed that rents, rent growth, hold period, and exit cap are the same as for the 50% occupied building, and that the building stays 95% leased in the base case (with no cap ex to maintain the building during the hold period). As you can see to the right, the cushion for cap rate expansion is only 230 basis points (if NOI drops 10%) compared to 430 for the value add building. If cap rates expand to 7.3%, you at least get your money back, but anything wider than that means you probably lose money.

CORE IRR						
Cap Rate / NOI	5.0%	5.5%	6.0%	6.5%	7.0%	7.3%
-10%	6.6%	4.9%	3.3%	2.0%	0.7%	0.0%
-5%	7.6%	5.8%	4.3%	2.9%	1.6%	0.9%
0	8.7%	6.9%	5.4%	4.0%	2.7%	1.9%

Risk is always in the eye of the beholder. When cap rates expand, it could be because the economy is strong and rents are growing. This could benefit the value add deal more because it is in lease up. If there is a downturn, the value add business plan might stall. One thing we know is this: purchase price matters. Once it is set, it cannot be changed, so in our view, if building quality is constant, wait for the value add deal. And despite how rare the value add deals seem due to recovery of market fundamentals broadly, the inventory of occupancy challenged buildings is still about 85% of peak inventory in 2010. So, it looks like there are still a number of value add deals to find.

HIGH VACANCY BUILDINGS (#)



* Data set includes buildings greater than 25,000 SF; Retail buildings with <80% occupancy; Office buildings with <60% occupancy

Source: CoStar Portfolio Strategy

William R. Lindsay
wlindsay@pccpllc.com
(310) 414-7868

Greg Eberhardt
geberhardt@pccpllc.com
(310) 414-2004

Steve Chase
schase@pccpllc.com
(646) 308-2101

K.C. Boback Kriegel
kkriegel@pccpllc.com
(646) 308-2102

Legal Notice: *The information contained herein is not to be construed as investment advice. Past performance is not an indication of future results. This information does not constitute an offer, or the solicitation of an offer, of any investment. Such offers are made only by the Private Placement Memorandum(s) related to such investment and only to persons and in circumstances in which such offers may legally be made without violation of U.S. federal or state securities laws or applicable laws and regulations. PCCP, LLC is registered as an investment adviser under the United States Investment Advisers Act of 1940, as amended.*