



January 2011

This cover letter and the attached individual property reports will serve as our 2010 annual report and look-back on various investments.

Surviving the Great Recession – How are we doing?

- Are we still in business? **Yes.**
- Are our buildings still cash flowing? **Yes.**
- Have we lost any properties to the banks? **No.**
- Are we still at risk? **Yes.**
- Will this recession ever end? **We hope so.**

2010 Davenport Partners Property Summary:

- Occupancies, as of year-end, are at 85%, down from 90% at the time of last year's report. We continue to experience tenants downsizing or leaving at the end of current lease terms. However, since the beginning of the year, we have seen a small pick-up in leasing activity at several of our projects.
- Rents fell by an average of almost 13% in 2010 when comparing the new rent against the prior rent for renewals or new leases in the same spaces.
- We paid distributions on every property last year (except for our Colton Office building, the one project in which we do not have any outside partners).
- We bought one property, Vista View Plaza in San Diego, our first investment in three years.

Bidding Wars: Quality and Distress

The highest quality properties, "A" properties in "A" locations, such as modern high rise office buildings, or institutional quality industrial properties in major cities and coastal markets, have been selling for very low cap rates. This means investors are paying a high price per square foot and accepting surprisingly low current returns. Call it a Flight to Quality and Safety. For example, Kilroy Realty (KRC) bought 2211 Michelson Drive in the Airport Area of Orange County for \$103 million or \$380 per square foot, while the Irvine Company purchased PIMCO's headquarters building in Newport Beach, Pacific Financial Plaza, for \$125 million or about \$450 per square foot.

Average quality properties, "A" properties in "B" locations, or "B" properties in "A" locations, such as low to midrise buildings, or non-institutional quality buildings in secondary cities or non-coastal markets, are just not selling. Most of our properties fit this category. Owners are holding out for a reasonable price while buyers are demanding a discount in order to achieve a higher cap rate return. This pricing disconnect has led to a stand-still in the trading of these properties. Our strategy is to continue to hold our properties and wait for the buyers to return to the stabilized "B" building marketplace before we consider sales.



“Distressed Properties”, such as partially or fully vacant buildings, broken condo deals, short sales, bank foreclosure sales and note sales, are starting to sell at prices well below their replacement cost. In fact, many of these distressed properties receive dozens of offers and many experience bidding wars. There is still little or no financing for most of these distressed properties, especially those in secondary locations or particularly hard hit markets. Also, there is very little leasing activity so one must assume it could take years to lease up the vacancies.

Our recent acquisition of Vista View Plaza in San Diego is an example of a lender short sale, distressed asset purchase. We are looking for more distressed asset acquisitions which we believe will provide excellent cash flow or value creation as the economy improves.

All Cash Deals vs. Levered Deals:

We recently purchased Vista View Plaza “All Cash”, i.e. without using debt. Some of our investors expressed concern (disappointment?) that the returns looked somewhat low, especially when compared to buying the property “Levered”, i.e. with debt, as is the tradition in real estate. Intuitively, we all know that buying All Cash or “Un-Levered” is less risky than buying with debt. Conversely, we know that a “Levered” return should be higher than an “Un-levered” return. But beyond intuition, do we really know the trade-offs of risk vs. return?

When we consider purchasing a property, we run pro formas with all kinds of variables and assumptions. It’s what we real estate people like to do, we play with numbers. Some of the variables include, time to lease up the vacant spaces, rental rates, inflation rate on rents, cost of tenant improvements, probability of tenant’s renewal, cost of leasing commissions, percentage of broker vs. no broker deals, average lease terms, cost of capital improvements, optimal hold period, cap rate at sale, costs of sale. On top of all those assumption we also estimate the financing, if any, the loan to value upon acquisition, loan to value upon stabilization, interest rate on the loan, the debt service coverage ratio, the term of the loan. After we have established our base case pro forma, we then run all kinds of scenarios altering the assumptions, in essence, doing stress tests.

We thought it might be interesting to run some scenarios to see how a property performs as an investment when owned “All Cash” vs. “Levered”. Let’s assume we purchase a \$10 million property with an initial return on project cost or Cap Rate of 6.1%. For the Levered pro forma we assume a loan of \$6.5 million, or 65% Loan to Value, with interest rate of 5.5%.

The first two scenarios are the “Pessimistic” pro formas in which we assume rents go down by 5% each year, vacancy increases by 5% each year, and we sell the property in Year 3 on a 6% Cap Rate. We will call these the “Great Recession” scenarios.

This second two scenarios are the “Optimistic” pro formas in which we assume rents go up by 5% each year, vacancy decreases by 5% each year, and we sell the property in Year 3 on a 6% Cap Rate. We will call these the “we hope this is how it goes coming out of the Great Recession” scenarios.



First, let's see what happens when things don't go our way, the "Great Recession" scenario:

Pessimistic Scenario - All Cash: (Rents down 5% per year and Vacancy up 5% per year)

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Gross Revenues:	\$1,300,000	\$1,235,000	\$1,173,250
Vacancy:	15.0% (\$195,000)	20.0% (\$247,000)	25.0% (\$293,313)
Effective Gross Revenue:	\$1,105,000	\$988,000	\$879,938
Operating expenses:	(\$500,000)	(\$500,000)	(\$500,000)
Net Income	\$605,000	\$488,000	\$379,938
Debt Service:	\$0	\$0	\$0
Cash Flow	\$605,000	\$488,000	\$379,938
Cap Rate on Project Costs:	6.1%	4.9%	3.8%
Return on Equity Invested:	6.1%	4.9%	3.8%
Sale Value:			\$6,332,292
Loan Payoff:			\$0
Sale Proceeds:			\$6,332,292
Equity Investment:			(\$10,000,000)
Sale Profit:			(\$3,667,708)
Profit on Equity Investment:			-37%

In the All Cash scenario, since there is no debt, the Cap Rate on Project Costs, (Net income/Total Project Costs), is the same as the Return on Equity Invested (Cash Flow/Equity Investment).

This scenario does not look so good! Rents are down, vacancy is up and the Cash Flow drops from \$600,000 per year to \$380,000 per year. Not good, but at least the property is still cash flowing. If you had to sell, you would lose 37% of your Equity. However, since there is no lender to force a sale, you probably would not sell, instead, you would just ride it out waiting for the recession to end.



Pessimistic Scenario - Levered: (Rents down 5% per year and Vacancy up 5% per year)

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Gross Revenues:	\$1,300,000	\$1,235,000	\$1,173,250
Vacancy:	15.0% <u>(\$195,000)</u>	20.0% <u>(\$247,000)</u>	25.0% <u>(\$293,313)</u>
Effective Gross Revenue:	\$1,105,000	\$988,000	\$879,938
Operating expenses:	<u>(\$500,000)</u>	<u>(\$500,000)</u>	<u>(\$500,000)</u>
Net Income	\$605,000	\$488,000	\$379,938
Debt Service:	<u>(\$357,500)</u>	<u>(\$357,500)</u>	<u>(\$357,500)</u>
Cash Flow	\$247,500	\$130,500	\$22,438
Cap Rate on Project Costs:	6.1%	4.9%	3.8%
Return on Equity Invested:	7.1%	3.7%	0.6%
Sale Value:			\$6,332,292
Loan Payoff:			<u>(\$6,500,000)</u>
Sale Proceeds:			(\$167,708)
Return of Equity Investment:			<u>(\$3,500,000)</u>
Sale Profit:			(\$3,667,708)
Profit on Equity Investment:			-105%

Note that in this Levered purchase, the Return on Equity is greater than the Cap Rate on Project Costs. When the Cap Rate (6.1%) is greater than the interest rate on the loan (5.5%), then the financing is accretive to Cash Flow, and so the Return on Equity Invested (7.1%) is greater than the Cap Rate. Here is how to think about this: you are earning 6.1% on the entire \$10 million investment, yet some of that investment, the debt portion, is costing just 5.5%, so the excess 0.6% (6.1% - 5.5%) on the debt of \$6.5 million, or \$39,000 goes toward the return on the \$3.5 million equity invested, and is accretive to (increases) the return on Equity from 6.1% to 7.1%. This accretive financing can lead to a false sense of security because look what happens in Year 2 and 3 as rents fall, the Return on Equity quickly goes below the Cap Rate on Project Costs. You could call this phenomenon dis-accretive?

The Levered pessimistic scenario looks really bad! By Year 3, the property is just barely servicing the debt. Even worse, if you were to have to sell, (and you might, if the lender calls the loan) the sale value would be less than the debt. The equity investment would be wiped out.

Now, go back in time to 2006, 2007 and 2008. Investors were in a frenzy to buy properties at ever higher prices, and ever lower cap rates. Then the Great Recession hit. Those who bought properties on cap rates less than 6%, with expectations of big rent increases, have probably, by now, given the properties back to the lender and lost all their equity. Those that bought properties at a 6% cap rate or above, or who successfully executed on a value add business plan which resulted in a stabilized property earning more than a 6% return are probably still hanging on and may even still be paying small distributions to their owners.



Now let's see what happens when things go our way, the "we hope this is how it goes coming out of the Great Recession" scenario.

Optimistic Scenario - All Cash: (Rents up 5% per year and Vacancy down 5% per year)

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Gross Revenues:	\$1,300,000	\$1,365,000	\$1,433,250
Vacancy:	15.0% (\$195,000)	10.0% (\$136,500)	5.0% (\$71,663)
Effective Gross Revenue:	\$1,105,000	\$1,228,500	\$1,361,588
Operating expenses:	(\$500,000)	(\$500,000)	(\$500,000)
Net Income	\$605,000	\$728,500	\$861,588
Debt Service:	\$0	\$0	\$0
Cash Flow	\$605,000	\$728,500	\$861,588
Cap Rate on Project Costs:	6.1%	7.3%	8.6%
Return on Equity Invested:	6.1%	7.3%	8.6%
Sale Value:			\$14,359,792
Loan Payoff:			\$0
Sale Proceeds:			\$14,359,792
Equity Investment:			(\$10,000,000)
Sale Profit:			\$4,359,792
Profit on Equity Investment:			44%
3 Year IRR:			31%

As rents inflate and vacancy decreases each year, the Return on Equity Invested increases from 6.1% in Year 1 to 8.6% by Year 3, an increase of about 41%. The sale generates a profit of over \$4 million. The overall Internal Rate of Return (IRR) for the three year hold period is 31%.



Optimistic Scenario - Levered: (Rents up 5% per year and Vacancy down 5% per year)

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Gross Revenues:	\$1,300,000	\$1,365,000	\$1,433,250
Vacancy:	15.0% <u>(\$195,000)</u>	10.0% <u>(\$136,500)</u>	5.0% <u>(\$71,663)</u>
Effective Gross Revenue:	\$1,105,000	\$1,228,500	\$1,361,588
Operating expenses:	<u>(\$500,000)</u>	<u>(\$500,000)</u>	<u>(\$500,000)</u>
Net Income	\$605,000	\$728,500	\$861,588
Debt Service:	<u>(\$357,500)</u>	<u>(\$357,500)</u>	<u>(\$357,500)</u>
Cash Flow	\$247,500	\$371,000	\$504,088
Cap Rate on Project Costs:	6.1%	7.3%	8.6%
Return on Equity Invested:	7.1%	10.6%	14.4%
Sale Value:			\$14,359,792
Loan Payoff:			<u>(\$6,500,000)</u>
Sale Proceeds:			\$7,859,792
Return of Equity Investment:			<u>(\$3,500,000)</u>
Sale Profit:			\$4,359,792
Profit on Equity Investment:			125%
3 Year IRR:			66%

In this Levered scenario the Return on Equity is 7.1% in Year 1, and then increases to 14.4% by Year 3, an increase of over 100%, compared with a 41% increase in the All Cash pro forma. The Sale Profit is the same whole dollar profit as in the All Cash pro forma, however, since the Investment is levered, the equity invested is much less, so the percentage profit on the Equity Investment is much higher at 125%. The overall Internal Rate of Return (IRR) on this levered scenario is 66% (vs. 31% for the All Cash deal).

So there you have it: In the pessimistic pro forma, All Cash wins out over Levered, as the property keeps cash flowing, albeit at a reduced level, and you can hold on to the property for a better day. In the optimistic pro forma, Levered wins out over All Cash, as returns are juiced and rise dramatically. The Return on Equity Invested is more than doubled.



So what does all this mean for us as buyers in 2011? Should we buy All Cash or Levered? Here are some of the criteria we review when thinking about debt on a real estate investment:

- Is debt available on reasonable terms (interest rates, recourse or not, reserves, etc.)?
- Is the financing accretive? Is the cost of debt less than the projected NOI returns?
- Does the term of the debt match the expected hold period?
- Does the project have stable cash flows sufficient to support the debt?
- Is the Loan to Value (LTV) appropriate for our business plan? It may be better to put financing in place after stabilizing the property, than to put too little debt in place at the acquisition.
- Is all cash even an option: do we have sufficient investors or a significant investor willing to fund the entire project cost without debt?

Given the option, how do we make the decision? One could use the theory that when investing it is better to diversify, or one could use another simple theory in life: take the path that presents itself! If we have financing available on reasonable terms, we will probably buy levered. If we have sufficient cash to buy without debt, we will probably buy all cash.

Bouncing along the Bottom:

The pessimistic scenario or “Great Recession” scenario is what the real estate world experienced over the last three years; the economy in a tailspin, companies downsizing or going out of business, and higher and higher vacancies. Less demand for space leads to lower and lower rents. Office vacancies in many of Southern California’s submarkets currently exceed 20%, (in the Airport Area of Orange County the availability rate exceeds 30%), while average rents are down about 25% from their 2007 peak.

It seems that we have finally stabilized and 2010 was the year of “bouncing along the bottom”. If the economy begins to perk up in 2011, then we should experience the Optimistic Scenario in the next few years, the “we hope this is how it goes coming out of the Great Recession” scenario. Companies should start growing, hiring employees and taking on more space. More demand for space should lead to higher and higher rents. Lower vacancy and higher rents leads to higher future sales values. The virtuous cycle - let’s hope for its return.

As always, we appreciate your interest and support. Please feel free to contact us anytime with any questions concerning your investments with us or the real estate markets, or your interest in other real estate investments.

Sincerely,

DAVENPORT PARTNERS

Enclosures