



Cycle Monitor — Real Estate Market Cycles

Second Quarter 2011 Analysis
August 2011

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

Slow growth continued during the second quarter of 2011 with a number of positive prospects. The start of the third quarter brought much turmoil with the government debt problems not getting a long-term solution and S&P downgrading U.S. Treasuries. The resulting turbulent stock market may dampen employer confidence and cause the economic recovery to slow further. Economists have increased the possibility of a double dip recession to 30%. Despite these problems, all five property types showed minor increases in occupancy as demand increased.

Office occupancies **improved** 0.2% in 1Q11, but rents fell 0.1% for the quarter and were down 0.2% annually.

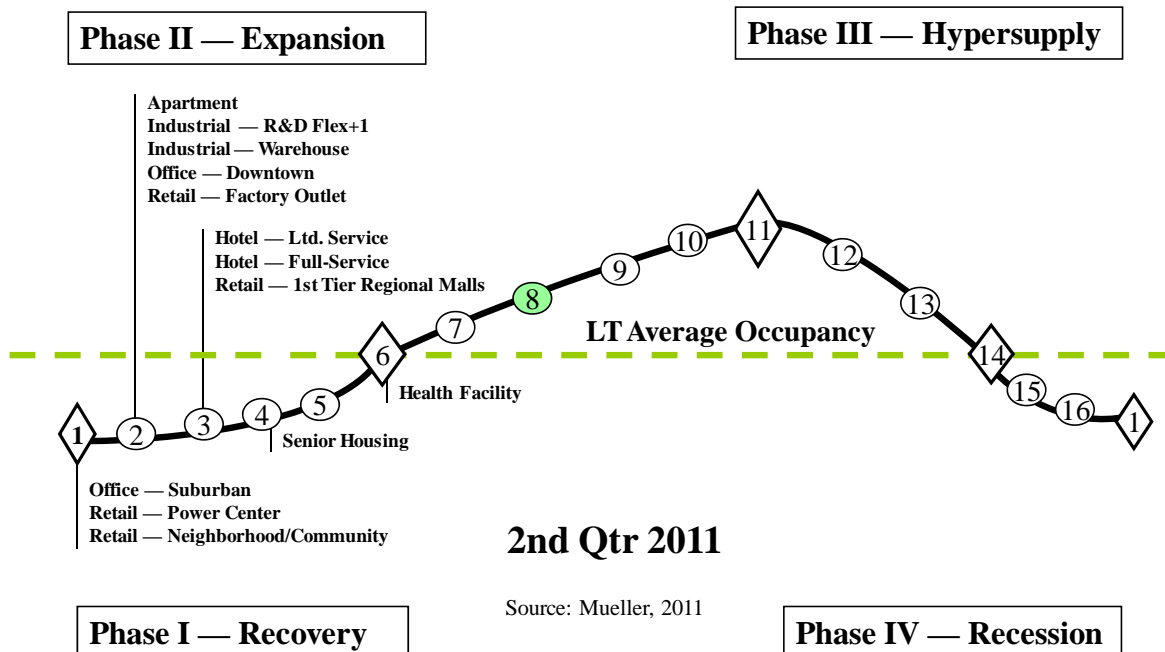
Industrial occupancies **improved** 0.3% in 2Q11, and rents were flat for the quarter and were down 2.2% annually.

Apartment occupancies **improved** 0.3% in 2Q11 and rental growth **improved** 1.5% for the quarter, and 3.9% annually.

Retail occupancy **improved** 0.3% in 2Q11, but rental growth fell 0.1% for the quarter and 2.8% annually.

Hotel occupancies **improved** 0.8% in 2Q11, and RevPAR **improved** 1.4% for the quarter and 8.9% annually.

National Property Type Cycle Locations



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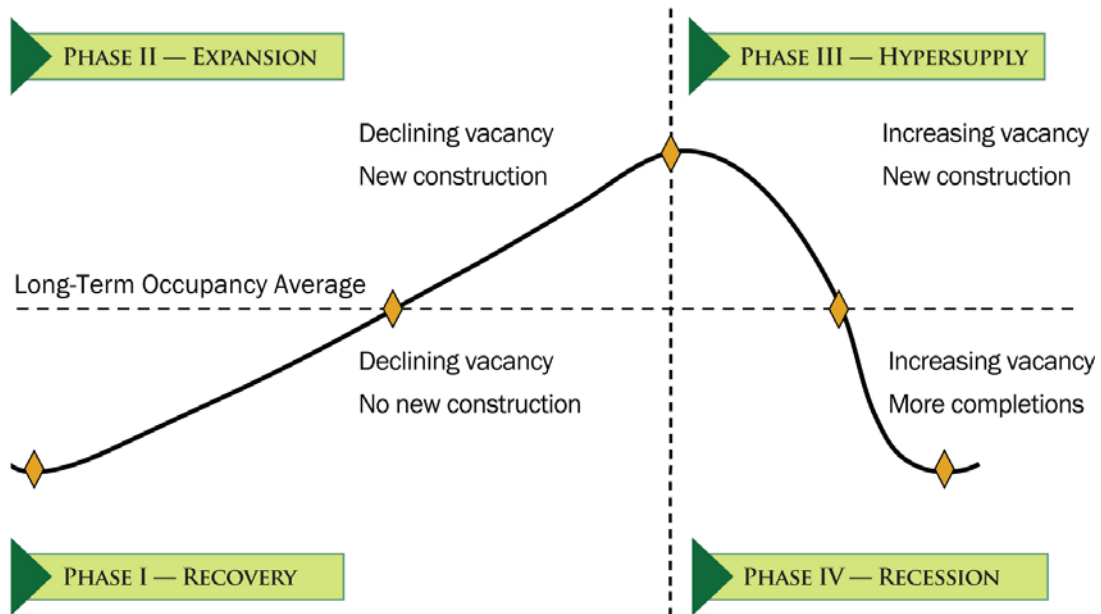
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All relevant disclosures and certifications appear on page 9 of this report.

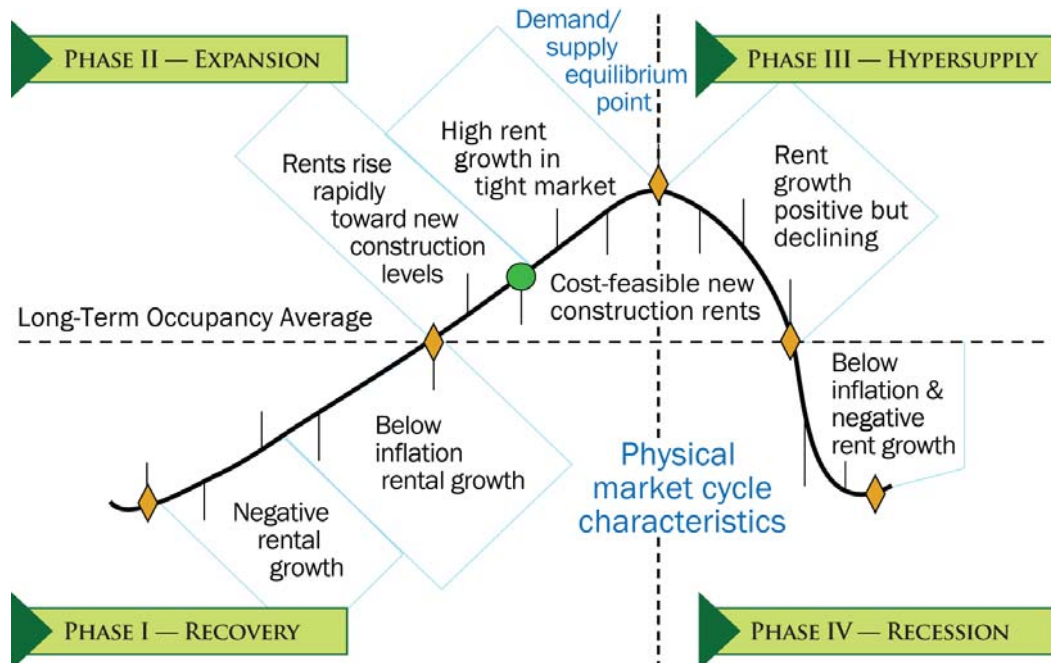
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that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

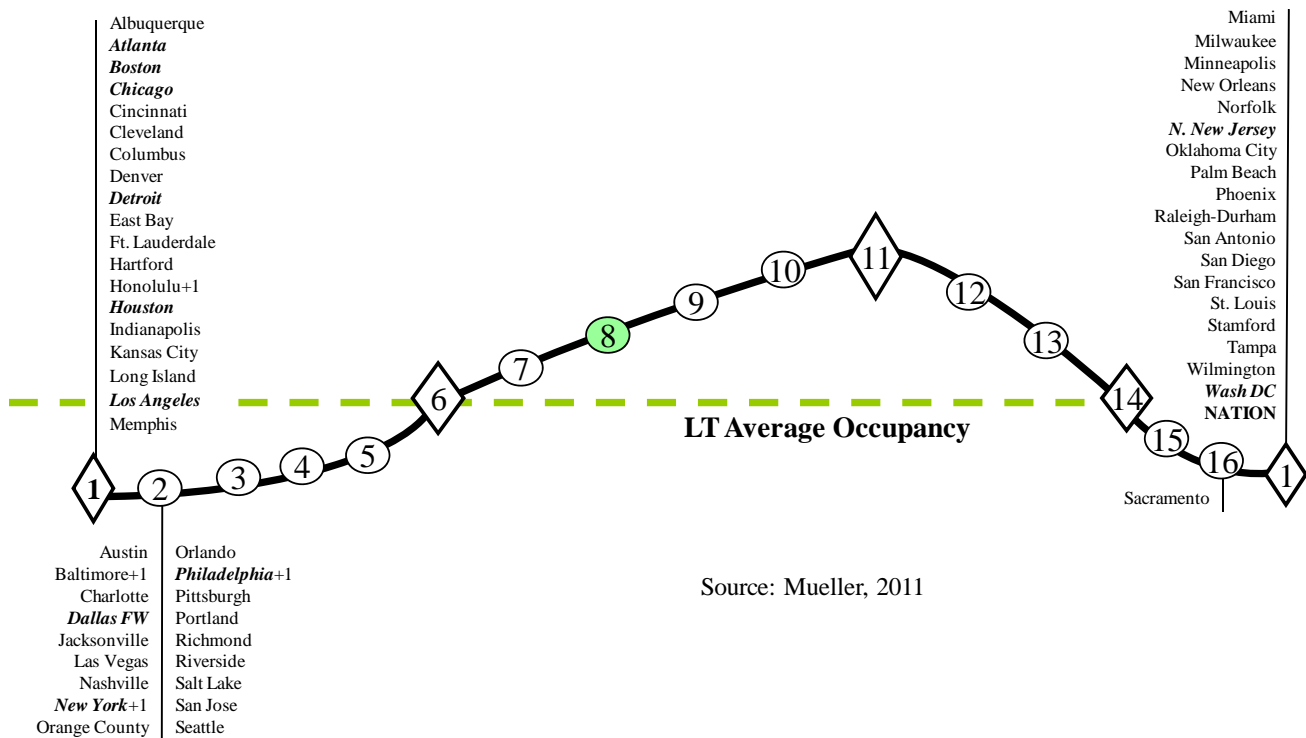


Source: Mueller. Real Estate Finance. 1995.

OFFICE

The national office market occupancy level improved 0.2% for 2Q11, and was up 0.4% year-over-year, but still not enough to move the national average off the bottom of the cycle at point #1. Only three markets improved their occupancies enough to move forward on the cycle graph to point #2. Net absorption was more than 12 million for the quarter while only 2 million of new construction was delivered. The majority of new office construction underway was in New York and Washington DC. Class-A downtown office has a 4% higher occupancy level than Class-B suburban space. We need to see occupancies rise to point #3 on the cycle graph before we can expect any rental growth. Rents were down 0.1% for 2Q11, and were down 0.2% year-over-year.

Office Market Cycle Analysis 2nd Quarter, 2011



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.

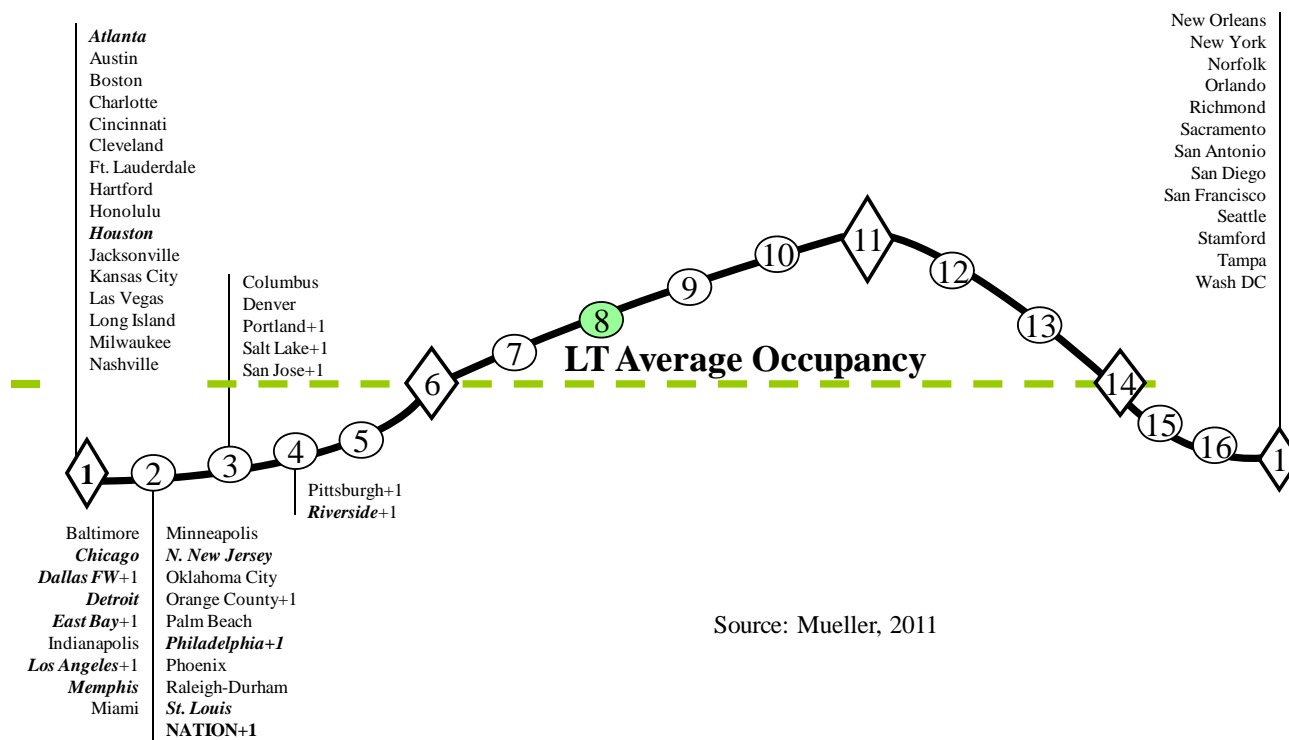
Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 improved 0.3% in 2Q11, which resulted in a 0.9% increase year-over-year and moving the national average to point #2 on the cycle graph. The national average vacancy rate dropped below 10% in 2Q11, but sub-let space caused availability to be about 13%. Net absorption increased to 32 million square feet in 2Q11 versus more than 3 million of new construction deliveries. This is the first time industrial has lead an economic recovery, but this could be hard to maintain unless GDP rises above 3% for the second half of the year. The industrial national average rents were flat for 2Q11, but were up in the major port markets with Riverside in the Inland Empire leading the way. Nationally, rents were down 2.2% year-over-year.

Industrial Market Cycle Analysis

2nd Quarter, 2011



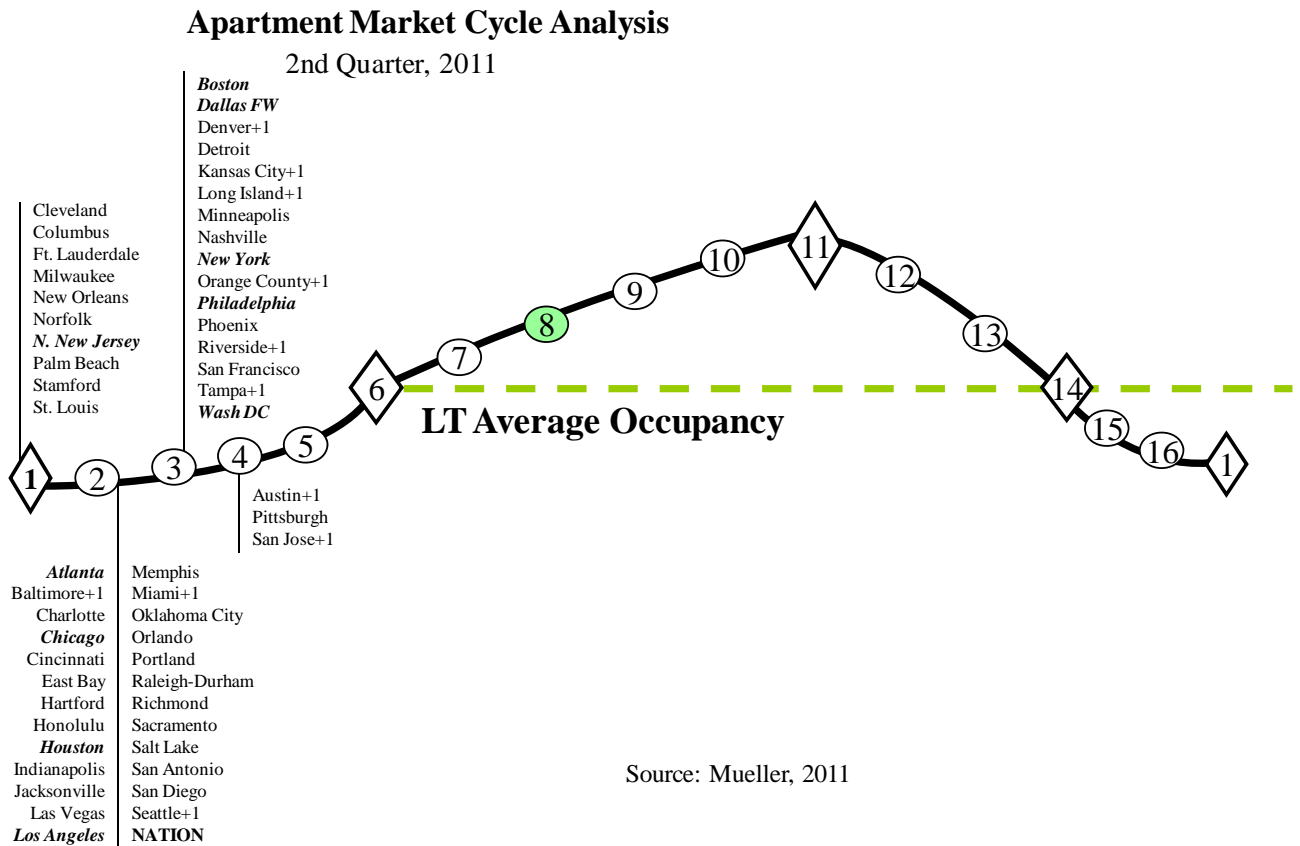
Source: Mueller, 2011

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 national apartment occupancy average increased 0.3% in 2Q11, and was up 0.8% year-over-year. Much of the new job creation is going to young graduates who are willing to accept lower pay. This age group is the biggest renter cohort, creating a very positive demand trend. Net absorption was positive at 48 million units in 2Q11 and continued low new supply. Average national apartment rents improved 1.5% in 2Q11, and were up 3.9% 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.

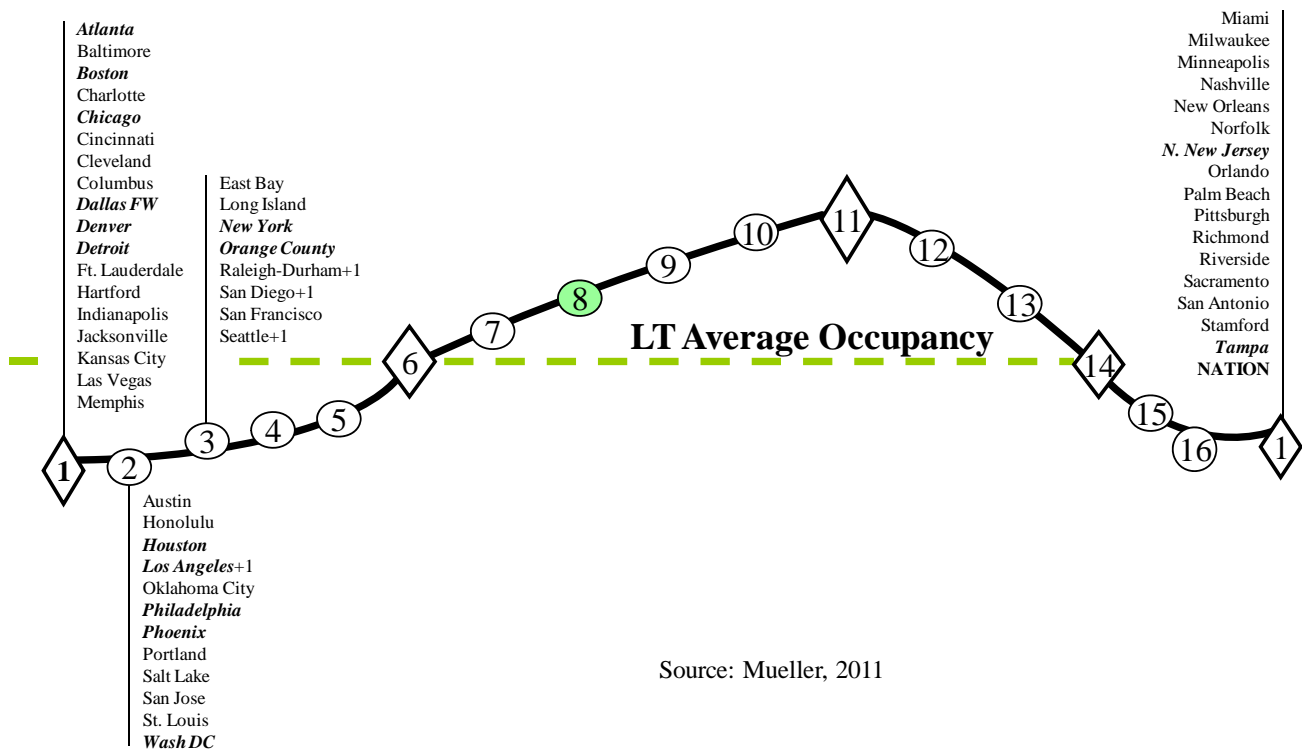
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RETAIL

Retail occupancies improved 0.3% in 2Q11, and were up 1.6% year-over-year. Most of the occupancy improvement continues to take place in regional malls with national chains expanding. Small tenants are still cautious about the recovery which hurts strip centers and small standalone properties. Most retailers continue to demand lower rents to occupy space and are winning at the negotiation table. The good news is that the rate of rent decline is slowing. Rents were down 0.2% in 2Q11, and were down 2.8% year-over-year.

Retail Market Cycle Analysis

2nd Quarter, 2011



Source: Mueller, 2011

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.

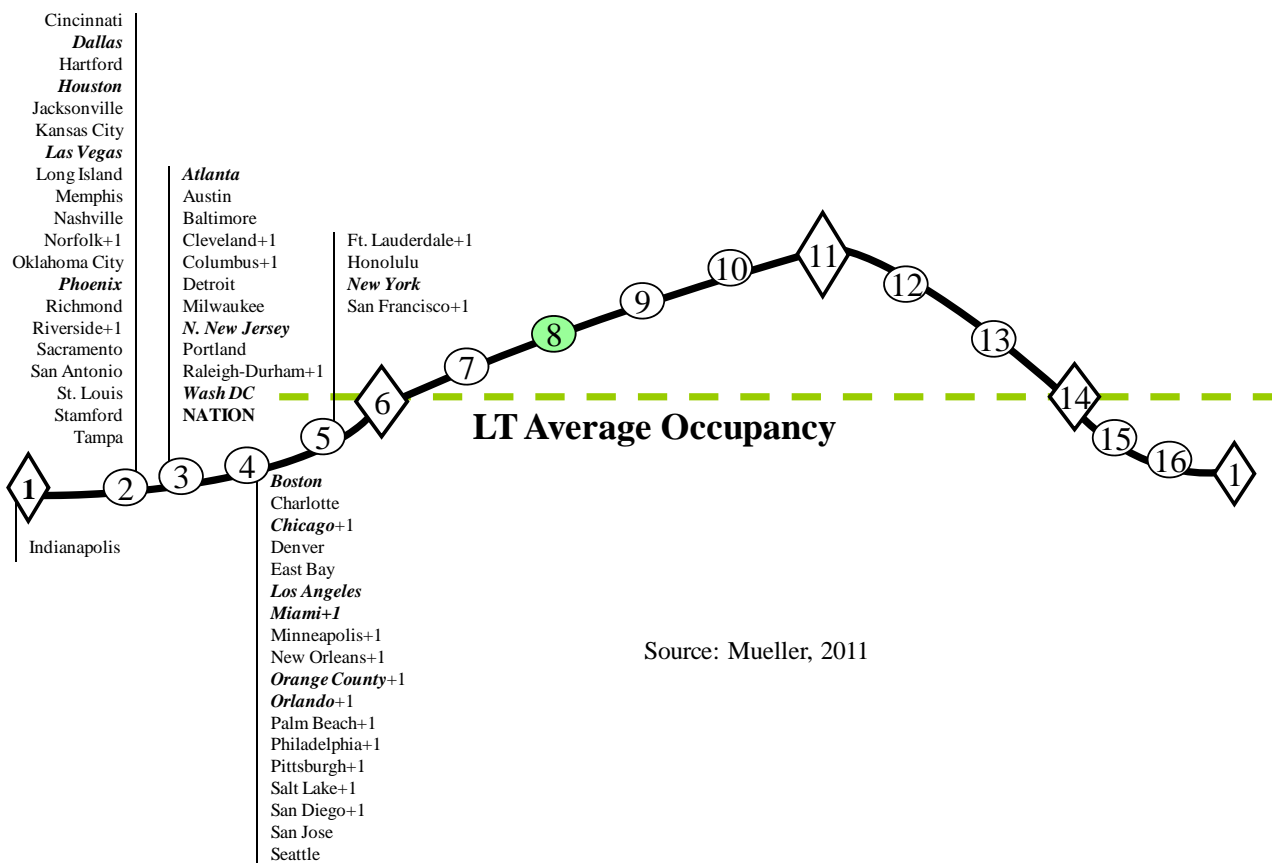
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 another 0.8% in 2Q11 and were up 3.7% year-over-year. Travel growth continued and airlines have begun to add additional flights as most planes are full. San Francisco and Ft. Lauderdale had occupancy increases above 1% that brought their levels to more than 70%, thus they joined New York and Honolulu at point #5 in the cycle graph as the best markets in the country. National average Hotel RevPAR was up 1.4% in 2Q11, and was up 9% year-over-year.

Hotel Market Cycle Analysis

2nd Quarter, 2011



Source: Mueller, 2011

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.

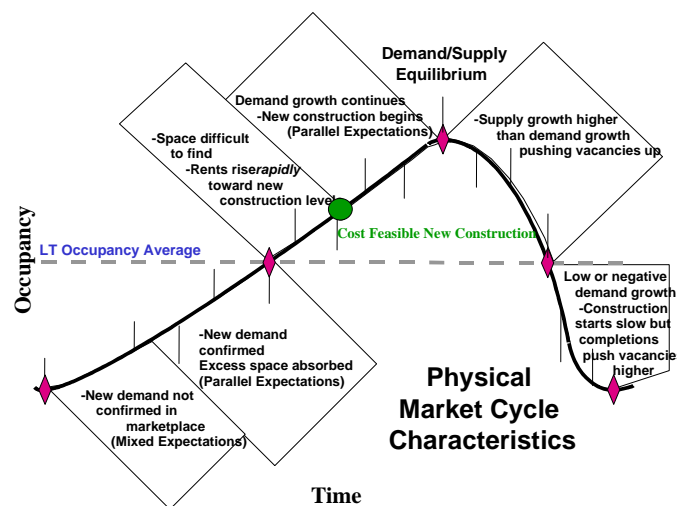
MARKET CYCLE ANALYSIS — Explanation

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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