



# Cycle Monitor — Real Estate Market Cycles

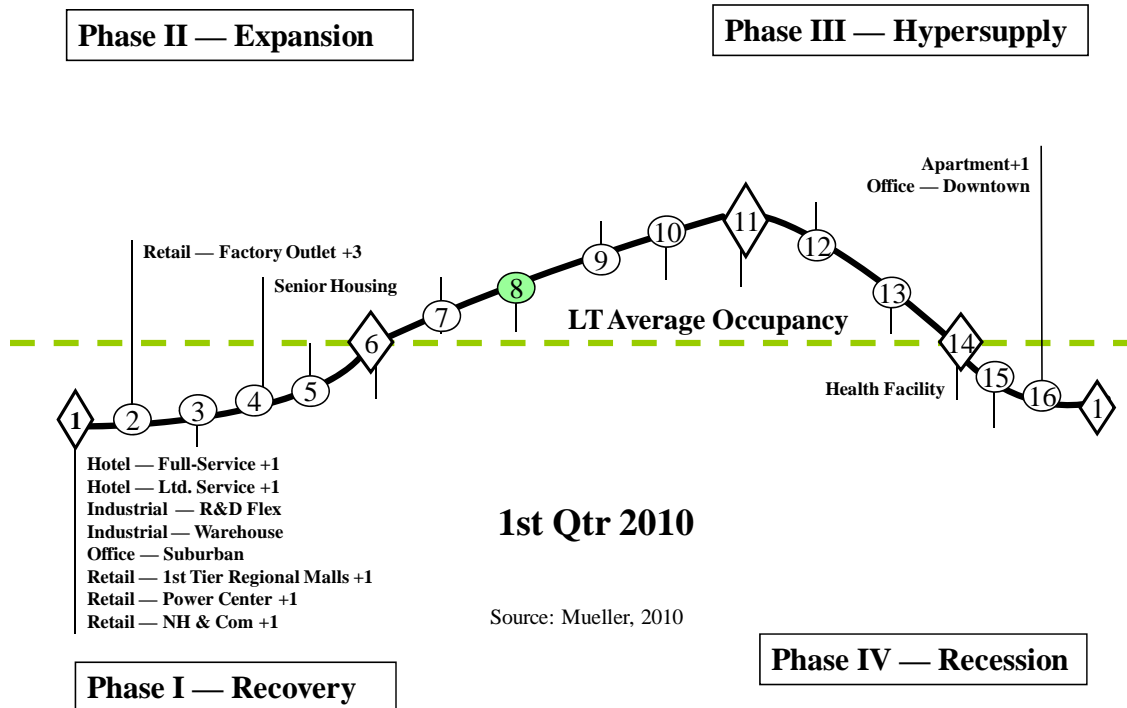
First Quarter 2010 Analysis  
May 2010

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

GDP growth was positive for the third consecutive quarter and employment declines stopped at the end of 1Q10 as job growth has resumed. These positive economic indicators normally precede the bottom of the real estate occupancy cycle by one to three quarters for the different property types. Thus our models forecast the bottom of each property type and the ensuing recovery in this issue, with hotels leading the way.

Office occupancies declined 0.2% in 1Q10 and rents declined by 1.4% for the quarter, resulting in a 7.0% annual decline. Industrial occupancies declined 0.2% in 1Q10 and rental growth fell 1.5% for the quarter and 8.5% annually. Apartment occupancy declined 0.0% in 1Q10 and rental growth declined 0.7% for the quarter and 5.2% annually. Retail occupancy declined 0.3% in 1Q10 and rental growth fell 0.9% for the quarter and 7.0% annually. Hotel occupancies INCREASED 0.4% in 1Q10, and RevPAR declined 7.6% for the quarter and 5.2% annually.

## National Property Type Cycle Locations



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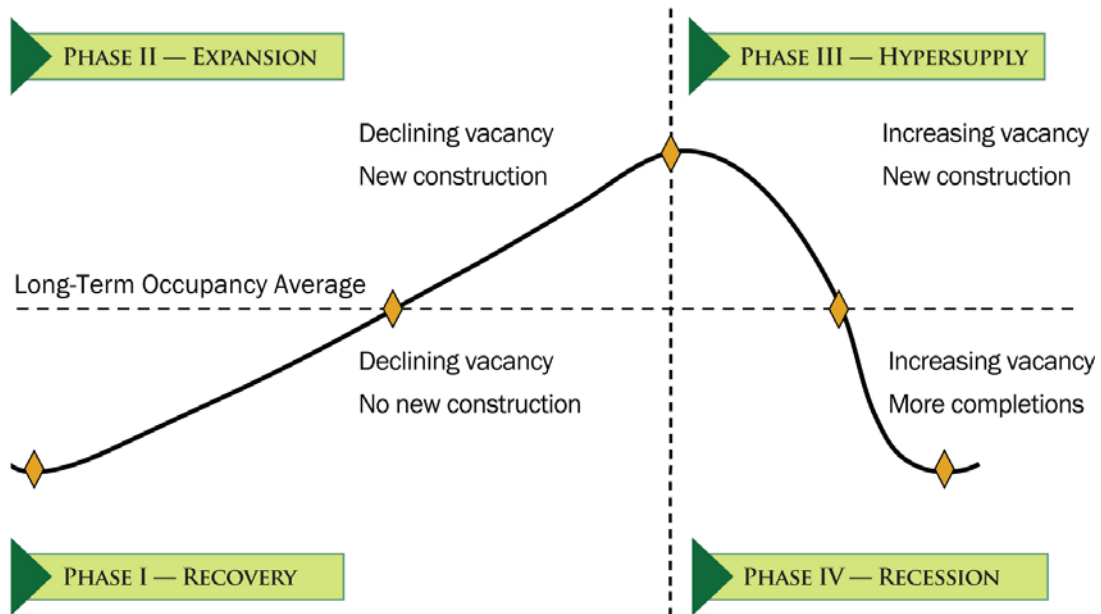
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All relevant disclosures and certifications appear on page 9 of this report.

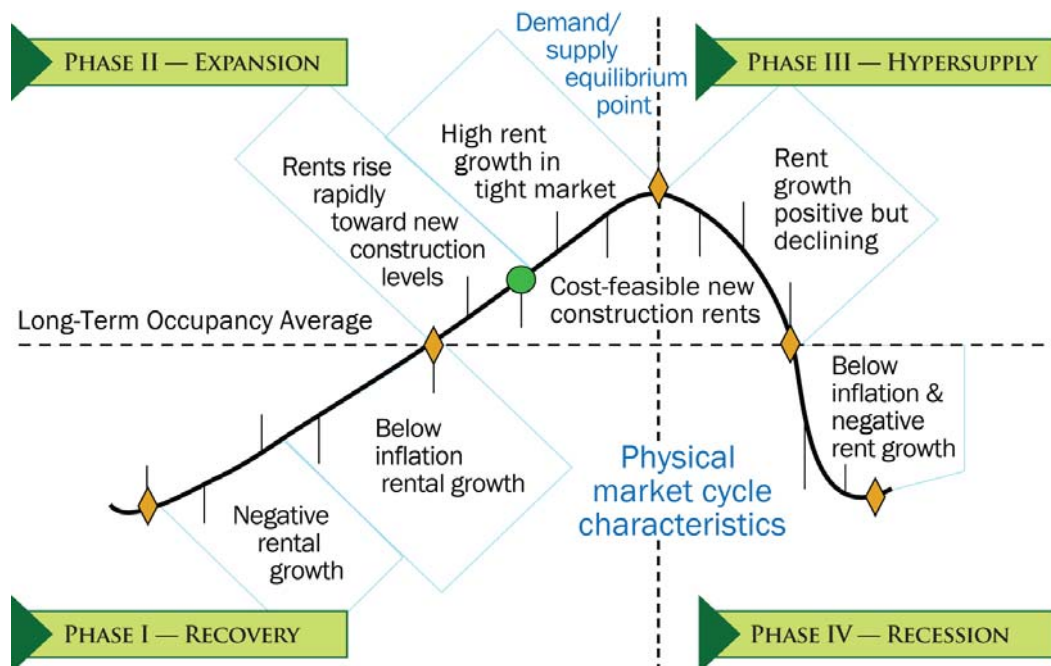
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that 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.



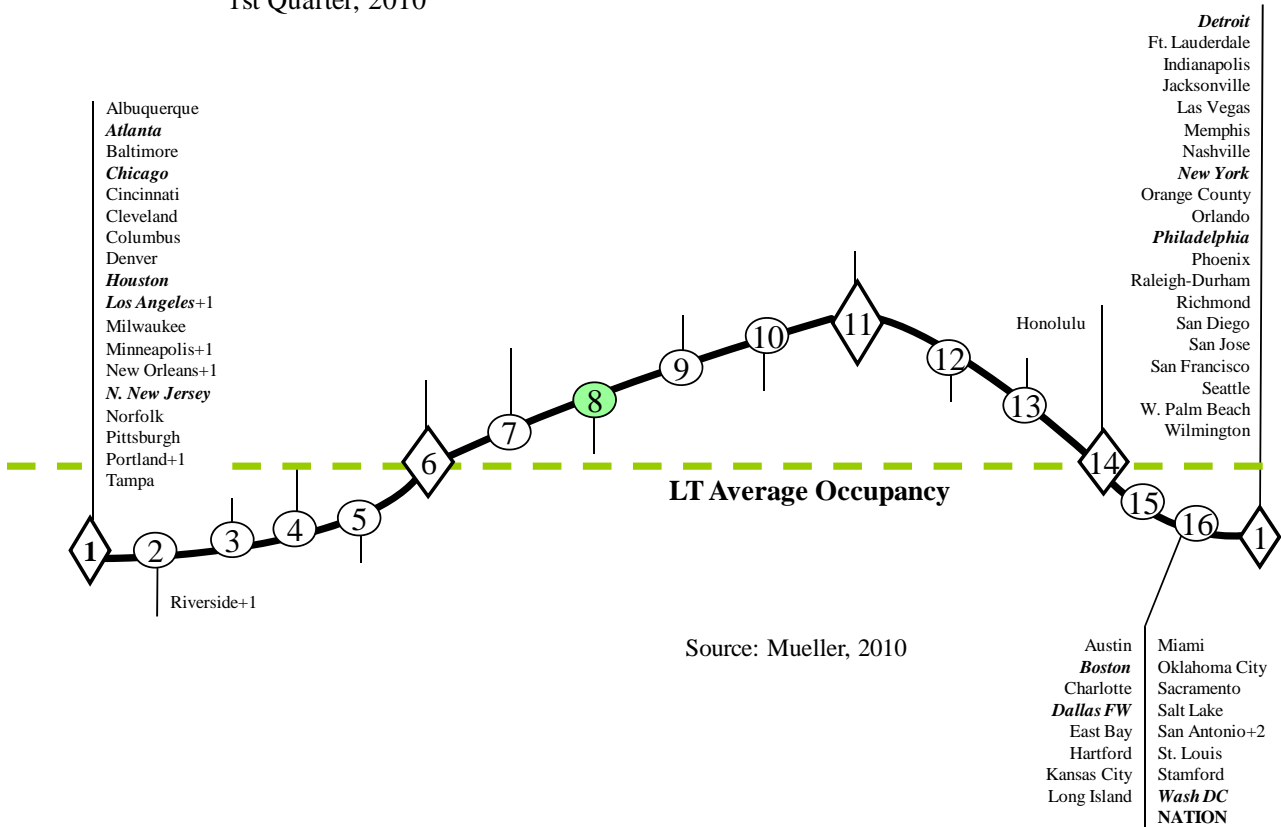
Source: Mueller. *Real Estate Finance*. 1995

## OFFICE

The national office market occupancy level declined 0.2% in 1Q10, which resulted in a 2.0% year-over-year decline. Our models now show that occupancy should bottom in 2Q10 and then start to rise in 3Q10. New construction is running at a rate of 0.5%, which is the lowest level in 14 years. The amount of sub-lease space available is also declining. We also hear that Class-A space landlords, in the largest primary markets, are lowering their concession packages. Rents declined 1.4% in 1Q10 and were down more than 7.0% year-over-year. We do not expect to see rents rise until 2011.

### Office Market Cycle Analysis

1st Quarter, 2010



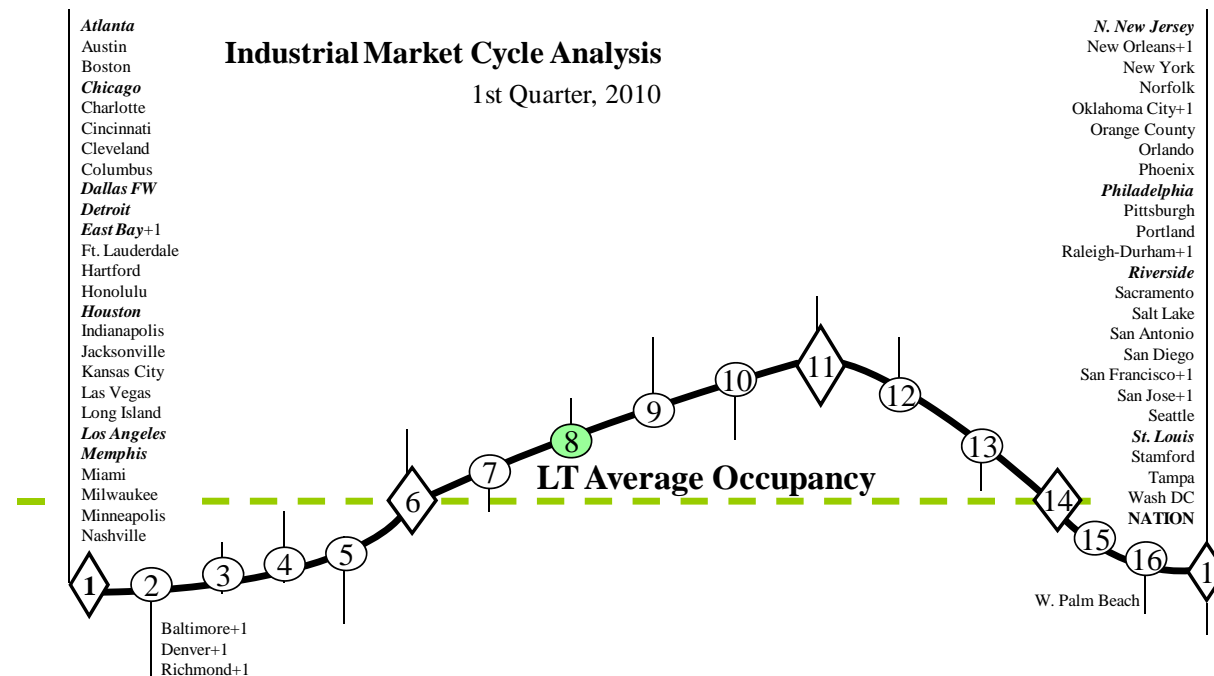
Source: Mueller, 2010

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 0.2% in 1Q10 which resulted in a 2.0% decline year-over-year. Our models show 1Q10 as the bottom of the occupancy cycle and we expect to see improvement begin next quarter. All the industrial demand indicators have been improving over the past six months — rail car load volume up 6%; intermodal shipping up 8%; truckload volume up 5% — which was driven partially by a 2.0% increase in retail sales and the Institute for Supply Management (ISM) manufacturing index running 16.0% over its long-term average. Industrial rents were down 1.5% for 1Q10 and 8.5% year-over-year.



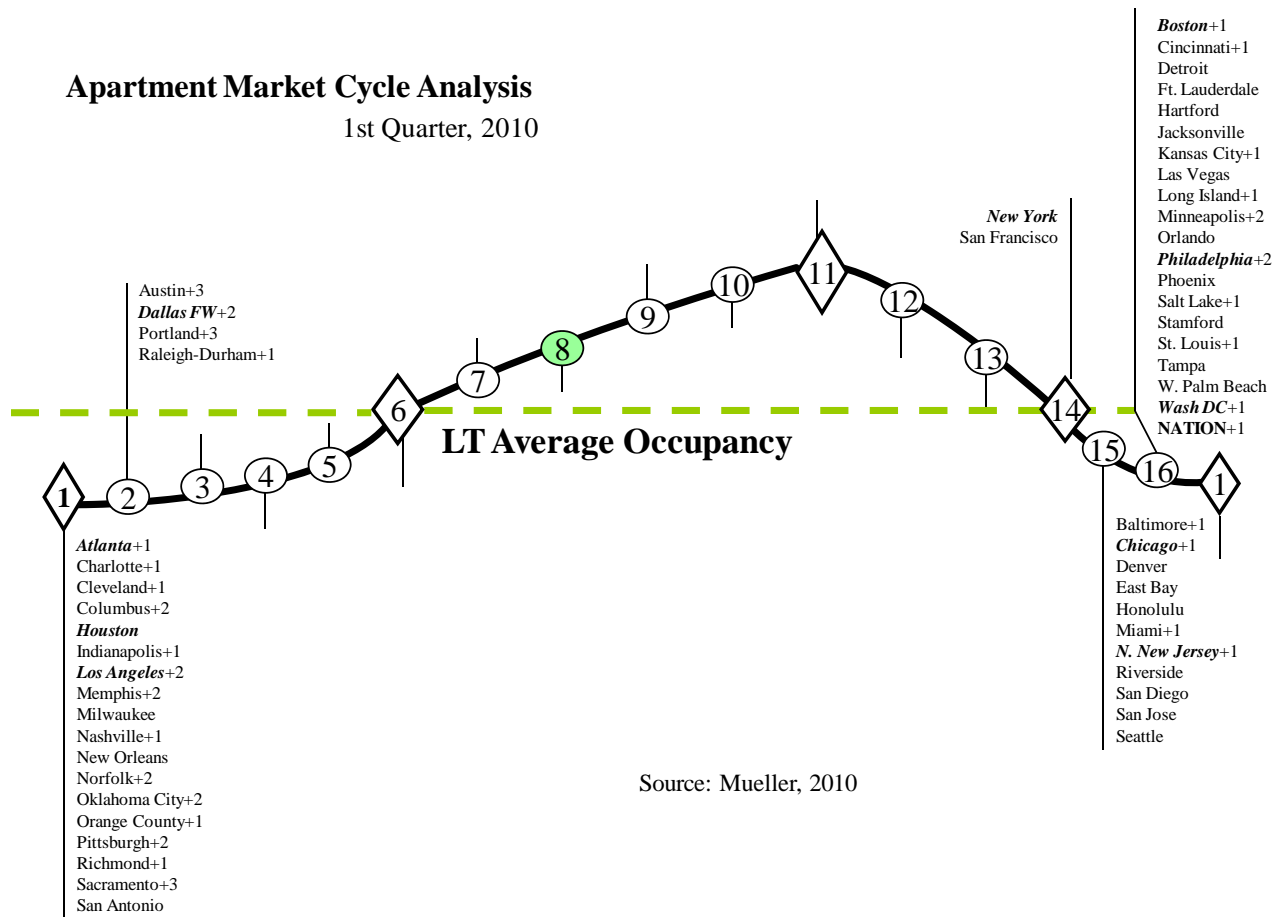
Source: Mueller, 2010

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

The apartment occupancy national average was flat in 1Q10 and down 0.6% year-over-year. The first time home buyer credit did not create as many occupant losses as expected. New apartment completions stayed at their 30-year low, keeping supply in check. Our model shows apartment occupancies staying at this bottom level through 3Q10 and then beginning to increase in 4Q10. The upside surprise would be from college graduates getting more jobs than expected, in which case 3Q10 could see an upturn in occupancy. Rents were down 0.7% in 1Q10 and down 5.2% year-over-year.

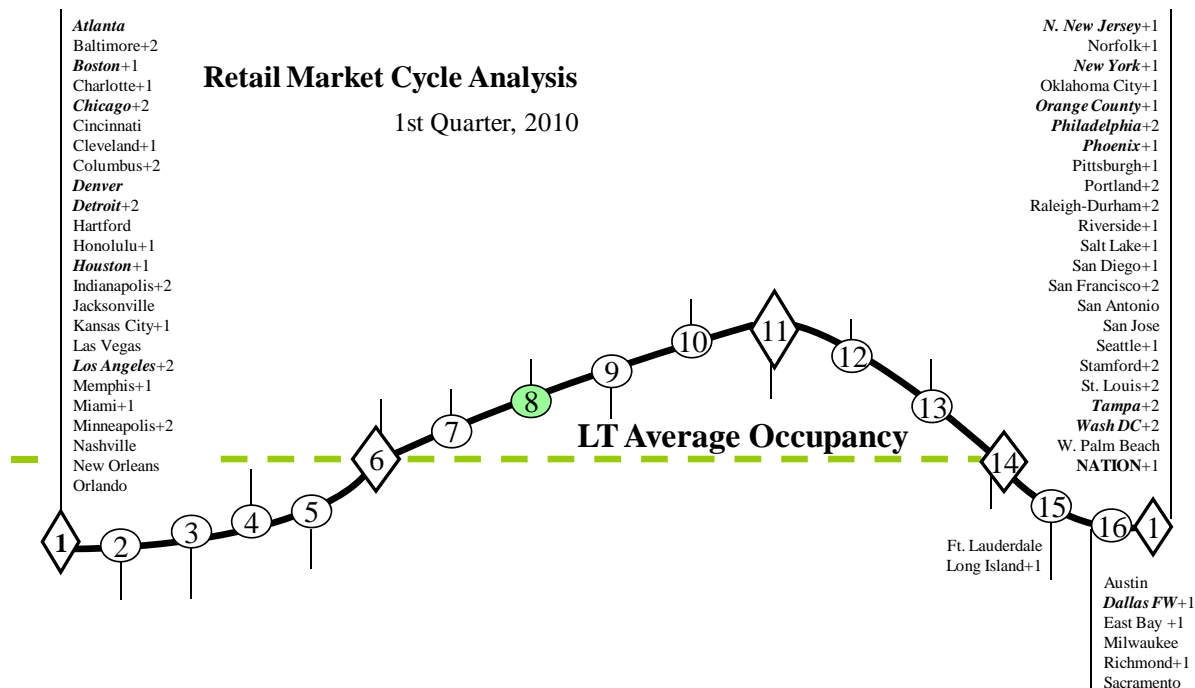


Note: The 10-largest apartment markets make up 50% of the total square footage of multifamily space we monitor. Thus, the 10-largest apartment markets are in **bold italic** type to help distinguish how the weighted national average is affected.

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 0.3% in 1Q10, resulting in a 3.2% decline year-over-year. Our models show retail occupancy bottoming in 1Q10 and we expect to see minor improvement in 2Q10 — due mainly to two months of positive job increases so far in 2Q10 and stock market levels that make people feel wealthy again. Some retailers have started to expand, already creating some new demand while new supply is at very low levels. Rents were down 0.9% in 1Q10 and down 7.0% year-over-year.



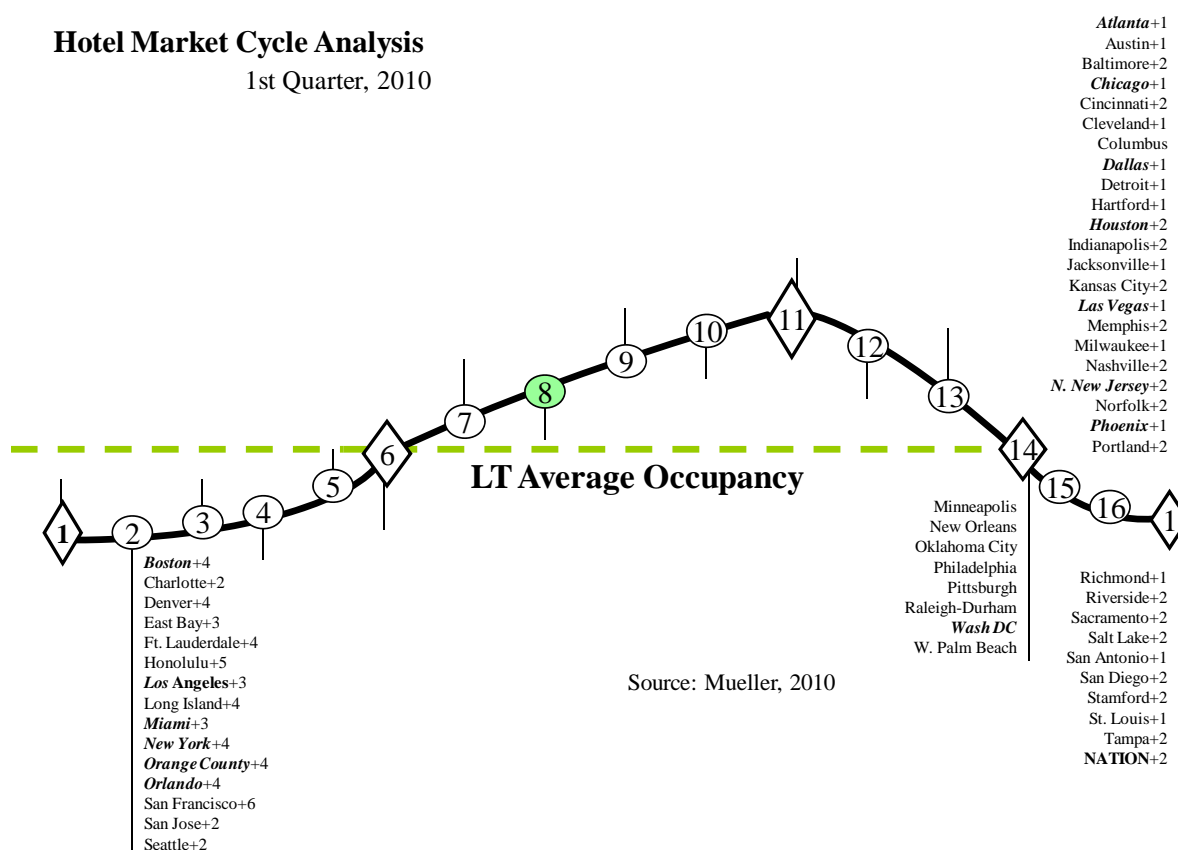
Source: Mueller, 2010

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 improved a moderate 0.4% in 1Q10 but were down 3.5% year-over-year. Tourist travel had a modest rebound in 1Q10 but may be subdued this summer due to higher airfares. Business travel has had a moderate 2.0% increase from low levels, but most corporate budgets are still tight. Our model shows that the hotel recovery has started, but should only have moderate increases over the rest of 2010. Hotel RevPAR declined 7.6% in 1Q10 and is down 5.2% year-over-year.



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.

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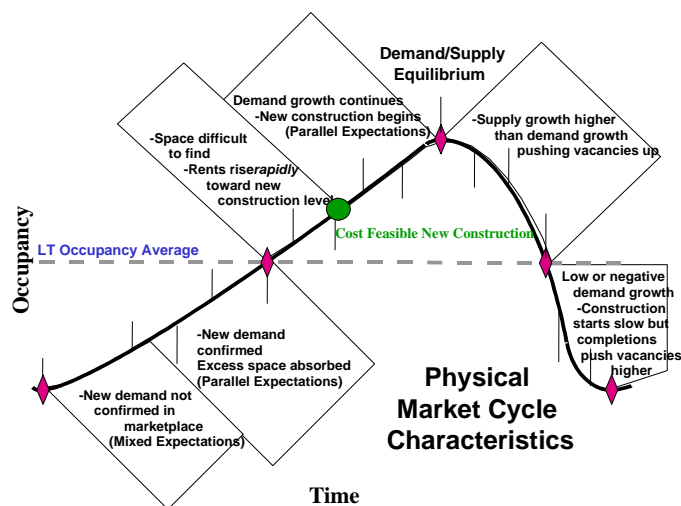
**MARKET CYCLE ANALYSIS — Explanation**

**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.

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