

COMMERCIAL REAL ESTATE: BACK TO THE BASICS THAT DRIVE TOTAL RETURNS

APRIL 2008

The news media has finally woken up to the fact that residential real estate (homes people live in) and commercial real estate (income-producing properties such as office, industrial, retail, hotels — and we include apartments) are very different. Instead of using the catch-all phrase of “real estate” in their reporting, they are now starting to focus on the “potential problems” commercial real estate mortgages may have by looking at the commercial mortgage backed securities (CMBS) marketplace, and hoping to forecast or create another disaster scenario like the sub-prime home mortgage problem that exists today. The press is throwing around individual problem property anecdotes and then extrapolating the worst potential scenario in their attempt to sell their stories.

Will all this panic news create major problems in the commercial real estate market? We think not. Why? The fundamentals, of course.

We need to look at three major factors that drive real estate returns:

1. **Demand** for space (growth in the economy, people and jobs)
2. **Supply** of space (existing space use and new commercial construction)
3. **Price** of space (sale prices of existing space and cost to build new space)

Demand

Demand for space comes from economic growth with jobs — people working in and using space.

Real GDP is the best indicator of economic prosperity as it is adjusted down for inflation and tells us if we are making progress in our production of goods and services. If GDP is negative for three quarters then it is considered a recession. Following are the three most recent forecasts of Real GDP.¹

Real GDP Forecast Source	Actual 2007	Forecast 2008	Forecast 2009	Projected Annual Average 2010 to 2013
Congressional Budget Office	2.5	1.6	3.0	3.1
Council of Economic Advisors	2.7	2.7	3.0	2.9
50 Blue Chip Economists Consensus	2.5	1.6	2.8	N/A

Long-term historic GDP growth has averaged 3%² and the forecasts look slower than that for 2008, but there is no recession forecast. So, 2008 looks like a slow half of a normal growth year. However, with the presidential election, tax cuts and stimulus packages, it may be better.

¹ www.cbo.gov

² www.bea.gov



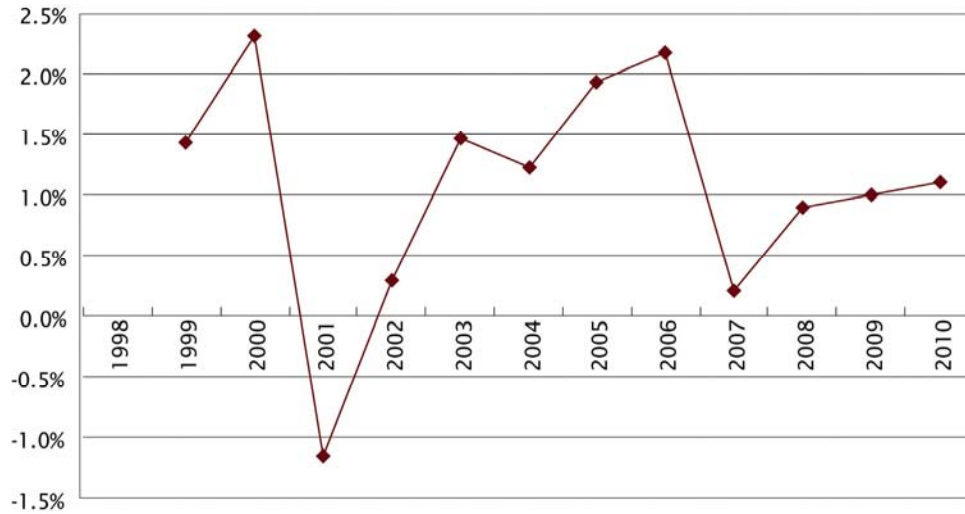
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Job growth comes from economic growth and the sheer population growth that creates demand for goods and services, which creates demand for jobs. Over the last ten years, U.S. employment growth has averaged 1.10% per year and only in one year (2001) was it negative. The Bureau of Labor Statistics forecast assumes below average job growth in 2008 and 2009, but it is not negative — so more workers will need more space in which to work. Even with the January and February 2008 combined job losses of 101,000 people³ (which is only 0.00068% of the 149 million workers in the U.S. — yes that is 6.8 one-hundred-thousandths-of-one-percent) all the major forecasters — the blue chip economists — show job growth for the full year of 2008. It is actually a rare event to have a full calendar year of net job losses.

U.S. Employment Growth Rate



Source: U.S. Bureau of Labor Statistics & Dividend Capital Research.

Supply

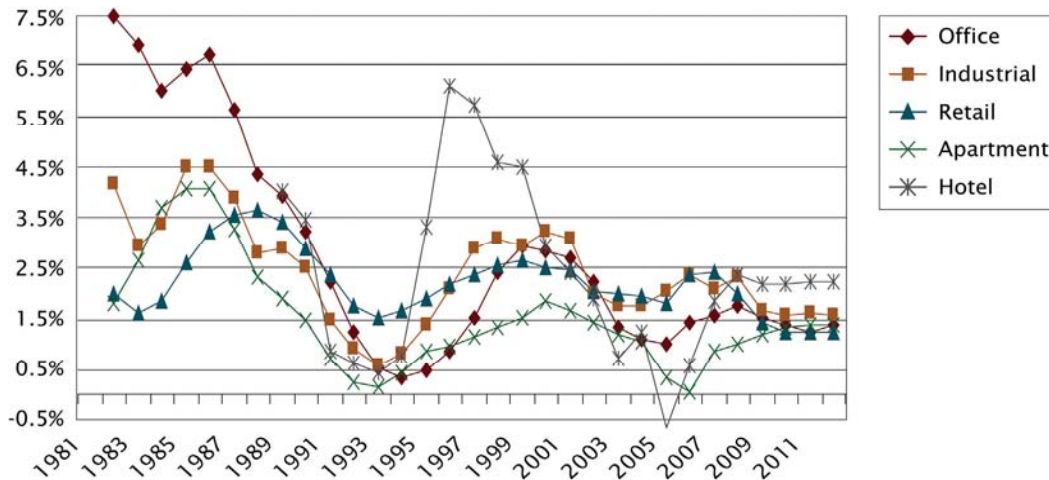
Commercial real estate has five major income producing sectors — office, industrial, retail, apartments and hotels. The amount of new supply in these five sectors has been in relative balance since the late 1990s, mainly due to the advent of real estate’s access to the public capital markets — equity in the stock markets from REITs and debt in the bond markets through CMBS (i.e., Wall Street). The public capital markets demand a lot of data about investments and there are many major sources supplying information. The chart below shows that new supply of space was actually down in 2006 and 2007 and the forecast is for moderate supply growth — well below the long-term average. The Associated General Contractors of America (AGC) just reported that January 2008 was the largest decline in commercial construction starts in 14 years⁴ — further evidence that supply is in check. Construction material costs have also increased at high rates in the past few years, making the cost of new buildings higher and harder to justify without rents rising at similar or higher levels.⁵

³ www.BLS.gov

⁴ *The Data Digest, March 10-14, 2008*

⁵ *AGC Construction Inflation Alert, March 2008*

Commercial Real Estate Supply Growth



Source: Property & Portfolio Research & Dividend Capital Research.

Demand and supply interact to produce the **occupancy levels** in the different property types. Occupancy levels have been proven to drive **rental growth**. Instead of providing a detailed analysis of occupancy and rental growth here, please refer to the Dividend Capital Market Cycle Monitor and Forecast reports available at www.dividendcapital.com. The summary of these reports is that occupancies are expected to have a very slight decline in many markets during 2008 and then improve in 2009, 2010, 2011 and 2012. Rental growth is expected to be **positive** in all five property sectors in 2008 as well as the future four years of the forecast. As a result, the income or earnings growth of the five property sectors is expected to be positive for the next five years. This means the future fundamentals of demand and supply of commercial real estate, while moderate, are positive. Therefore, there is a good probability that commercial mortgage payments can be made and equity investors will receive reasonable returns.⁶

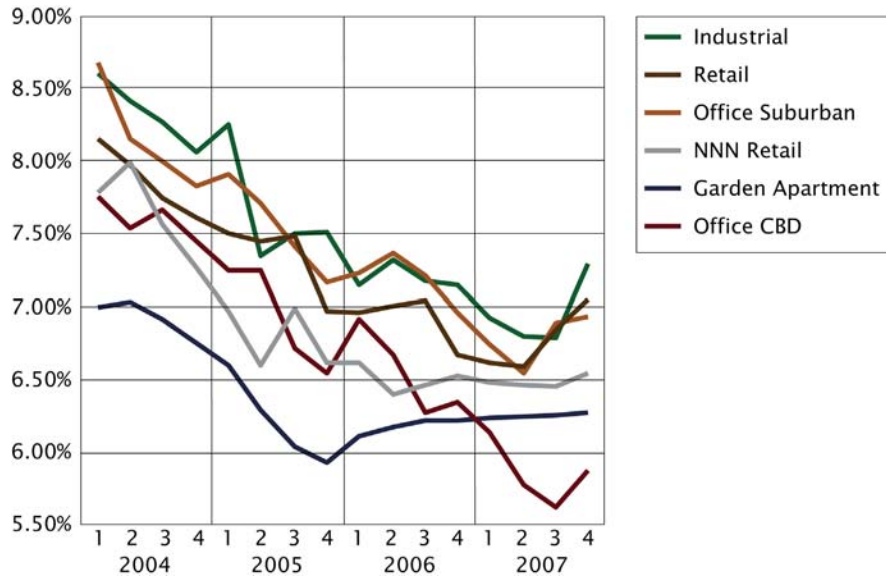
Pricing

Commercial real estate prices have risen every year since 2000, including the years of the tech bubble bursting and the U.S. economy going through job losses. The price of any piece of real estate is determined by a willing buyer and a willing seller coming to an agreement. Prices are expressed in terms of capitalization rates or “cap rates” in real estate lingo. A cap rate is the unleveraged (no mortgage) net operating income (NOI) to be received from a property divided by its all-cash purchase price. This is the same concept as a bond yield. Thus if cap rates go down, this means the price of the property has gone up for the same income. U.S. commercial real estate cap rates have varied between 6% and 10% over the past 40 years. Over the past year they have moved to an average 6.5% level.⁷ Real Capital Analytics covers every commercial real estate transaction over 2.5 million dollars in the United States and their national cap rate composites are shown in the next graph. Real Capital Analytics notes that cap rates have moved up a quarter to a half percent in the second half of 2007. A half percent increase in cap rate equates to a 7.6% decline in price if income did not change.

⁶ Property and Portfolio Research

⁷ Real Capital Analytics

Average Cap Rates



Source: Real Capital Analytics.

As most people know, it is the attractiveness of an investment that brings capital flowing into the investment and pushes the prices up. So we next look at the motivations of the sellers and the buyers of real estate.

Sellers sell when they believe the price of their investment has peaked, they are tired of the investment, they want to reallocate their portfolio investments or they can no longer afford the investment (usually when it is not producing enough cash flow to cover their costs). From 2004 through 2007 many local investors sold their commercial real estate investments as they had never experienced cap rates this low (prices this high) in their 20- or 30-year experience.⁸ However, if they cannot get the price they are asking, they may not sell as the income on those properties is most likely higher than when they purchased the property ten years ago and they are more than covering their debt service and expenses and producing a reasonable cash flow. Many owners are also not sellers as they cannot find an alternative investment that will provide them as good of a cash flow yield of 6.5% with some appreciation potential. (Currently 10-year U.S. treasuries yield 3.5%⁹ and the stock market has a 2.1% average dividend yield with very volatile pricing¹⁰). Or they are doing a 1031 tax-deferred exchange into another real estate investment with good yield. There are very few distressed sellers in the commercial real estate markets today — so don't expect fire sale prices.

Buyers of commercial real estate are plentiful and varied. The commercial real estate markets have changed over the decades in the following ways:

- In the 1970s, commercial real estate was a mostly local marketplace with local buyers and sellers.
- In the 1980s, commercial real estate became a national marketplace as institutional investors (pension funds and endowments) began to make major investments.
- In the 1990s, commercial real estate added the public markets (REITs and CMBS) as investors and financiers.
- In the 2000s, commercial real estate has become a global marketplace with international buyers and sellers.

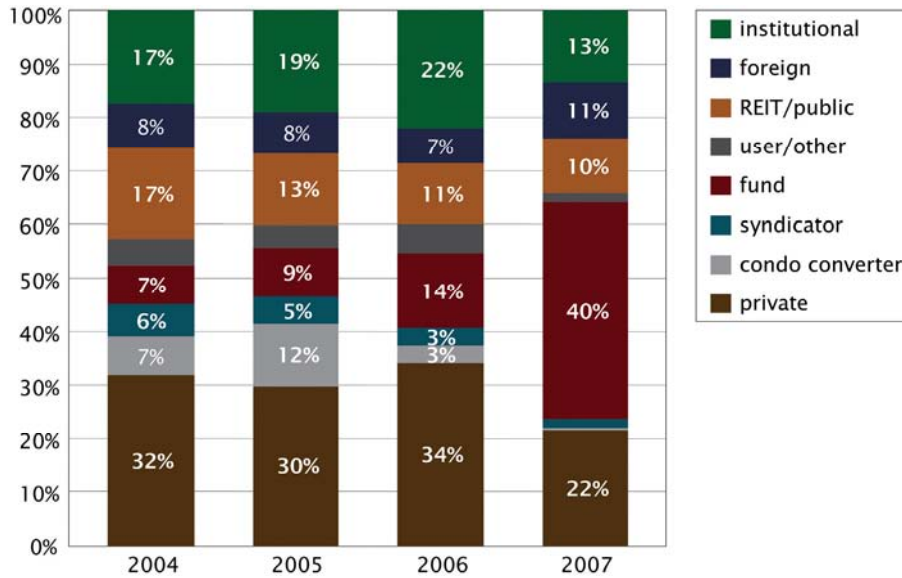
⁸ Real Capital Analytics

⁹ www.Bloomberg.com

¹⁰ www.Indexarb.com

The number and composition of buyers is now quite diverse (see graph below).

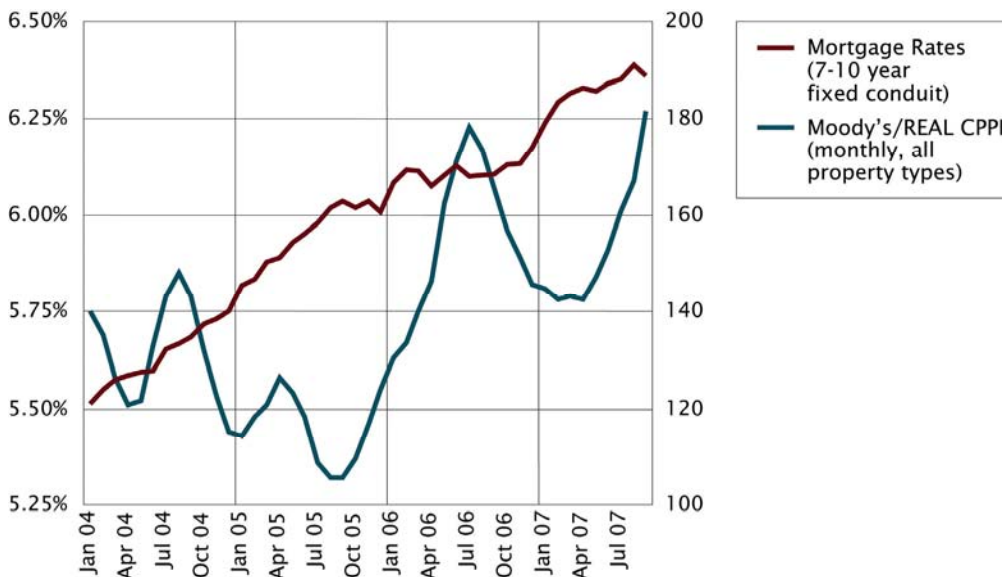
***Diversified Buyer Group—Composition of Equity Buyers
(office, industrial, retail and multifamily properties \$5+ million)***



Source: Real Capital Analytics, 2008.

Institutional investors, public REITs and international buyers have different motivations. They usually buy with cash (they do not finance their purchases and thus interest rates do not affect their purchases), therefore, mortgage rates have not had much effect on commercial property prices in the past few years (see the next graph).

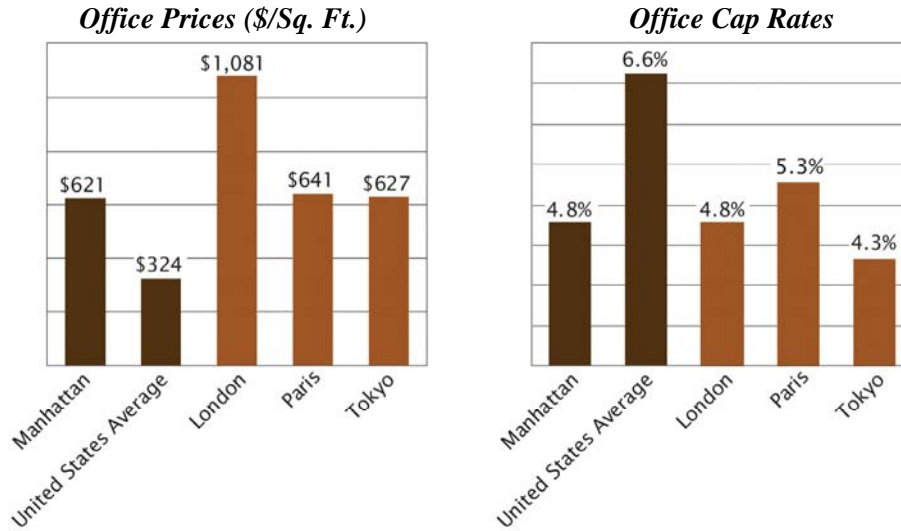
***Debt Rates Having Little Effect on Prices,
Mortgage Rates and Price Appreciation***



Source: Real Capital Analytics.

Commercial real estate has become a separate asset class for big investors, and they now purchase all over the world. Even though a U.S. investor may feel that U.S. commercial real estate has appreciated substantially and thus the price must come down, international investors see U.S. real estate as a good relative value in comparison to their own countries and are thus very happy to buy U.S. real estate as a stable long-term investment. The next graph shows the relative value of U.S. office space versus other major countries in which investors are purchasing.

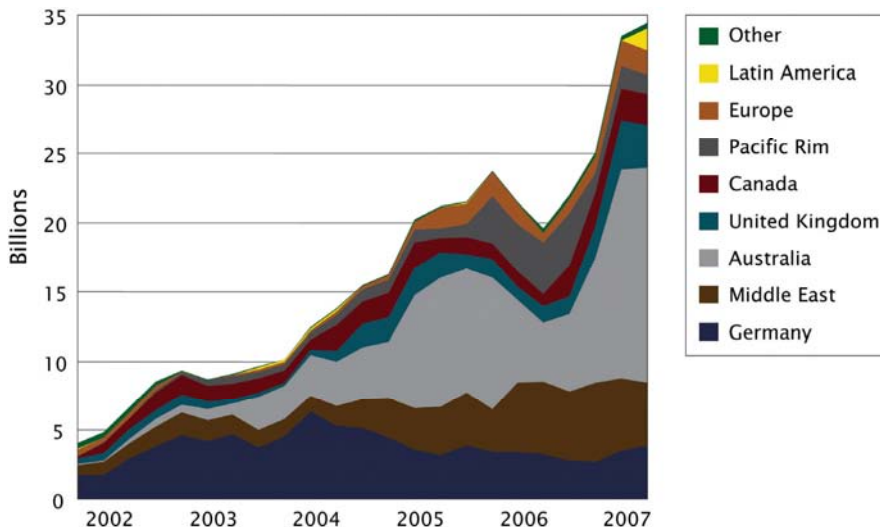
**Globalization of Real Estate Markets
U.S. Still Looks Cheap**



Source: Real Capital Analytics, January 2008.

This attractiveness is also greatly enhanced by a low currency exchange value of the U.S. dollar. The next graph shows the growth of major foreign investors in U.S. real estate from just \$4 billion in 2002 to more than \$34 billion in 2007. Note that Australia has had major growth — due to the “Super Annuation” law there that requires every working citizen to put 8% of their salary into a retirement account. Australians have had 50% of their commercial real estate in publicly traded investment vehicles (like REITs) and their new retirement funds continue to have a strong allocation to real estate.

**Foreign Acquisitions of U.S. Property
(trailing 12 months, office, industrial, apartment and retail properties)**



Source: Real Capital Analytics, January 2008.

In the United States, major investors such as California Public Employees Retirement System¹¹, South Carolina¹² and the Teacher Retirement System of Texas¹³ have increased their allocations to real estate over the past year. The largest allocation known is Yale's endowment with a 27% allocation to real assets, which includes real estate, in their \$20 billion investment portfolio.¹⁴

Conclusion

The conclusion is that there are many buyers for U.S. commercial real estate — thus prices should remain relatively stable in a much more volatile investment world. Fundamentals are slowing but still positive. Timing any investment market has always shown to be impossible, thus a long-term investment perspective should produce the best potential risk-adjusted returns.

¹¹ *REIT Flash, December 18, 2007*

¹² www.pionline.com

¹³ www.tr.s.state.tx.us

¹⁴ *The Yale Endowment 2007 Annual Report*

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