

# DAVENPORT PARTNERS



## ANNUAL REPORT ON INVESTMENTS WITH DAVENPORT PARTNERS

October 30, 2008

Dear Investor:

This investor letter and the attached individual property reports will serve as a brief annual report and look-back on our various investments.

In 2008 to date, we have sold one property, the Sprint Building in Honolulu. We refinanced the loan on 800 S. Barranca in Covina. We have not purchased any properties. Our buildings are well positioned with an average occupancy of 95.5%.

It has been an interesting year.

Have you been to a cocktail party lately? It wasn't long ago that all we talked about was how much our houses had gone up in value. Now it's all the rage to talk about the stock market and how poorly our 401 K's are doing.



This picture says it all: a modern day run on the bank. This was not supposed to happen in our lifetimes. On July 15, 2008, this picture of the IndyMac Headquarters building in Pasadena was on the front page on virtually every newspaper in the world. We used to own the IndyMac building while at Spieker Properties. Jeff Nickell and Ray Lin know this building all too well. They spent one week of their lives in total crisis mode after a cooling tower on the roof sprung a leak and water poured down through the 11 story building flooding the main bus duct and all the electrical rooms. The building had to be evacuated and shut down. IndyMac camped out in the local Doubletree Hotel for a week. It was their quarter end and there were mortgages to be written and sold.

**Owning real estate is indeed a very risky endeavor.**

A \$.25 plastic connector on a water line to a coffee machine breaks and water leaks all weekend flooding the lower floors of the building and causes \$300,000 damage. A contractor leaves a roll of carpet in the middle of the driveway and a tenant crashes their car into it. The State of California has a budget impasse and stops paying rent. Alarms go off on a Saturday night due a loading dock roll gate that is going up and down and up and down, non-stop, and so we are called in to disconnect power before the motor burns up. A claustrophobic tenant becomes “trapped” in the elevator and rather than push the Door Open button, begins screaming and pounding on all the buttons and kicking on the door. A random earthquake leave walls cracked. A tenant’s architect fails to field measure and the construction plan for a 5,000 sf. space was off by almost one foot - the whole plan has to be revised. There is a run on the banks and a world-wide credit crisis, and so, our lender, who is fighting its own credit battles, refuses to honor a one year extension option and sends us a default notice with a demand for payment and an \$800,000 late fee penalty. The above are some of the issues we experienced in just one of our projects this year, 800 S. Barranca in Covina. You are wondering – why are we in this business?

**In times of despair, we just need to dream a little.**

Joe’s Crab Shack, on Pacific Coast Highway in Newport Beach sold earlier this year for \$10.6 million. This equates to a 1.72% Cap Rate, \$391 per sf of land and \$2,078 per sf of building. The sale price was 7.5 times its assessed value of \$1.4 million.

Applying the same metrics to our property at 1400 Quail Street in Newport Beach, based on Cap Rate and land value, Quail would be worth about \$25 million, and based on building value it would be worth \$57 million. We paid about \$5 million for 1400 Quail Street.

This comparison sounds a little absurd. After all Joe’s Crab Shack is retail and waterfront. But do you think the Seller of Joe’s Crab Shack ever thought his property would sell for more than 7.5 times what he paid for it?

**Real Estate 101: Cap Rates:**

Cap Rate (Return) = Net Operating Income (NOI) / Purchase Price

OR

Purchase Price (Sale Value) = NOI / Cap Rate

Since Sale Value = NOI/Cap Rate, increasing the numerator, NOI, raises Sale Value and lowering the denominator, Cap Rate, raises Sale Value.

Example: an office building has NOI of \$900,000 and sells at a 9% cap rate.  
 Purchase Price = \$900,000 / 9% = \$10,000,000.

Traditionally, Cap Rates on good quality well leased multi-tenant office buildings during periods of stability in Southern California have been in the 8-9% range. From 2002 to 2007, we experienced five years of unprecedented increases in commercial real estate sales prices, generally as a result of what is now being commonly called “Cap Rate Compression”. Investors were accepting lower and lower returns on commercial real estate. Cap rates moved from 8-9% to 6-7% and in some cases as low as mid 4%.

This means that the office building that in 2002 would have sold on a 9% Cap most likely would have sold on a 6% Cap in early 2007.

For example, suppose we buy a building and do nothing to change the NOI, but over four years we experience Cap Rate Compression.

	Year 1	Year 2	Year 3	Year 4
Net Operating Income	\$900,000	\$900,000	\$900,000	\$900,000
Cap Rate	9.00%	8.00%	7.00%	6.00%
Sale Value	\$10,000,000	\$11,250,000	\$12,857,143	\$15,000,000

Buying a building and hoping to sell it for more in a few years without doing anything to increase the NOI or to improve the property is just speculating. However, what we should have done from 2002 to 2006 is buy every building we ever looked at – for no matter how poorly we might have executed our business plan – each building would have gone up in value. Of course, we have been too cautious. We watched as investors bought buildings at prices we thought were way too high, did very little, if anything, to improve the building, and then resold them 1-2 years later at even higher prices.

Now suppose Cap Rate Compression does not occur and Cap Rates remain at 9%. Using the example from above, we buy the building and through lease up and/or improving the quality of the property which allows us to raise the average rental rate, we increase the NOI by 15%/year and then sell it in the fourth year.

	Year 1	Year 2	Year 3	Year 4
Net Operating Income	\$900,000	\$1,035,000	\$1,190,250	\$1,368,788
Cap Rate	9.00%	9.00%	9.00%	9.00%
Purchase Price	\$10,000,000	\$11,500,000	\$13,225,000	\$15,208,750

You can see, that even without lowering the Cap Rate it is possible to increase the value of the building quite substantially. On every purchase we make, our business plan is to BOTH increase the NOI and to attempt to sell the building on a lower Cap Rate, thereby providing a double benefit to the Sale Value. We raise the NOI through leasing up the project, increasing the average in-place rents, lowering the operating

expenses or adding value by securing development entitlements for more leasable square footage. We obtain a lower Cap Rate on sale by increasing the quality of the property, because, all other factors being equal, buyers will typically accept a lower return (Cap Rate) on a higher quality property. We increase the quality through rehab and cosmetic improvements to the building, by leasing to stronger credit tenants, renewing major tenants, by extending the average maturity of the leases or by solving environmental and structural problems.

In 2008 sales transactions in commercial properties have nearly halted. Most buyers are projecting 0% to 4% rent inflation and increasing Cap Rates over the next few years. Suppose we increase NOI by 4%/year and Cap Rates go up by 0.5% each year.

	Year 1	Year 2	Year 3	Year 4
Net Operating Income	\$900,000	\$936,000	\$973,440	\$1,012,378
Cap Rate	7.50%	8.00%	8.50%	9.00%
<hr/>				
Purchase Price	\$12,000,000	\$11,700,000	\$11,452,235	\$11,248,640

The above numbers are not very compelling.

Deal junkies we are, but thankfully, we have stayed disciplined and not bought any buildings this year. But there is distress in the air and there may be some good opportunities coming soon. If we could just buy on an 8% or 9% Cap and get better than 7% NOI increases....

### **Hey Mister, I need a cup of coffee, can you spare me a few shares of stock?**

I know of a hotel company whose stock trades for about \$1/share. It has a book value of \$6/share and based on reasonable EBITDA multiples could be worth \$10-12/share. It is quite possible the company will go bankrupt this year when the whole financial world implodes. But if they don't and if this company survives, I suspect it will be a \$4 or \$6 or \$10 stock some day in the near future.

There is an apartment REIT who is one of the largest owners of multifamily apartments in the country. REITs, by law, must pay out 90% of their income as a dividend. They have paid a regular dividend of \$2.40 year for the last three years. In 2008 they are paying special dividends of an additional \$5.51/share. The total dividend in 2008 will be \$7.91/share! The stock is currently trading for about \$12/share. When you buy this stock, you are buying part of a huge, diversified portfolio of 95% leased apartments, with professional management included, on a dividend return of 65%. Typically apartments trade in the private market on a 6-7% return.

Maybe the world will implode and every bank, insurance company, car manufacturer and real estate company will go bankrupt. Maybe people won't stay in hotels or rent apartments in the future. Maybe the sky really is falling?

Or maybe not.

Speaking of cocktail parties, do you know anyone who isn't planning to buy stocks the day the market bottoms? Wake me up early that day, please; I want to be the first person to start buying.

### **Can we have asset deflation and rent inflation?**

The Feds are flooding money into the economy. They are cramming money into banks. But it's not showing up yet. Instead, money is being hoarded and saved, invested in T-Bills for almost zero interest. But what happens when fear subsides? Won't that money start to circulate? Will it be used to bid up the price of commodities or real estate? I doubt it, we have been there, done that already. But it might go into business loans, or alternative energy projects, or road and bridge construction, or anything GREEN. Or - the speculators that we are - the money could go roaring back into the stock market, indirectly leading to more investment on the part of all those public companies with their new found cheap equity. In any event, won't all that new money circulating in the economy spur demand for goods and services leading to a huge bout of inflation? Then, maybe, just maybe, landlords will enjoy some really big rent increases.

**Ridiculous, you say, couldn't happen.**

The first project I worked on when I got into the real estate business was 601 Montgomery, a 20-story high rise across the street from the Pyramid Building in downtown San Francisco. Ned Spieker and Trammell Crow built this building in the late 70's and leased it in the early 80's when inflation was at its all time high. (Do you remember, interest rates were almost 20%?) The first few leases were signed at \$14 per sf gross or about \$8 per sf net. The last few leases were signed at \$30 per sf gross or about \$24 per sf net. All said and done, average gross rents were nearly double the pro forma rents and net rents nearly triple. I have been waiting for that to happen to one of our buildings ever since.

**So, can we just dream a little, please?**

We appreciate your interest and support.

Please feel free to contact us anytime at (949) 640-5100 with any questions concerning your investment, the property or the real estate markets, or your interest in other real estate investments.

Sincerely,

Davenport Partners

John Davenport

Enclosure