

Global CMBS Newsletter

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SUB-URBAN FOR A REASON

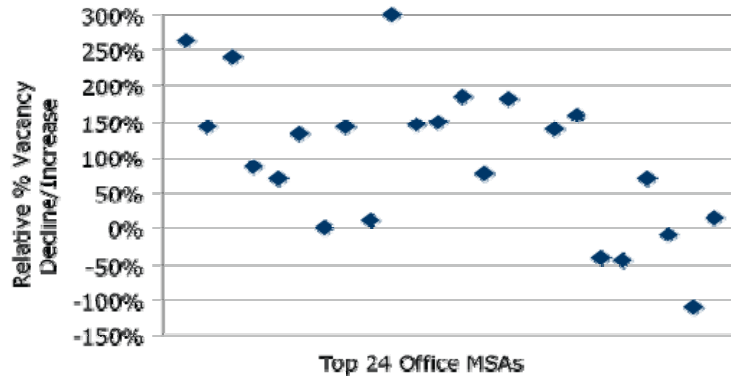
On the drive from downtown Chicago to O'Hare International Airport (or from any number of cities to their respective airports), one notices small groupings of office buildings that prominently display the name of the anchor tenant on the side of the building. This Chicago trip includes corporations such as Bally's, LaSalle Bank and True Value. It is also indicative of one of the more common asset types in CMBS transactions, the suburban office, which, as of July 24, 2007, represents more than \$9 billion worth of CMBS collateral through the first half of 2007, approximately 10% of new issuance. Similar to retail (see the February 23, 2007, Global CMBS Newsletter, "[Et Tu Anchored Retail?](#)"), suburban office properties behave quite differently from offices located in the downtown core of a city. Below we examine some of the differences that both benefit and hinder suburban office loans, including tenant profile, rent and vacancy dynamics and new supply growth.

Suburban offices, as the name implies, are located outside of the recognized Central Business District (CBD) and generally cater to smaller tenants that appreciate the space for both the lower rents when compared with CBD rates and the proximity to their workforce. For example, many industrial firms strive to be in a centralized location and generally prefer to have their corporate offices located near their manufacturing sites, hence the strong performance of such markets as suburban Cincinnati. Suburban office locations attract both smaller, regional tenants and larger corporations looking for back-office, support space, such as those mentioned above. The smaller tenants usually sign leases for no more than five years and that expire well within the typical ten-year loan term. In the CBD, tenant rollover is less frequent. Tenants sign longer-term leases and downtime between leases is generally shorter because of the larger universe of tenants seeking space. This creates demand for brokers, leasing agents and comparable market data, features that can be harder to come by in some suburban markets. The lack of transparency and market players in some suburban markets could lengthen the time required to lease vacant space and potentially result in cash flow shortfalls whereby the borrower has to come out of pocket to cover debt service.

Specifically a feature attracting these tenants to suburban office is the rent differential between suburban and CBD office space. According to CoStar Group's second quarter national office report, suburban asking rents are also almost \$6 per square foot (psf) less than the CBD (\$22.20 versus \$28.02), a feature desirable to tenants. This differential in rent psf can significantly lower occupancy costs for small to mid-sized firms that do not need to have a high-profile address to attract clientele. In addition to lower rents, tenants have more space options from which to choose as vacancy rates tend to be higher in suburban office. Although the suburban office market exhibited positive net absorption of 18.7 million sf, the vacancy rate actually rose to 11.7% from 11.4% as of year-end 2006. Alternatively, in the CBD markets, vacancy decreased in the same time frame in the CBD markets, from 10.4% at YE2006 to 9.9%.

Each market also responds to demand generators differently. When analyzing the difference in change in vacancy from YE2004 to Q1 2007 of the top 24 Metropolitan Statistical Areas (MSAs), the results reveal that CBD office vacancy trends are more drastic than suburban performance. Current property fundamentals are strong across most office markets and we would expect to see vacancy declines in both CBD and suburban markets. The graph below shows that for 17 out of the top 24 MSAs in the United States, the decline in office vacancy over the same time frame was much larger for CBD properties versus suburban (those above the 0% mark).

CBD to Suburban Vacancy Relationship



MSAs that did have suburban office vacancy decrease faster than the CBD are good examples of the positive aspects of suburban offices. Specifically, where local and regional businesses, such as law and insurance firms, can conduct business closer to their customer's and workforce's residences and offer parking to help ease both the time and cost compared with long commutes and daily parking fees usually seen in the CBD. Also, suburban office performance in markets such as San Diego and Tampa, where the CBD lacked mass transit options, proved strong.

Vacant land in the CBD of any major market is scarce compared with suburban locations, which justifies the higher rent and subsequently higher value and thus a much higher loan psf compared with its suburban counterpart. The availability of land and the fact that rents and yields are now justifying new construction are highlighted in the development pipeline statistics in Integra Realty Resources' Viewpoint 2007 report. The CBD markets have 69 million sf of CBD office in the development pipeline for 2007–2010, representing a 4.8% increase over the current supply. The suburban pipeline in the same time span is more than 240 million sf, which is 8.1% of the current supply.

The attractive aspects of suburban office, of which there are many, are also those that can hurt it the most and underwriting practices should differentiate between the two. Tenant profile and leasing terms are different, market rent and vacancy generally move in the same direction but at much different paces and at some point the availability of land in the suburbs will lead to more development. With already 240 million sf in pipeline, this new supply could cause further depression on suburban market rents and vacancies, leaving the borrower fewer options and an inability to grow cash flow and maximize its return on equity.

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