



Cycle Monitor — Real Estate Market Cycles

Third Quarter 2009 Analysis
November 2009

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

The good news is that U.S. GDP growth was positive in 3Q09 — even if half the amount came from the government’s cash for clunkers auto program. The bad news is that job losses continue and are not expected to turn positive until the second half of 2010 (another jobless recovery). Labor productivity hit a cyclical high, which means employers may have to start hiring soon — and employment is where demand for commercial real estate comes from.

Office occupancies declined 0.8% in 3Q09 and rents declined by 2.1% in the third quarter, producing a 7.5% annual decline.

Industrial occupancies declined 0.8% in 3Q09 and rental growth fell 2% for the quarter and 8% annually.

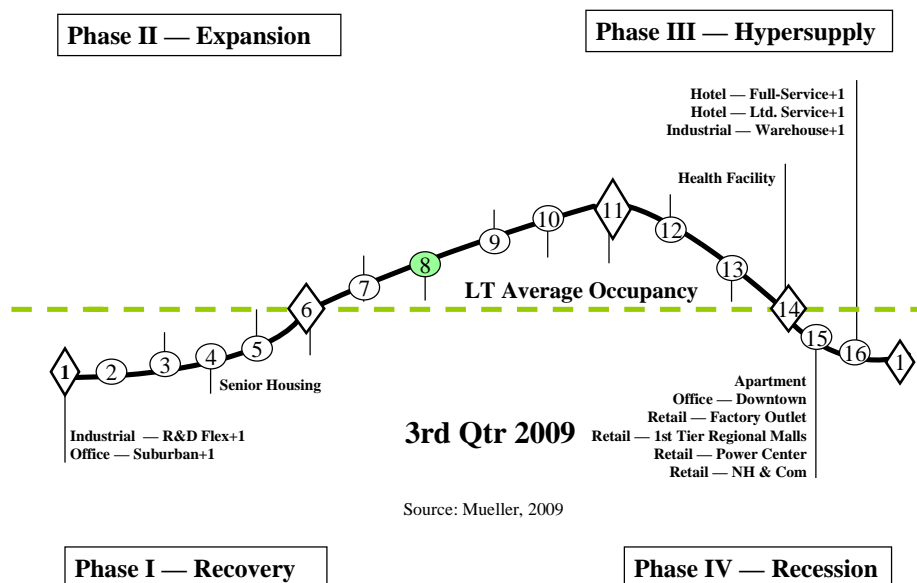
Apartment occupancy declined 0.2% in 3Q09 and rental growth declined 1.4% for the quarter and 4.6% annually.

Retail occupancy declined 1.1% in 3Q09 and rental growth fell 1.8% for the quarter and 5.8% annually.

Hotel occupancies declined 1.3% in 3Q09, and RevPAR declined 2.4% for the quarter and 21% annually.

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

National Property Type Cycle Locations



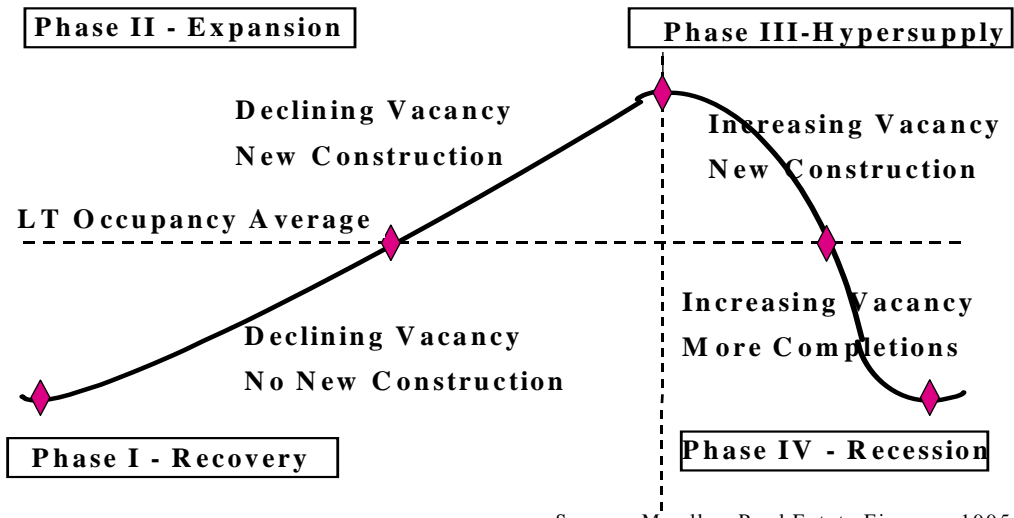
Glenn R. Mueller, Ph.D. 303.953.3872 gmueller@dividendcapital.com
Dividend Capital Research, 518 17th Street, 17th Floor, Denver, CO 80202
www.dividendcapital.com 866.324.7348

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.

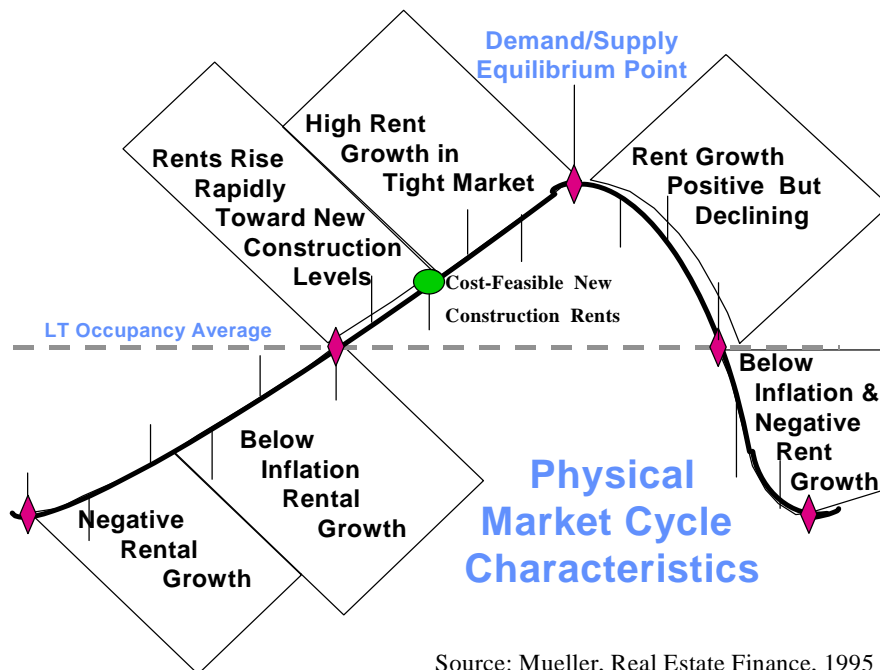
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that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

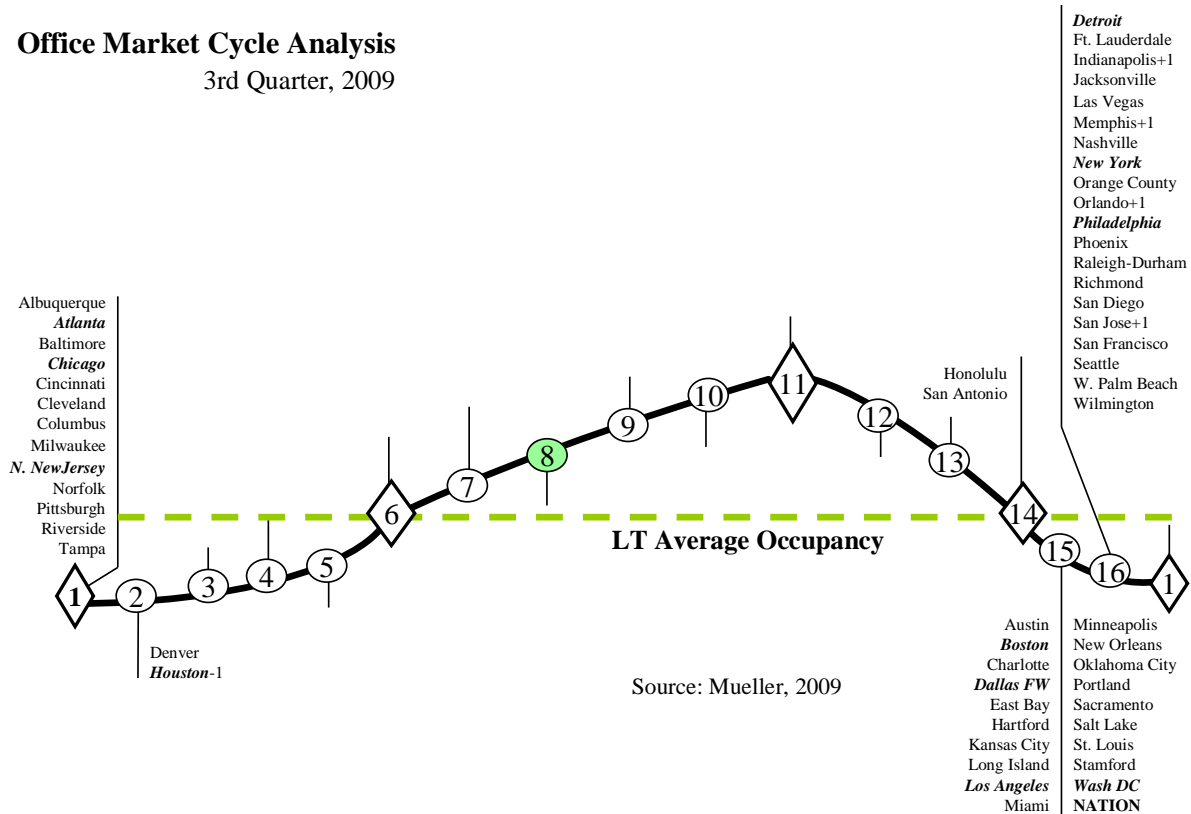


Source: Mueller, Real Estate Finance, 1995

OFFICE

The national office market occupancy level declined 0.9% in 3Q09, which resulted in a 3.5% year-over-year decline. The U.S. national average vacancy rate has moved above 17%. Sub-lease space jumped by over 10 million square feet in 3Q09, bringing the total to nearly 125 million square feet of sub-lease space. Job losses are slowing and while office absorption was still a negative 11 million square feet for the third quarter, it was only 1/3 of the negative absorption realized in 1Q09 and 2Q09. Rents declined 2.1% in 3Q09 and were down over 7% year-over-year. Free rent and above-standard tenant improvements abound in this difficult market.

Office Market Cycle Analysis 3rd Quarter, 2009



Source: Mueller, 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.

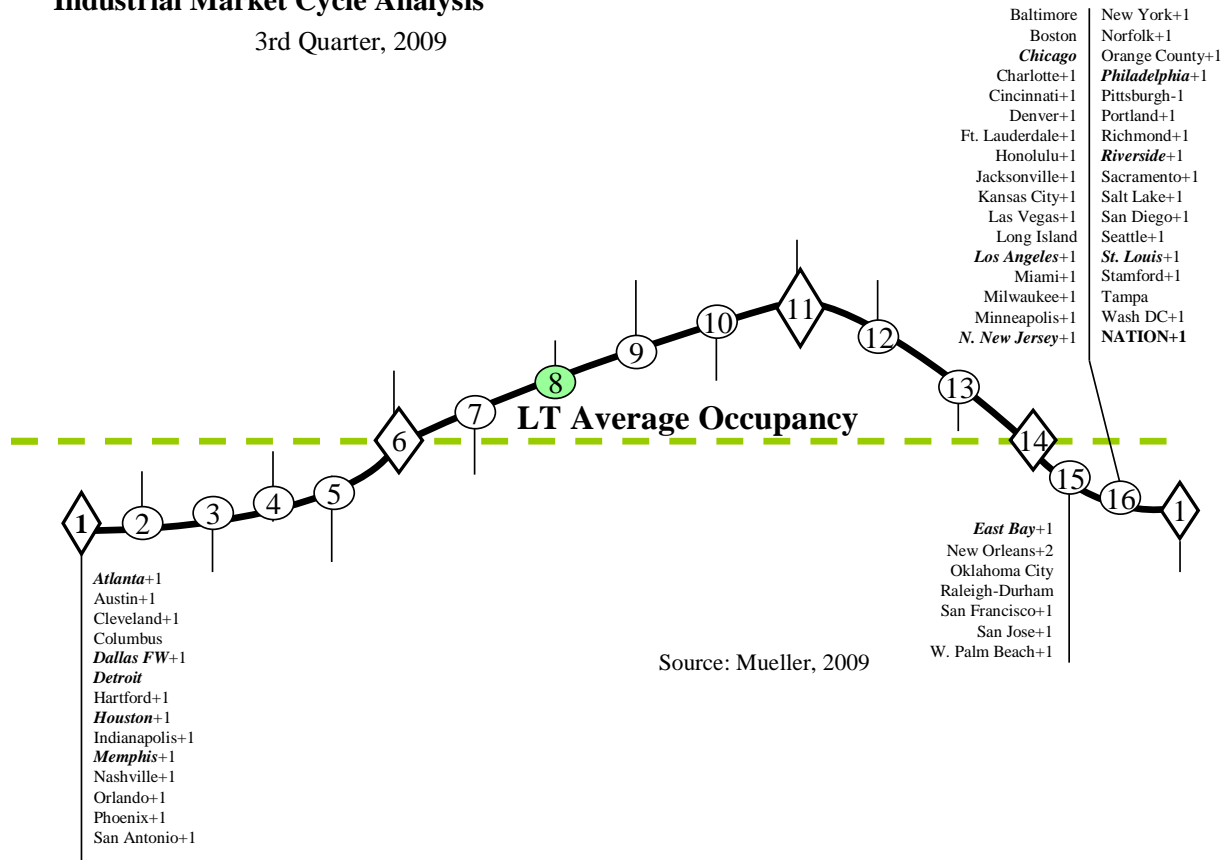
Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 0.8% in 3Q09 which created a decline of 3% year-over-year. The national industrial vacancy now stands just above 10%. Negative absorption topped -44 million square feet in 3Q09, and is now close to -200 million square feet in this recession. The bottom does look near, however, as firms are starting to rebuild their inventories from cyclically low levels. In addition, many other countries are experiencing positive economic growth, thus international demand for U.S. products is growing again. Rents were down 2% for the quarter and 8% year-over-year.

Industrial Market Cycle Analysis

3rd Quarter, 2009

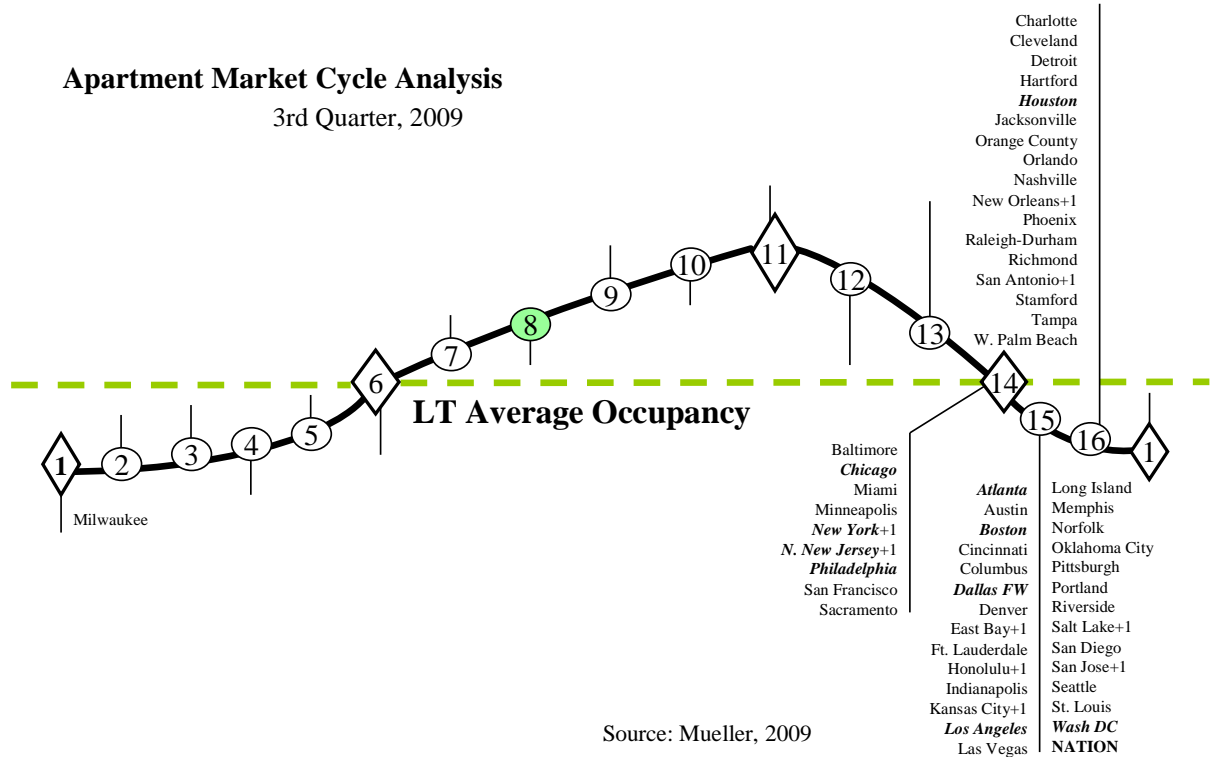


Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space we monitor. Thus, the 12-largest industrial markets are in **bold italic** type to help distinguish how the weighted national average is affected.

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.

APARTMENT

Apartment occupancy declined 0.2% in 3Q09, producing a 1.8% decline year-over-year. House closings were strong in the first two months of the quarter as people pushed to close and take advantage of the \$8,000 first-time home buyer credit, but slowed in the third month when the homebuyer credit was extended for another six months. Renters are moving up the quality scale as class-A apartment owners drop their rents to keep occupancies higher. Rents were down 1.4% in 3Q09 and down 4.6% 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.

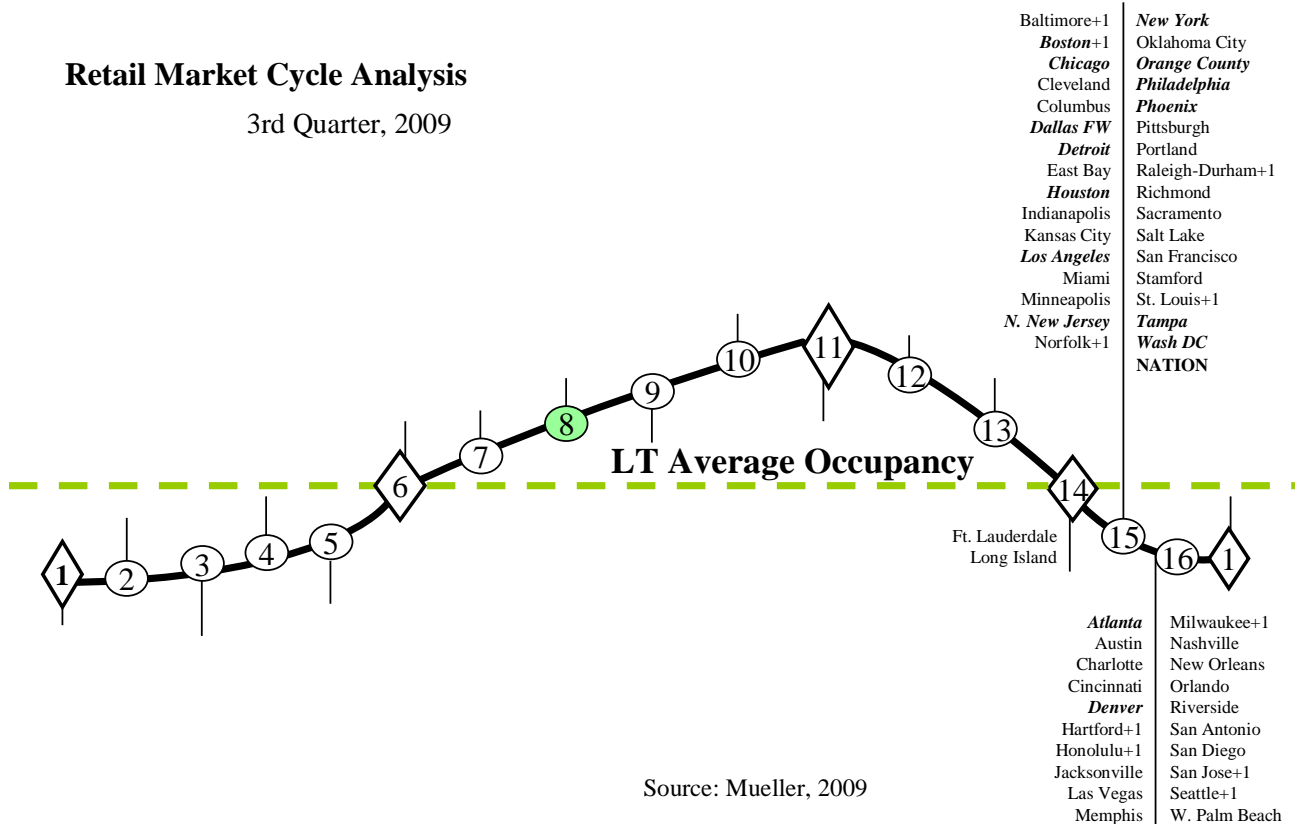
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RETAIL

Retail occupancies declined 1.1% in 3Q09, producing a 5.8% decline year-over-year. Retailers continued to close unprofitable stores while additional retail bankruptcies created more vacant space ahead of lease expirations. The good news is that GDP turned positive in 3Q09 and with 70% of GDP coming from consumption, retail sales should begin to pick up. The moderator of this uptick was that half of the GDP growth came from the government's cash for clunkers program. Rents were down 1.8% in 3Q09 and 5.8% year-over-year. We expect occupancies to decline through most of 2010 as well.

Retail Market Cycle Analysis

3rd 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.

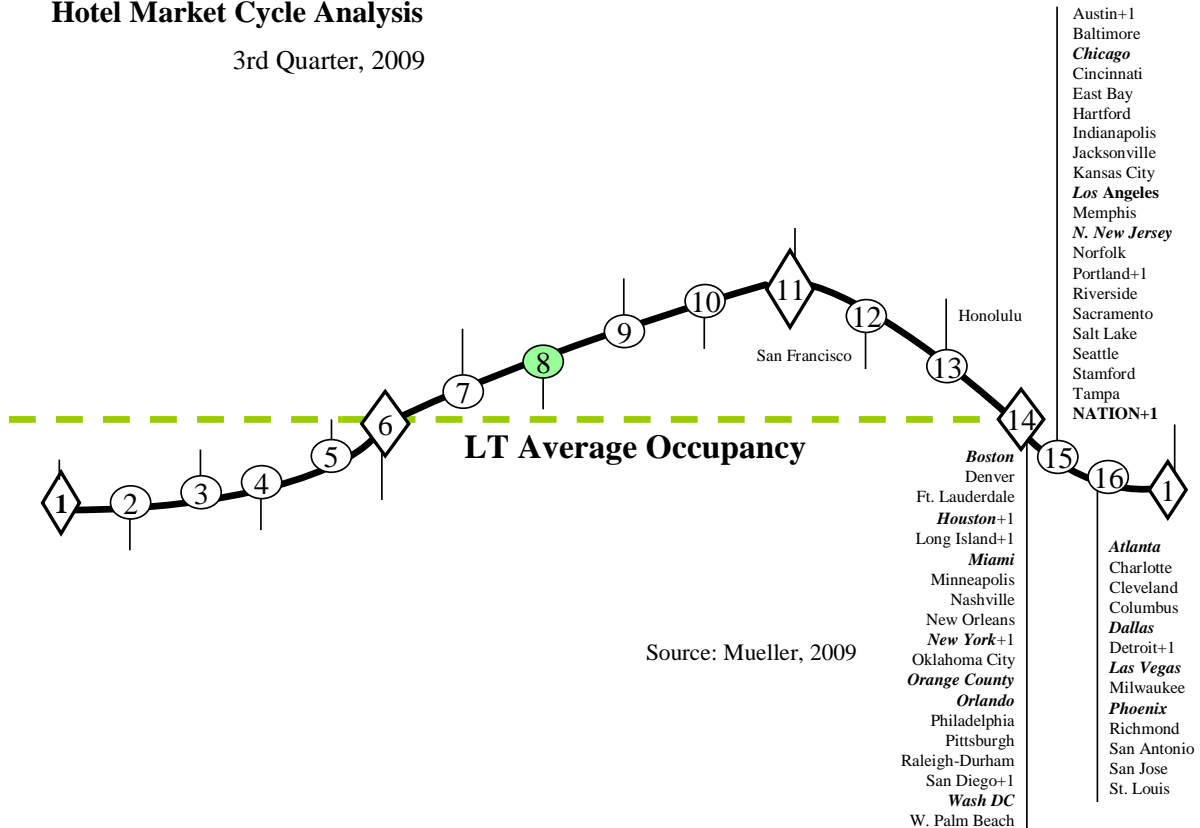
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 1.3% in 3Q09 and 6.8% year-over-year. Airlines reduced the number of flights further, making it more difficult for business travelers to attempt last minute trips. Unfortunately, many downtown hotels that were started during the boom times of 2005 to 2007 are now being completed and adding to supply at just the wrong time. Hotels continue to offer specials, but are trying to keep their advertised room rates from falling too far. Hotel RevPAR declined 2.4% in 3Q09 and is now down 21% year-over-year.

Hotel Market Cycle Analysis

3rd 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.

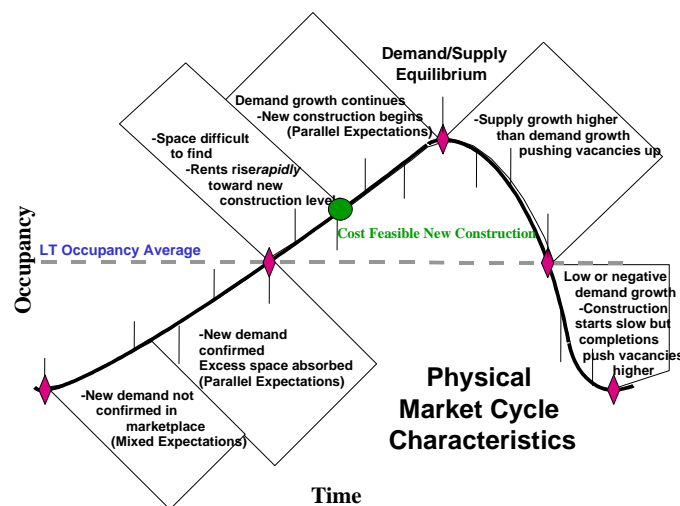
MARKET CYCLE ANALYSIS — Explanation

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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