Crittenden Pension Funds & Real Estate™

Crittenden Publishing, Inc.
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Vol. 24, No. 6 **March 17, 2008**

PFs SEEK CORE OFFICE

Expect pension funds to target core office investments, as overbuilding and high construction costs make long-term core strategies more appetizing. Open-ended fund strategies practiced by PF advisers like **Intercontinental Real Estate Corp.** and **Henderson Global Investors** are particularly attractive right now for PFs as the dominating theme of conservative investing in 2008 fits with their long-term investment strategies. However, the medical office segment follows a different path in 2008 as all investors covet the property type backed by strong demand and immunity to an economic slump. Expect advisers that do value-added and development plays, such as **Harrison Street Capital**, to find more attractive opportunities for medical office deals right now.

Traditional office investors are looking more conservatively at the market with long-term strategies for core-value properties. While Intercontinental has a track record of conservative leveraging with a long-term and value-oriented focus, the more conservative business model practiced by open-ended funds is especially attractive for PFs, which have the money and time to invest through an entire cycle — especially with fears brewing over being in the middle of a recession and the U.S. real estate market moving toward a correction after the last several years of phenomenal growth and performance. Expect investors to think twice about the risk involved in high-leveraged, short-term strategies for traditional office plays right now. One segment of the office market where PFs and their advisers are more willing to take a bit more risk is with medical office. Backed by demographic demands like a growing senior population and booming medical technology allowing for procedures outside a hospital setting, this segment of the office sector is more immune to economic volatility. Expect investors like Harrison Street to take advantage of opportunities in the market with value-added medical office deals that create value quickly and see shorter holds than what the rest of the office sector is seeing right now. The strength of the property type is even pushing some development while medical office also gets attention from core investors because of its strong fundamentals.

Intercontinental Real Estate Corp. is investing its fifth real estate fund, US Real Estate Investment Fund, and has seen several office deals close during the first quarter. Most recently, the PF adviser acquired Lakeside Commons, a 514,000 s.f., Class A office complex in Atlanta for $102.8M, with 48% leveraging with assumed debt. The two-office complex is currently 97% leased and served as an entrance into the Atlanta market for the PF adviser. The discretionary, open-ended fund invests across all property types and has a primary strategic focus on core and core-plus investments, but it can also make value-added plays on a select basis. The fund launched January 2007 has seen 14 acquisitions with approximately $500M invested. Intercontinental, where **Paul Nasser** is CFO and chief operating officer, looks for long-term investments underwritten at 10 years and focuses on quality, income-generating properties. While diversified across various property types, the PF adviser sees about 60% of its investments going towards office properties and the rest divided evenly between the remaining main food groups, with some specialty properties in the mix. Six of its 14 deals closed so far for the fund were office acquisitions. The targeted equity raise for the fund is currently set at $1B but, with no set lifespan, that size may grow. Leveraging set at 50% plays to the overall conservative nature of the fund. Other recent office deals for the fund this year include the core-plus acquisitions of the 295,700 s.f. Lock Drive Technology Park flex/office portfolio in Marlborough, Mass., and the 151,000 s.f. two-building, Class A Northpoint Center in Austin. Those two buys were leased in the low 90s at acquisition.

Repositioning Play Sought

Intercontinental has a robust pipeline, with dislocation in the market feeding it attractive deals. Currently, its focus has been on core-plus properties. Lakeside Commons was a strong asset at acquisition but in addition to its existing appeal and the opportunity it presented to enter a desired market, the PF adviser sees some upside potential to increase value with many leases on the properties nearing expiration and set at below-market rates.

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The PF adviser is currently looking at a potential repositioning play for an office property it sees better suited for medical office use. Intercontinental is also considering making some note purchases, with dislocation in the CMBS market providing some attractive deals for debt notes on properties that fit its appetite. The PF adviser sees deals ranging from $20M to $150M but has its sweet spot in the $30M to $60M range. Intercontinental targets investments of $600M to $800M per year, including leveraging, and is currently looking at retail, office, hospitality, senior living and industrial in its pipeline. Adding to the company's market focus along the East Coast, Midwest and Texas, its newest office opening in Los Angeles expands its presence into the Western and Southwestern markets of Denver, Hawaii, Las Vegas, Los Angeles, Orange County, Phoenix, Salt Lake City, San Diego and San Francisco.

PF adviser Harrison Street Real Estate Capital has been active in targeting health care properties with its JV with Montecito Medical Investment Co., formed last October. The partners, with Harrison Street contributing its share of equity from its specialty-focused Harrison Street Real Estate Partners Fund I, recently closed on a 75,000-s.f. portfolio of three medical office buildings located on the John C. Lincoln North Mountain Hospital Campus in Phoenix for an undisclosed price. The partners are using 75% debt leveraging at 5.8% with a five-year term and a two-year investment outlook. The partners anticipate a 7.5% cap rate for the property at stabilization. Expect $700T in capital expenditures to go toward enhancing curb appeal and renovating common areas for the 100% leased properties. With 75% of tenant leases rolling during the next three years, below-market rents and a 3% vacancy rate for medical office space in a one-mile radius of the properties, Harrison Street and Montecito see additional opportunity to add value through rent increases. The properties have 27 tenants, with the hospital being the largest leaseholder. So far, Harrison Street has seen approximately 13 assets with 400,000 s.f. of space acquired for its MMIC JV, with 10 of the properties located on hospital campuses. The MMIC JV has so far invested in Alabama, Arizona, California, Florida, Hawaii, Indiana, New Mexico and Texas.

Harrison Street also has a medical office JV with Riverside County, Calif.-based **Medical Real Estate Development**, in which the PF adviser is funding the development of a medical office campus in the Inland Empire. The project will consist of eight medical office buildings — four lease buildings and four medical condo buildings — totaling 125,000 s.f. While medical offices have been trading for very low cap rates in Harrison Street's target markets, its acquisition strategy for its partnerships is focused on building relationships with hospital systems, merchant builders and local owner/operators to source attractive off-market opportunities. The PF adviser, where Assistant VP **Michael Gordon** works on acquisitions and **Chris Merril** leads as managing director, is primarily focused on value-added acquisitions for its portfolio, with some development projects as well. Harrison Street targets strong growth areas with above-average household incomes and a strong insured patient market — especially with private-pay coverage — where there is a strong medical demand both at current and five-year projected levels. The PF adviser also looks at markets with attractive supply/demand imbalance. Although Harrison Street has only invested in medical offices for the medical segment, it has been looking into full-service general hospitals, LTACs and surgery centers. The adviser currently has an extensive pipeline of medical office investments, roughly split 50/50 between acquisitions and developments.

JV Seeks Core Medical Office

Henderson Global Investors partnered with investment and property management firm Glenborough LLC, a former REIT bought out by **Morgan Stanley Real Estate** in 2006, to acquire the 31,000 s.f. Oceanview Medical Center in San Clemente, Calif., last December. Henderson contributed equity from its diversified, open-ended, core Henderson Property Fund. The fund uses conservative leveraging at 50% and targets properties in the four main food groups with a long-term investment focus. The five-story building is located across from Saddleback Memorial Hospital. While the fund doesn't have a strong focus on medical office, the acquisition highlights the strong fundamentals carried by the niche. The fund also acquired four other properties during 2007, consisting of another office deal with Glenborough, a retail center, and two Chicago industrial buildings as well as the divestment of an apartment, bringing total 2007 transactions for HPF to $100M. Total returns in 2007 for the fund was 19.1% before fees, beating the NCREIF Property Index, which was 15.9% for the year. **Charles Wurtzebach**, Ph.D., is managing director of North American and chief investment officer for Henderson Global. Henderson Property Fund's investors include public and corporate PFs as well as endowments, foundations, high-net-worth individuals and international investors.