

U.S. Quarterly

Market Perspective

Executive Summary

- Many economic indicators have stopped their free fall or have started showing signs of improvement, but that may be of little consolation in the commercial real estate market, which lags the broader economy.
- The rate of job losses has slowed, but unemployment continues to rise, and positive growth may not start until sometime in 2010. As a result, space market fundamentals, which are dependent on employment, will continue to deteriorate.
- Lenders' appetite for commercial real estate is restrained. Loans are available on a selective basis, but not enough to support a robust level of new transactions or refinancings. The government's efforts may get the CMBS market restarted this summer, but deal activity will be limited at first.
- The deleveraging of commercial properties, a process that will take years, is just beginning. Loan defaults are rising, particularly on assets whose owners overleveraged during the boom times and now cannot pay off existing debt.
- Property values continue on a downward spiral. As measured by the NCREIF Property Index, they have dropped nearly 25% since peaking in 1Q08, and are likely to slide by another 15% or more before the cycle ends.
- One sign of encouragement in the second quarter came from the REIT market, where the NAREIT equity index rose 28.9% amid a flurry of equity offerings that demonstrated REITs' ability to tap the public markets for precious capital.

Overview

Much of the overwhelming doom-and-gloom that enveloped the country in the first quarter has been replaced by cautious optimism, producing a rally in the stock market. Yet the picture in the commercial real estate market is unfavorable. Demand for commercial property is tied to employment, which continues to drop. Consumer confidence is improving, but households have no choice but to restrain spending and increase savings. As a result, vacancies will rise and rents will fall in all property types through the rest of the year and probably into 2010.

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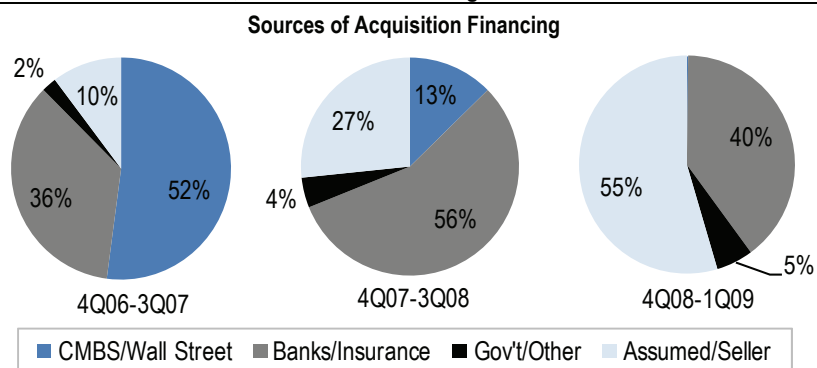
The combination of deteriorating fundamentals and lower property values during a period of deleveraging in a more-conservative debt environment is a tall order that will prove to be the undoing of many property owners. The recapitalization of the industry, which is just getting underway, will be a major issue for years. Private and public firms are repairing balance sheets and starting the process of raising capital in an effort to get in position to take advantage of the opportunities that should arise as values drop and distress becomes more widespread.

Debt Markets

In a move of near-perfect symbolism, the Commercial Mortgage Securities Association recently announced that it was moving its annual January conference from South Beach in Miami to Washington, D.C. An industry that in a short decade grew fat on giant deals and lavish beach parties now spends its energy negotiating with congressional aides and Treasury officials over the details of new regulations and government assistance. Yet the market would have no prospects were it not for the government's Term Asset-Backed Securities Loan Facilities (TALF) program.

If all goes according to plan, TALF will replace the lending on securities that is no longer available from financial institutions. In theory at least, the government debt will help investors to bid up the prices of CMBS to the point at which it will become cost-effective to once again write loans. While it remains to be seen how effective the program will be, the prospect of TALF has prompted CMBS spreads to narrow. Help for the CMBS market cannot come soon enough. Only one CMBS deal involving new loans – a \$1 billion multi-family pool with a Freddie Mac guarantee – has been issued this year. Industry analysts expect a couple of new offerings inspired by TALF to be completed by the end of summer.

With CMBS Market on Ice, Transaction Financing is Difficult to Find



Real Capital Analytics

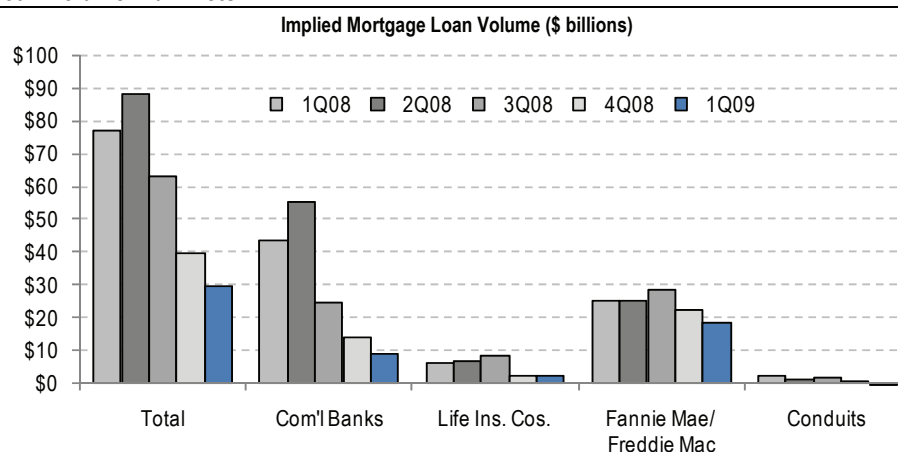
Initial TALF-generated CMBS will be limited to two types of transactions. One would encompass \$500 million to \$1 billion offerings backed by low-leverage debt on portfolios owned by a single sponsor, most likely a REIT. The second type deal might involve banks securitizing a pool of new loans that would refinance mortgages in their existing inventory, enabling them to clear balance sheet space. Impediments to CMBS deals include the inability of banks to hedge loans they warehouse before securitization and the lack of matching financing available to CMBS investors. The upshot is that although CMBS will return in some form, volume will be extremely limited until the banking system recovers.

The CMBS market is critically important because the other two largest providers of commercial mortgages, banks and insurance companies, are largely inactive at the moment, and are likely to remain so for at least the near-term future. According to the American Council of Life Insurers (ACLI), life companies' mortgage commitments fell to \$2.6 billion in the first quarter, down an astounding 73% from a year ago and the lowest volume of commitments since the first quarter of 1993 (\$1.4 billion). The pace of lending by insurers puts the industry on track to write \$10.4 billion of mortgages for the year, which would be the lowest full-year

number since 1992, when the industry originated \$6.3 billion of loans. By contrast, the sector wrote \$42 billion of mortgages annually, on average, between 2004 and 2007, according to the ACLI.

The average size of life company loans in the first quarter – \$13.4 million – is little changed from recent years. Otherwise, loans have more conservative terms. For example, the 1Q09 average loan-to-value ratio of 57.1% is the lowest since the ACLI began keeping statistics in 1965. Insurers are trying to reduce exposure to commercial real estate and are worried about the possibility of rising delinquencies in their existing portfolios, although the ACLI's delinquency rate remained extremely low (0.12%) as of March 31.

Loan Volume Plummet



ACLI; Commercial Mortgage Alert; Mortgage Bankers Assoc.; PREI®

Commercial banks, which own nearly half of the \$3.5 trillion of commercial mortgages in the U.S., have by-and-large reduced new originations by 50% or more. Many banks are just starting to deal with rising delinquency rates, particularly in development and land-loan portfolios. The commercial bank delinquency rate jumped to 6.4% at the end of the first quarter, quadrupling since 2Q07, according to the Federal Reserve. The delinquency rate hovered between 1-2% for a decade between 1998 and the end of 2007 and last reached 3% in 1996. Until banks get a handle on the bad loans on their books, they are unlikely to start lending freely once again. Most maturing loans are being extended by banks rather than refinanced.

With all types of lenders cutting back and lending more conservatively, and property fundamentals declining due to the weak economy, a growing number of properties are experiencing distress because owners can't pay debt service or refinance highly leveraged loans. Firms that perform special servicing and workouts are about the only growth businesses in the commercial-mortgage arena. The percentage of securitized loans transferred to special servicing because of poor performance or a borrower's inability to refinance at maturity rose to 5.4% at the end of June, up from 0.40% in August 2007, according to analytics firm Trepp, which tracks the CMBS market. Some \$40 billion of CMBS loans are now in special servicing.

Nevertheless, we have yet to see a surge of distressed transactions. All told, the volume of troubled commercial mortgages rose by \$60 billion during the first half of the year, bringing the total to \$107.1 billion, according to Real Capital Analytics (RCA). Yet only \$4.1 billion reportedly has been resolved this year. Unlike the early 1990s, regulators are not pushing banks to reduce their commercial real estate loans as long as they are performing. This could change once banks are back on firmer footing and reserves are

sufficient to absorb the hits that would come with taking back properties in the today's market. For their part, banks are not eager to take on the complexity of large structured deals, which may result in legal proceedings and tie up many properties for years to come. Additionally, the institutional memory of the last capital crunch, when lenders sold assets at steep discounts only to see buyers reap outsized gains, runs deep in the lending community and may discourage some banks from acting more aggressively.

REIT Market

Despite the dire conditions in the debt markets and ongoing deterioration in space market fundamentals, U.S. equity REITs chalked up huge gains in the second quarter. It was a welcome reprieve from the beating they took in the prior two quarters. After tumbling 38.8% in fourth-quarter 2008 and 31.9% in the first three months of this year, the FTSE NAREIT equity REIT index rebounded with a 28.9% total return in the second quarter. The strong second quarter performance might be best characterized as a "world-is-not-ending" relief rally. The REIT rally, which began in early March, was fueled by a new wave of equity offerings from companies deleveraging their balance sheets. Between March 1 and June 30, public REITs and real estate operating companies raised more than \$14 billion in follow-on equity offerings and another \$3.4 billion in secured debt. The equity offerings were dilutive, obviously, to existing shareholders – highly dilutive in some cases. Nevertheless, most companies were rewarded with higher share prices and multiples, particularly those who were earlier in the wave.

As encouraging as it is to see REITs successfully access the capital markets, most companies still have a long way to go before they can stop worrying about their balance sheets and looming debt maturities. Equity issuance has fallen dramatically since early June, perhaps to allow investors a chance to catch their breath. If REITs can hold on to their second-quarter gains, the higher multiples at which they trade today will make future offerings less expensive. But they will still be dilutive, which means more shareholders will have to make do with an already shrinking stream of earnings.

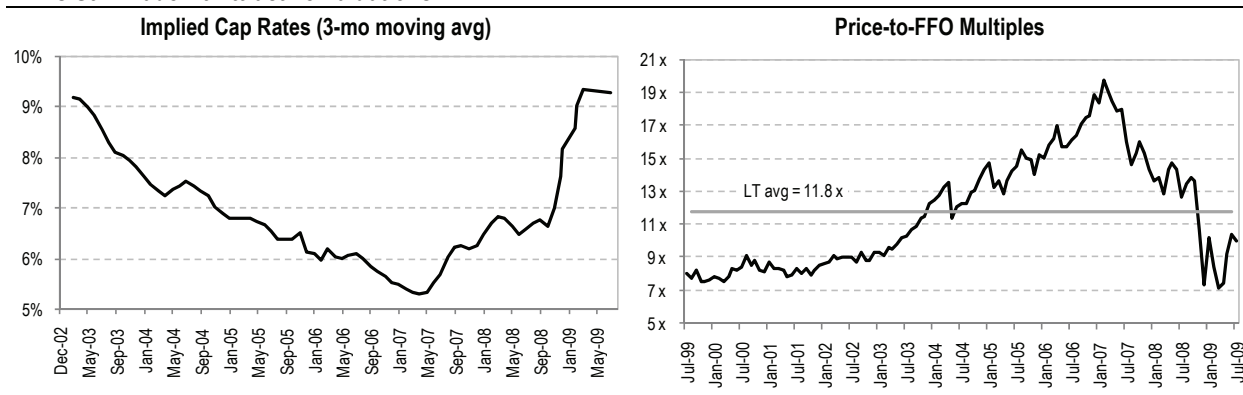
The recapitalization activity in the first half of the year was likely the first in a multi-step process that should position REITs to take advantage of the seemingly inevitable widespread distress in the next year or two. Although few, if any, companies are poised to begin actively acquiring assets in the near term, the volume of capital raised and generally strong performance of companies that issued equity should help to allay investor fears about solvency. This is not true for every company, obviously. But for a broad cross-section of the REIT market, investors can focus on operating and property market fundamentals and relative value.

Unfortunately, REITs clearly were far less attractive on a relative basis at the end of the second quarter than in early March, when they were trading at historic discounts by almost every measure. The second-quarter rally caused yield spreads to narrow sharply, and closed the gap between REIT shares and net asset values (NAVs). More importantly, the near-term outlook for REIT earnings versus the broader equities market is not terribly compelling for REITs. The ongoing deterioration in property market fundamentals will weigh on REIT earnings through 2010, while forward earnings estimates for the broader market are improving.

By other measures, however, REITs look fairly attractive at their current levels, particularly as a way to access the commercial property market at discounted pricing that is not widely available in the direct market. According to Merrill Lynch, equity REITs were trading at implied cap rates of about 8.8%, on

average, at the end of June, roughly 360 bps higher than at the peak of the market in early 2007. The dearth of private market transactions makes it difficult to know where assets would trade today, but many long-term investors would consider an 8.8% initial yield very attractive for institutional quality assets. Likewise, REIT earnings multiples have fallen dramatically since the market peak. The average price-to-FFO multiple for equity REITs, based on forward earnings, was about 10x as of mid-July, slightly below the 10-year average. (Source: Merrill Lynch) As long as earnings estimates and REIT multiples can hold their ground in the face of what could be significant equity issuance, today's below-average multiples on trough earnings provide a compelling entry point in the REIT market.

REITs Still Trade At Attractive Valuations



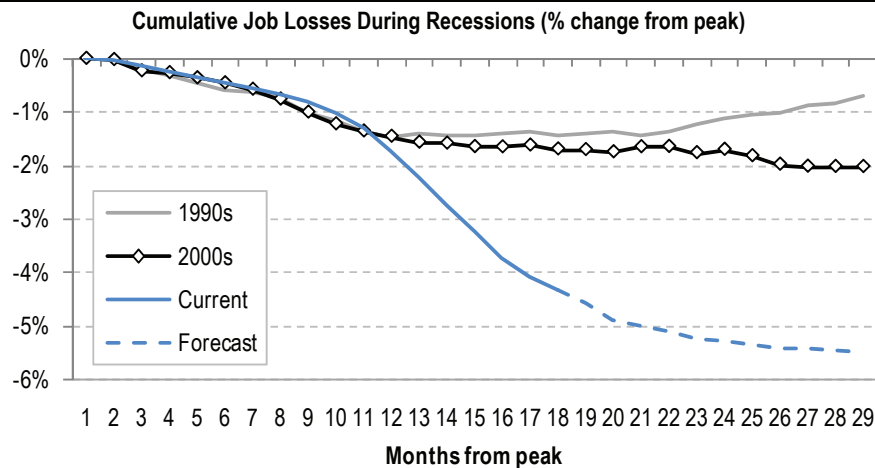
Merrill Lynch; PREI®

The outlook for REITs over the next 12 months is mixed with the risks still weighted to the downside due to the uncertain trajectory of the economy and capital markets. We can be fairly certain that share prices will remain volatile. Short interest has retreated from the peak levels earlier this year, but it remains elevated and will only compound the skittishness in the market already. Unfortunately, the near-term trend in REIT earnings will do little to help build a case for the group, especially when compared with the broader equity market. Between now and year-end, we expect REITs will remain more or less range bound and will finish the year with negative total returns. Investors can count on 2-3% from dividends, but it will be tough for REITs to sustain much upward momentum until investors have greater clarity on the economy and access to capital for commercial real estate. Over the next 12 months, we expect REITs will deliver total returns in the 9% to 12% range as the economy picks up and the outlook for REIT forward earnings improves.

Space Markets

The current recession has proven to be the worst since the 1930s in terms of duration, negative gross domestic product growth and the increase in unemployment. As a result, commercial real estate fundamentals deteriorated in the second quarter, and they are unlikely to improve much for at least 12-18 months. In virtually all sectors and all regions of the country, vacancy rates are rising and property incomes are falling. The overriding fact is that there can be no substantial recovery until the dismal employment situation turns around. Some 1.4 million jobs were lost in the second quarter, bringing the total to 6.5 million since December 2007. The downturn has already wiped out nine years' worth of job growth and many forecasts call for up to 2 million more job losses over the next 10 months before employment growth resumes.

Job Losses Have Exceeded Recent Recessions



Bureau of Labor Statistics; Moody's Economy.com; PREI®

There are signs that the economy is through the worst part of the downturn, but the same cannot be said of the commercial real estate market. Consumer spending has stabilized, albeit at a level that is materially lower than before, the banking system has pulled back from the brink of insolvency and the government's stimulus is just starting to gain traction. More than \$300 billion of stimulus will work its way into the economy over the next four quarters, according to Moody's Economy.com. However, as a lagging sector, commercial real estate fundamentals are unlikely to improve meaningfully in the next two years.

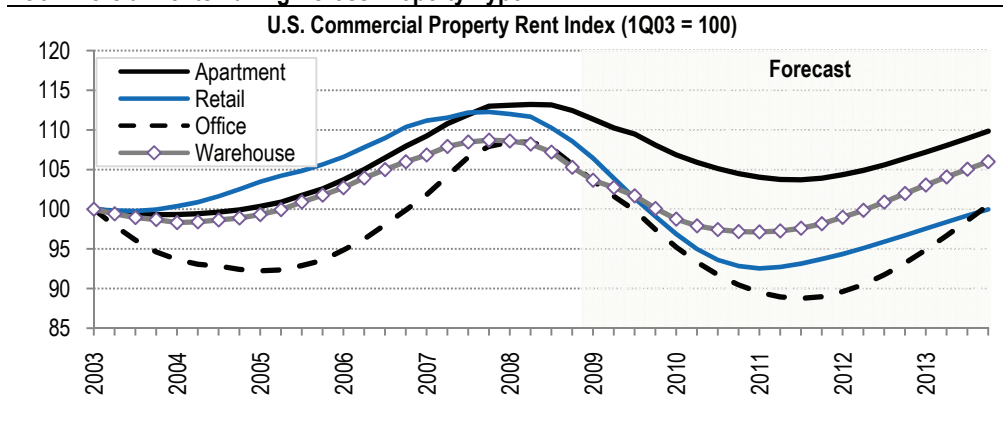
Office: Rising unemployment is pushing vacancy to its highest level since the early 1990s and the negative trend is likely to continue for another year. According to estimates by Property & Portfolio Research (PPR), the national office vacancy rate rose 80 bps to 18.3% in the second quarter. Negative absorption totaled 32.8 million square feet, the third-worst quarterly result since PPR began keeping track in 1982. That served to push asking rents down by 1.9% during the quarter and 6.5% since the peak in 2Q08. Leasing demand is soft, and tenants who are looking for space are probably more cost-conscious than they were in previous downturns. Both landlords and tenants are focused on leasing costs, which puts buildings with high build-out needs at a disadvantage.

Retail: The many households that have experienced job losses or reduced income naturally spend less on discretionary items, although spending on necessities is holding up as expected. The Conference Board's consumer confidence index, after rising from historically low levels in the first quarter, dropped in June as business and employment conditions remained weak. The household savings rate is projected to rise to about 10% in the near term, its highest level in two decades. Consumer spending seems to have stabilized on a month-over-month basis, but it remains down nearly 10% year-over-year. Credit card debt outstanding is shrinking, and produced the first year-over-year decline since 1969, according to Bank of America. Consequently, retail sales growth is likely to be tepid for years as households delever and banks ration credit.

All these signs point to protracted headaches for the retail sector. Vacancies at shopping centers are increasing as retailers go out of business or close underperforming stores. Landlords are losing income not only from the vacancies, but many remaining tenants are using the lower occupancy and difficult operating

environment as leverage to renegotiate leases downward. Dominant centers should survive, but secondary-level properties and markets are likely to struggle. The U.S. retail vacancy rate rose by 140 bps, to 17.6% in the second quarter, according to PPR estimates. The 70 million square feet of negative absorption in the quarter was topped in PPR's 27-year history only by the 80 million square feet of negative absorption in 1Q09. That prompted rents to drop by 2.4% for the quarter, and 7.6% since the peak in 1Q08. Retail assets will face significant pressure over the next year or so. The retail sector has \$31.2 billion of distressed assets, more than any other property type, according to RCA.

Commercial Rents Falling Across Property Type



Property & Portfolio Research; PREI®

Apartment: Vacancies in the multi-family arena are rising in the short term, but the lack of supply and demographics should enable apartments to recover before other sectors. Negative job growth has tempered the demand for multi-family units, as young people choose to live with their parents longer or double up. What's more, apartments are increasingly facing competition from vacant single-family houses. The result was that at the end of June, apartment vacancies soared to 7.5% nationally, up from 6.1% a year earlier, according to Reis. With landlords granting larger-than-normal concessions to maintain occupancy, Reis said that effective rents dropped 0.9% and asking rents fell 0.7%.

Property values in the sector are aided by the presence of government agencies, which are lending freely at a lower cost than is available to other property types. Landlords also will eventually benefit from the drop-off in construction. According to PPR, supply growth of multi-family units will average 0.2% in 2010 and 2011, well below historical averages. So when the job market turns around, existing property owners will be in good position to raise revenues, first by eliminating concessions and gradually through raising rents.

Industrial: While there is less distress in industrial properties than other sectors, and global trade has recovered somewhat from the low levels earlier in the year, the struggling auto industry and falling demand for products has taken its toll. The industrial sector recorded an all-time high of 53 million square feet of negative absorption in the second quarter, according to PPR estimates. The vacancy rate in 2Q09 rose 120 bps to 12.3%, another all-time high, while rents declined 0.9%, bringing the total to -5.7% since peaking in 1Q08. Leasing activity remains weak. With the economy uncertain, both tenants and landlords prefer to sign leases with shorter expiration dates.

Hotel: The economic downturn has been most painful for the hotel sector, due to the reduction in both leisure and business travel. Upscale hotels in particular are hard hit as individuals search for value and businesses are focused on avoiding extravagant expenses. Lodging data has been trending down for more than a year, and the trend continued in June. According to Smith Travel Research (STR), total hotel occupancy fell 9-11% in June on a year-over-year basis, while revenue per available room (RevPAR) was down a whopping 18-20%. The RevPAR of luxury hotels was down 28-30%. What's more, STR downgraded forecasts that previously saw hotel income improving in the second half of 2009. The firm now anticipates that it will take years for hotels to get back to 2007 income levels.

Meanwhile, cracks have appeared in many large hotel portfolios that were traded during the peak of the property cycle with highly leveraged debt packages. Some \$11.8 billion of hotel assets have joined the ranks of distressed assets in the first half, bringing the total to \$17.3 billion, according to RCA. One example is an Extended Stay Hotels portfolio that was acquired in 2007 by Lightstone Group, a neophyte to the hotel industry, for \$8 billion with \$7.4 billion of financing. Lightstone recently filed for Chapter 11 bankruptcy in a petition that valued the company at \$3.3 billion, which is \$800 million less than the portfolio's senior debt alone.

The weak fundamentals and lack of acquisition financing have put a brake on the transactions market. The annualized turnover rate for properties in the NCREIF Property Index (NPI) fell to 0.5% in 1Q09, a fraction of historical levels. However, there is capital available for acquisitions. While estimates vary as to the amount, private equity funds, REITs and offshore investors have set aside cash to acquire real estate when the time is right and property owners are willing to sell assets at a price acceptable to buyers. With little deal flow and sustained job growth not seen for another year or more, property values are likely to continue on a downward path. Our forecast for the NPI remains for -25% to -30% unleveraged appreciation returns in 2009 and a peak-to-trough drop of -40% to -45%. Assuming an anticipated income return of 7%, that would bring 2009 total returns to -18% to -23%.

Closing Thoughts

While we are encouraged to see signs of stabilization in the economy and financial markets, the outlook for commercial real estate will be dominated by three powerful themes: deleveraging, deflating asset values and deteriorating fundamentals. With less debt capital available globally and weakening demand for space, property values will continue to decline. The question is how much values will fall and over what period of time.

What is clear is that the correction in asset values is occurring much faster than in past downturns. In the 1990s, it took 24 quarters for the NCREIF property index to reach bottom, during which time property values fell 32%. As of June 30, the NCREIF index has declined 24.5% in just five quarters. The pace of the falling values will come as little comfort to investors who have exposure to the asset class, but the sooner asset values reach bottom, the sooner they can begin to position themselves to take advantage of opportunities that may arise as a result of the distress. The peak prices in 2006-2007 were undoubtedly caused by excessive liquidity and aggressive underwriting, but if history is any guide, there is an excellent chance that investors who buy assets or originate debt at or near the bottom of the cycle will be rewarded.



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