THE NEXT FRONTIER IN THE U.S. OFFICE SECTOR

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REAL ESTATE INVESTMENT ADVISORS

Shifts in the Office Sector

Introduction

In the midst of the resurgence from the recent recessionary period, the traditional commercial office sector is witnessing shifts in demand driven by a multitude of market forces. As a result of changing work practices, office tenant requirements for corporate real estate have evolved in recent years, to include both cost reductions and functional efficient spaces.

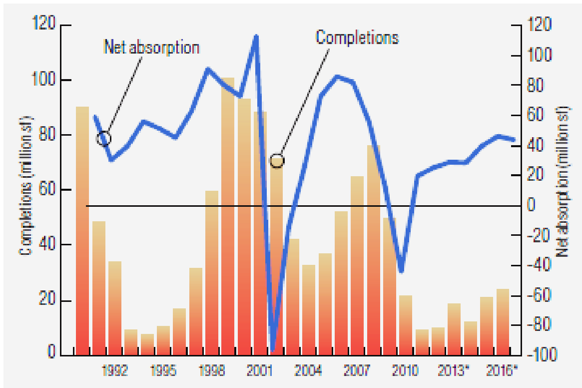
To date, the slow national recovery in the office sector has been driven largely by negative forces such as high unemployment rates and owner desires to reduce operating costs. Today, however, there exists an opportunity to counterbalance those negative influences by understanding the technological, generational and locational forces that are driving the new frontier in office space demands. This demand for "creative space" offers an opportunity for investors to leverage changing space utilization trends through investment in office assets that provide a competitive advantage against other space in the market.

In order to optimize portfolio returns, it is important to conduct a review of existing assets and their current and future positions in the marketplace in order to benefit from repositioning and mitigate potential risk. The purpose of this white paper is to discuss the role of commercial office assets within investor portfolios by assessing the effects of various market forces that are driving shifts in tenant demand for office space.

Market Forces

Understanding office market sector fluctuations is essential to be successful in office investment, development and leasing going forward. These forces are the drivers behind modification trends in type, layout and location of office space, even if new demand for new net square footage is lacking.

U.S. Office New Supply and Net Absorption



Source: ULI

According to the NCREIF Property Index, total returns for office properties have lagged the performance of apartment, industrial and retail property types over the last four years. Additionally, suppressed national job growth and the oversupply of office space has slowed any new construction or speculative developments. At the same time, some positive forces are emerging within the office sector that will affect the opportunities and competitiveness of the market.

1. MILLENNIAL GENERATION

The millennial generation ("Generation Y") represents 36% of US labor force today; by 2030, they will account for about three-quarters of the workforce, according to a study done by the Urban Land Institute. Even though many offices employ people who fall into each of the four generations in the workforce, the Millennials are the rising demographic, and thus, have significant influence on decisions regarding office design. This massive demographic shift from Baby Boomers (born 1947-1964) to Millennials (born 1982-2004) is changing the way work gets done, as the new generation brings a different mindset with expectations for a unique work environment. In particular, Millennials recognize the following as essential factors for their work environment:

Connectivity

Nearby Amenities

Collaborative Space

Sustainable Design

Companies with offices containing these features have embraced "creative design" and consequently are able to attract and retain the top talent within the Millennial workforce.

2. TECH INDUSTRY GROWTH

Through a stagnant economic recovery, some industry sectors, such as technology, media and healthcare-related industries, have been bright spots in job creation and overall growth. The strength of the tech sector can be seen specifically in the office sector. According to a Real Capital Analytics study, the tech sector accounted for 17.4% of office leasing year to date by square footage, making it the largest volume of office leasing and increasing its share from 13.6% in 2013. While traditional sectors, like government and legal, are showing negative leasing activity patterns, the tech industry is expected to remain strong and ahead of other markets. In particular, high-tech firms are leading leasing activity in some of the largest markets across the United States: San Francisco, Denver, Boston, Manhattan, Seattle, Atlanta and more.

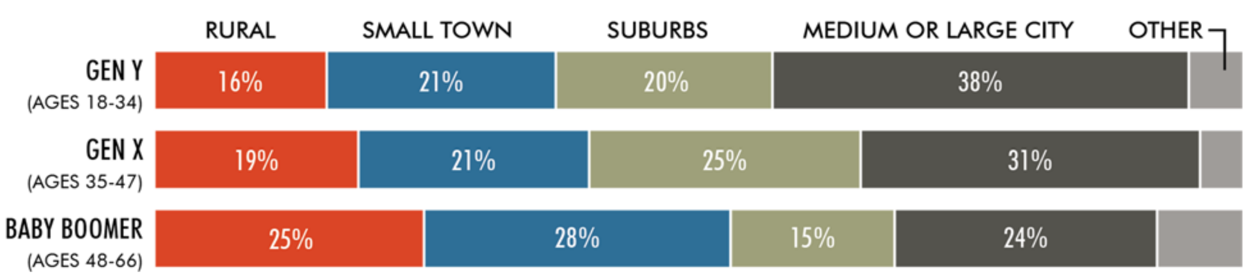
As the tech industry continues to grow, companies are being driven by fierce competition for employee recruitment and retention. Concurrently, the Millennials' use of technology and their affinity for the digital world, in comparison to other generations, have driven them towards jobs in the top growing tech companies. Ultimately, tech companies want to operate efficiently, but they also want to appeal to the generation that grew up surrounded by innovative technology. Not surprisingly, the companies that have already been the most successful in attracting talented Millennials – Google and Apple among them – are naturally innovative employers that are embracing the creative design office style to appeal to that generation. This, in turn, has caused major office sectors to grow along with the booming tech industry and shift away from the traditional office setting.

3. LOCATIONAL PREFERENCES

Driven in part by the convergence of powerful demographic forces and market preferences, the current trend in office space demand has shifted away from the suburbs to central city markets and urban cores. Propelled by young Millennial professionals and creative types who prefer urban lifestyles, the desire for bustling city centers, transit lines, shops, restaurants, etc. has revitalized urbanization in submarkets across the nation. Currently, fourth-fifths of Americans live in urban areas that make up over 50% of the world's population, and that number is projected to grow significantly. Office space in developed urban cores is often more expensive and harder to find, but that is where young workers ultimately want to be. This demand has resulted in a notable increase in corporations migrating from outlying suburbs to downtown or urban locations.

After decades of big businesses leaving the cities for the suburbs, United States firms have begun a new era of corporate urbanism. Nearly 200 Fortune 500 companies are currently headquartered in the top 50 cities across the nation. Many others are staying put in the suburbs, but are also opening high-profile satellite offices in nearby cities, sometimes aided by tax breaks and tempered down rents from the recession. Nationwide, commercial vacancy rates in central business districts have decreased faster than those in the suburbs since the real-estate market began to recover in 2011, with 13.9% of urban space empty versus 18.5% in the suburbs at year-end 2013, according to research from Reis, Inc. Overall, companies are under pressure to establish an urban presence that projects an image of enthusiasm and innovation.

As such, emerging creative markets, like Downtown Los Angeles, are in the early stages of redevelopment and adaptive reuse. Many owners are openly discussing their plans to convert older and functionally obsolete office properties into a more creative environment, as the space is considered a more viable and in-demand option for many of these properties. Urban areas are increasingly understood as drivers of economic growth, culture, and innovation, resulting in new demands and constraints on space. As more corporations seek new or renovated downtown office spaces with more open layouts and flexible footprints, it will become increasingly important for owners to transform space through creative design in order to attract top tier tenants.



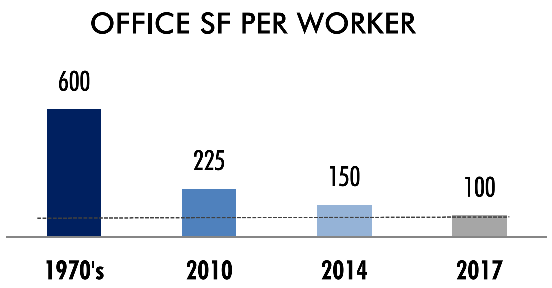
Effect of Market Forces

Market forces, such as technology growth and a new generation of workers, are leading to fundamental changes in where, how and when today's workers perform their jobs. The convergence of these forces raises questions about what the workplace is – and more importantly – what it should look like. Ultimately, market forces will have a large impact on how employers make decisions on the restructuring of their office spaces. As tenants' 10-15 year leases signed in the 1990's and early 2000's continue to expire, companies will be more inspired to make upgrades into the creative design office space. The overarching effect of shifts in market forces is the **reduction in the amount of square footage needed by organizations going forward.**

DENSIFICATION

As tenants strive to leverage real estate resources and manage costs, the trend toward densification – or decreasing the amount of office space allocated per employee – remains a common theme. Densification refers to the concept of having fewer individual offices and utilizing collaborative areas for team environment work.

In a study done by Gensler, it was found that offices and workstations are unoccupied during the day about 50% of the time, creating a pricey carrying cost for the unused space. Tenants are downsizing their space requirements, particularly larger firms, as they adopt policies for sharing unassigned workstations and implement technology to support their employees' flexible work practices.



An August 2013 survey conducted by CoreNet Global found that the average space per office worker has dropped globally to no more than 150 square feet, down from 225 in 2010. This number is predicted to drop to as low as 100 square feet per person by 2017. Yet, while organizations are still compressing their rentable square footage, the decrease is not nearly as great as originally envisioned, due to the large increase in collaborative spaces necessary.

MOBILITY/TECHNOLOGY

Companies continue to be impacted by transformations in the way work is done globally, largely driven by the vast technological advances of the past decade. It is important to understand how mobility can reshape the role of office hierarchy, lease term, physical presence and permanence of space within the office sector.

According to Nemertes Research, 91% of employees do some work outside of the office and if given the choice, 69% of the American workforce would chose to work remotely. Thus, workers are increasingly mobile, and a majority of enterprises are focused on supporting the growing number of employees who use mobile devices such as smartphones or tablets to do their work at the office, at home and while traveling. The increased dependence on mobility has caused workers to become less location dependent, ultimately reducing the necessary footprint for corporate occupiers.

DESIGN

In order to coexist with changing demands, the actual physical building configurations and specifications have transformed from a traditional professional office space with narrow depths and cellular layouts to modern space utilization techniques. These creative layouts call for flexible, efficient and multi-functional spaces. Higher quality building amenities that complement high worker densities have become a significant part of design in order to include social spaces such as cafeterias, lounges, modern conference rooms and more.

Additionally, sustainable/green buildings with high ratings under the Leadership in Energy and Environmental Design (LEED) program and energy-efficient systems have become increasingly important to today's workforce. Beyond that, fresh air and natural daylight are also important factors in overall employee satisfaction, as the new generation continues to create a work/live/play type atmosphere in the office. As the world has become increasingly aware of its natural environment, buildings with sustainable design or those operated with sustainability in mind become more desirable.

Progressively, buildings will be refurbished for adaptability for potential future alterations, with floor plates that can be configured and re-configured to suit different tenants and their changing needs.

Impact on Investors

In the wake of the recent recession, it is imperative to evaluate and restructure existing short-term strategies and long-term sustainability of real estate portfolios by assessing sources and indicators of demand within the market. The demand for creative office space will have a significant effect on the office investment market, as the influence of creative office tenants transforms the values of properties. Opportunities for investors are emerging as needs for the type, layout and location of office space change, even if there is no pent-up demand for new net square footage. In order for investors to capitalize on the shift toward creative space, they must have an understanding of the generational, technological and locational forces that are driving it.

First, it will be important for investors to add investments that can benefit from the generational shift. These will include properties in markets with relatively strong job growth, especially in the growing tech sector. Collaborative and team-oriented space, sustainable design and technologically advanced offices will capture the Millennial generations office preferences.

Second, investors should be seeking to restructure office investment strategies away from suburban office parks with lack of access to amenities and public transportation towards popular urban core areas. Investors must focus more than ever on location. Urban, dense, vibrant places will benefit from lower market vacancy rates and higher lease rates than those located in the suburban office markets.

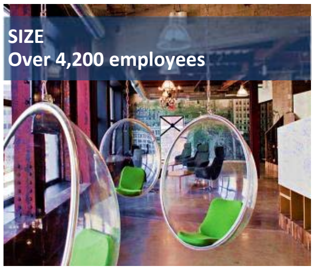
Third, the transformation of space through leasing opportunities with higher tenant improvement allowances will attract prospective tenants requiring creative office space. As new development in the office market remains stagnant, refurbishing existing traditional office space with flexible space design and adaptable building structures is an effective way to adapt to changing tenant layout requirements. Providing larger tenant build-out budgets is a simple value-added solution to revitalizing functionally obsolete office buildings, as it creates a "win-win" situation for both the new tenant and the owner.

A deliberate, strategic change in the repositioning of an office asset can lead to higher returns on investment down the road. In beginning the process, it is important to determine whether the asset is currently performing at market rate, what is its potential and how can it be improved to increase financial performance. By properly navigating this transitional period in office space demand, an investor can achieve greater leasing opportunities from a larger tenant pool, greater resale value, overall reductions in operating expenses from improved design and more. The specific statistics can vary widely from building to building when it comes to repositioning assets, but creating an investment strategy consistent with market drivers can improve short-term and long-term financial results.

Case Studies

1.

QUICKEN LOANS

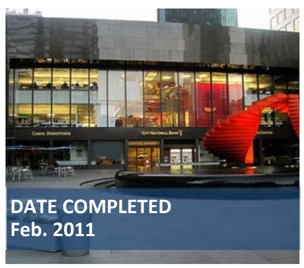


As a part of a phased move to downtown Detroit, Quicken Loans and several sister companies moved from the suburbs into renovated office space in April 2011. The 14-story Chase Tower, which occupies a full city block on Woodward Avenue, was completely renovated to reflect the company's young Millennial-based culture. All 505,000 square feet of the building feature bright neon-colored walls, open floor plans, and high-tech, collaborative meeting areas that encourage teamwork, communication and creativity. This move was a part of an effort to transform downtown Detroit into a work, live and play epicenter where young professionals go to plant roots and grow their careers.

2. GENSLER

MARKET
Downtown Los Angeles


SIZE
47,162 SF Relocation


DATE COMPLETED
Feb. 2011

In 2011, the global architectural firm, Gensler, relocated their regional Los Angeles headquarters from Santa Monica to City National Plaza in the heart of the Financial District. The unique structure of the building, named the “Jewel Box”, allowed the firm to design creative office space unparalleled in the downtown LA marketplace. The landlord of the building provided a $75 per square foot tenant improvement allowance on core and shell, which resulted in 45,000 square feet of LEED Platinum state-of-the-art open office space.

About Us

Plante Moran REIA brings a distinct advantage to our clients, through a fully integrated approach to real estate investment advisory and personal wealth management designed to preserve, protect, or grow all of our clients' investments. Our services include: portfolio strategy, asset management, capital markets, and acquisition/disposition.

Through a relationship partner, our clients have access to a broad and holistic range of wealth management services provided by Plante Moran, one of the nation's largest accounting and management consulting firms, as well as our affiliated entities, offering the services of more than 2,000 professionals with expertise in every major asset class including industry leaders in:

- Family office
- Tax
- Wealth management
- Trust administration
- Capital markets
- Real estate and construction

All of Plante Moran's affiliated entities can work together to make sure all of your holdings and investments are working together. Benefits of our fully integrated model include:

- Effective tax planning to minimize your tax liabilities
- Assets invested in the right industry at the right time
- Income events anticipated and proceeds reinvested wisely

Marty West

PRESIDENT

For more than 25 years Marty has been a leader in the real estate investment community serving a distinguished list of both private and institutional clients. His background includes a broad array of experience that begins with developing a tailored, strategic approach to his client's portfolios that analyzes risk/return projections.

Throughout his career he has directed loan and equity originations including deal identification, financial analysis and negotiations, due diligence procedures, agreement negotiation, and documentation drafting. He brings a highly sophisticated perspective to monitoring portfolio investment performance and, in conjunction with clients, determines appropriate hold/sell strategies for each asset. He has extensive experience overseeing disposition transactions from initial marketing of properties to offer analysis, sales negotiation through final closing documentation.

Education:
Marty holds an MBA from the University of Michigan where he graduated with distinction. He holds an undergraduate degree in accounting and finance from the University of Michigan - Dearborn.

Affiliations
Marty was an adjunct Professor of Real Estate at Wayne State University and is a licensed real estate broker in the state of Michigan. Marty was a founder and director of The Matthew M. West Foundation and a board member of Lighthouse of Oakland County, an organization committed to helping families in crisis and the promotion of self-sufficiency and long term financial independence for these families.

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Benjamin Smith

PARTNER

Ben brings a highly analytical and strategic perspective in providing real estate investment advisory services to family office, private capital, and institutional investors. Ben assists these clients in analyzing broad based economic and market trends to develop a real estate investment strategy that aligns with overall goals and objectives of the enterprise. Ben is currently responsible for the oversight of approximately $200 million in real estate assets across multiple geographies and asset classes. In this capacity, his role includes the development and monitoring of investment strategy, oversight of the asset management team, structuring debt financing, and oversight of acquisitions/dispositions, as necessary.

Ben's background consists of both real estate advisory and development work involving complex real estate investment transactions. In this capacity, he has deep expertise in real estate financial analysis and structuring, debt and equity procurement, lease and purchase negotiations, project due diligence and entitlement, and real estate investment strategy. This background enables Ben to understand real estate from multiple perspectives, adding significant value to a wide variety of client engagements and transactions.

Ben graduated with honors from the University of Michigan with a bachelor of arts and a master's degree in urban planning (M.U.P.) with a concentration in real estate finance and development. He is an active member of the Family Office Exchange and the Pension Real Estate Association.

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