



# Cycle Monitor — Real Estate Market Cycles

Second Quarter 2009 Analysis  
August 2009

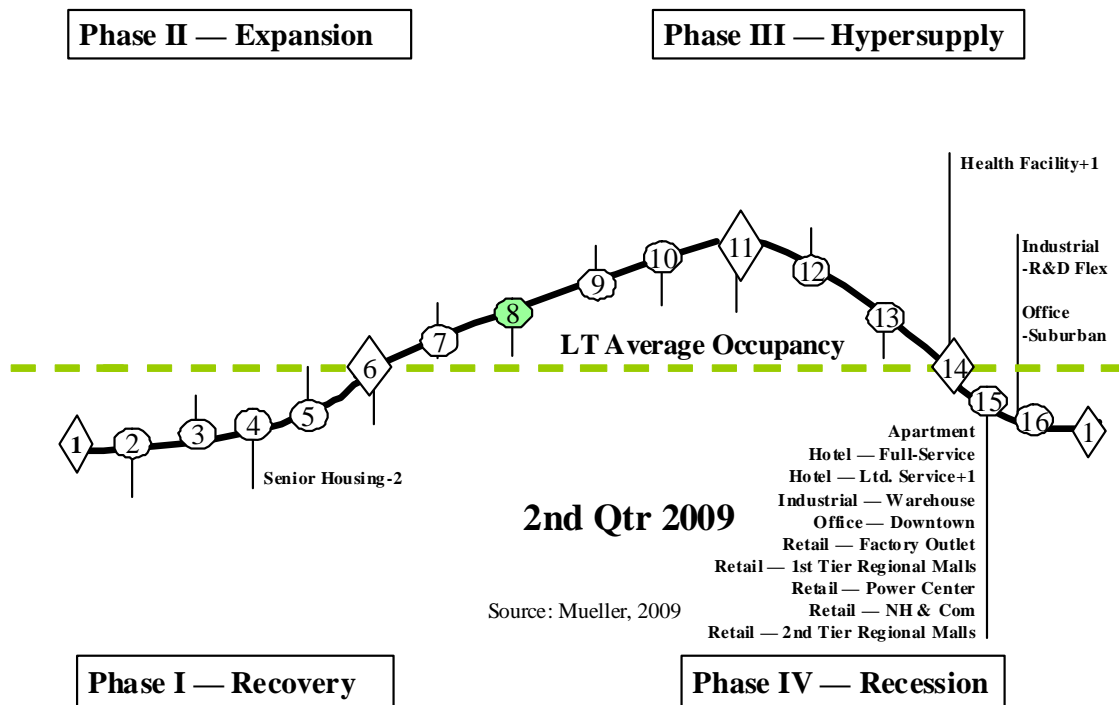
## Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.

Commercial real estate cycles follow, but lag, economic cycles. The most recent economic indicators predict positive GDP growth in 3Q09 then slow employment growth beginning in 2010. These two fundamentals indicate that the five real estate property type occupancy cycles should continue to decline in 2009 and start to recover some time in 2010 or 2011. Our *Market Cycle Forecast* report predicts the future cycle bottoms of all five property types.

Office occupancies declined 0.5% in 2Q09 and rents declined by 2% in the first quarter, producing a 5% annual decline. Industrial occupancies declined 1% in 2Q09 and rental growth fell 1.8% for the quarter and 6% annually. Apartment occupancy declined 0.6% in 2Q09 and rental growth declined 1.5% for the quarter and 3.8% annually. Retail occupancy declined 1.4% in 2Q09 and rental growth fell 1.8% for the quarter and 4.6% annually. Hotel occupancies declined 2.1% in 2Q09, but RevPAR rose 3% for the quarter, while still declining 20% annually.

The National Property Type Cycle graph shows positions of most sub-property types, major markets are reviewed inside.

## National Property Type Cycle Locations



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

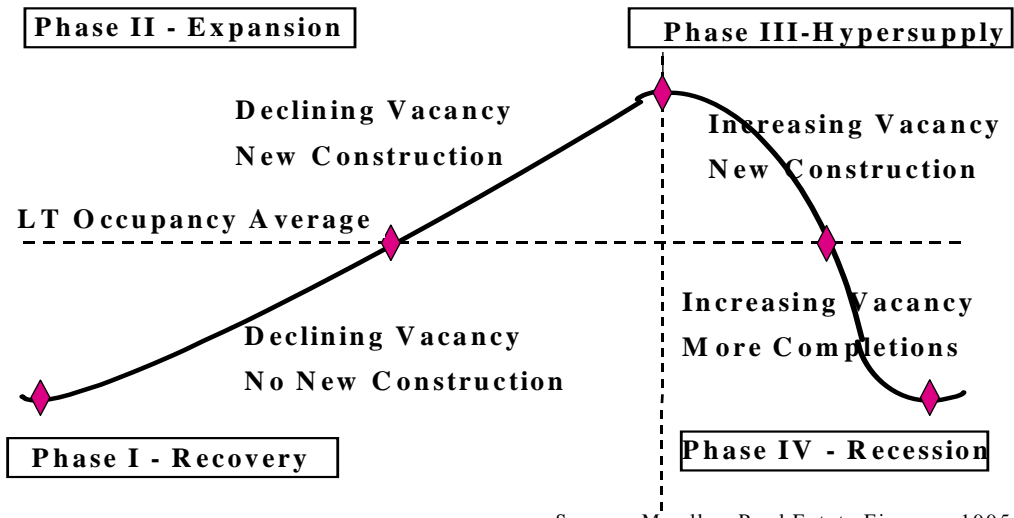
Dividend Capital Research, 518 17<sup>th</sup> Street, 17<sup>th</sup> Floor, Denver, CO 80202

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

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

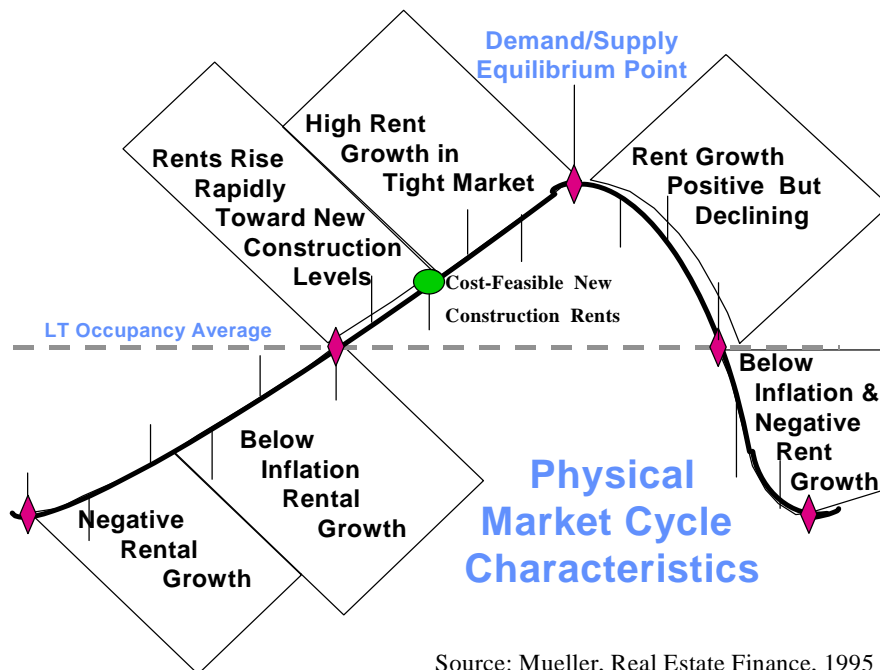
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that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

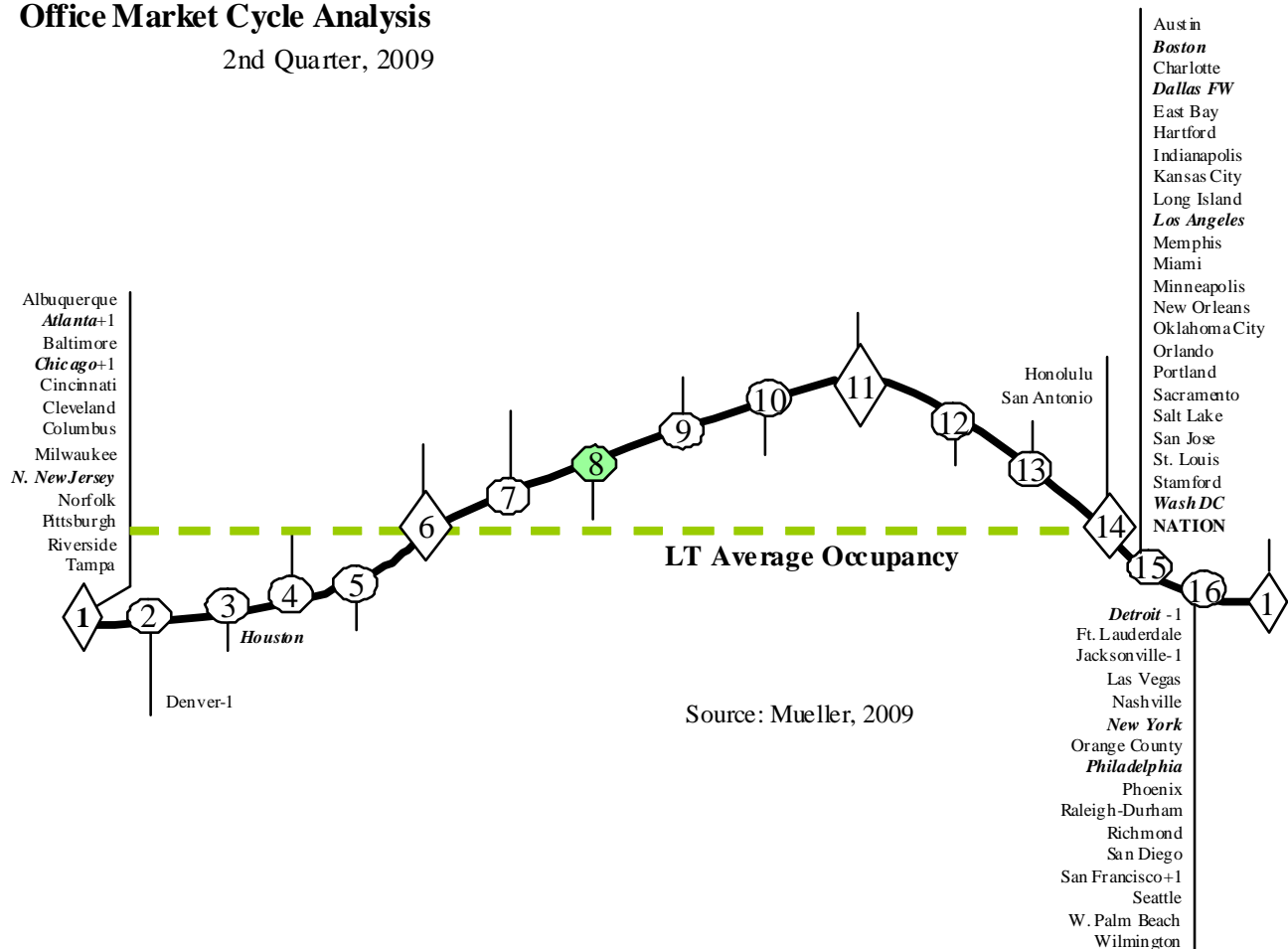


Source: Mueller, Real Estate Finance, 1995

## OFFICE

The national office market occupancy level declined 0.9% in 2Q09, which resulted in a 2.5% year-over-year decline. An additional 10 markets now have vacancy rates above 20%, bringing the total to 18. Job losses continue to slow down each month, but are still large. Net negative absorption was over 19 million square feet in 2Q09. Occupancy declines of more than 1% were seen in 14 markets this quarter. Construction dropped to its lowest level since 2001, which should help when the recovery starts. Rents declined 2% in 2Q09 and were down more than 5% year-over-year. The expected positive GDP growth in 3Q09 could translate into a recovery in late 2010 for office.

### Office Market Cycle Analysis 2nd 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.

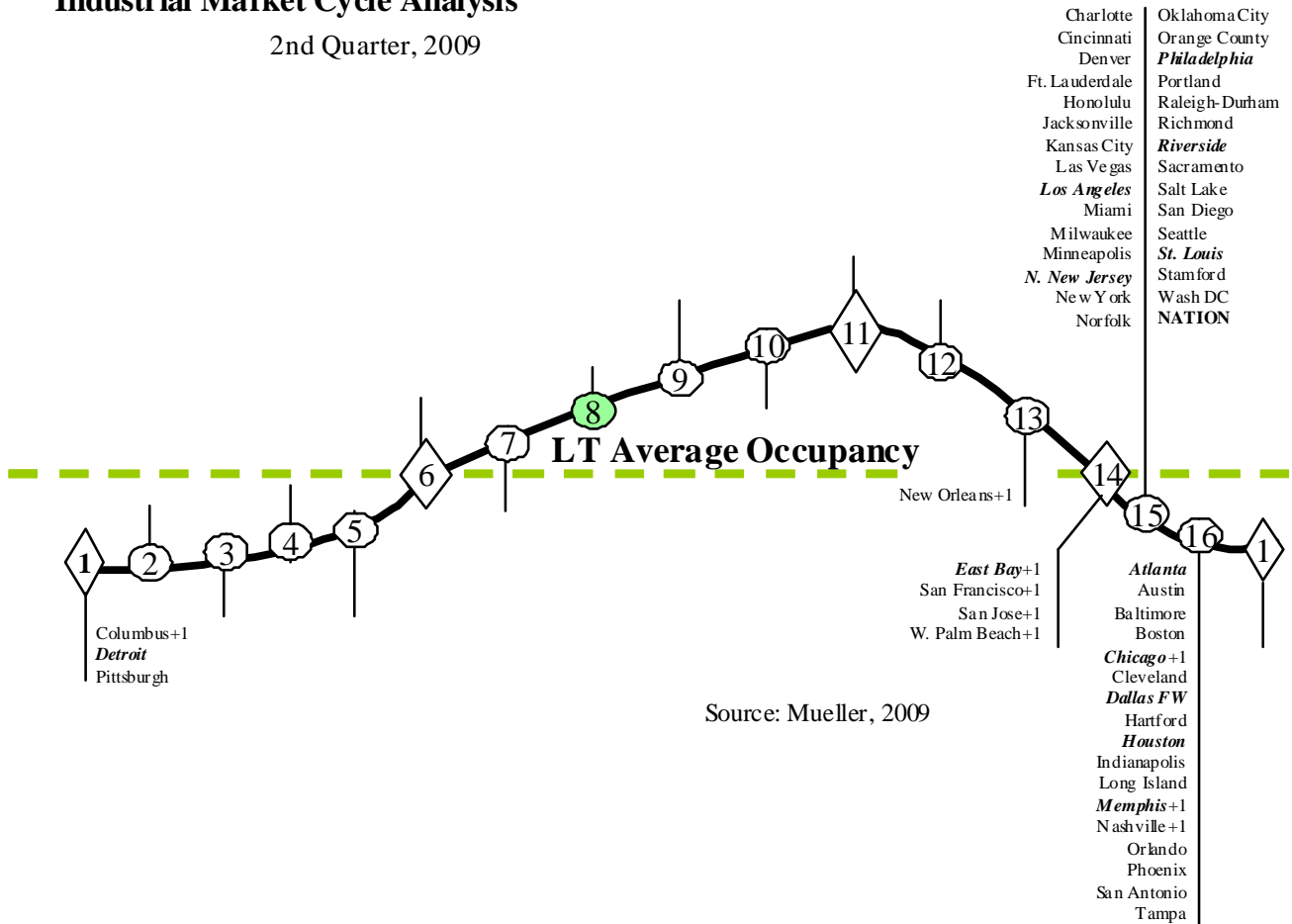
Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 1% in 2Q09 — the largest decline in eight years — creating a decline of 2.5% year-over-year. The net negative absorption of 43 million square feet was led by the declines of Northern and Central New Jersey and Atlanta. However, twelve markets saw positive absorption — led by Denver and followed by other energy and alternative energy industry markets. New construction has now dropped nationally to the lowest rate since the early 1990s. Now that industrial orders have turned up in 2009, we expect to see industrial space occupancy bottom in 4Q09 and begin its recovery in 2010. Rents were down 1.8% for the quarter and 6% year-over-year. Lots of free rent and other concessions are driving effective rents down even further.

### Industrial Market Cycle Analysis

2nd Quarter, 2009



Source: Mueller, 2009

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.

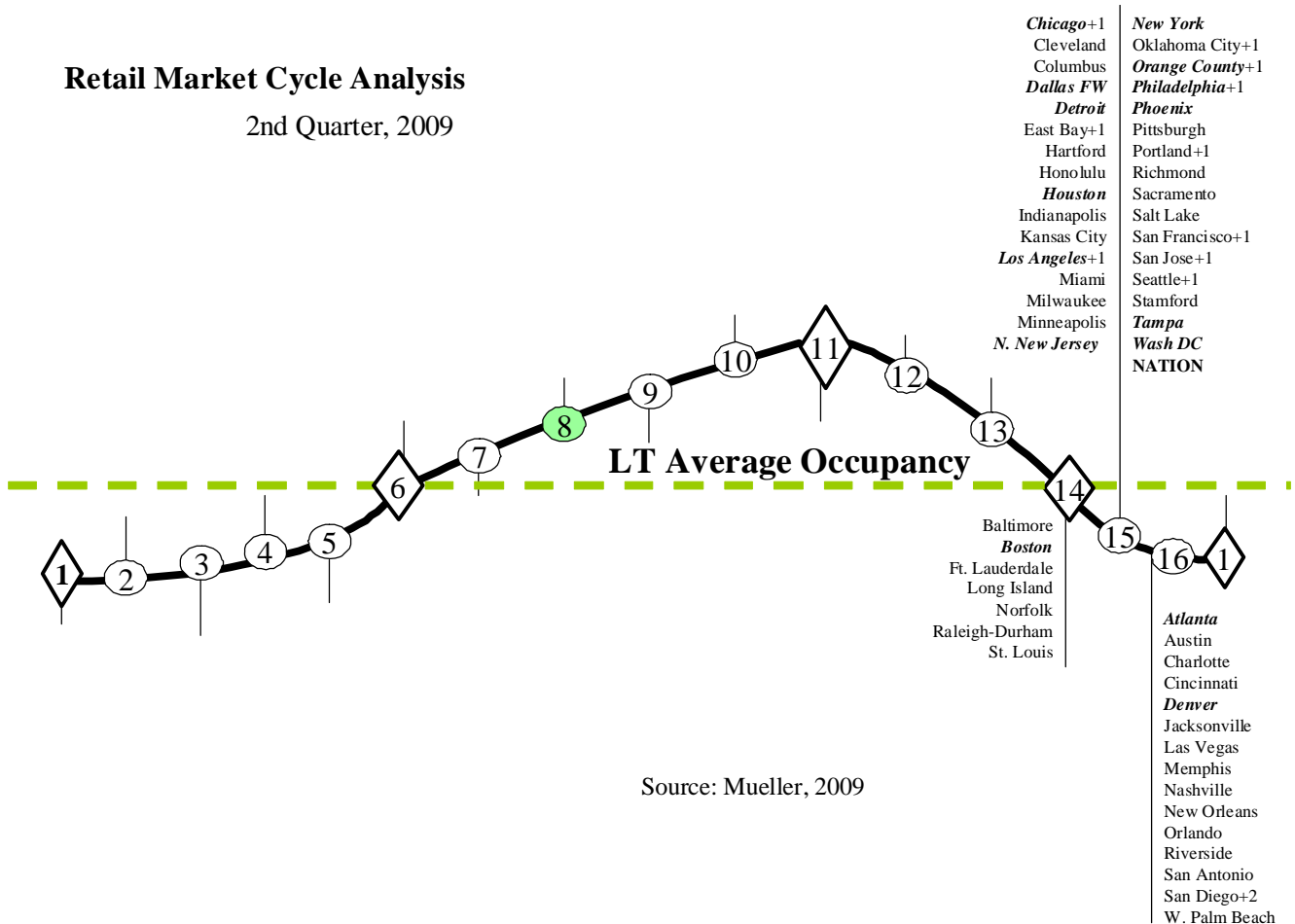


## RETAIL

Retail occupancies declined 1.4% in 2Q09, producing a 4.7% decline year-over-year. Retail net absorption continues to be strongly negative because of retailer bankruptcies and fewer retail renewals. We estimate occupancies should decline an additional 1.8% in 2009 and continue to decline the first half of 2010. Retail sales were down 8.3% through July 2009 according to the Census Bureau. Discount retailers such as WalMart and grocery stores are the only bright spot on the retail map. The latest CPI numbers show that retail prices for almost all goods have declined in 2009 — even basic commodities such as food have experienced lower prices. Rent concessions and average time to lease space continue to increase, creating a difficult environment for all retail landlords. Rents were down 1.8% in 2Q09 and 4.6% year-over-year. We expect occupancies to decline another 1.8% in 2009, which should cause rents to decline about 8% in 2009.

### Retail Market Cycle Analysis

2nd Quarter, 2009



Source: Mueller, 2009

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.

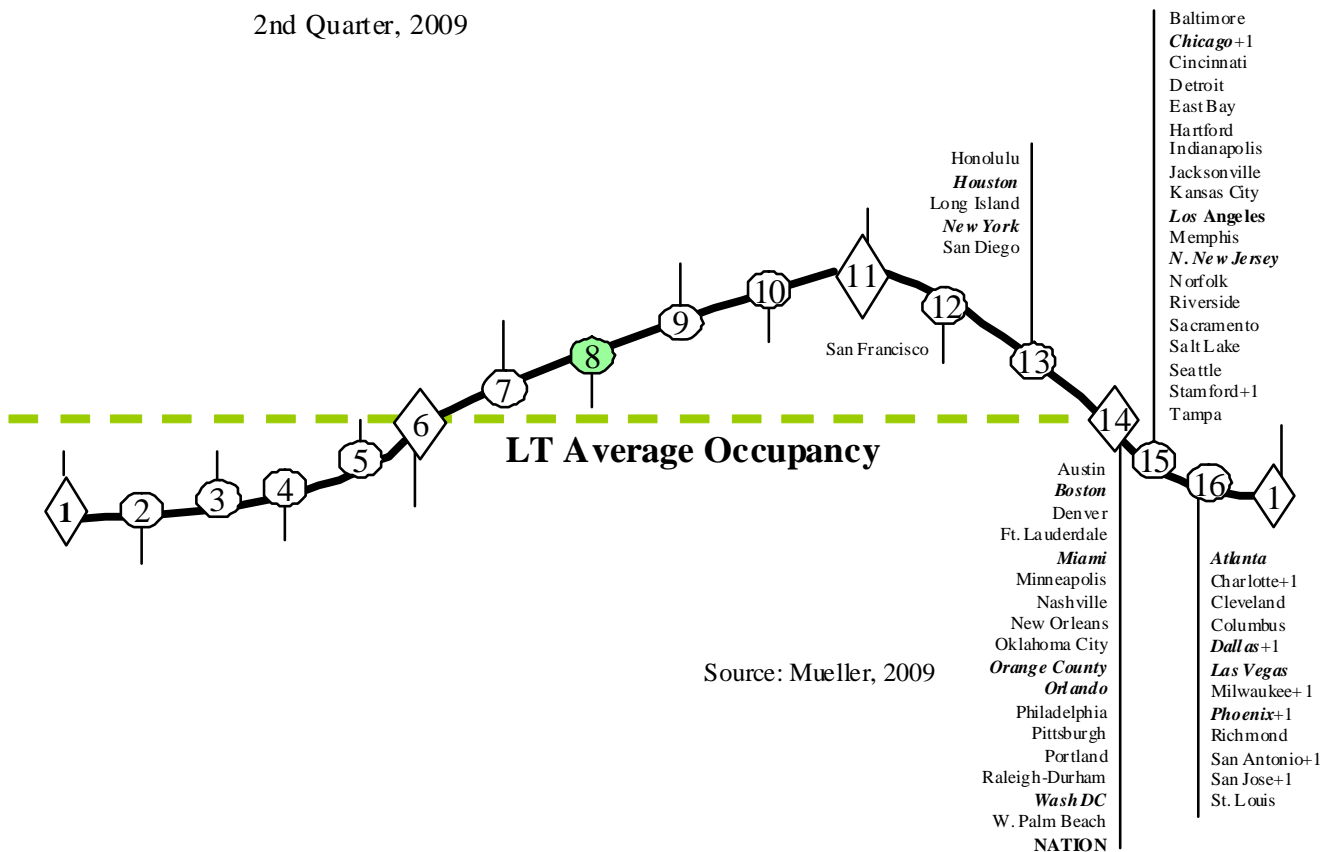
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 2.1% in 2Q09 and 5.5% year-over-year. Summer vacation bookings were down substantially and business travel always softens in the summer as well. The national average occupancy level stands at 60%, which is **below break-even occupancy level** for hotels. The remainder of 2009 looks worse, with occupancies dropping further to about 56%. RevPAR growth improved 3% for the quarter as hotels changed their strategy and decided to hold and increase room rates instead of dropping rates to try to increase occupancy. We estimate occupancies could drop another 3.5% during the second half of 2009, and overall RevPAR for 2009 could be down as much as 20% for the calendar year.

### Hotel Market Cycle Analysis

2nd Quarter, 2009



Source: Mueller, 2009

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.

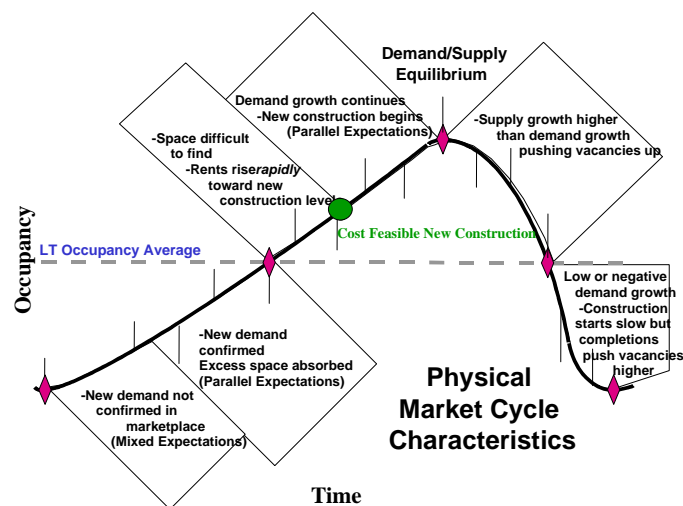
### MARKET CYCLE ANALYSIS — Explanation

**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.

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