

U.S. Quarterly

Market Perspective

Executive Summary

- The recent appearance of positive indicators – economic and otherwise – has turned market sentiment in the commercial real estate sector decidedly more favorable.
- Property values have been resilient and by some measures have already rebounded modestly from their peak-to-trough decline of approximately 40%. While transaction volume remains low, demand for the few institutional-quality assets that have come to market speaks to the healthy appetite for income-producing properties, and has given greater visibility to pricing.
- An ample amount of capital is available through both the public and private markets. REITs start the year in a position of relative strength, having raised \$37 billion of capital in 2009, and other sources of private equity are in relative abundance.
- REIT balance sheets are much healthier than a year ago and companies seem positioned for growth. However, having gained 28% in 2009, REIT share prices are high and it may be difficult to meet investors' expectations for growth through accretive acquisitions.
- Widespread distress has yet to materialize, although it should be more apparent in 2010 due to increasing defaults within CMBS pools. However, many banks lack incentive to foreclose on overleveraged properties, having learned from the early 90's that acting too hastily may exacerbate financial losses. Both borrowers and lenders are trying to buy time and salvage as much value as possible by extending and modifying loans, particularly those that cover debt service.
- The banking sector remains far from healthy, but the availability of debt is improving. Some lenders – particularly life companies and a small group of banks – are eager to finance stable properties in major markets. As a result, spreads of loans backed by high-quality properties have compressed meaningfully. However, mortgage originations remain a fraction of their pre-crisis levels and far below that which is required to refinance debt coming due over the next few years.
- While the recession is over and the economy is beginning to create more jobs after two years of steady losses, demand in the space markets is likely to remain weak for at least another year. Rents will not rise until after vacancy rates peak, which may not happen in some sectors until 2011.

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Debt Markets

For lenders, the spirit may be willing, but the math is weak. Except for multi-family properties, which are covered by Fannie Mae and Freddie Mac, the availability of mortgage financing is inconsistent. Traditional commercial mortgage providers are increasingly returning to the market, and will write loans for high-quality assets. In particular, small-to medium-sized properties with stable cash flows and good sponsors will have no trouble finding a life company or bank to originate a mortgage. Such deals, however, are relatively rare, because demand from borrowers is weak and properties with some “hair” on them have fewer options.

Commercial banks, holders of roughly half of the \$3.4 trillion commercial-mortgage market, continue to be reluctant to foreclose or take write-downs, in part because they have so many troubled assets to deal with. The delinquency rate for commercial mortgages owned by banks rose to 8.74% in 3Q09, up from 4.7% in 3Q08 and 2% in 3Q07, according to the Federal Reserve. Some 140 banks failed in 2009, and with more than 1,000 banks meeting the FDIC’s definition of being “overexposed” to commercial real estate, more failures are expected. On the property level, refinancing doesn’t pencil out for many bank loans that mature. With property values down 30-40% from the market peak, most maturing bank loans are overleveraged. We estimate that well more than \$300 billion of loans written by banks and CMBS programs between 2005 and 2008 will be underwater at refinancing. Many borrowers can’t or don’t want to sink capital into an overleveraged property, and banks want to avoid foreclosing as long as the borrower is paying debt service, creating a situation where loan extensions work for both borrower and lenders. The vast majority of maturing bank mortgages are being extended, usually in exchange for a higher interest rate, equity infusion, increasing the amortization or some combination thereof.

However, the “extend and pretend” mode can’t continue forever. The volume of distressed loans in the U.S. rose above \$180 billion in December, according to Real Capital Analytics (RCA), and the total is expected to climb steadily as various triggers force a resolution. An obvious trigger would be when a borrower can no longer pay debt service because of a reduction in property income or a rise in interest rates. With Libor at historical lows, floating-rate loans in particular are at the mercy of low interest rates. Many borrowers would not be able to afford payments if loan coupons rise from prevailing 3-5% rates. But there will be other triggers, especially as assets require capital to secure or retain tenants. And at some point, regulators may require banks to resolve problem loans, or they might become healthy enough to absorb write-downs.

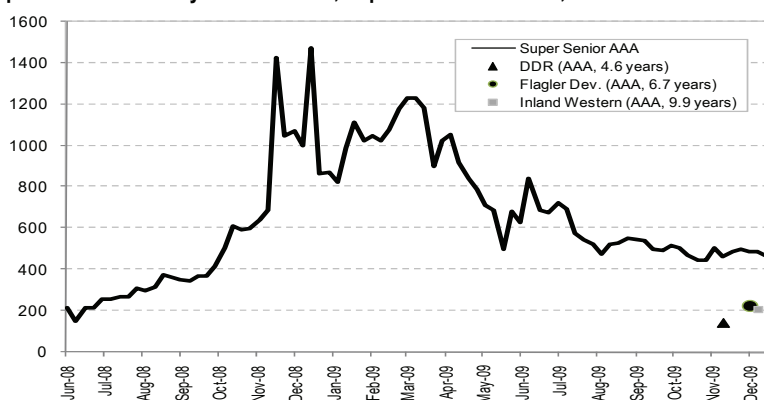
Life companies by-and-large are eager to lend on bread-and-butter assets. Insurers have few delinquent loans on their books, and they can book low-leverage loans backed by high-quality properties at higher spreads than in past years when competitors were aggressive. However, combined, life companies might originate about \$40 billion of loans, which remains a fraction of the \$300 billion-plus demand for commercial mortgages in 2010. The competition for high-quality deals is already compressing loan spreads.

CMBS spreads have dropped to their lowest levels in more than a year, and for the first time since 2007, a handful of banks are trying to originate conduit loans. Yet spreads are not low enough to create a sustained amount of new business. To protect against spread volatility, securitizers must bake an extra profit cushion into loan coupons. But those rates are likely to be unappealing to high-quality borrowers who can get lower rates from other lenders and too rich for borrowers that can’t afford the high payments. There is room for CMBS spreads to rally, since senior triple-A bonds are trading 200-275 bps wider than similarly rated products such as corporate bonds and credit cards. Three new-issue CMBS deals recently were priced at

spreads well inside of secondary trading, largely because the new product was underwritten conservatively and contains a variety of protections for investors baked into the collateral.

New-Issue CMBS Pricing Tighter Than Older Vintages

Spreads of Secondary-Market CMBS, Sept. 2008 to Jan. 2009, and Three Recent Deals



Morgan Stanley Fixed Income Research; Commercial Mortgage Alert; (DDR = Developers Diversified)

CMBS issuers also have to cope with uncertainty surrounding new regulations on securitization that are being drafted, and questions about whether the federal government's Term Asset-Backed Loan Facilities (TALF) program – which provides low-cost financing to the purchasers of triple-A rated CMBS – will be renewed when it expires mid-year. CMBS delinquencies are skyrocketing. As of Dec. 31, 9.4% of CMBS loans are in special servicing, up from 1.6% a year earlier, according to CMBS analytics firm Trepp.

If the market can work through these issues, there is investor demand for CMBS. According to Commercial Mortgage Alert, cash investors bought 74% of the triple-A classes of three deals totaling \$1.4 billion that priced in the fourth quarter. Investors using TALF financing bought the balance. Given the volume of loans maturing in 2010 and beyond, and the constraints on life companies and banks, a revived CMBS market is an important factor in the health of the commercial real estate market. However, CMBS volume will remain tepid in 2010. The market will surpass the \$2.2 billion issued in 2009, but volume is more likely to top out in the \$10 billion to \$15 billion range.

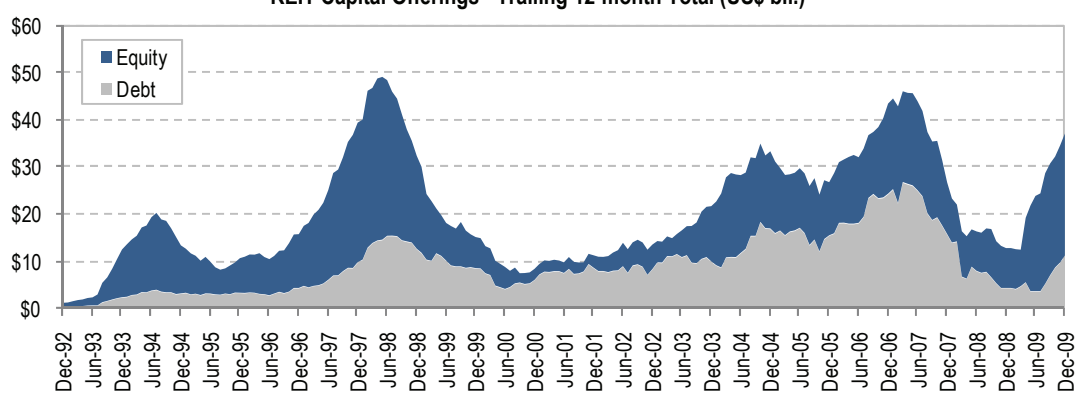
REIT Market

The monster relief rally in the global stock and bond markets that started in March, when central banks and governments around the world took extraordinary actions to avert Armageddon, was especially good for REITs. After falling more than 40% in the first nine weeks of the year, the NAREIT Equity REIT Index more than doubled from the bottom in March to finish the year with a 28% total return, narrowly edging the healthy total returns for the S&P 500 (+26.5%) and Russell 2000 (+27.2%) indexes. The recovery was broad-based, both within the REIT sector and across the broader market. Shopping center REITs held the unfortunate distinction of being the only major property type that not only failed to post double-digit returns last year, but actually delivered negative total returns (-1.7%) for the year. Total returns for the other major property types ranged from 12.2% for industrial REITs to 63% for mall REITs and 67.2% for lodging REITs.

REITs' access to capital improved significantly in the third quarter thanks in part to the rally in the corporate bond market, which caused yield spreads to narrow sharply. Amid strong demand from high yield investors, both institutional and retail, REITs turned to the unsecured bond market. Most of the capital raised to date has been used to refinance maturing debt or pay down credit lines. All told, REITs raised about \$37 billion in 2009, mostly through follow-on equity offerings. The total includes about \$4 billion in IPOs, mostly mortgage REITs and Hyatt (lodging). Whether we see a wave of initial public offerings (IPOs) similar in magnitude to the early 1990s, activity will certainly pick up in 2010. Roughly a dozen planned REITs were in the IPO pipeline at the start of the year, although not all will get done. A handful of last year's proposed IPOs fizzled out before they went public due to underwhelming enthusiasm from investors.

REITs Spent Much of 2009 Deleveraging and Repairing Balance Sheets

REIT Capital Offerings - Trailing 12-month Total (US\$ bil.)



SNL Securities; NAREIT; Bloomberg; PREI Research

REITs finished 2009 in remarkably good shape considering where they started the year. The deleveraging process has further to run before leverage ratios reach the conservative levels (about 20-40%, on average) that investors believe are appropriate in a post-credit bubble world. But many companies have defused the immediate threat from near-term maturities and appear poised to begin looking for acquisition opportunities. Indeed, one of the questions facing investors today is whether REITs have run too far, too fast. The U.S. REIT market looks pricey against the weak near-term earnings outlook for commercial real estate. REIT earnings multiples are a little above their long-term average, which is appropriate at this point in the cycle, when earnings are depressed. But the deterioration in space market fundamentals has further to go before vacancies peak and rents stop falling, which means REIT earnings from their existing portfolios will likely continue to decline.

REIT dividend yields also look a little skinny after a year of dividend cuts and other policy changes to retain cash flow (i.e., stock in lieu of cash). However, dividends should grow quickly as companies recapitalize and can restore cash distributions. Dividend payout ratios are near historic lows (approximately 64% as of 2Q09, per NAREIT, well below the long-term average 73%), which should allow many companies to grow dividends even before earnings turn positive.

As always, investor sentiment will determine how REITs fare in 2010. In sharp contrast to the environment a year ago, sentiment toward REITs has become noticeably more positive recently, even though it is usually tempered by acknowledgement of poor space market fundamentals and the refinancing challenges

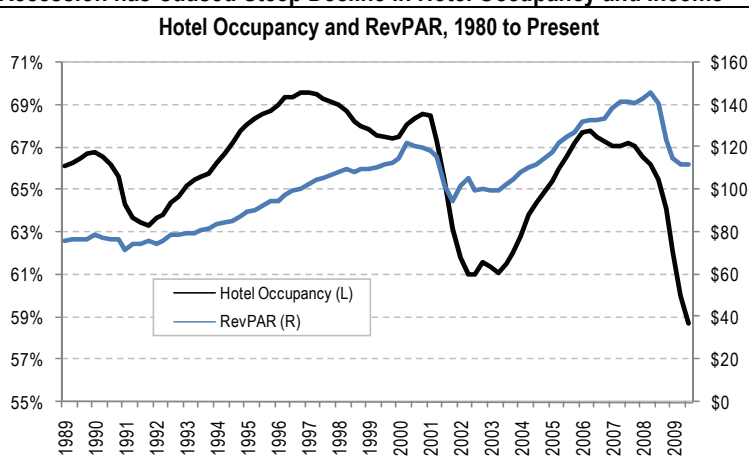
the industry faces. Nevertheless, REITs are showing up on a lot of generalists' "best investment ideas" lists for 2010. REITs may face further declines in earnings before the space markets reach bottom, but there is far less uncertainty about the potential downside risk in both the capital and space markets. As long as the economy continues to expand and begins to add jobs by midyear, we expect REITs will deliver modest positive total returns in the 7-10% range in 2010. But if recent history is any guide, returns could be fairly volatile, at least until investors have greater clarity on the pace of the job market recovery.

Property Markets

Aside from the severity, the most devastating feature of the most recent recession was how broad-based it has been. The economy has shed 7.2 million jobs since December 2007 and the ranks of the underemployed, including part-time workers who want full-time jobs and those who have given up searching, has risen to 17.3%. Every sector in the commercial real estate market is mining historic depths in terms of demand and income growth. Some relief will come early this year when the government hires about 1 million temporary workers for the Census, but it will take sustained employment growth before fundamentals improve. Even with construction levels at historic lows, positive absorption of space and rising rents are still likely a year off, and perhaps longer in some markets.

Hotels: No sector has been hit harder by the recession than hotels. A reduction in both business and leisure travel has prompted national occupancy rates to drop 8.7%, to 55.1% in 2009 from 60.3% a year earlier, while revenue per available room (RevPAR) plunged by 16.7% in 2009, to \$53.71 in 2009 from \$64.49 a year earlier, according to Smith Travel Research. To make matters worse, new supply from the construction boom that started a few years earlier will come online in 2010, which means occupancy levels may have further to fall. Hotel loan defaults are rising fast. Some 18.2% of CMBS loans backed by hotels are in special servicing as of year-end, according to Trepp.

Recession has Caused Steep Decline in Hotel Occupancy and Income



Property & Portfolio Research, as of 3Q09

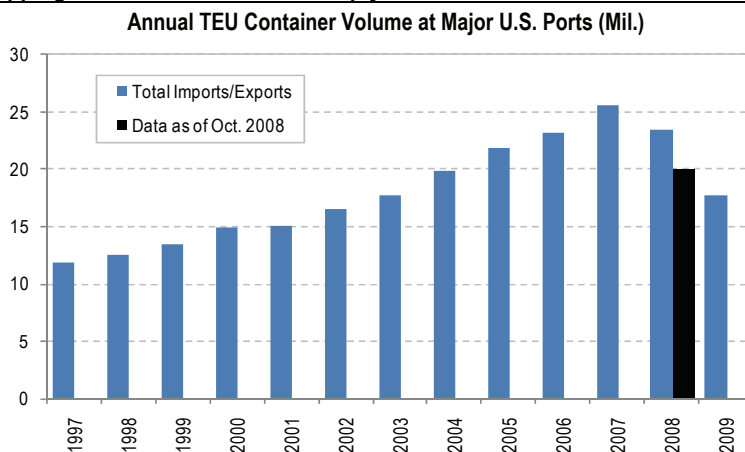
Offices: Negative net absorption of office space has totaled 123.2 million square feet of over the past two years, which will prompt vacancy rates to rise above 18%, according to Reis. It takes at least six months of job growth before office absorptions turn positive, so vacancies will continue to rise into the second half. While it's difficult to predict where jobs will be created, the likelihood is that the recovery will touch a broad

range of office-using employers, including financial activities, information and professional business services. Unlike some other sectors, office development has been fairly stagnant in recent years, which means that vacancy rates should begin to fall soon after job growth returns. Still, with so much empty space, landlords are likely to have to offer steep concessions to attract tenants.

Retail: The unprecedented drop in consumer spending has hit the retail sector hard. Property & Portfolio Research (PPR) forecasts retail vacancy rates to reach nearly 20% in 2010, or double the vacancy rate in 2006. Retail property values have fallen sharply, prompting a rise in distress. Still, there could be value in the sector. Consumer spending remains below 2007 levels, but it has stabilized and will increase as the employment market recovers. Many retailers survived the lean times surprisingly well given the severity of the contraction in sales. To be sure, the weak economy has thinned the field of retailers, but those remaining are well-positioned to prosper. The best-quality assets and locations stand to outperform second-tier assets which rely more heavily on local tenants, many of which don't have access to financing.

Industrial: Yet another property type slated to reach record vacancy rates this year due to declining demand and several years of excess development. PPR forecasts 13.2% industrial vacancy rates in 2010, with rental income dropping about 5%. After this year, though, the sector should recover quickly. Warehouse properties are sensitive to retail spending, which should grow as the recession ends. Port activity fell sharply during the recession, but import/export volume should rise due to an increase in consumer spending in the U.S. and demand for U.S. products outside the country as the dollar remains weak. Like other property types, new supply has been shut down.

Shipping Volume Has Declined Sharply



Maritime Institute, PREI Research (2009 as of October)

Apartment: The apartment sector continues to struggle with weak demand due to job losses and excess supply from the single-family and condominium markets. The national apartment vacancy rate reached 8% in the fourth quarter, according to Reis, the highest level in 30 years. The high vacancy rate will constrain rents in 2010. However, the outline of a rebound is in sight. Young apartment dwellers will be the first to benefit from a rise in employment, and with almost no new units being built, within two years there could be a shortage of supply in some markets. The presence of the government-backed agencies to provide multi-family financing has helped the sector avoid a big drop in property values, but by the same token, it is not

clear how the sector will be weaned once Fannie Mae and Freddie Mac shrink their balance sheets as planned.

For all the capital rumored to be on the sidelines, transactions continue to be rare. Through November, only \$41.9 billion of sales were completed, according to RCA, down about 70% from 2008 and about 90% from 2007. Volume is not likely to pick up soon, especially since many properties are in limbo due to overleveraging, awaiting something to trigger a resolution. Owners remain reluctant to sell when prices are low, as they have been for nearly two years. But that isn't to say the dynamics of the sales market aren't changing. There is a large amount of capital on the sidelines but anxious to get into the game. DTZ Capital estimates that some \$315 billion of capital (including leverage) is available this year for investment in commercial real estate globally, about one-quarter targeting the Americas. Others estimate that more than \$100 billion of equity targeting U.S. commercial real estate is available. Will investors be patient and pick their spots or will they start bidding up prices so they can put money to work? If they bid aggressively, cap rates for stable class-A assets could decline this year. Even if they are more cautious, the fact that demand is ahead of supply will likely stabilize cap rates for all properties, although some assets could lose value due to declining cash flows.

Given the dynamics of the sales market and improving capital markets, we have upgraded our forecast for the NCREIF Property Index, which fell 3.7% in 4Q09 is down 31% from its 1Q08 peak. Last year, we expected the peak-to-trough decline in the appreciation index to hit 40%, but we believe that the bulk of the write-downs are behind us, and in 2010 property values will drop only slightly. Income returns should roughly offset the decline in values, leaving some potential for positive total returns.

Closing Thoughts

The market can't be fully healthy until the distress cycle is completed, and we remain early in the game. And while a large amount of capital has been raised relative to the current level of opportunities available, it remains small relative to what will be needed to recapitalize distressed properties over the course of the cycle. Unfortunately, we are unlikely to see a large-scale resolution of distress in the near future, which would free banks to resume lending and put properties into the hands of healthy sponsors. What might play out is a less favorable scenario in which the majority of banks and property owners extend problem loans for several years, or until some trigger forces a day of reckoning. If that happens, the debt markets will be weak for an extended period and properties will suffer because owners don't have the wherewithal to maintain them. In this scenario, only properties with unstable incomes or weak sponsors will trickle into the market amid heavy competition from buyers.

That said, for the first time in a long time, commercial real estate market players can see the eventual upside. The market is wrestling with many of the same problems it faced a year ago – mortgage delinquencies are rising, fundamentals are weak and sources of debt are uncertain – but the tone is far different. It no longer appears that commercial real estate's troubles will trigger a broader downturn. Positive momentum in the capital markets enabled REITs to more than offset the negative impact of the deterioration in operating fundamentals. With construction virtually shut off, demand for space will eventually rise as the economy slowly recovers and job growth resumes. So there may not be much tangible improvement in statistical measures in 2010, but it is likely a year in which the market transitions to a more positive direction.

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