



## Cycle Monitor — Real Estate Market Cycles

Fourth Quarter 2009 Analysis  
February 2010

### Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.

Fourth quarter 2009 GDP growth came out at 5.6%, which is a strong indication that the economic recovery is on the way, however job growth has not yet turned the corner and is not expected to do so until the second half of 2010. Most markets should bottom in 2010.

Office occupancies declined 0.6% in 4Q09 and rents declined by 1.8% for the quarter, resulting in an 8% annual decline.

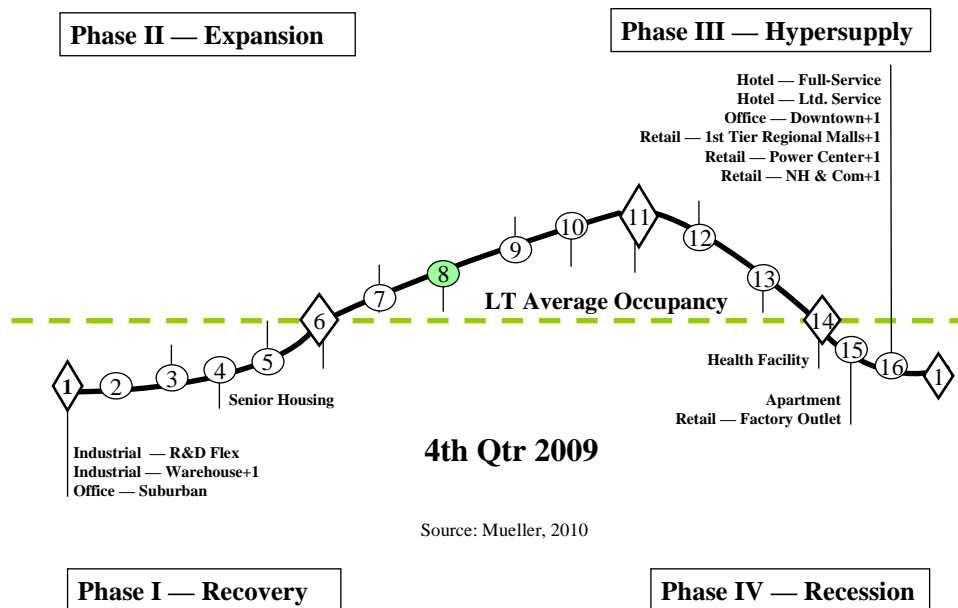
Industrial occupancies declined 0.3% in 4Q09 and rental growth fell 2% for the quarter and 8% annually.

Apartment occupancy declined 0.3% in 4Q09 and rental growth declined 1.1% for the quarter and 6.3% annually.

Retail occupancy declined 0.6% in 4Q09 and rental growth fell 1.6% for the quarter and 9.2% annually.

Hotel occupancies declined 0.5% in 4Q09, and RevPAR declined 0.8% for the quarter and 9.1% annually.

### National Property Type Cycle Locations



Glenn R. Mueller, Ph.D. 303.953.3872 [gmueller@dividendcapital.com](mailto:gmueller@dividendcapital.com)

Dividend Capital Research, 518 17<sup>th</sup> Street, 17<sup>th</sup> Floor, Denver, CO 80202

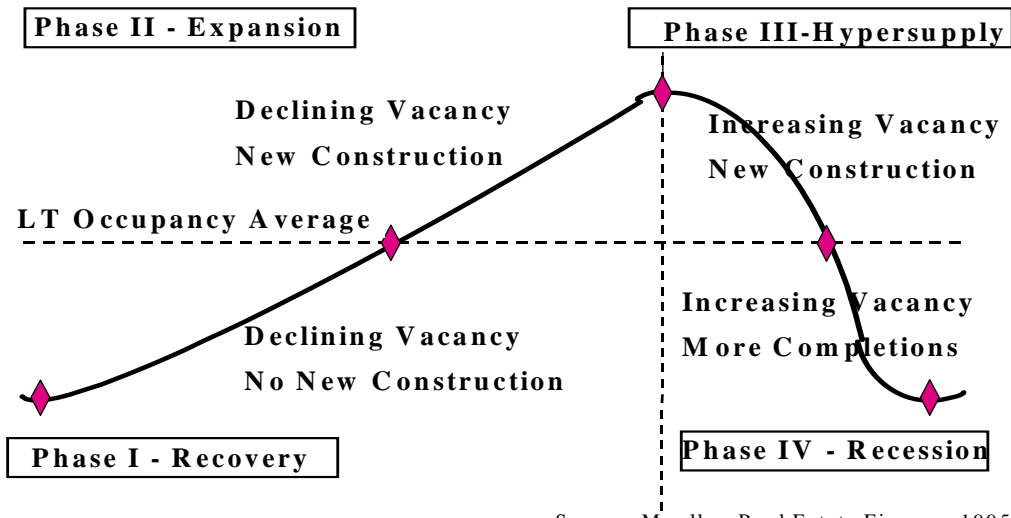
[www.dividendcapital.com](http://www.dividendcapital.com) 866.324.7348

All relevant disclosures and certifications appear on page 9 of this report.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

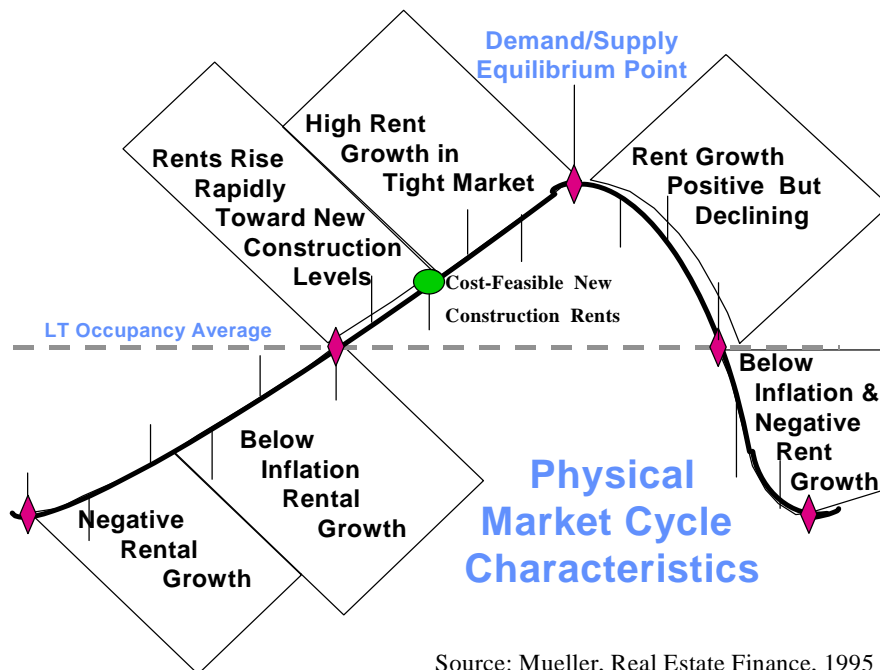
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that analyze occupancy levels and rental growth rates to provide the foundation for long-term investment success. Real estate markets are cyclical due to the lagged relationship between demand and supply for physical space. The long-term occupancy average is different for each market and each property type. *Long-term occupancy average* is a key factor in determining rental growth rates — a key factor that affects real estate returns.

### Market Cycle Quadrants



Source: Mueller, Real Estate Finance, 1995

Rental growth rates can be characterized in different parts of the market cycle, as shown below.

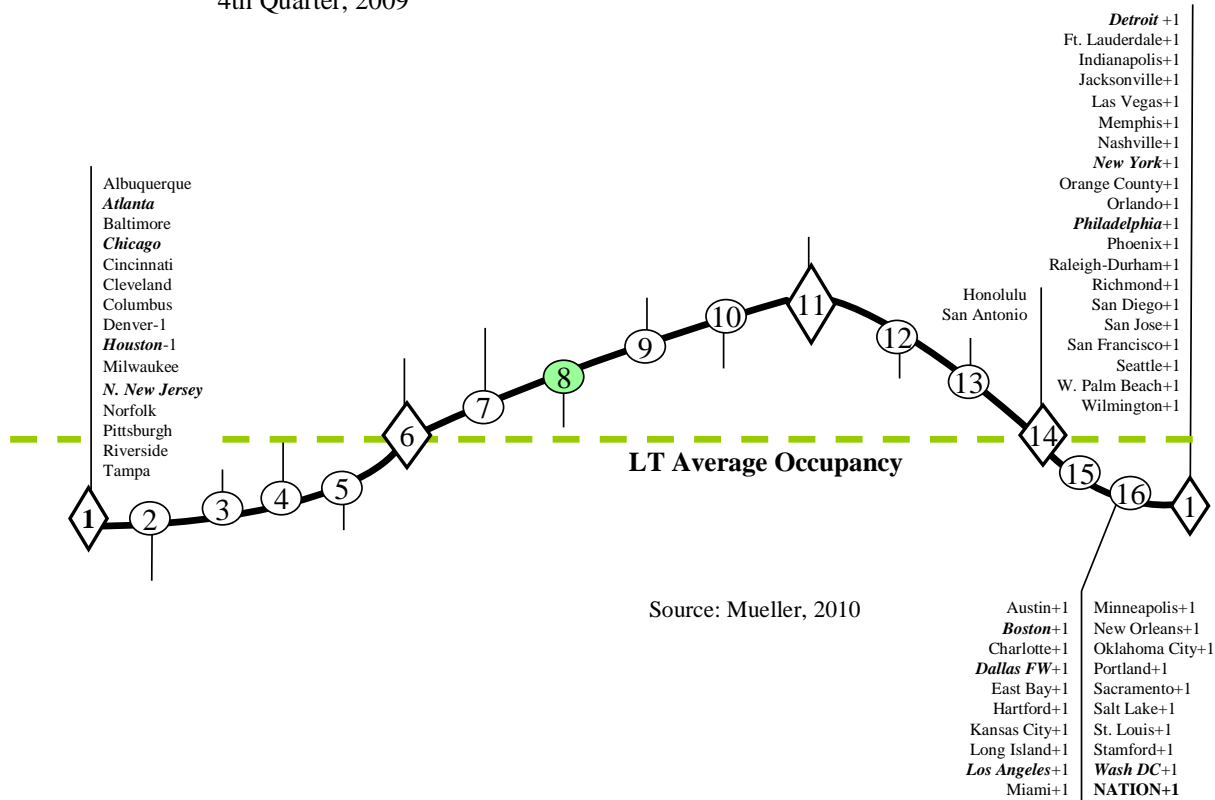


Source: Mueller, Real Estate Finance, 1995

## OFFICE

The national office market occupancy level declined 0.6% in 4Q09, which resulted in a 3% year-over-year decline. Occupancy decline is slowing, which is a typical situation as the bottom of the cycle is reached. Sub-lease space ended the year at 120 million square feet, which is below the 146 million in 2002. We do not expect to see any occupancy growth until job growth resumes. The supply side of the equation shows the lowest new construction in 30 years. Many landlords are renegotiating leases early to keep tenants. Some are blending old and new rental rates while others are giving two- to three-year extensions, hoping to get higher rates after the market recovers. Rents declined 1.81% in 3Q09 and were down more than 8% year-over-year.

### Office Market Cycle Analysis 4th Quarter, 2009



Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor. Thus, the 11-largest office markets are in **bold italic** type to help distinguish how the weighted national average is affected.

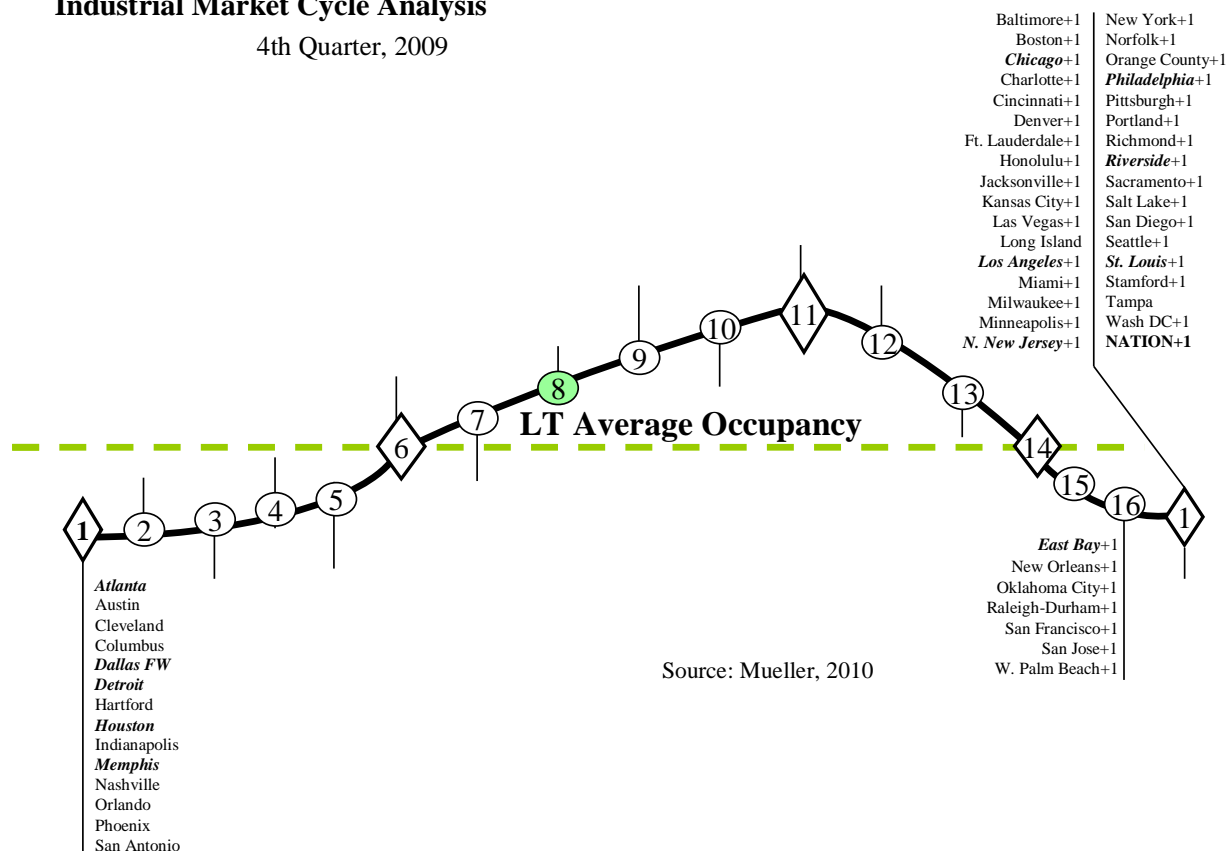
Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## INDUSTRIAL

Industrial occupancies declined 0.3% in 4Q09 which created a decline of 2.7% year-over-year. The national industrial vacancy hit 10.5% during the quarter. Negative absorption slowed to 14 million square feet in 4Q09. Some markets are seeing new demand as tenants look for great deals on rents. The economic growth in other countries and continued increase in the U.S. manufacturing index bodes well for industrial demand in 2010 and it should be the first property type to recover as new construction is at a 35-year low. Rents were down 2% for the fourth quarter and 8% year-over-year.

### Industrial Market Cycle Analysis

4th Quarter, 2009



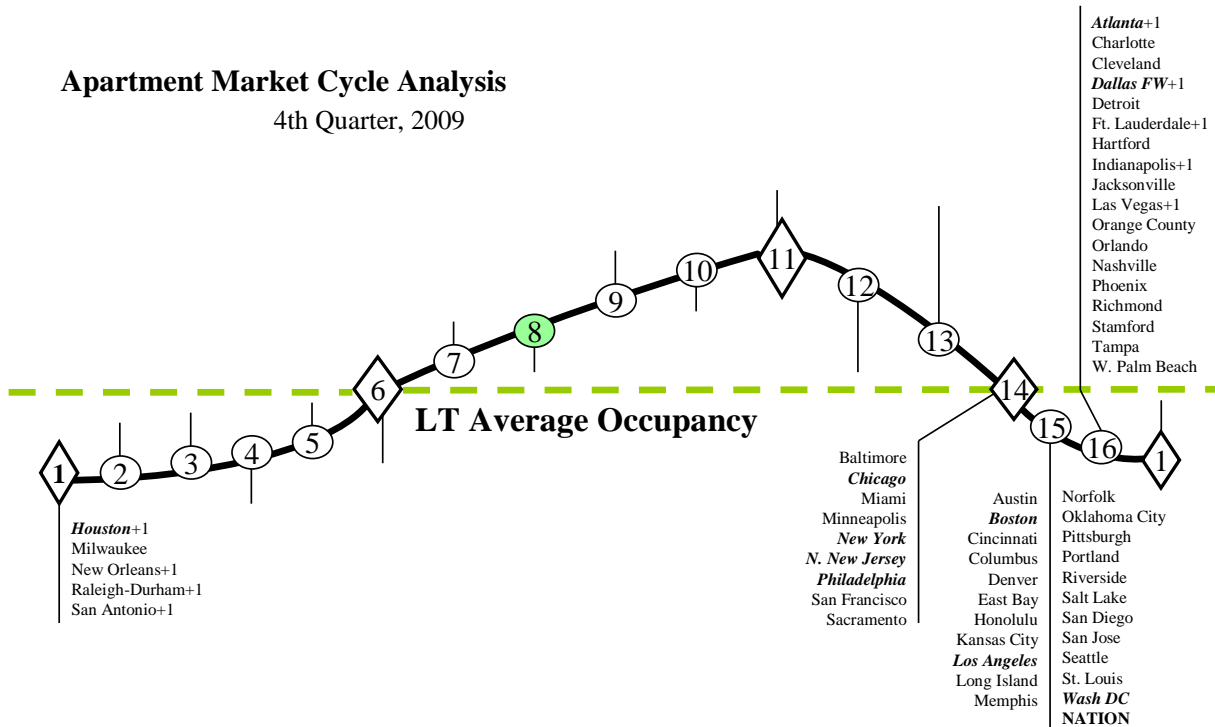
Source: Mueller, 2010

Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space we monitor. Thus, the 12-largest industrial markets are in **bold italic** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## APARTMENT

Apartment occupancy declined 0.3% in 4Q09, resulting in a 1.5% decline year-over-year. The extension of the first time home buyer credit into 2010 slowed home purchases and kept more people from moving out of their apartments. Even though financing apartments is the easiest of all the income-producing property types due to the quasi-government Fannie Mae, Freddie Mac and Ginnie Mae mortgage support, new supply is at the lowest level in 30 years. Rents were down 1.1% in 4Q09 and down 6.3% year-over-year.



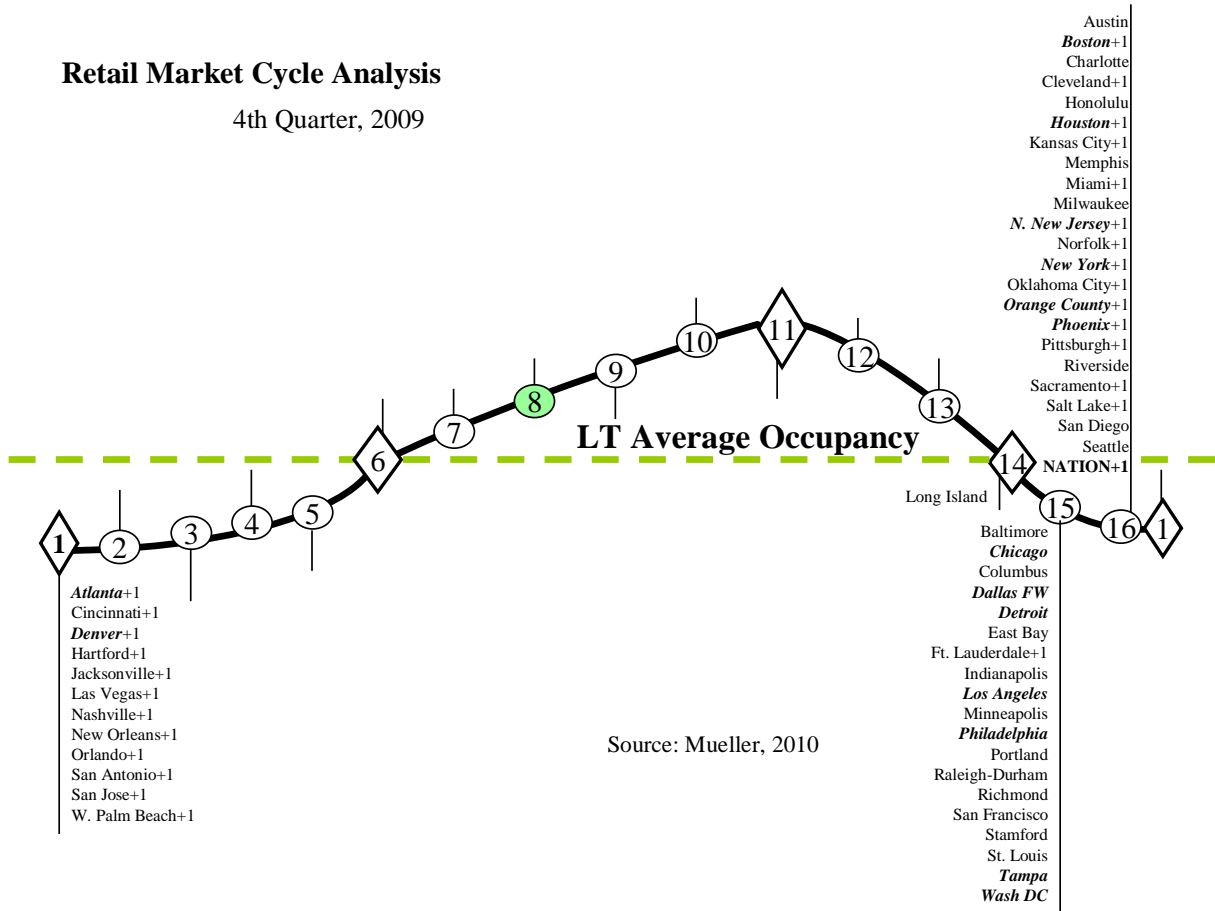
Source: Mueller, 2010

Note: The 10-largest apartment markets make up 50% of the total square footage of multifamily space we monitor. Thus, the 10-largest apartment markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## RETAIL

Retail occupancies declined 0.61% in 4Q09, resulting in a 4.6% decline year-over-year. Retail vacancy now stands at just over 19% nationally. The positive retail sales for Christmas were subsequently reflected in the strong 5.6% GDP growth for 4Q09. This helped to keep some retailers alive, and many retailers have reported better than expected year-end earnings. We expect to see the retail occupancy cycle bottom late in 2010. Most retail tenants are asking for rent relief so they can keep their doors open and most landlords are accommodating those requests. Rents were down 1.6% in 4Q09 and 8.2% year-over-year.



Note: The 15-largest retail markets make up 50% of the total square footage of retail space we monitor. Thus, the 15-largest retail markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

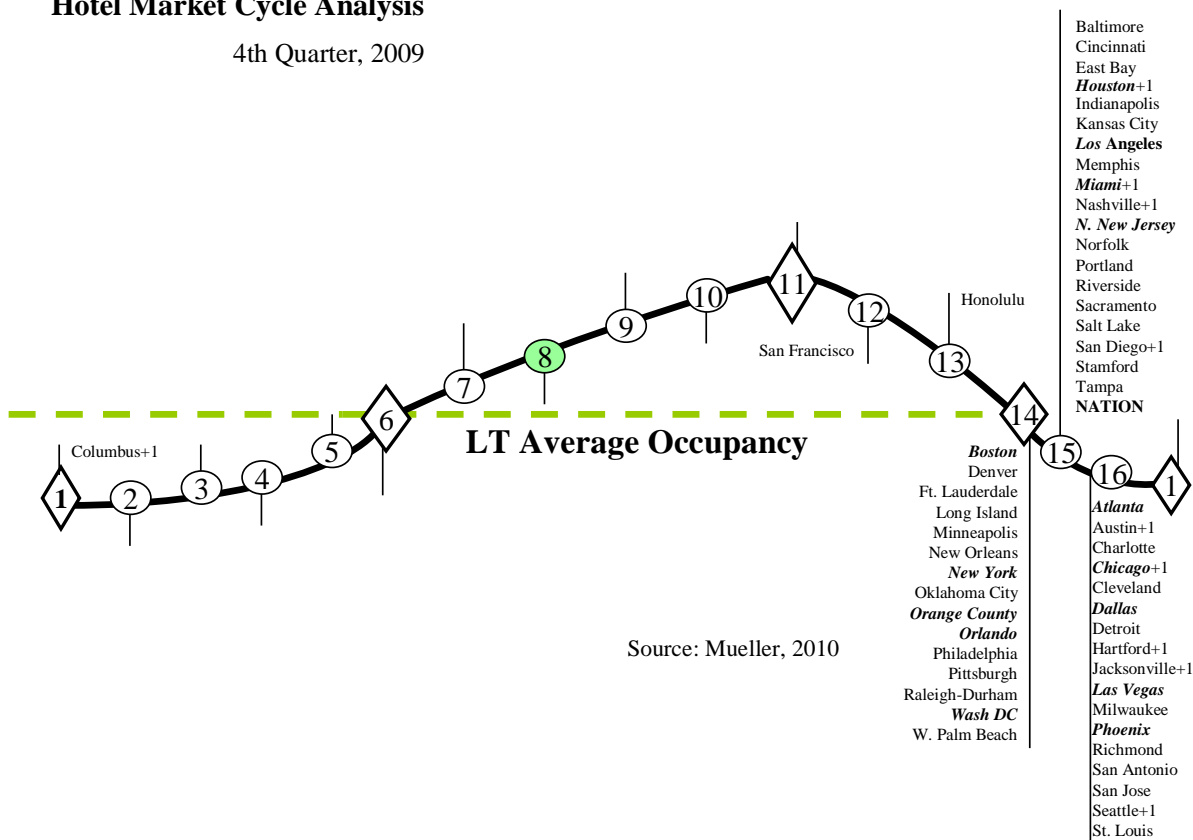
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## HOTEL

Hotel occupancies declined 0.5% in 4Q09 and 9.2% year-over-year. While they tried to hold room rates at higher levels, most hotels have been offering numerous discounts through every marketing channel they can find. Newly completed hotels are hurting existing business as well, but the supply completions are now slowing. Financing for hotels is next to impossible and some of the hotel REITs are working with “Angel Investors” who will take their profits after the recovery. As business picks up in 2010, hotel occupancy should start to improve late in the year. Hotel RevPAR declined 0.8% in 4Q09 and is down 9.1% year-over-year.

### Hotel Market Cycle Analysis

4th Quarter, 2009



Source: Mueller, 2010

Note: The 14-largest hotel markets make up 50% of the total square footage of hotel space that we monitor. Thus, the 14-largest hotel markets are in boldface italics to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

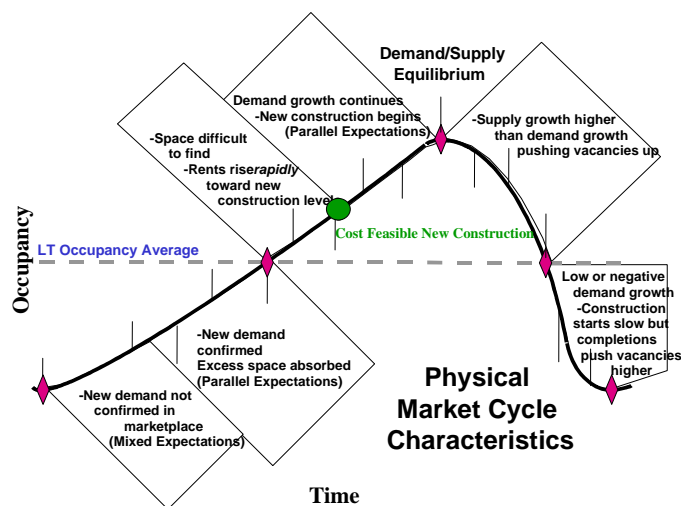
**MARKET CYCLE ANALYSIS — Explanation**

**Supply and demand interaction is important to understand. Starting in Recovery Phase I at the bottom of a cycle** (see chart below), the marketplace is in a state of oversupply from previous new construction or negative demand growth. At this bottom point, occupancy is at its trough. Typically, the market bottom occurs when the excess construction from the previous cycle stops. As the cycle bottom is passed, demand growth begins to slowly absorb the existing oversupply and supply growth is nonexistent or very low. As excess space is absorbed, vacancy rates fall, allowing rental rates in the market to stabilize and even begin to increase. As this recovery phase continues, positive expectations about the market allow landlords to increase rents at a slow pace (typically at or below inflation). Eventually, each local market reaches its *long-term occupancy average* whereby rental *growth is equal to inflation*.

**In Expansion Phase II, demand growth continues at increasing levels, creating a need for additional space.** As vacancy rates fall below the *long-term occupancy average*, signaling that supply is tightening in the marketplace, rents begin to rise rapidly until they reach a cost-feasible level that allows new construction to commence. In this period of tight supply, rapid rental growth can be experienced, which some observers call “rent spikes.” (Some developers may also begin speculative construction in anticipation of cost-feasible rents if they are able to obtain financing.) Once cost-feasible rents are achieved in the marketplace, demand growth is still ahead of supply growth — a lag in providing new space due to the time to construct. Long expansionary periods are possible and many historical real estate cycles show that the overall up-cycle is a slow, long-term uphill climb. As long as demand growth rates are higher than supply growth rates, vacancy rates will continue to fall. The cycle peak point is where demand and supply are growing at the same rate *or equilibrium*. Before equilibrium, demand grows faster than supply; after equilibrium, supply grows faster than demand.

**Hypersupply Phase III of the real estate cycle commences after the peak/equilibrium point #11 — where demand growth equals supply growth.** Most real estate participants do not recognize this peak/equilibrium’s passing, as occupancy rates are at their highest and well above long-term averages, a strong and tight market. During Phase III, supply growth is higher than demand growth (hypersupply), causing vacancy rates to rise back toward the long-term occupancy average. While there is no painful oversupply during this period, new supply completions compete for tenants in the marketplace. As more space is delivered to the market, rental growth slows. Eventually, market participants realize that the market has turned down and commitments to new construction should slow or stop. If new supply grows faster than demand once the long-term occupancy average is passed, the market falls into Phase IV.

**Recession Phase IV begins as the market moves past the long-term occupancy average with high supply growth and low or negative demand growth.** The extent of the market down-cycle will be determined by the difference (excess) between the market supply growth and demand growth. Massive oversupply, coupled with negative demand growth (that started when the market passed through long-term occupancy average in 1984), sent most U.S. office markets into the largest down-cycle ever experienced. During Phase IV, landlords realize that they will quickly lose market share if their rental rates are not competitive; they then lower rents to capture tenants, even if only to cover their buildings’ fixed expenses. Market liquidity is also low or nonexistent in this phase, as the bid-ask spread in property prices is too wide. The cycle eventually reaches bottom as new construction and completions cease, or as demand growth turns up and begins to grow at rates higher than that of new supply added to the marketplace.



Source: Mueller, Real Estate Finance, 1995

This Research currently monitors five property types in more than 50 major markets. We gather data from numerous sources to evaluate and forecast market movements. The market cycle model we developed looks at the interaction of supply and demand to estimate future vacancy and rental rates. Our individual market models are combined to create a national average model for all U.S. markets. This model examines the current cycle locations for each property type and can be used for asset allocation and acquisition decisions.

## Important Disclosures and Certifications

**I, Glenn R. Mueller, Ph.D. certify that the opinions and forecasts expressed in this research report accurately reflect my personal views about the subjects discussed herein; and I, Glenn R. Mueller, certify that no part of my compensation from any source was, is, or will be directly or indirectly related to the content of this research report.**

The information contained this report: (i) has been prepared or received from sources believed to be reliable but is not guaranteed; (ii) is not a complete summary or statement of all available data; (iii) is not an offer or recommendation to buy or sell any particular securities; and (iv) is not an offer to buy or sell any securities in the markets or sectors discussed in the report.

The opinions and forecasts expressed in this report are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Any opinions or forecasts in this report are not guarantees of how markets, sectors or individual securities or issuers will perform in the future, and the actual future performance of such markets, sectors or individual securities or issuers may differ. Further, any forecasts in this report have not been based on information received directly from issuers of securities in the sectors or markets discussed in the report.

Dr. Mueller serves as a Real Estate Investment Strategist with Dividend Capital Group. In this role, he provides investment advice to Dividend Capital Group and its affiliates regarding the real estate market and the various sectors within that market. Mr. Mueller's compensation from Dividend Capital Group and its affiliates is not based on the performance of any investment advisory client of Dividend Capital Group or its affiliates.

Dividend Capital Group is a real estate investment management company that focuses on creating institutional-quality real estate financial products for individual and institutional investors. Dividend Capital Group and its affiliates also provide investment management services and advice to various investment companies, real estate investment trusts, and other advisory clients about the real estate markets and sectors, including specific securities within these markets and sectors.

Investment advisory clients of Dividend Capital Group or its affiliates may from time to time invest a significant portion of their assets in the securities of companies primarily engaged in the real estate industry, such as real estate investment trusts, or in real estate itself, and may have investment strategies that focus on specific real estate markets, sectors and regions. Real estate investments purchased or sold based on the information in this research report could indirectly benefit these clients by increasing the value of their portfolio holdings, which in turn would increase the amount of advisory fees that these clients pay to Dividend Capital Group or its affiliates.

Dividend Capital Group and its affiliates (including their respective officers, directors and employees) may at times: (i) release written or oral commentary, technical analysis or trading strategies that differ from or contradict the opinions and forecasts expressed in this report; (ii) invest for their own accounts in a manner contrary to or different from the opinions and forecasts expressed in this report; and (iii) have long or short positions in securities or in options or other derivative instruments based thereon. Furthermore, Dividend Capital Group and its affiliates may make recommendations to, or effect transactions on behalf of, their advisory clients in a manner contrary to or different from the opinions and forecasts in this report. Real estate investments purchased or sold based on the information in this report could indirectly benefit Dividend Capital Group, its affiliates, or their respective officers, employees and directors by increasing the value of their proprietary or personal portfolio holdings.

Dr. Mueller may from time to time have personal investments in real estate, in securities of issuers in the markets or sectors discussed in this report, or in investment companies or other investment vehicles that invest in real estate and the real estate securities markets (including investment companies and other investment vehicles for which Dividend Capital Group or an affiliate serves as investment adviser). Real estate investments purchased or sold based on the information in this report could directly benefit Dr. Mueller by increasing the value of his personal investments.