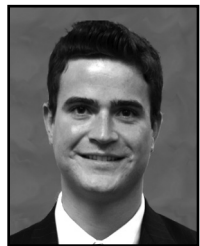


## WESTERN PA

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## Stabilized assets offer attractive yields

Without a doubt, these are turbulent times and a far cry from the frothy 2005 to 2007 real estate markets. Over and over again, we talk of recession and a jolt to the worldwide financial system. For real estate practitioners, especially those who focus on investment sales, the next 12 months will bring the promise of attrac-



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tive yields for stabilized office properties (compared with alternative investments such as fixed income or equities), the specter of illiquid capital markets, and the risk of falling demand coupled with a rising supply of sublease space.

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Notwithstanding the residential housing crisis, the capital markets have been disciplined in recent years

in terms of new construction and speculative office development. From a supply perspective, the high cost of construction and site development has minimized the quantity of new, un-leased office space in most markets.

According to the Turner Building Cost Index, construction costs have risen 40% since 2004. At first glance, this seems almost impossible, but after you consider the inflationary pressures and global demand trends of the past few years, it's easy to see why this number makes

sense. Today, in addition to dramatically higher construction costs, the weighted average cost of capital continues to increase for developers of all sizes. What was 80 to 85% LTV with a possible "B" note or Mezzanine kicker is now 60 to 70% LTV with a large origination fee for pure, quality-tenanted office buildings. The blended cost of capital continues to rise, with equity requirements now in the 30 to 40% range, additional collateral and covenants, and increasing interest rates as spreads widen.

What happens to the value of existing real estate in this situation? From an office market perspective, higher development costs increase the barriers to entry for delivery of new space. This restriction of supply, in effect, drives vacancies down because tenants have fewer choices and will be subject to an increasing rental rate atmosphere. This dynamic pushes rents closer to the cost-feasible rental rate that a new construction project would require. Lower vacancy rates and higher rents/net operating income create an environment of increasing value for existing, stabilized office properties.

According to Dividend Capital Research, office rental rates increased an average of 1.1% for the second quarter of 2008, providing a 4.2% year-over-year increase in asking rents. Overall, office occupancy levels are expected to decline just 0.8% for 2008, with asking rents actually rising by 4%, bolstering the supply and demand argument.

The X-Factor, however, is the amount of sublease space and the level of demand as office users become more conservative. As a lagging indicator of the general economy, we expect that sublease space will begin to hit the market in late 2008 due to layoffs and restructurings. As landlords compete for fewer tenants with greater choices, concessions should increase while effective rents should decline. But how deep will the X-Factor cut? In the short term, falling energy prices (and perhaps tenant improvement costs) could help property owners bolster the bottom line.

Finally, despite a global economic crisis and the downsizing of businesses, current yields and the acquisition/replacement cost differential are providing strong evidence for stabilized commercial real estate investments in 2009. And, that makes investment sales specialists eager to start a new year.

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## GRANT STREET ASSOCIATES



Welcomes  
**Peter J. Licastro, CPA**  
to its brokerage  
and leasing team!

Pete joins the firm as Senior Manager - Brokerage and Leasing and brings with him more than 16 years of industry knowledge and experience. Pete's focus includes landlord and tenant representation for office properties, strategic consulting services, land, office and investment property sales.

With his wealth of financial expertise and his vast professional achievements, Pete is one of the reasons Grant Street Associates is Pittsburgh's choice for commercial real estate solutions.

To learn more about Pete, visit our website at [www.gsa-cw.com](http://www.gsa-cw.com) or call him directly at 412-391-2635.

