October 2008

U.S. Quarterly

Market Perspective

Executive Summary

- The dramatic deterioration in the capital markets and increasing weakness in the overall economy will bleed into the commercial real estate markets. All sectors of the real estate market will be affected.
- The unprecedented nature of the current banking crisis makes it difficult to come up with a historical analogy from which to devise a solution or draw conclusions.
- Few banks are willing to lend and are instead focused on shoring up their balance sheets and conserving capital. Any debt that is available is expensive. This will dramatically decrease construction starts.
- The U.S. REIT market remains extremely volatile. Although REITs offer attractive dividend yields and generally are trading at sizable discounts to net asset value, the near-term risks for the REIT market as a whole remain weighted to the downside.
- Other than distressed situations, transaction activity in the commercial real estate market will remain depressed until the broader markets regain their footing. As a result, property values will continue to weaken, though a broad consensus on market values will not emerge until transaction activity normalizes.

Overview

The outlook for commercial real estate has darkened since we published our second quarter market perspective in July. The reversal of the credit cycle that drove investment performance over the past few years will take a bigger toll on real estate capital and space market fundamentals than we anticipated even a few months ago. Distress has been noticeably absent since the onset of the credit crisis in the summer of 2007. However, that appears about to change in the aftermath of the near-meltdown of the financial system and the unprecedented federal intervention. While there is no single catalyst that will precipitate an immediate drop in values, the dramatic withdrawal of credit for the sector will have the most immediate and profound impact. Add to that the deterioration of market fundamentals due to the weakening economy and there is the potential for a somewhat prolonged downward cycle for the sector over the next several years.

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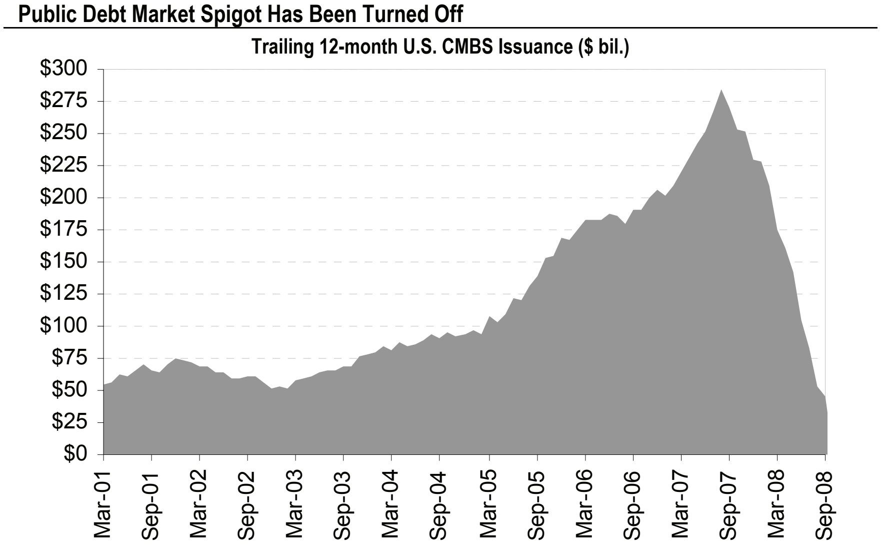
Debt Markets – End of the (Debt) World as We Knew It

Access to debt capital has become increasingly constrained as the fallout from the subprime crisis has spread from the public debt markets to private lending. Until fairly recently, however, commercial banks and portfolio lenders were still active in the commercial real estate sector, albeit at a much restrained pace from recent years. **Unfortunately, the lending environment has deteriorated markedly over the past month or so.** With banks unwilling to lend to each other and the commercial paper market all but frozen, capital preservation has taken on new urgency for lenders everywhere. Many commercial real estate lenders who were still writing loans have stepped back to assess how the landscape has changed and how the proposed government interventions might affect the capital markets.

It is not yet clear whether the latest pullback will persist beyond the fourth quarter. However, the disruption will cause already-depressed origination and transaction volumes to slow even further over the next six months, perhaps longer. Even after the credit markets begin to thaw, we expect commercial real estate debt will remain scarce and expensive until there is an improvement in the outlook for the economy and commercial space market fundamentals. The commercial MBS market is for all intents and purposes closed. Only $12.1 billion of CMBS has been issued in the United States so far this year, none in the third quarter. The last time no CMBS was floated during a quarter was 1986, essentially before there was a market. Volatility and low bond prices have rendered securitization programs uncompetitive and have kept conduit lenders from originating new loans. CMBS spreads regularly reach new highs. In early October, senior triple-A bonds topped swaps plus 500 bps, up from swaps plus 22 in early 2007.

Public Debt Market Spigot Has Been Turned Off



Commercial Mortgage Alert

Other types of lenders should return to some level of activity once the immediate crisis subsides, but they will be far more selective than in recent years. Fannie Mae and Freddie Mac, the main source of multi-family loans in wake of the CMBS market collapse, had become more conservative even before their mandate to shrink their portfolios following their seizure by the federal government. Life companies have been picking their spots, primarily writing low-leverage loans with short- to medium-term maturities for existing clients. Insurers have almost no bad loans on their books at present, and although delinquencies will rise, their commercial mortgage portfolios should weather the storm well. The vast majority of loans originated by insurers are conservative enough to withstand a downturn in the economy and some deterioration of property values.

The outlook is less clear for commercial banks, whose combined $1.7 trillion commercial mortgage portfolios contain massive exposure to construction and land loans, sectors in which delinquencies are rising. Some of the largest commercial banks, formerly the most-active lenders in the nation, were already sidelined before the latest series of shocks exacerbated the credit crunch. Banks that were still lending were doing considerably less volume than in recent years. How soon and to what extent banks return to commercial real estate lending is an open question. **However, because commercial banks are the largest single source of debt capital for the industry, there can be no recovery in the property markets until banks get healthy again.**

The debt markets are in the midst of a long-term transformation. From 2005 through the first half of 2007, CMBS programs had unlimited capacity to write loans because they could sell everything they originated, which created an environment that favored volume over quality. Those days are gone. Securitization is likely to be sporadic at best through 2009, and maybe longer. When it does return, CMBS will no longer be used as a conduit by investment banks to "manufacture" product to support an origination and trading machine. Instead, it will be a tool used selectively by lenders to recycle capital or to finance loans that otherwise would be held on balance sheet. The new model will almost certainly require that lenders be willing to own the risk of the product they originate. That might mean traditional CMBS shops will keep the junior portion of securitizations, or we might see a new wave of specialty finance firms that incorporate new technologies. Whatever form it takes, the public debt market will not return to the volumes seen in recent years anytime soon.

Property owners will have to plan accordingly for the new environment. Deals will have to pencil out without generous debt packages, and asset values will depend once again on income generated by properties rather than the financial engineering that dominated the market in recent years. In short, "old school" underwriting will be back in fashion. **In the interim, however, virtually all financing will be difficult and expensive.** The potentially large sums of capital that have been raised for mezzanine and distressed debt funds could provide some relief to property owners, but the capital will neither be cheap nor sufficient to fill the void that now exists in the real estate debt markets.

REIT Market – Knives Still Falling

The U.S. REIT market showed surprising resilience through the first three quarters of 2008, but only on a relative basis. Equity REITs outperformed the broader stock market by a wide margin through September. After gaining 5.6% in the third quarter, the NAREIT Equity REIT Index moved back into positive territory with a 1.8% total return, well ahead of the broader market. Since then, however, REITs have fallen sharply, and now trail the broader stock market.

The most striking aspect of REIT performance continues to be the extreme volatility that has whipsawed investors since early 2007. REITs historically have been attractive for their relative stability compared to other stocks, a characteristic that stems from their stable yields based on long-term leases and relatively high dividend payout ratios. This year, however, REITs have gyrated like never before. In

Volatile Year in the Equity Markets

	2008				
	YTD*	**1Q08**	**2Q08**	**3Q08**	**2007**
Equity REITs	-41.5%	1.4%	-4.9%	5.6%	-15.7%
S&P 500	-39.2%	-9.4%	-2.7%	-8.4%	5.5%
Russell 2000	-37.6%	-9.9%	0.6%	-1.1%	-1.6%

* year-to-date through October 24

Ibbotson Associates; NAREIT; Standard & Poor's; Frank Russell

fact, as noted in "REIT Wrap," the 10 biggest one-day gains and 10 biggest one-day losses in the 13-year history of the Morgan Stanley REIT Index (RMS) have occurred in 2008. At least some of REITs' struggles can be blamed on continued association with the financial and residential sectors. Correlations between REITs and financial stocks have been running well above average since mid-2007. But the REIT market's troubles since the third quarter ended likely reflect investors' aversion to stocks and risk generally, and perhaps to growing concerns about REIT earnings in a slowing economy.

REIT performance in the first nine months could have been much worse. Capital flows into dedicated REIT funds (including ETFs) have been positive for most of 2008. According to Merrill Lynch, about $4.9 billion has flowed into U.S. REIT funds this year (through Oct. 15). Flows turned negative at the end of the third quarter, however, and if the broader market is any indication, REIT funds could see sizable outflows in the near term. **A number of REITs took advantage of the more favorable market conditions in the third quarter to raise capital, mostly by issuing common stock.** According to SNL Securities, REITs raised about $4 billion through common stock offerings in 3Q08 and the first two weeks of the fourth quarter, nearly matching the amount raised ($4.2 billion) in the first half of the year. While the amount of capital raised is impressive given investors' intense aversion to risk, the fact that REITs resorted to issuing equity at depressed share prices, thereby diluting the value of existing shares, underscores the limited financing options available today. With the recent sell-off in REIT shares, the window of opportunity to raise capital through the public market may be closed. Already, at least one planned REIT IPO has been shelved since the third quarter ended and another has reportedly been "delayed."

The near-term outlook for the REIT market remains challenging. Earnings have held up relatively well so far and falling share prices have made dividend yields much more attractive. However, we expect more companies will fall short of earnings expectations in the third quarter, and growth estimates for 4Q08 and 2009 will be revised downward to reflect weaker tenant demand, transaction activity and merchant building. Performance will continue to vary widely by company, sector and, in some cases, by market exposure. Unsurprisingly, companies with moderately leveraged balance sheets, limited near-term debt rollovers and proven management teams have tended to outperform and should continue to do so until the credit crunch begins to ease and access to capital improves.

Longer-term, the REIT market could play an important role in the commercial real estate market recovery similar to the early 1990s, when REITs helped to recapitalize the industry. If asset values in the private market "correct" to the levels implied by the current pricing in the REIT market, REITs should be well-positioned to compete in the transaction market, especially since the same forces that would cause asset values to fall would likely mean that private capital sources are reducing their exposure. Whether such a scenario would trigger a new wave of IPOs or simply present an opportunity for existing companies to grow their portfolios, is harder to say. Alternatively, if asset values decline by less than REIT shares indicate and the outlook for tenant demand improves, REITs will provide an attractive way for investors to gain exposure to the asset class at a discount.

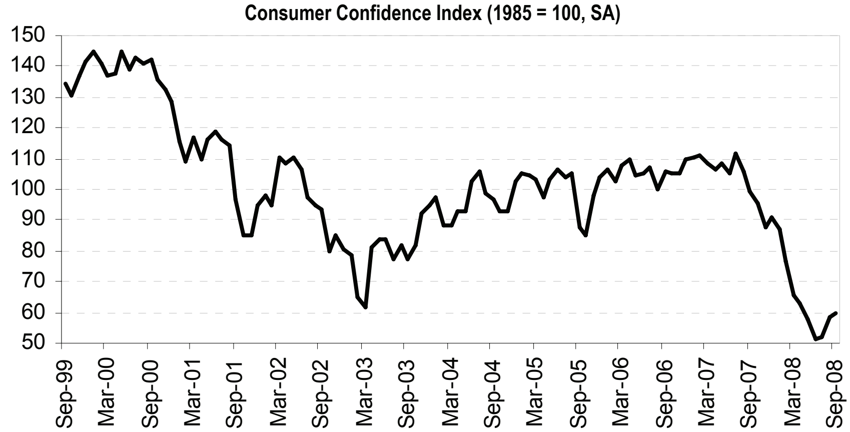
Property Markets – The Tide Has Turned

Commercial real estate fundamentals have held up remarkably well to date, but there is no getting around the fact that the space markets will suffer due to the economic downturn. As a result of the financial market chaos, what appeared just a few months ago to be a shallow downturn in the commercial real estate market is likely to morph into a much deeper recession. For the most part, supply remains very modest in most property types and markets with the notable exception of retail. However, any supply is too much when demand is contracting, which appears to be the case in a growing number of markets across all the major property types. The economy lost 760,000 jobs in the first nine months of the year. By the time the economy stabilizes, total losses will likely be at least twice that high, resulting in higher vacancies and flat or falling rents in all property types.

The biggest reversal of fortune over the past 18 months has been in the office sector. At the peak of the investment cycle in early 2007, many investors were expecting strong rent growth for office properties and, in some markets, rent spikes. Needless to say, deals that were underwritten based on such assumptions will have a hard time achieving their projected returns, and may face serious challenges when it comes time to refinance. Consolidation in the banking industry is causing demand to contract, particularly in prime downtown space in the nation's largest markets. In Manhattan, for example, Lehman Brothers, Merrill Lynch and AIG alone occupy 9.2 million square feet of space. Only a portion of that space will be vacated, but demand is clearly on the downswing. Green Street Advisors projects that office vacancy in the 375 million-sf Manhattan office market will climb to 13.1%, up from the current 7.1%, as a result of the fallout from the banking crisis. Nationally, Torto Wheaton Research projects that the office vacancy rate, which stood at 12.6% at the end of 2007, will rise to 13.9% by yearend 2008 and 15.4% in 2010. Few tenants are interested in making long-term decisions on space needs in the current environment. As a result, landlords have lost much of the leverage they held in recent years, which means that rental growth will be weaker than projected even a year ago and will be negative in many markets.

Retail is the sector that could get hit the hardest by economic conditions. Consumer confidence is low as a result of a variety of factors, including job losses, the end of the easy credit era and the drop in home prices. In a sense, consumers are deleveraging in the same fashion as corporations. Most homeowners can no longer borrow against their houses, and with the sharp decline in home sales, fewer people are buying durable goods. In such times, consumers naturally increase savings and cut back on discretionary purchases. Retail sales have been very weak this year, even with the stimulus package. The 1.2% drop in sales in September marked the third consecutive month of falling sales, a feat last achieved in 1992. A second stimulus package would obviously be welcome news for retailers and retail landlords alike. However, until the housing market finds a bottom, consumer spending will remain weak. All signs point to increased vacancies and declining rents for owners of shopping centers. Strip malls and big-box stores are particularly vulnerable due to the rise in supply as compared to regional malls.

Consumers Rarely Have Been More Bearish



The Conference Board

Other sectors will struggle due to many of the same factors. The global nature of the economic downturn will impact trade, bad news for industrial properties. Hospitality properties, particularly luxury resorts, are already seeing drops in occupancy and revenue. **Sectors that might perform relatively better include apartments and niche property types such as health care and self-storage.** Falling home ownership rates and a shrinking supply pipeline bode well for apartment demand once the overhang of excess housing units abates and the economy begins adding jobs again, but in the near term tenant demand in most markets will likely weaken before conditions improve.

The drop in new construction as an outgrowth of the credit squeeze is a positive for the long-term outlook in commercial real estate. In the apartment sector, for example, several of the largest developers report that their 2008 volume will be half the levels in 2007 and will fall by another 50% in 2009. The market took years to absorb the flood of new construction in the late 1980s, which was the last time the industry faced strong headwinds from both capital and space market forces. **With the modest levels of new supply delivered in recent years and a limited amount of product in the pipeline, the market should recover more quickly from the current downturn and may experience a prolonged period of little or no supply and excess demand once tenant demand begins to grow again.**

The deterioration in the commercial real estate capital and space markets over the past month or two has clearly increased the risk that property values will fall more sharply than expected. The lack of transactions continues to make price discovery extremely challenging, and bid-ask spreads remain wide. However, appraised values for properties in the NCREIF Property Index (NPI) weakened in the second quarter as appreciation turned negative for the first time since first-quarter 2003. The downward trend accelerated in the third quarter as appraisers turned more bearish. The -1.4% appreciation return in the third quarter caused the total return to fall to -0.2%, the first negative quarterly total return in 15 years. Accordingly, we have revised our NPI total return forecast for this year down to 0-2% from our initial estimate of 4-7%.

Closing Thoughts

After many years during which capital and space market forces have helped drive investment performance and attract a larger and more diverse investor base, the U.S. commercial real estate market faces serious challenges on both fronts. For reasons that have little to do with commercial property, capital has become incredibly scarce and tenant demand is weakening. As a result, asset values are poised to fall as property cash flows deteriorate and transactions begin to reflect the higher cost of capital. The magnitude and duration of the downturn are still difficult to predict, however, particularly in an environment where asset values and risk premiums seem completely detached from fundamentals. Asset values have a habit of overshooting in either direction, so we would not be surprised to see cap rates rise sharply in the near term. Over the long term, however, spreads between cap rates and benchmark interest rates such as the 10-year Treasury should not stray too far from their historical averages. As the crisis abates and the massive liquidity that has been injected into the financial system begins to flow, demand for both commercial space and stable cash yields will return. Though we expect the next year or two will be challenging, we continue to believe that commercial real estate, public and private, should play an important role in the portfolios of investors seeking diversification and stable cash yields.

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