April 2011

U.S. Quarterly

Market Perspective

Executive Summary

- With the economy growing at a healthy pace, commercial real estate fundamentals are finally moving in a positive direction in all sectors. Fears of a double-dip recession have mostly abated, although turmoil in the Middle East and the disaster in Japan are reminders that exogenous events are always lurking. Questions remain as to how strong the recovery will be and how long it will take the space markets to fully recover from the recession.
- The momentum should continue in the apartment and hotel segments, which bottomed a year ago, due to increased demand for rental units and rising travel. Fundamentals are just shifting to positive in the office, retail and warehouse sectors. Gains in those property types are bound to be inconsistent based on the market and segment.
- Capital continues to flow to commercial real estate, particularly “prime” assets in “gateway” cities. Acquisition yields in a handful of core markets have been reduced to historically low levels. Transaction activity is up about 50% from a year ago and should reach 2004 levels.
- Looming over the market is the prospect of rising interest rates. That would increase the cost of capital and likely push acquisition yields higher, which could impact property values. However, to the extent that rising rates are a harbinger of a stronger economy, upward pressure on capitalization rates could be moderated by increasing risk appetite and expectations of higher income.
- Availability of debt capital is strong and expanding. CMBS programs, insurance companies and the largest banks are lending at a healthy level for stable properties. Debt is scarcer for properties with leasing issues, although an increasing number of specialty lenders are looking to fill that niche. The volume of loan resolutions is growing as banks get healthier, but the pool of overleveraged loans that are being extended rather than refinanced remains massive.
- After two strong years of appreciation, REIT stocks are relatively pricey, but there is upside if earnings growth is robust. Access to capital is once again a strong point for REITs, which are on pace to raise more than $50 billion of debt and equity for a second straight year. REITs are looking to use that capital for growth through property purchases and mergers. The first quarter alone produced $26.4 billion of announced M&A activity, which already makes it one of the most active years in industry history.

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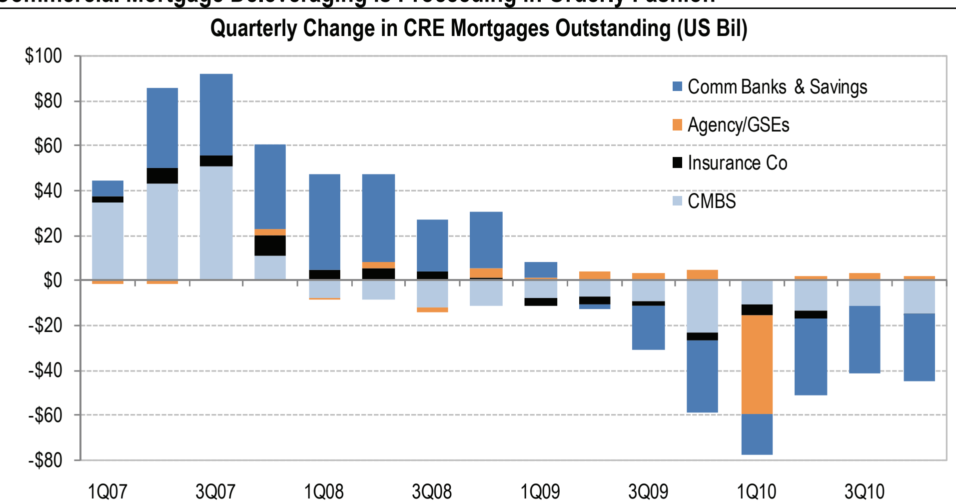
Debt Markets

It may be too soon to say the debt markets are fully healed, because segments remain incapacitated, but lenders are growing healthier. Life companies started the ball rolling early last year, after three years in which few new mortgages were originated, by actively financing stable assets. CMBS programs came back to life in the second half of 2010, writing loans on properties that were a small step down in quality from the targets set by insurers. Lenders are increasingly moving down the risk spectrum and competing on price and leverage. Private specialty lenders have started to emerge in the bridge lending market, which they hope to use to win clients and feed newly created securitization programs. There is a significant amount of capital looking to provide mezzanine debt. Financing construction or properties with little or no cash flow remains difficult, as lenders are reluctant to take on risk.

Loan modifications and restructurings are on the rise, evidenced by a drop in the volume of distressed assets to $180.9 billion in February, down $7.3 billion from the September 2010 peak of $188.2 billion, according to Real Capital Analytics (RCA). Meanwhile, loan defaults are peaking. After 17 consecutive quarterly increases, the default rate of commercial mortgages held by banks fell slightly in 4Q10, to 4.28% from 4.36% in 3Q10, according to the FDIC. Led by a decline in holdings of banks, the commercial mortgage market continues to delever, with total outstanding volume dropping to $3.1 trillion in 4Q10 from its $3.4 trillion peak in 1Q09, according to the Federal Reserve.

Commercial Mortgage Deleveraging is Proceeding in Orderly Fashion



Federal Reserve

Like most of commercial real estate, banks are bifurcated between the haves and have-nots. A handful of the largest banks have emerged from the crisis in relatively good position and are once again writing loans. These banks were fortified by the government, are big enough to absorb losses in commercial real estate and have been able to earn their way out of trouble. Many regional and local banks are still teetering due to problem commercial mortgages, which represent a large proportion of their balance sheets, and thus have not been able to participate in the resurgent lending environment. Most bank loans originated during the peak lending period remain underwater, and banks continue to extend them to avoid taking write-downs, creating a backlog that will take years to resolve. One issue banks face is that their best-quality loans are the first to be refinanced, which leaves them holding a greater proportion of lesser-quality assets. This trend should be positive for potential borrowers, as pressure mounts on lenders to keep loan portfolios from shrinking and deteriorating in quality.

Some $8.7 billion of CMBS was floated in 1Q11, after $7.6 billion in 4Q10, according to Commercial Mortgage Alert. Issuance should continue at that pace or better, barring a steep increase in CMBS spreads or interest rates that would make loans uneconomical for borrowers. Ten-year fixed-rate CMBS loans generally carry coupons in the 5.5% to 5.75% range, so it would probably take an increase of a 50-100 bps or more to have much of an impact on demand, especially considering the intensifying need for debt coming from rising property sales and the huge volume of maturing bank debt.

In many ways, the CMBS market has come full circle. Just two quarters into the market's recovery, more than two dozen firms have assembled teams to write loans. This has created spirited competition for the small amount of deals, leading to grumbling that underwriting standards are already too loose. While that is true in relation to the initial CMBS 2.0 deals, there are important changes from 2007-vintage transactions. Elements that were common then but are now rare (at least for the time being) include: pro-forma underwriting, which involved projecting future increases in cash flow, and interest-only loans that do not amortize. CMBS players also will be wrestling for some time with proposed regulatory changes, which have the potential for major impact on the business. One new proposal would require CMBS issuers to put excess cash flow – which traditionally has been sold to lock in profits up front – into a reserve account that would cover loan losses. It is doubtful that many lenders would want to securitize mortgages under those conditions. However, the proposals are all under review and are likely to be changed before the regulations are implemented, which won't happen until 2013 at the earliest.

Life company activity surged in 2010 and should expand even more this year. Volume almost doubled in 2010, to $28.4 billion, up from $14.7 billion in 2009, according to the American Council of Life Insurers (ACLI). Meanwhile, the average loan spread has fallen to about 175 bps over 10-year Treasuries, down from the average of 477 bps in 2009 and 298 bps in 2010, according to the ACLI. Life companies are hard to beat on price for class-A deals. What's more, insurers are once again forming teams to originate large loans, a practice that was commonplace until the early 2000s, when large loans became the purview of the CMBS market. In an attempt to diversify their portfolios, insurers are also competing on apartment loans against Fannie Mae and Freddie Mac, which had a virtual monopoly on the sector for a few years. The government-sponsored enterprises should top $30 billion of volume this year, but they are likely to reduce market share in the wake of ongoing reform efforts and increased competition from other lenders.

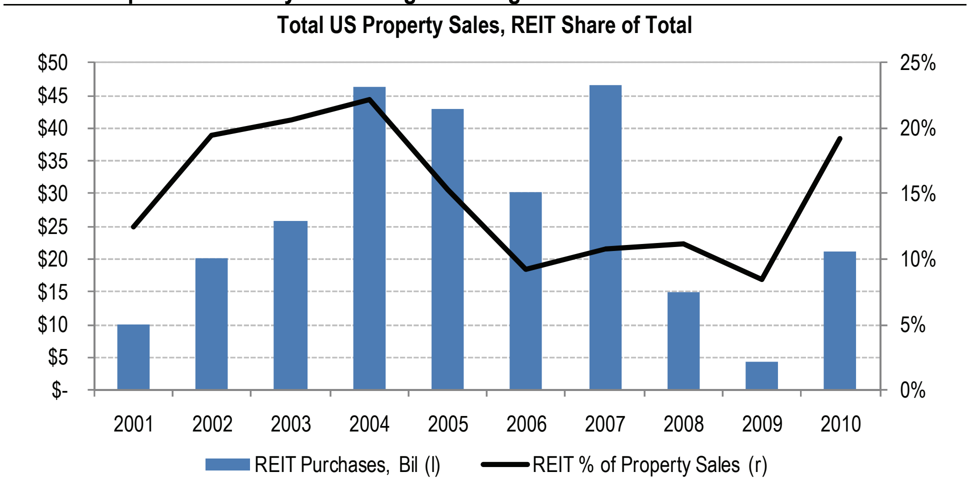
REIT Market

After outperforming the broader equity market with back-to-back 28% total return years in 2009 and 2010, public equity REITs had enough steam to keep climbing in the first quarter. The FTSE NAREIT Equity REIT Index gained 6.3% in 1Q11, slightly outpacing the 5.9% total return for the S&P 500 index. Other than hotels (-0.5%), each property type in the REIT index in 1Q11 returned at least 4.5%, led by industrial (11.7%) and self storage (11%). While it is not possible to produce consistently positive returns indefinitely, the near-term outlook appears to have more upside than downside. REITs are raising ample capital at attractive rates and are growing through one-off purchases and M&A, all while the fundamentals outlook is beginning to pick up.

Access to capital is the big story for REITs. Coming off a year when they took in a record $56 billion of capital, REITs raised $16.6 billion through mid-April, split fairly evenly between debt and equity, according to SNL Securities. Meanwhile, real estate mutual funds had $2.7 billion of positive fund flows in the first quarter, more than half of 2010's total of $4.5 billion. Investors are redirecting capital from bond funds and cash accounts, as they worry about rising rates eroding the value of bonds and look to take on more risk in wake of the improving economy. REITs provide steady dividends and carry the potential for price appreciation if fundamentals improve. Capital is not only plentiful, but it is favorably priced. Debt terms are particularly cheap, with 4% coupons for long-term paper. For example, Health Care Properties Trust issued $2.4 billion of 10.3-year unsecured notes with a coupon of 4.8% and Biomed Realty Trust floated $400 million of five-year unsecured bonds at 3.85%. On the secured side, Douglas Emmett Realty's took out a $510 million five-year secured loan at 4.12% and a $350 million seven-year loan at 4.46%.

Over the last two years, REITs primarily used capital proceeds to pay down and extend debt, but now it is mostly directed toward growth. Public companies bought $21 billion of properties in 2010, or 19% of sales in the US, according to RCA. During the first quarter of 2011, REITs bought $2 billion of properties and reached three merger agreements totaling $26.4 billion, including the $16.6 billion combination of industrial REITs AMB Property and ProLogis. While the pool of available merger targets is limited, REITs will continue to use their cheap cost of capital to target public and private buying opportunities.

REITs' Acquisition Activity Is Once Again Rising



Real Capital Analytics

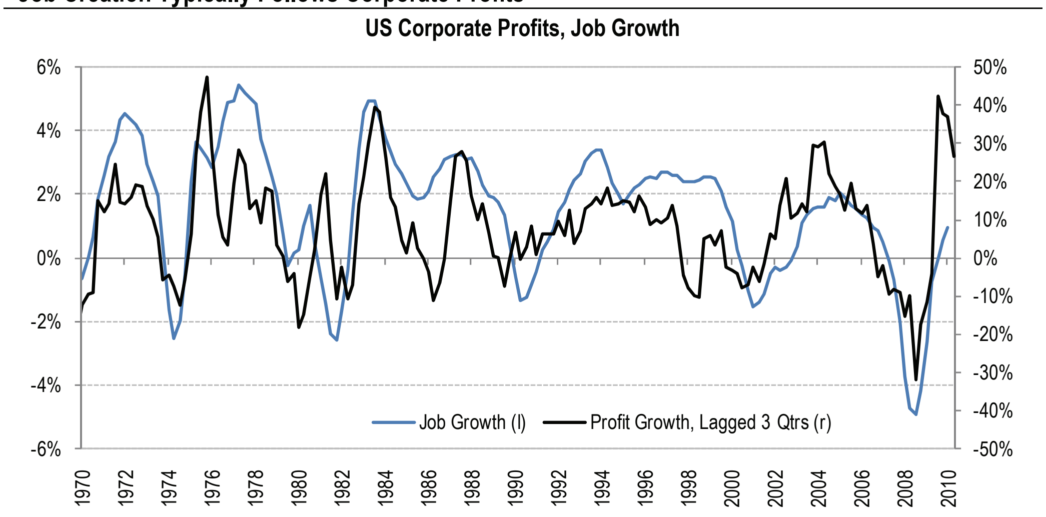
REITs are trading at fairly rich multiples, with investors pricing in strong 7-9% growth in funds from operations (FFO). However, there are preliminary indications that many REITs will produce better-than-expected earnings, which means there is some upside in stock prices and a strong likelihood that dividends will increase. Yields are near historical lows of 3.5%, according to Barclays Capital. As of the end of the first quarter, REITs are paying out about 60% of FFO on average, well below their long-term average payout ratio of 80-85%. Many REITs will be forced to increase dividends to comply with regulatory requirements, and the payout could be even greater if earnings are strong.

As in the private market, there is a wide pricing gap between firms that own core assets and those with holdings in second-tier markets or property types. For example, there is a stark difference between the implied cap rates of companies that own office buildings in suburban markets versus Midtown Manhattan and Washington DC. The gap could compress as capital moves into the sector looking for yield. Overall, we think REITs are fairly valued, and maintain our forecast of low double-digit total returns for the year. Since total returns were 6.3% in the first quarter, gains over the rest of the year should be modest.

Property Market

Job creation has dominated the discussion of space market fundamentals in recent years. About 8 million jobs were lost during the recession, and since it ended job creation has been painfully slow. The economy added about 1 million new jobs last year, but now the pace is picking up. In February, 216,000 jobs were created, with the private sector adding 230,000, according to the US Labor Department. The highlights were professional business services, leisure/hospitality and health care. Areas that remain weak include construction and the public sector. Strong corporate profits – which reached record levels in 4Q10, according to the Bureau of Economic Analysis – should herald job growth this year and potentially beyond. Corporate profits historically have been a leading indicator of job creation. Assuming that holds true in this cycle, it should produce a broad-based recovery that benefits all commercial property types.

Job Creation Typically Follows Corporate Profits



Moody's Analytics

A growing economy gives rise to concerns about higher interest rates, which have been kept artificially low by the Federal Reserve since the recession. Higher rates would raise the cost of capital for property owners by making debt more expensive. What's more, investors may demand higher acquisition yields in a higher interest-rate environment. Yields to buy core properties are at or near historic lows, and it is hard to imagine that they would stay that way if yield spreads versus Treasury bonds turn negative. Accordingly, an increase in rates of 100 bps or more would likely prompt capitalization rates to rise, which would probably produce a negative impact on property values. However, that is by no means certain, since in recent economic cycles, property yields have fallen when interest rates rose. There are a variety of factors involved, but typically interest rates increase during periods of strong economic growth, when investors anticipate higher net operating income (NOI) for real estate. Capital tends to move into commercial real estate during periods of growing NOI, producing a reduction in the risk premium.

Certainly capital is flowing into the sector today on the public and the private side, encompassing both equity and debt providers. Many institutions want to increase their exposure to core assets, creating fierce competition for them and widening the pricing gap with non-core assets. For example, according to the Moody's REAL Property Price Index, since the market bottomed in October 2007 core properties in six top markets are down 18.9%, compared to 53.9% for distressed properties.

That said, more capital is being redirected to second-tier properties and markets. Investors are becoming more optimistic about fundamentals, and looking to get in at the low point of the cycle, and there are more sources of debt willing to finance such transactions. Property sales totaled $31 billion in 1Q11, a 60% increase over the first three months of 2010, according to RCA. Sales volume in 2011 should easily surpass last year's $120 billion total.

Apartment: All signs point toward a continuation of the positive trends for the multi-family industry in 2011. Five straight quarters of positive absorption has dropped the national vacancy rate to 6.2%, down 40 bps in 1Q11 and 180 bps from its 8% peak in 4Q09, according to Reis. Demand remains high due to demographics, the strengthening job market and the declining homeownership rate, particularly among younger households. At the same time, construction is at its lowest level in decades, although that is in the process of turning around. Multi-family is the first segment in which developers are ramping up, although it will take a couple of years for volume to reach a critical mass. In the meantime, bidding for properties in top-tier cities is intense, which is prompting some investors to look for assets in secondary markets.

Hotel: Last year, hotel operators attracted customers by cutting rates, which boosted occupancy while revenue was relatively flat. Now, with strong demand from both leisure and business travelers, hotels are posting strong gains in occupancy and revenue. US hotel occupancies were up 5.7% year-over-year during 1Q11, while average daily rates increased 3.1%, leading to a solid 9% gain in revenue per available room (RevPAR), according to Smith Travel Research (STR). Luxury hotels achieved the greatest increase in RevPAR (12.9%), but all segments of the chain scale rose by at least 5.3%. Likewise, each of the top 25 markets posted increases in RevPAR. Hotel performance should be strong for the next several years.

Office: Demand for office space is slowly rising, as the market has had two quarters of positive absorption on the heels of three years of falling occupancy rates. Nationally, 4.7 million square feet of office space was absorbed in 1Q11, prompting the vacancy rate to decline 10 bps to 17.5%, according to Reis. Demand is being driven by employment gains in the professional services and technology sectors. As a result, the recovery will be most robust in markets with exposure to technology such as San Francisco, Seattle, Boston and Austin, or exposure to professional services such as New York. Rent rates are rising in stronger markets, but in most markets rents will remain flat until more space is absorbed. Top markets are also garnering the lion's share of sales.

Retail: Although consumer spending has rebounded strongly since the end of the recession, demand for retail space is running just about even with the minimal amount of new supply. Consequently, retail vacancies increased by 10 bps, to 13.1%, in 1Q11, according to CBRE. Retailers are enjoying improving productivity of existing stores, but few are in a rush to expand. That reflects uncertainty about the sustainability of consumer spending in the face of rising prices, weak credit availability for small retailers and the natural evolution of the industry. For example, competition from the Internet has led to the demise of booksellers such as Borders, and easy access to movies has eaten the market share of video chains such as Blockbuster. Demand for retail space is likely to lag other segments, and when it does pick up, it will take a few quarters to absorb the huge amount of vacant space.

Industrial: Buoyed by increasing retail sales, growth of foreign trade and restocking of manufacturers' inventories, demand for warehouse space turned positive in the second half of 2010. The momentum should continue for another year or two. According to Property & Portfolio Research (PPR), roughly 135 million square feet of space should be absorbed in 2011 and 2012, reducing the national vacancy rate to 8.9% at year-end 2012 from 12.1% at year-end 2010. Absorption has been particularly strong in coastal markets that benefit from trade, including the Inland Empire and North-Central New Jersey, PPR said. However, rents will remain flat until vacant space is absorbed. Developments are rare and dominated by build-to-suits.

The NCREIF Property Index (NPI) rose 3.4% in 1Q11, its fifth straight positive performance, after producing a 13.1% return in 2010. Although we remain concerned that rising interest rates will temper the recovery in valuations, the healthier outlook across all property types leads us to slightly increase our expectations for NPI total returns for the year to 12-15%, up from 10-14% in our last outlook.

Closing Thoughts

Even as we are reminded that unexpected events such as political strife and natural disasters are always on the horizon, the outlook for US commercial real estate has improved in recent months. The questions have shifted from whether the economy will grow to how strong the growth will be. Space market fundamentals have turned the corner, particularly involving property types with short duration leases such as apartments and hotels, prompting investors to debate how much revenue growth to price into their models. The availability of debt, always strong for stable assets, is branching into less-pristine segments. And capital is flowing into the sector to take advantage of its long-term stability, steady income and potential for growth.

Certainly there are enough concerns to justify vigilance. Unemployment remains stubbornly high, and is likely to remain so for another two years or more. Excessive public sector debt is likely to be a drag on economic growth and consumer confidence. Higher savings can dampen consumption growth, while bank deleveraging is a drag on credit availability. Interest rates seem certain to rise sooner or later, although that might be a double-edged sword if it emanates from strong economic growth.

One feature that distinguishes the current cycle from past experience is the speed at which it has moved from the trough, driven in large part by capital flow focused at the core and distressed ends of the spectrum. While core real estate remains attractive over the long-term, investors would also be well-served to exploit their expertise in individual segments or submarkets. That would enable them to avoid the herd and find niches that stem from demographic trends or one-off opportunities that arise from market circumstances, such as the large volume of underwater loans that will mature over the next several years.

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