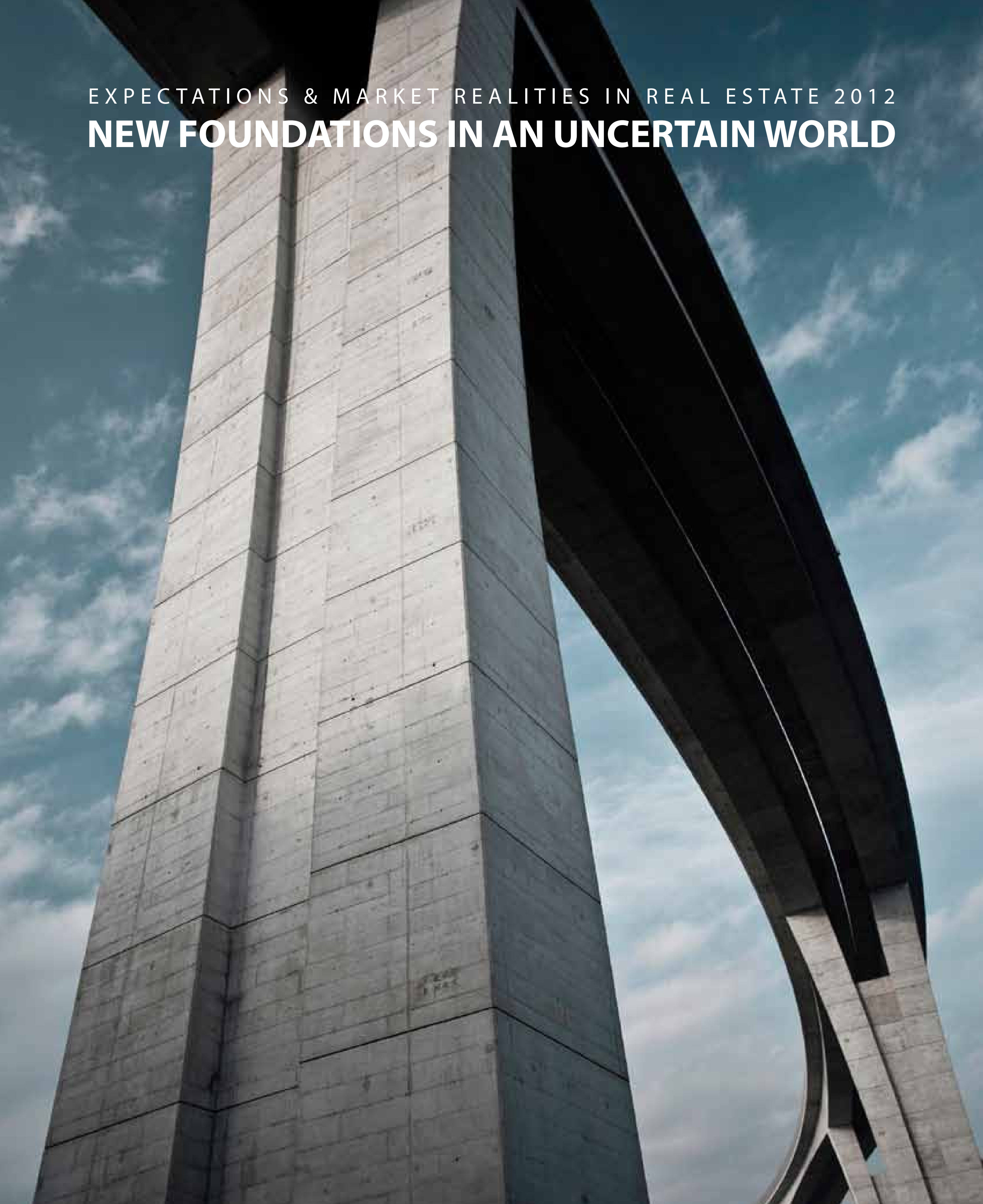
EXPECTATIONS & MARKET REALITIES IN REAL ESTATE 2012

NEW FOUNDATIONS IN AN UNCERTAIN WORLD



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Expectations & Market Realities in Real Estate 2012—New Foundations in an Uncertain World

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FOREWORD

January 2012

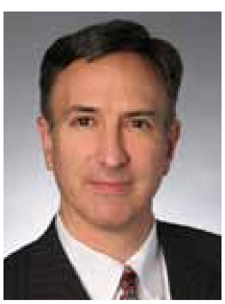
Dear Readers,

As we prepare to issue our annual outlook report, ***Expectations & Market Realities in Real Estate 2012—New Foundations in an Uncertain World***, the financial world appears to still be at risk. The sovereign debt crisis in Europe seems to be unresolved, and many nations' debt burdens may be unsustainable. Our memories are good enough that we recall the implosion of our credit markets just a few years ago, and given the apparent interconnectedness of the world's big banks today, we think of how fragile the world's financial system might be and what may unfold.

Although there are no guarantees and there are elements of risk with any investment, we—**Real Estate Research Corporation (RERC), Deloitte, and the National Association of Realtors (NAR)**—generally agree that institutional-grade commercial real estate appears to have remained relatively stable during recent periods of uncertainty. Besides seeming to have avoided the recent volatility of the stock market, some commercial real estate investments have offered returns greater than those experienced by non-real estate equity investors.

Thank you to everyone who has contributed to this report, especially our researchers and data providers, economists, business associates, research survey respondents, and the many others who have shared their insights and observations. We also thank you—our clients, subscribers and membership professionals, and consultants—for your interest and support of this report. We hope you find ***Expectations & Market Realities in Real Estate 2012—New Foundations In An Uncertain World*** of value in this fragile investment environment.

Sincerely,



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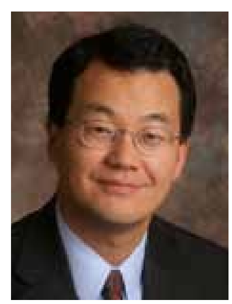

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1 | INTRODUCTION

New Foundations in an Uncertain World

When Real Estate Research Corporation (RERC), Deloitte, and the National Association of REALTORS® (NAR) began making plans to publish ***Expectations & Market Realities in Real Estate 2012***, the already sluggish economy was starting to slow. The ups and downs in the stock market were becoming more pronounced as the second round of the government's quantitative easing initiative started winding down, and this volatility further increased as we witnessed the inability of politicians to come to an agreement about the nation's debt ceiling. Finally, the market nearly collapsed as the nation's credit rating was downgraded from its AAA status and investors—afraid the economy was about to fall into another recession—retreated to the relative stability that investments like commercial real estate could offer.

As the year 2011 comes to an end, fear and uncertainty have spread beyond the U.S., and Europe is focused on its own economic difficulties. The sovereign debt crisis has expanded beyond Greece and Portugal to Italy and Spain, and although there are moves toward strengthening the European Union's response, a risk remains that one or more nations may eventually default on their obligations and a new financial crisis that could affect the West will emerge. As a result, the investment world is uncertain and the relative safety of commercial real estate investment may be more attractive as investors look for ***"New Foundations in an Uncertain World."***

In this first chapter to our outlook report, we have focused on the economy and various risks associated with our fragile recovery. This is the environment in which people invest, and the economic risks—particularly high unemployment, but also high debt and the housing market—affect the performance of this asset class.

Chapter 2 of this report discusses the capital markets and the debt and equity available for investing in commercial real estate. We have also included a guest commentary provided by The Real Estate Roundtable, which describes some of the capital market uncertainties related to the regulatory environment.

In Chapter 3, we take a closer look at the office, industrial, retail, apartment, and hotel property sectors. Our analysis examines volume, pricing, capitalization rates, vacancy/occupancy rates, absorption and completions, and rental rates/revenue for each of these major sectors.

In our final chapter, we offer our collective analysis of the investment environment, the capital markets, and the property markets.

THE ECONOMY

The commercial real estate market often lags the broader economy by a year or two, and the economic recovery and growth in retail sales and jobs

gains that follow can lead to renewed demand for commercial space, falling vacancies, and rising rents. This recovery is different however, and even with the Great Recession of 2008 and 2009 already in the rearview mirror, the nation's economy remains very subdued. Toward the end of 2011, total U.S. employment was still nearly 7 million below the prior peak in 2007, according to the Bureau of Labor Statistics (BLS). Compared to what might have been, had the recession never occurred and had job growth kept pace with population increases, the economy remains short some 11 million jobs, according to NAR's analysis of data provided by the BLS. That shortfall is the reason behind the stubbornly high unemployment rate, even while the economy is adding jobs — albeit at a slow rate.

One of the more worrisome aspects of the recent business cycle is that the number of people considered long-term unemployed (those without a job for longer than six months), remains near a troubling 6 million at the end of 2011, according to the BLS. In "normal" expansionary times, fewer than 1 million people stay unemployed for such an extended period, while during bad economic times, like the 2001 recession, the figure topped 2 million. This past recession saw a fundamental realignment of industries and of the large pool of long-term unemployed, many of whom may never again be gainfully employed in their specialty area.

Those who do have jobs should feel a bit more fortunate in this context, but many of them are not happy either. Hourly earnings are rising at a rate of less than 2 percent, which is well below the consumer price inflation (CPI) rate of 3.6 percent. In short, American workers are falling behind in their standard of living. The combined frustration of the jobless and workers losing their spending power is reflected in weak, if somewhat improving, consumer confidence. According to the Conference Board, the Consumer Confidence Index registered 44.5 as of Aug. 18, 2011, the lowest reading in 50 years (with the exception of the period between autumn 2008 to spring 2009 when there was massive hemorrhaging in the financial markets) before rising to 55.2 in November and 64.5 in December.

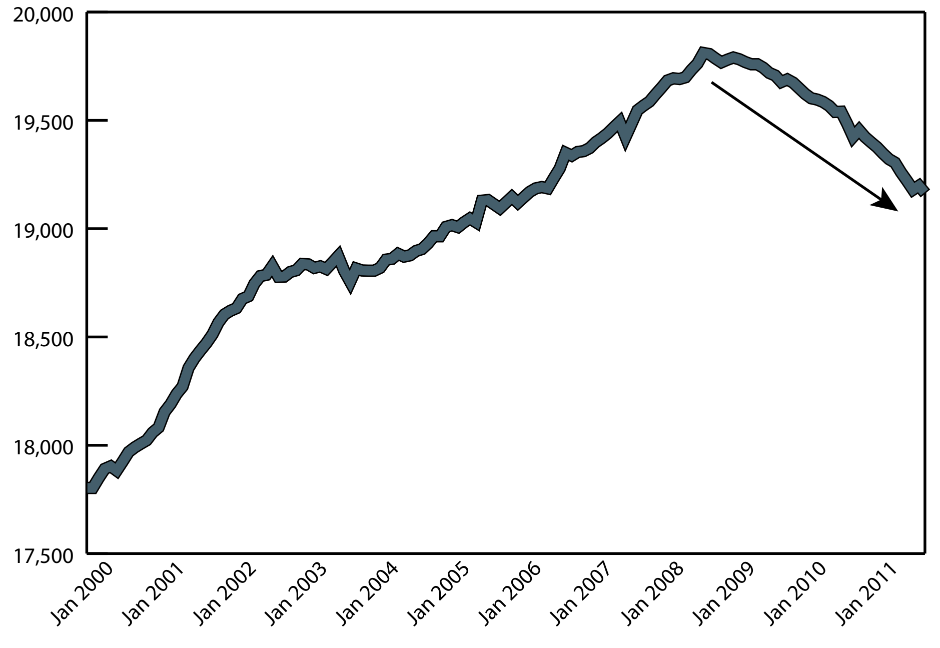
Deleveraging

Often, economic recovery following a recession tends to be above trend. In 1983, for example, GDP rose at a whopping 8 percent while in 1992, GDP grew at a very respectable 4 percent, compared to the long-term trend growth rate of 3 percent, according to the Bureau of Economic Analysis (BEA). This time around, the post-recession expansion has not been and may not be strong. In the aftermath of a financial market crisis, there is usually a balance sheet "readjustment" by key players in the economy. Persistent high spending and low savings rates would generally be neither sustainable nor healthy, and the adjustment from this environment would necessarily take time. History has clearly shown that too much borrowing by even a small number of entities could lead to a financial disaster sooner or later. As a result, some form of adjustment was needed after the 2008 financial crisis.

Americans socked away $250 billion annually in the 10 years prior to the onset of the financial crisis, according to the BEA. The savings rate was a very low 2 to 3 percent of disposable income, but from 2008 onwards, consumers started to become more careful about spending, and the annual savings rose to nearly $600 billion, nearly 5 percent of disposable income as of mid-2011, according to the BEA.

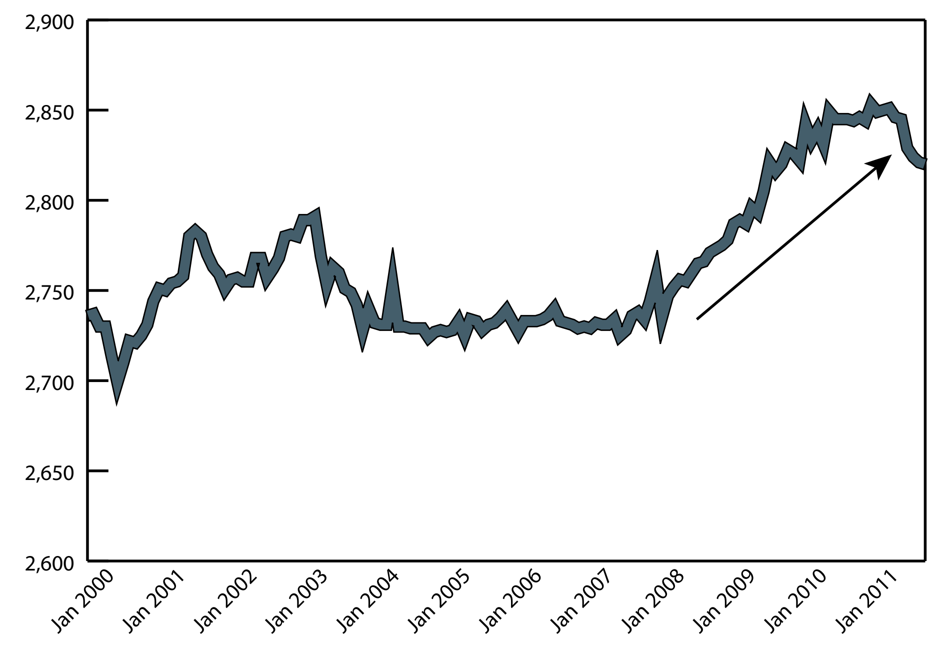
The rise in the pre-crisis savings rate, however, has not negated the necessity of buying food, clothing, utilities, and health care—the prices of which have recently hit new highs. Interestingly, even discretionary spending on recreation has recently reached an all-time high, according to the BEA. The increased savings rates of recent years have principally hit households' two biggest purchase items: cars and homes (though both items have been impacted by the ability of financing as well). We've seen sales rates of 11 to 12 million vehicles every year for the past three years, according to Autodata Corp.—well below the 16 to 17 million that would be more typical in normal economic times. And, as most Americans know only too well, home sales are also off their high marks. In 2005, a bubble year, new and existing annual home sales hit 1.2 million units and 7.1 million units, respectively, according to the U.S. Census. The most recent comparable figures are currently 300,000 units for new home sales and 5 million units for existing home sales.

Exhibit 1-1. State and Local Government Jobs Declining (600,000 Job Cuts in Past 3 Years)



Source: BLS, July 2011.

Exhibit 1-2. Federal Government Jobs Have Increased (110,000 Jobs Over 3 Years)



Source: BLS, July 2011

It is not only consumers who are watching their spending. Businesses and banks too have undergone belt-tightening by reducing debt or holding onto excess cash. State and local governments, faced with balanced budget rules, have deeply slashed employment, as shown in Exhibit 1-1. However the federal government has been moving in the opposite direction (see Exhibit 1-2), with increased spending from borrowed money.

The good news related to such deleveraging is that the process could move in the reverse direction soon, and further deleveraging in the private sector may not be needed. Consumers have been saving, and some of that savings may inevitably show up as down payments for home purchases. Businesses may be pressured by shareholders to either invest in new plants and equipment or pay out higher dividends. Tax revenues at local and state governments have been rising of late as a result of some economic recovery, according to U.S. Census data. The increased revenue could help slow down the job cuts.

More Stimulus?

Two policy options are potentially available for moving the economy forward: fiscal and monetary. There is some concern by certain parties that the traditional 'crowding out' effect of business investment falling as interest rates move higher in the face of higher budget deficits, although interest rates are currently at historic lows. However, another crowding out scenario could be on the horizon. With the national debt continuing to grow at a fast pace, individuals and businesses are faced with great fiscal and economic uncertainty. And, uncertainty often leads to consumers and business holding back on spending.

Regarding monetary policy, some of the options available to the Federal Reserve to fight the economic downturn have already been used. The federal funds rate is already at zero, and it cannot possibly go lower. The quantitative easing approach of printing money to buy government debt has been tried twice already. Another plan, dubbed "Operation Twist," in which the Federal Reserve buys long-term bonds by selling short-term bonds, is also underway so that there would not be any additional printing of money.

Banks have steadily built up reserves over the past three years and can be said to have large amounts of cash, but they have generally been unwilling to lend at the same levels they lent money prior to the Great Recession. Any further rate decline may be inconsequential.

Inflation

It is unclear what impact the monetary policy of the past three years has had on the economy, although it can be argued that the printing of money may have at least moderated the degree of economic downturn, and may have prevented the unemployment rate from rising above its current level. It will be very hard to determine the effectiveness or the ineffectiveness of recent policy until well after the fact, and it may well be a topic on which economic professors debate over the next 50 to 100 years.

Printing money is said to lead eventually to higher inflation. Consumer prices have inched up, with the CPI up by 3.4 percent from a year ago in November, according to the BLS. The recent "easy" monetary policy may have impacted commodity prices, with the price for oil, corn, wheat, pork, beef, copper, coffee, and in particular, gold, rising significantly in the recent past. In addition, there appears to be even more price inflation pressure in the pipeline. Producer prices are rising at a faster clip, as shown in Exhibit 1-3, particularly for those products in the early stages of production. Producer prices are generally known to be volatile, with larger increases followed by larger declines. But, if producer prices do not retreat, then another concern may be the pass-through of inflation into consumer prices.

Exhibit 1-3. Prices are Rising - Broad Inflationary Pressure

Indicator	Percent Change from One Year Ago
Consumer Price Index	3.6%
Producer Price Index (Finished Product)	7.0%
Producer Price Index (Intermediate Product)	10.8%
Producer Price Index (Crude Product)	21.1%
Dow Jones Commodity Spot Price Index	20.0%
Gold Price	Around Record High Price

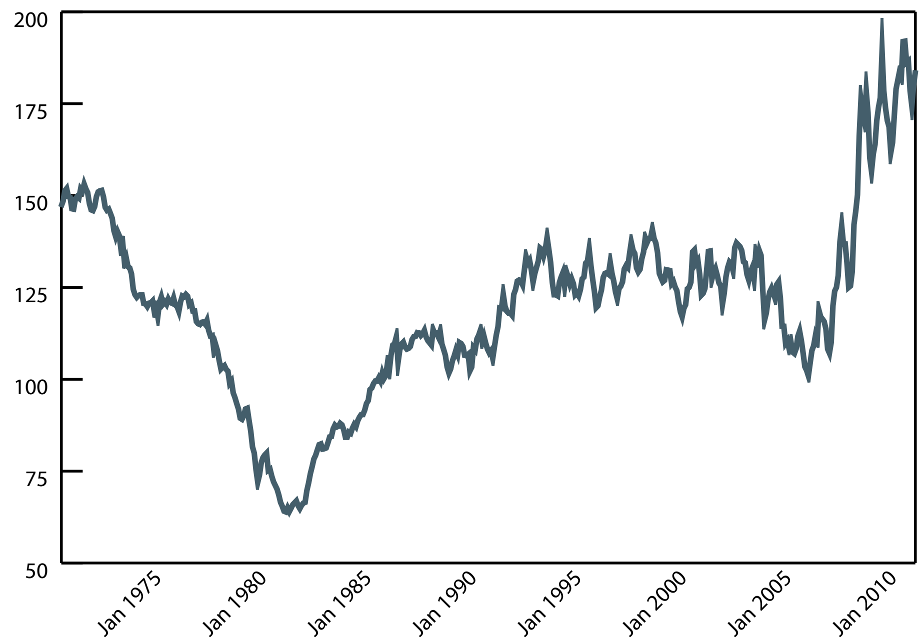
Sources: BLS (October 2011), Dow Jones, The Wall Street Journal, September 2011.

Housing to the Rescue

Housing, which has sometimes been the first sector to come out of a recession and to help power the broader economy forward, has shown almost no indication of revival in 2011. Home sales are running below levels seen a decade ago, foreclosures remain high, and housing starts are at a 60-year low. Furthermore, according to CoreLogic, 10.7 million homeowners, representing a fifth of homeowners with a mortgage, were underwater as of third quarter 2011, with mortgage balances higher than home values. This huge debt overhang may keep these households subdued in their spending or in their ability to trade-up for several years to come.

The good news is that housing market activity has been so low and so deeply corrected that it is likely that over time, there may be only one direction to move: up. Though its degree of strength is unclear, a housing recovery could propel the economy, and help reduce the chances of another recession.

Exhibit 1-4. NAR Housing Affordability Index at Record High



Sources: NAR, Haver Analytics, Sept. 14, 2011.

Despite the housing market struggles that are likely to continue in the near term, there are many compelling factors showing potential improvement, and while there are no crystal balls, these improvements could lead to a housing market recovery.

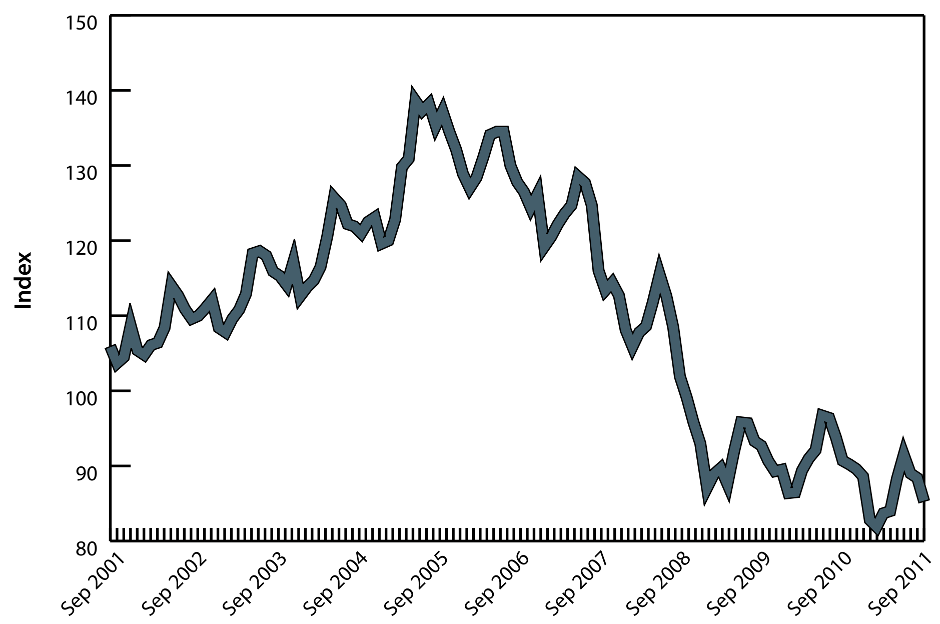
NAR's Housing Affordability Index, which incorporates house price, family income, and mortgage rates, is at its highest level since 1970 when the data were first compiled (see Exhibit 1-4). The record-high Index does not automatically mean there will be more buyers, however, for two major reasons. One reason is that the Index does not incorporate recent trends in lender underwriting standards, which are much tighter than in past years. The second is that it cannot capture consumer moods with respect to home buying.

The rise in rental property rents is also a factor for improving home sales. When rents rise, more renters pull out their calculators to see if buying makes more sense than renting.

The most fundamental metrics to assess whether a market may be overinflated or overcorrected are the simple home price-to-income ratio and home price-to-rent ratio (see Exhibit 1-5). Both metrics clearly show the imbalanced, unsustainable conditions that prevailed during the bubble years of 2004 to 2006. Interestingly, both metrics now point to a possible slight overcorrection in the market, which indicates that home values need to rise under these ratios in order to catch up with income and rent.

Another indication that the worst in the housing market may be coming to an end is that the inventory of unsold homes is declining. The peak inventory was set in the middle of 2008, with 4.5 million homes available for sale, as reported by NAR on www.realtor.org. A steady chipping away at supply has brought the inventory to only a hair above 3 million near the end of 2011. The corresponding months' supply, at that level of inventory, will not likely reach double digits, and it could even fall to 7 months or less depending on the pace of home sales. In short, the pressures for additional home price declines may be coming to an end, and in fact, home prices have already shown some signs of stabilization. The Case-Shiller Repeat Price Index has risen for four straight months. The same is true of the Federal Housing Finance Agency's (FHFA's) House Price Index, which is seasonally-adjusted and covers only conforming Fannie/Freddie-backed properties.

Exhibit 1-5. Home Price-to-Rent Index



Sources: NAR, BLS, CPI, September 2011.

The 40-year low on newly-constructed inventory could also help heal the housing market over the short term. Though the minimal housing starts of the past three years have not helped in terms of job creation in the construction sector, the low starts may have helped to trim away inventory, thereby setting the conditions for a potentially brighter and healthier housing market recovery.

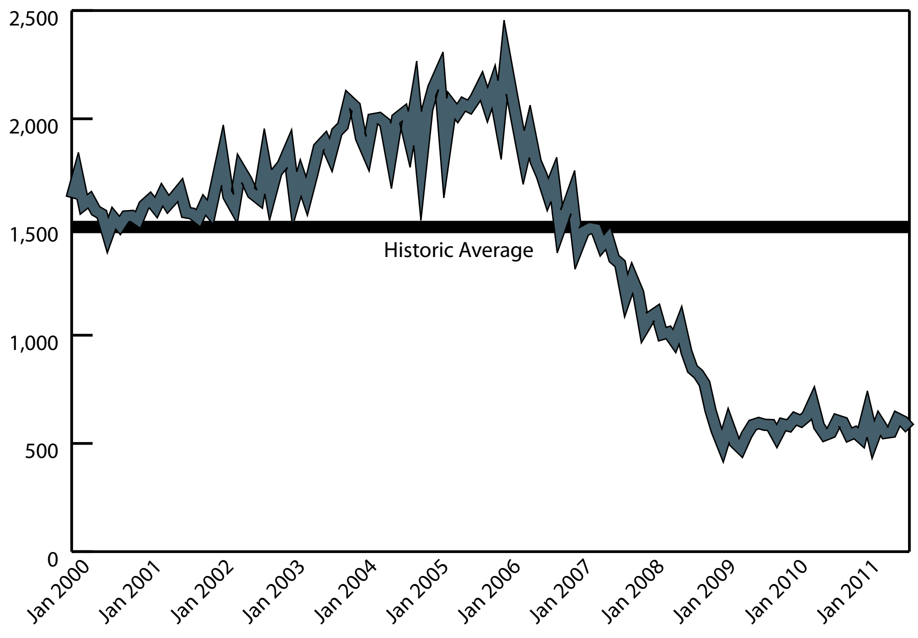
Other smaller, though not insignificant, factors that could propel housing upwards include recovery in stock market wealth, which helps second home purchases, and real estate investment demand arising from the search for inflation hedges. Those who are currently able to get Fannie- or Freddie-backed conforming mortgages have an average credit score of 760, according to FHFA data. Under normal underwriting standards (and not the lax underwriting situation of the bubble years), credit scores would be closer to 720 on conforming mortgages. For FHA mortgages, today's borrowers have an average credit score of 700, compared to historic FHA borrowers who had average credit scores of 660.

According to the Census Bureau, the number of people who "doubled-up" recently was 12 percent higher than at the beginning of the recession in 2007, which represents 7.5 million additional people cooped-up in tight living spaces. Such a trend is not likely to rise indefinitely. A more likely scenario is a decline in doubling-up in upcoming years, provided the economy expands and generates jobs. As shown in Exhibit 1-6, housing starts have been scraping along a deep bottom over the past few years. This extremely low level of housing starts is subject to the "low boil" of household formation which should require more housing units. The apartment sector, perhaps the healthiest of the commercial property sectors, may continue to provide opportunities in terms of rent growth and new apartment construction.

The historical average growth in housing starts in the U.S. has been 1.5 million units each year, according to the U.S. Census Bureau. This volume of new housing starts would likely be needed to replace some number of demolished housing units that occur each year and from the rising population in the U.S. Currently at 130 million housing units, according to Census, even a very conservative assumption of a 0.3-percent depreciation rate implies 360,000 demolitions each year. In addition, the Census projects about 3 million in additional population gains each year for the next 10 years. According to the Joint Center for Housing Studies at Harvard, such an increase in population will generate household formations to the tune of 1.2 million per year. Therefore, under these assumptions, long-term housing starts would need to be at least 1.5 million units annually, although housing starts activity in the past three years has been less than 600,000 annually. If new housing production activity were to lag for another few years, then a legitimate question arises about a potential housing shortage in the U.S. in the not-too-distant future. Based on this assumed scenario, either housing starts would need to steadily rise or home prices may be squeezed measurably higher.

While housing may be poised for some type of recovery, we are not out of the woods yet. If the housing recovery is delayed, the broader economy and commercial real estate market may be hard-pressed to squeak out gains.

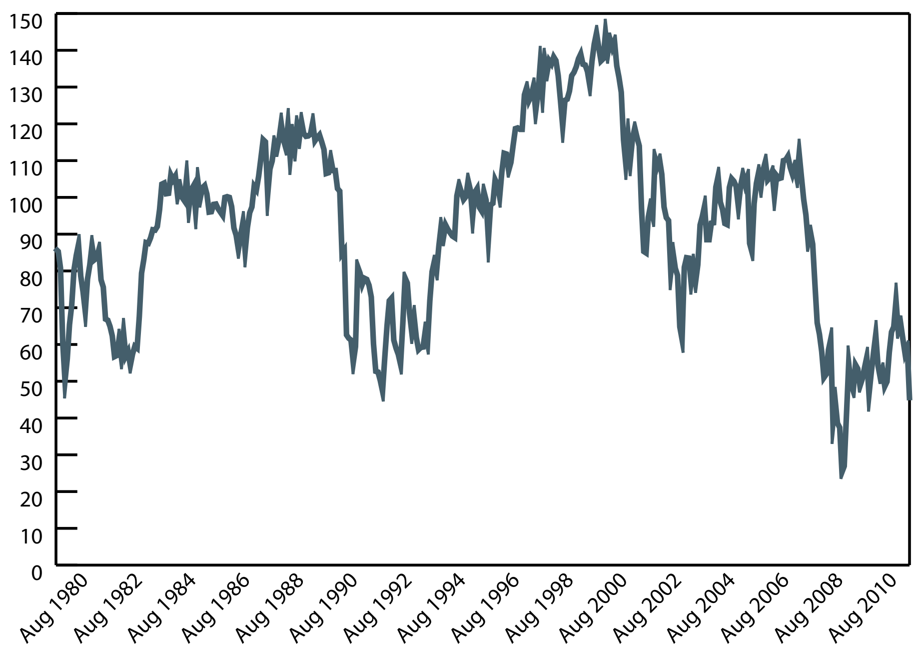
Exhibit 1-6. Actual Versus Historic Average Housing Starts



Source: U.S. Census, July 2011.

Consumer confidence remains stubbornly low, with the Conference Board's Consumer Confidence Index hovering in the 50s and 60s, as shown in Exhibit 1-7. From the perspective of consumers, confidence corresponds to deep recessionary conditions. Despite the favorable conditions to re-engage

Exhibit 1-7. Consumer Confidence Remains Low



Sources: The Conference Board, Haver Analytics, Sept. 14, 2011.

in the housing market, from the current low interest rates to affordable pricing, consumers are the ones who ultimately must pull the trigger; if consumers stay on the sidelines, then housing and economic conditions may remain troublesome throughout 2012.

Policy changes may impact the housing recovery as well. For example, changes to the percent down-payment requirement and phasing out the mortgage interest deduction are proposals that could be detrimental to the housing market. Irrespective of the merits and demerits of these policy changes for the long term, such policies could affect housing and the economy in the near term.

Outlook

A housing recovery may help bring about economic recovery. Both fiscal and monetary policies may not matter too much, but due to the effects of deleveraging, economic growth may not be terribly strong. As summarized in Exhibit 1-8, GDP is expected to expand at 2 percent to 2.5 percent in 2012 and 2013.

Wildcards

Many southern European countries are facing the difficulties associated with past years' government payouts now clashing with very high, possibly unsustainable, budget deficits. Greece is the most acute case, although Portugal, Spain, and Italy may not be too far behind. In addition, French banks have significant exposure to the sovereign debts of these countries, so France could also be included on the watch list—if its government has to bail out the French banks. Germany's meaningful size may potentially help out its fellow euro-zone countries, but there are intense political pressures from German citizens not to throw money at countries perceived as irresponsible.

Putting it all together, one would not expect significant help from Europe to fuel U.S. export growth. A potentially troubling scenario is one in which the meaningfully-sized economies of Spain or Italy technically default and then give up the euro currency. The hemorrhaging that could result in the financial markets might be as severe, or more so, as the one the U.S. economy experienced after the fall of Lehman Brothers in late 2008. It is not about a single firm or a country; rather, it is about the broad financial liquidity panic wrought by a single firm or a country. Normally a wildcard, oil prices are known to change quickly, and could also affect consumer spending globally.

Still, aside from the European picture and uncertainty in the Middle East, emerging markets are growing at quite a healthy pace in terms of GDP. Recovering economies typically engage in greater international trade. According to NAR's outlook, U.S. exports may rise at an 8- to 10-percent annualized clip in the next two years, although import growth may be slower (5 percent to 7 percent), in part due to slower U.S. income growth and some residual impact of consumer deleveraging. The trade deficit will likely persist, even at these differential export and import growth rates, because the starting point of the gap is just too large at $560 billion in the past 12 months. Still, the deficit gap is likely to slowly narrow and to contribute to GDP growth, per NAR's outlook.

Exhibit 1-8. Economic Forecast: Growth and Interest Rates

Growth	GDP	Consumption	Investment	Government	Net Exports (in $billions)
2009	-3.5	-1.9	-17.9	+1.7	-359
2010	+3.0	+2.0	+4.4	+0.7	-422
2011 estimate	+1.6	+1.6	+8.1	-1.9	-411
2012 forecast	+2.0	+1.8	+8.7	-0.5	-390
2013 forecast	+2.5	+2.0	+7.5	-0.4	-345

Interest Rates	Fed Funds	Prime Rate	10-year Treasury	Corporate AAA Bond	30-year Mortgage
2009	0.2	3.3	3.3	5.3	5.1
2010	0.2	3.2	3.2	4.9	4.7
2011 estimate	0.1	3.1	2.8	4.7	4.5
2012 forecast	0.1	3.1	3.1	5.3	5.0
2013 forecast	0.7	3.7	3.7	5.8	5.6

Sources: Federal Reserve Board, NAR, October 2011.

2 | THE CAPITAL MARKETS

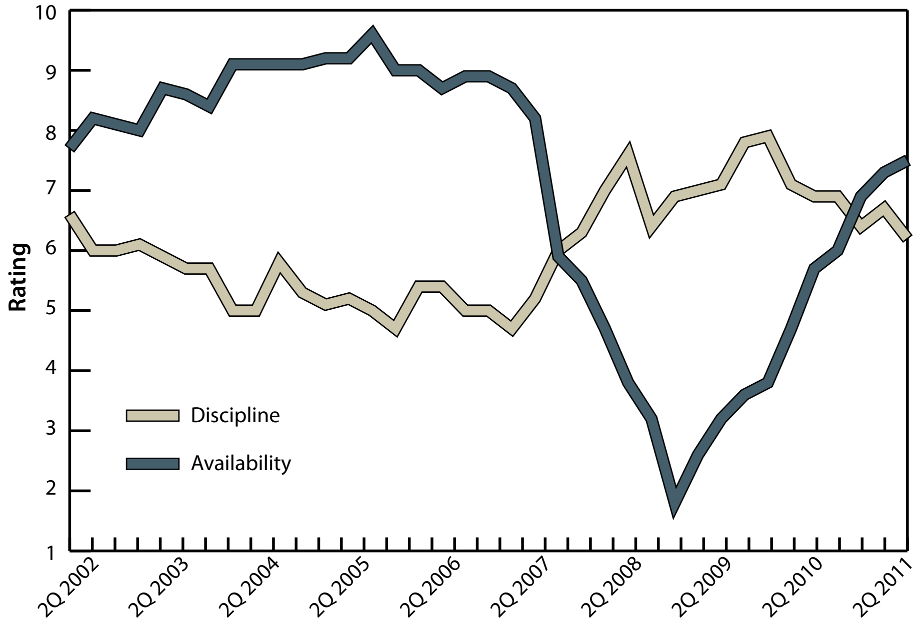
Easing Continues

Given the volatility of the stock market, worry that the U.S. economy may tip back into recession, and fears about the sovereign debt crisis and financial weakness in Europe, investors continue to search for stability in their investments, and as such, commercial real estate is becoming even more attractive as an asset class for some investors. These investors view commercial real estate as more transparent and tangible. What's more, according to RERC's institutional investment survey respondents, lending is increasing for this asset class.

RERC's institutional investment survey respondents also state that both the availability of capital for commercial real estate investment and investment risk are continuing to increase. Interestingly, as shown in Exhibit 2-1, we are now in a period where the availability of capital has outpaced discipline. While capital is amply available for high-profile/core assets, bifurcation of available capital continues to exist among the lower-tier asset classes.

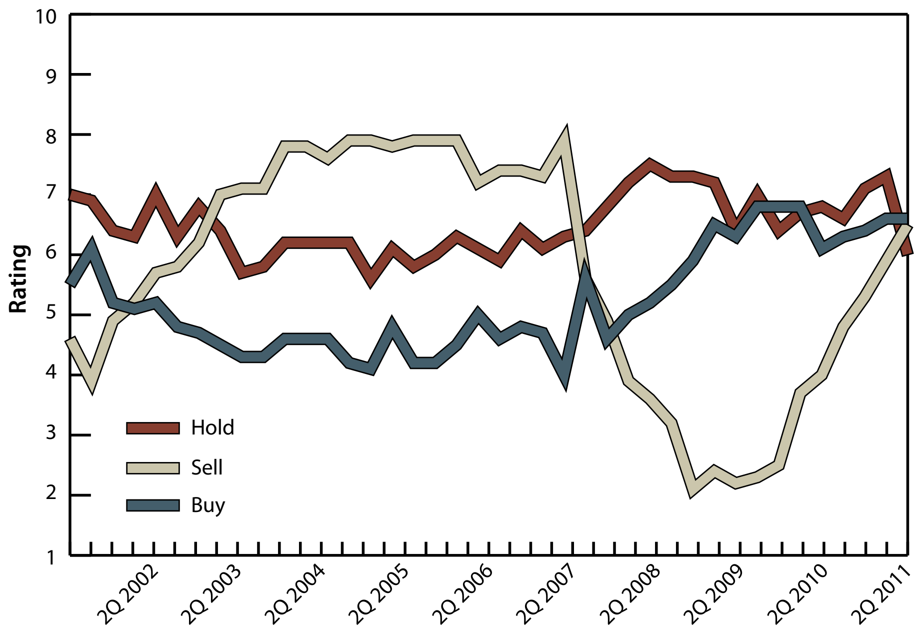
The increasing availability of capital is also reflected in the buy-sell-hold recommendations offered by RERC's institutional investment survey respondents. As illustrated in Exhibit 2-2, the recommendation to hold commercial real estate dropped during second quarter 2011, while the recommendation to buy remained steady and the recommendation to sell increased. This is the first time in recent history that both the recommendation to buy commercial property and the recommendation to sell commercial property were higher than the recommendation to hold this asset class.

Exhibit 2-1. Historical Availability & Discipline of Capital



Ratings are based on a scale of 1 to 10, with 10 being high.
Source: RERC, 2q 2011.

Exhibit 2-2. Historical Buy, Sell, Hold Recommendations



Ratings are based on a scale of 1 to 10, with 10 being high.
Source: RERC, 2q 2011.

These indications of investor sentiment are further demonstrated in the Mortgage Bankers Association's (MBA) Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations, with second quarter 2011 mortgage loan originations 52 percent higher than first quarter originations, and 107 percent higher in second quarter 2011 than in the same period a year ago. The increase in loans for commercial properties was led by loans for health care properties, followed by loans for hotels, retail properties, apartments, office buildings, and industrial properties.

Among investor types, the MBA reports that loans for commercial mortgage-backed securities (CMBS) increased by 638 percent in second quarter 2011 compared to second quarter 2010. During the past year, loans for commercial bank portfolios increased 150 percent, loans for life insurance companies increased 87 percent, and loans for government-sponsored entities (GSEs)—primarily Fannie Mae and Freddie Mac—increased 58 percent (see fixed-income lender composition in Exhibit 2-3).

LENDING AND MORTGAGE ORIGINATION

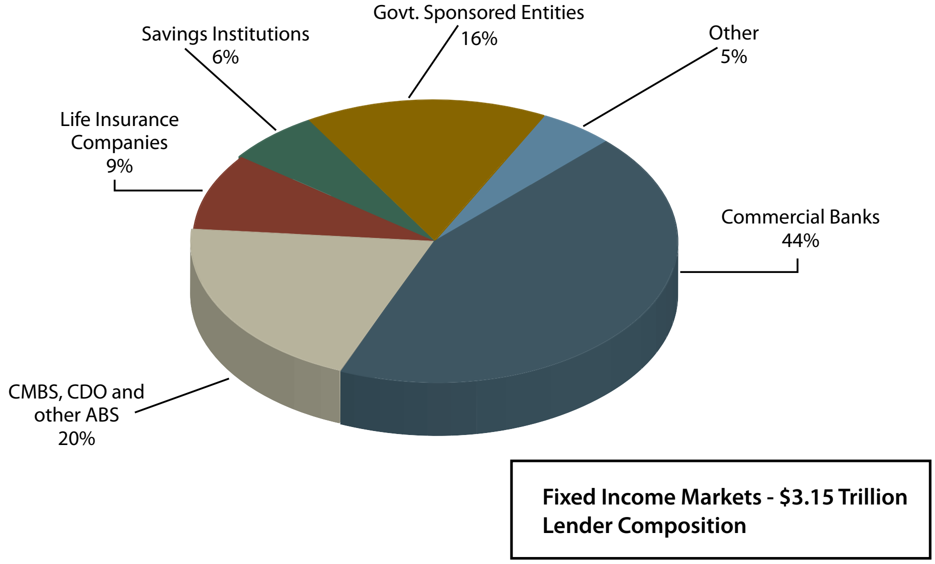
The scarce lending that occurred following the September 2008 financial market blow-up generally consisted of loans with government backing, and commercial real estate loans with no guarantee from the government were essentially non-existent in 2009 and early 2010, according to RERC's institutional investment survey respondents. Now, more than two years after the credit crunch, money is starting to flow into commercial real estate, per RERC data. Commercial and multifamily mortgage originations more than doubled in the first half of 2011 compared to the same period a year earlier. Still, current activity remains subdued compared to the hyperactivity back in 2006 and 2007.

The strong increase (150 percent) in portfolio lending by banks is potentially encouraging. Of course, bank originators cannot simply off-load those whole loans onto the non-government backed CMBS market, as memories remain fresh of the disasters brought to those who bought any private MBS—commercial or residential—in the past.

While extra care goes into these bank balance sheet originations, compared to the pass-through of CMBS, lenders may be feeling more confident about the direction of commercial real estate.

Along with higher loan originations, many commercial real estate investors have easier access to debt and

Exhibit 2-3. Fixed-Income Lender Composition



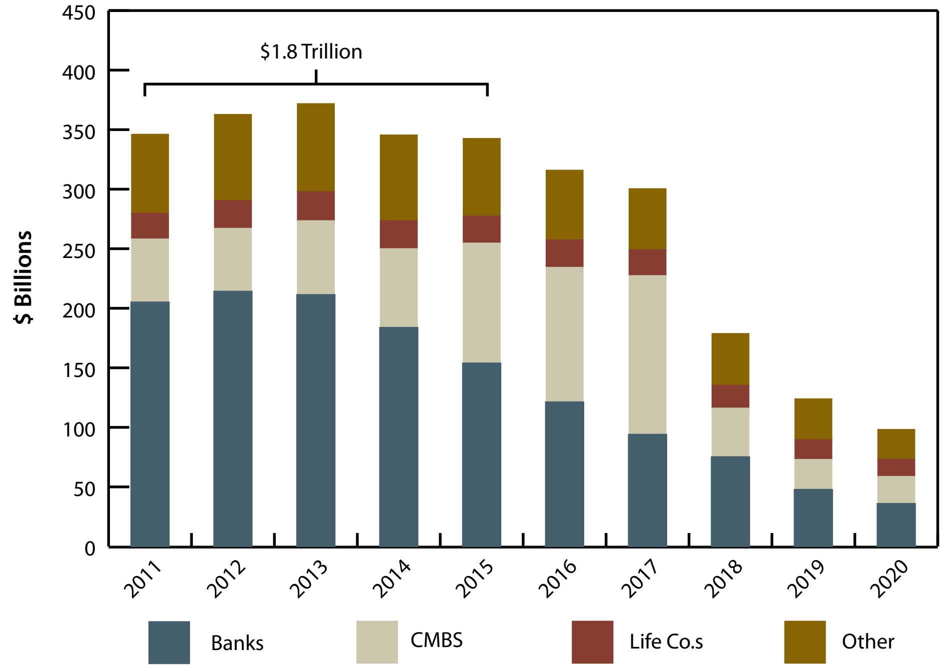
Source: Federal Reserve Flow of Funds, September 2011.

equity capital to meet their refinancing requirements. In addition, as commercial real estate values rose and as distressed debt resolution through loan sales, refinancing, and foreclosure increased, lenders have been gradually moving away from the 2010 "amend and extend" strategy, according to the Federal Reserve's third quarter 2011 Senior Loan Officer Opinion Survey.

The uptick in loan restructuring and improved property fundamentals have decreased commercial real estate loan delinquencies to 7.1 percent in second quarter 2011 compared to 8.8 percent in second quarter 2010, according to the Federal Reserve. However, slower recovery of non-prime properties and continued economic uncertainty remain challenges for the $1.8 trillion in commercial real estate debt maturities due by 2015 (see Exhibit 2-4), according to Trepp, LLC, despite an improved refinancing market for commercial real estate loans. (Trepp, LLC estimates that nearly 60 percent of these loans are underwater, raising concerns about the timing for a commercial real estate recovery.)

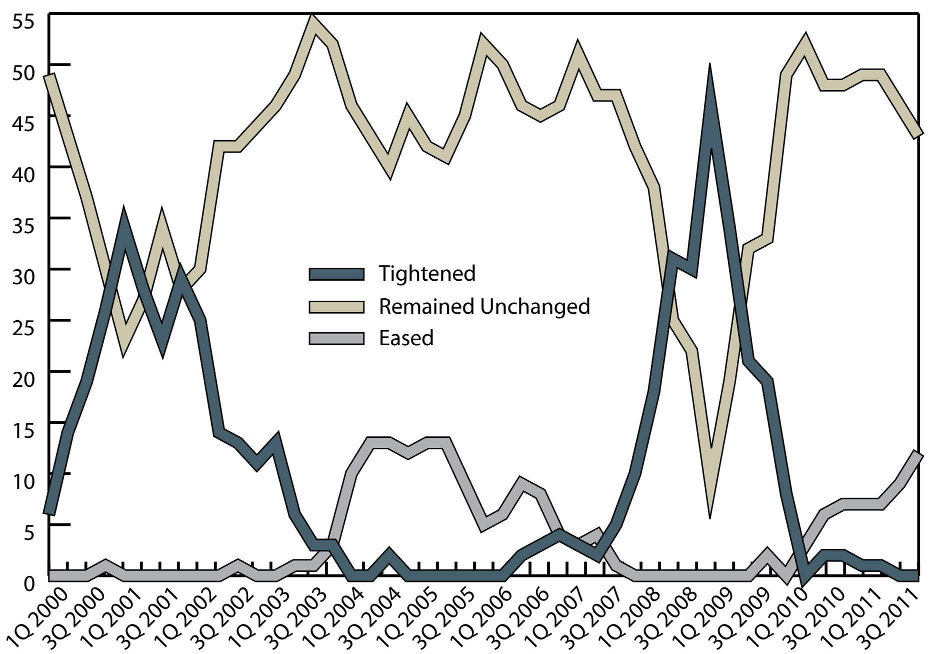
The Senior Loan Officer Opinion Survey on Bank Lending Practices conducted by the Federal Reserve has shown some degree of easing credit. After the near-collapse of lending in late 2008, the trend toward easing has been rising with each passing quarter, as illustrated in Exhibit 2-5. For commercial and industrial loans, no loan officer indicated further tightening in credit standards for loan approvals in third quarter 2011, while 22 percent indicated slight easing. The basic fundamentals for easing are developing from the simple fact of cash flowing into the banking system. In addition to the exceptionally low federal funds rate and the Federal Reserve's discount window borrowing rates for financial institutions, corporate profits in the U.S. financial industry have recovered quite nicely in a relatively short span of time. After suffering a loss during the credit crunch in fourth quarter 2008, corporate financial profits reached an all-time high during fourth quarter 2010 at an annual rate of $512 billion, according to the BEA. At the end of 2010, domestic industries earned

Exhibit 2-4. Commercial Real Estate Debt Maturities Remain a Challenge



Source: Trepp, LLC, 1q 2011 Update.

Exhibit 2-5. Bank Credit Continues to Ease

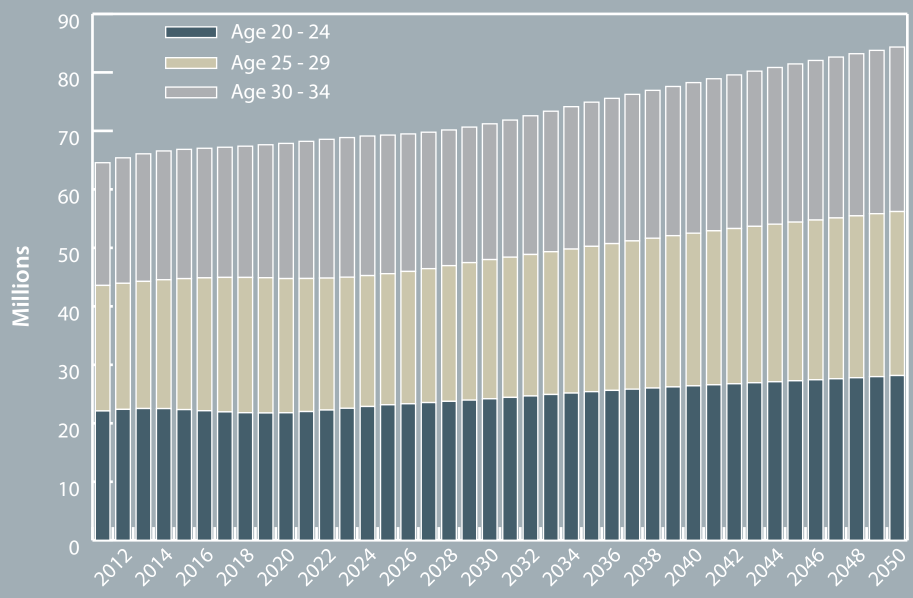


Source: Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, 3q 2011.

APARTMENT LENDING TO INCREASE

According to the FHFA, Fannie Mae and Freddie Mac have boosted lending in the multi-family/apartment arena by 58 percent from a year ago. Given the measurable declines in apartment vacancy rates and rising rent trends, GSEs may be willing to provide more purchases of multifamily loan originations. And, demographic trends tracked by the U.S. Census Bureau, point to a solid and sustained increase in the number of young households for at least the next 40 years, if not more, suggesting continued strong demand for rental housing going forward, as depicted in the accompanying graph.

Demographic Trends Forecast



Source: U.S. Census Bureau, September 2011.

According to the U.S. Census, in 2011, there are 17.4 million people who range in age from 16 years to 19 years. As these young people move into their 20s, many will choose rental housing. Census Bureau projections state that by 2050, the number of people who range in age from 16 years to 19 years is projected to be 22.4 million. Assuming two persons per household, those figures show the need for 2.5 million new additional rental units just to house young households in their 20s, not counting the volume of new construction needed to replace uninhabitable units.

profits at an annual rate of $1.485 trillion, which has grown during the first half of 2011 to an annual rate of $1.492 trillion.

Exhibit 2-6. Spread Between Required Going-in Cap Rates and 10-Year Treasurys

Sources: RERC Institutional Data (Preliminary), U.S. Department of the Treasury, 3q 2011.

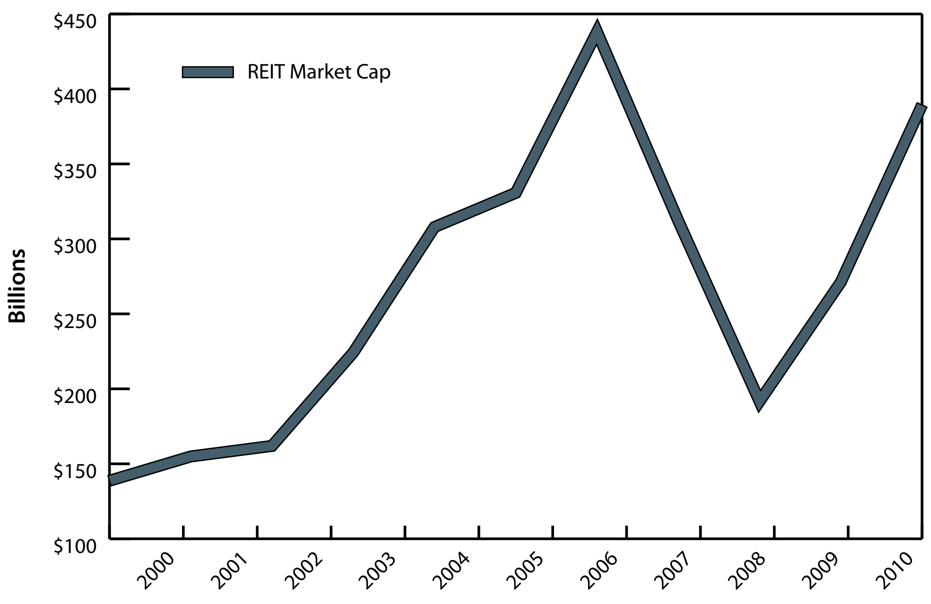
Some life insurance companies, pension funds, and other institutional investors who include commercial real estate holdings in their investment portfolios may also be hoping to achieve higher yields than can be realized by parking money in low-yielding money market funds or U.S. government bonds. Though capitalization rates have been sliding, the gap between commercial real estate rates of return and ultra-safe U.S. government bond yields (irrespective of the S&P's downgrade of U.S. debt) provides a nice safety cushion, should U.S. government borrowing rates rise in the near-to-medium term from higher inflation or a much improved economy (see spread between required going-in cap rates and 10-year Treasurys in Exhibit 2-6). In either case, higher rents may be extracted, leaving a buffer zone against any possible rising interest rate environment.

CMBS

Although CMBS issuances dropped to near zero in 2009, the CMBS market showed signs of recovery in 2010, with issuance of $11.6 billion, and has increased to $22.5 billion year-to-date 2011, according to Real Capital Analytics. However, recent credit market volatility will likely have an adverse effect on the pipeline. For instance, J.P. Morgan reduced its CMBS issuance target to $30 billion to $35 billion from its prior estimate of $45 billion, due to pull-out by borrowers. Pricing of new CMBS issuance is being impacted by wide spreads, given fresh concerns about U.S. economic growth. CMBS issuance may pick up once the market returns to normal. The re-emergence of the CMBS market is having a significant impact on the availability of debt capital going forward.

While CMBS delinquency rates remain high at 9.5 percent as of August 2011, the pace of delinquencies has significantly moderated, and any future rise in delinquencies should continue to be slow amid improved refinancing options, reported Real Capital Analytics. In fact, Fitch recently lowered its 2012 estimate of CMBS delinquencies to 10 percent from 12 percent. Further, the bulk of CMBS maturities are due in 2015-2017, with an average annual figure of $116.3 billion compared to $59.1 billion in 2011-2014.

Exhibit 2-7. REIT Capitalization Values



Source: NAREIT, September 2011.

REITs

Real estate investment trust (REIT) market capitalization values have shot up sharply from overcorrected levels following the 2008 credit crisis (see Exhibit 2-7). According to the National Association of Real Estate

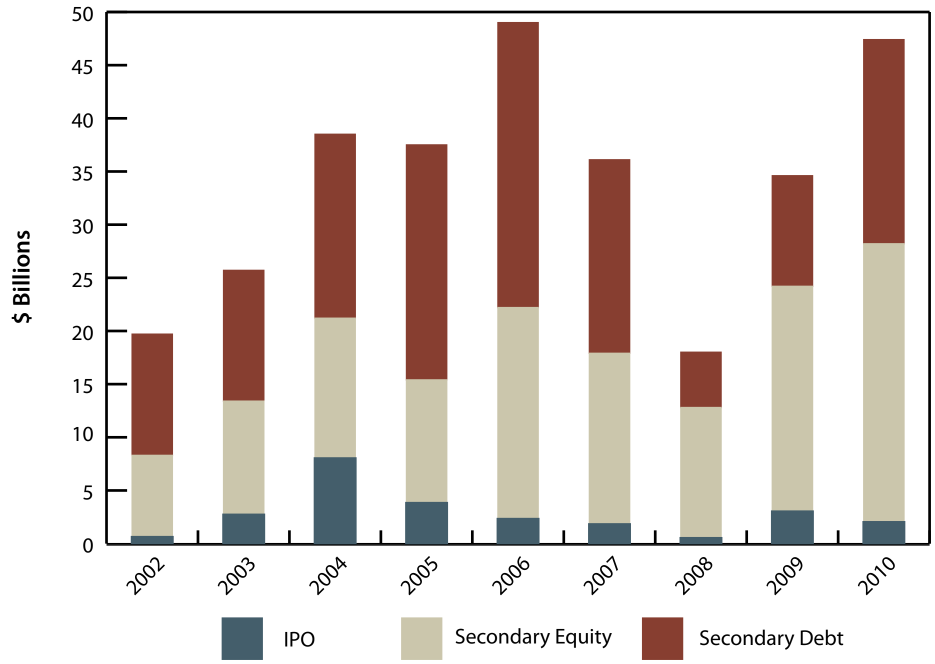
Investment Trusts (NAREIT), the total market valuation of outstanding public REIT companies was $191 billion in 2008. That total rose to $271 billion in 2009 and to $389 billion in 2010. Market conditions have been volatile in 2011 with a continued increase in market value in the first half of the year, but falling measurably in the second half, with the valuation likely settling around an estimated $350 billion in September, based on changes in the REIT Price Index.

Higher valuations have naturally permitted new REITs to be formed and to raise capital for investment in commercial real estate (as well as to deleverage balance sheets), and they have allowed existing REITs to go on a shopping spree for opportunistic and strategic opportunities, especially with development activity remaining low.

As shown in Exhibits 2-8 and 2-9, new capital raised by REITs in 2010 was $47 billion, and based on incoming data, even more may be raised in 2011. Going into 2012, there appears to be plenty of cash ready to come into the commercial market arena.

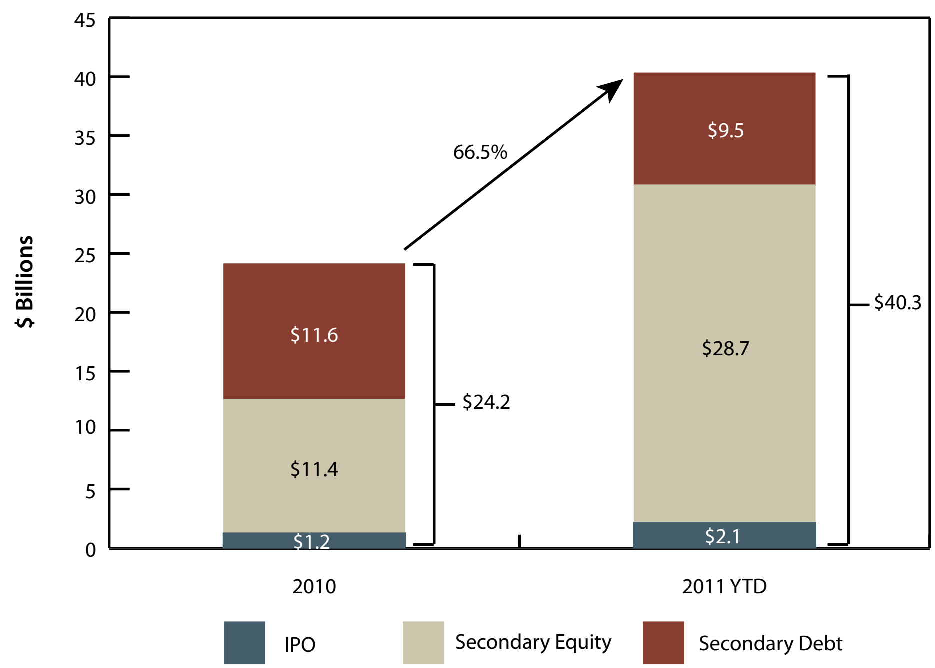
Following negative returns during the recession (Exhibit 2-10, on the following page), REITs rebounded in 2009 with attractive returns of 27.5 percent and continued the trend in 2010. In 2011, however, REIT returns have been lower due to the underperformance of the broader equity markets amid continued economic uncertainty. Despite modest returns of 3.4 percent, as of August 29, 2011, REITs still outperformed most asset classes as investors sought portfolio diversification and required inflation-hedged returns.

Exhibit 2-8. Public REIT Fundraising (2002-2010)



Source: NAREIT, August 2011.

Exhibit 2-9. Rise in Public REIT Fundraising (2010 year-to-date vs. 2011 year-to-date)



Year-to-date = as of July 31, 2011.
Source: NAREIT, August 2011.

Exhibit 2-10. REITs Outperformed Other Investment Classes

Asset Class	FY07	FY08	FY09	FY10	FY11 YTD*
Private Real Estate (NCREIF Property Index)	15.9	-6.5	-16.9	12.6	7.3**
Public REIT (All REIT Index)	-17.8	-37.3	27.5	27.6	3.4
DJIA	6.4	-33.8	18.8	11.0	-0.3
S&P 500	5.5	-37.0	26.5	15.1	-2.5
NASDAQ	9.8	-40.5	43.9	16.9	-3.4
Russell 2000	-1.6	-33.8	27.2	26.9	-6.8

*YTD is as of August 29, 2011. **As of June 30, 2011
Sources: NCREIF, NAREIT, DJIA, S&P 500, NASDAQ, Russell 2000, Aug. 29, 2011.

Forging a Path to Recovery: Lifting the Cloud of Regulatory Uncertainty

by Clifton E. Rodgers, Jr.

With nearly 14 million people still unemployed, the U.S. economy faces some very tough challenges, and the commercial property industry continues to be affected by this economic distress.

Hopes for a broader recovery in real estate credit markets continue to be undermined by uncertainty in the global credit markets and the broader economy, and further exacerbated by a lack of confidence in the credit rating process and the regulatory climate. Persistent weakness in the housing market, anemic job growth, and tight credit in many parts of the country are also impeding a strong economic resurgence.

The $30 billion in new CMBS issuance projected by J.P. Morgan for 2011 is an improvement from the prior year ($14 billion), but is well below what is needed to refinance hundreds of billions of dollars in maturing commercial real estate debt. Despite the positive turnaround in issuance, the delinquency rate on loans in CMBS rose to the highest level in 14 years.

With an estimated $1.4 trillion of commercial real estate loans maturing over the next few years, credit problems persist. This number reflects the fact that many commercial real estate loans will not qualify for refinancing at maturity without significant equity infusions. As such, "re-equitizing" the mountain of commercial real estate loans made during the boom remains a serious challenge.

One approach to possibly filling this "equity gap" is to encourage capital from foreign investors, including sovereign wealth funds.

Climate of Regulatory Uncertainty

The 2,300-page Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in 2010, unleashed the biggest wave of new federal financial rule-making in generations. A year after its enactment, Dodd-Frank continues to reverberate across the financial services industry, as 11 federal agencies try to implement some 243 new formal rule-makings.

One of the rules imposed by Dodd-Frank affects asset-backed securitization, and specifically, CMBS. This so-called "skin in the game" rule requires banks who package loans to retain 5 percent of the credit risk on their balance sheets, and is intended to better align the interests of the sponsor with those of investors by providing sponsors with an incentive to control the quality of securitized assets. In March 2011, five federal banking and housing agencies, as well as the Securities & Exchange Commission (SEC), released a 367-page set of proposed rules to implement the Dodd-Frank mandated credit risk retention requirement for certain securitization transactions.

As stated in The Real Estate Roundtable's August 1, 2011 comment letter, The Roundtable believes that the proposed risk retention rules were intended to ensure that the commercial real estate lending market function with an appropriate level of integrity and discipline. Although risk retention may be intended to safeguard bondholders, it also introduces the potential to raise costs for borrowers or to limit the amount of credit and liquidity that are available, particularly to borrowers in secondary and tertiary markets. (The Real Estate Roundtable supports efforts to promote economically responsible commercial real estate lending that reflects sound underwriting and risk management practices, and rational pricing of economic risk.)

Clifton E. Rodgers, Jr. is the senior vice president of The Real Estate Roundtable. The Roundtable represents the leadership of the nation's top privately-owned and publicly-held real estate ownership, development, lending, and management firms, as well as the elected leaders of the 17 major national real estate industry trade associations. Collectively, Roundtable members hold portfolios containing over 5 billion square feet of developed property valued at over $1 trillion, over 1.5 million apartment units, and in excess of 1.3 million hotel rooms. Participating Roundtable trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business. More information on The Real Estate Roundtable can be found at ***www.rer.org****.*

3 | THE PROPERTY MARKETS

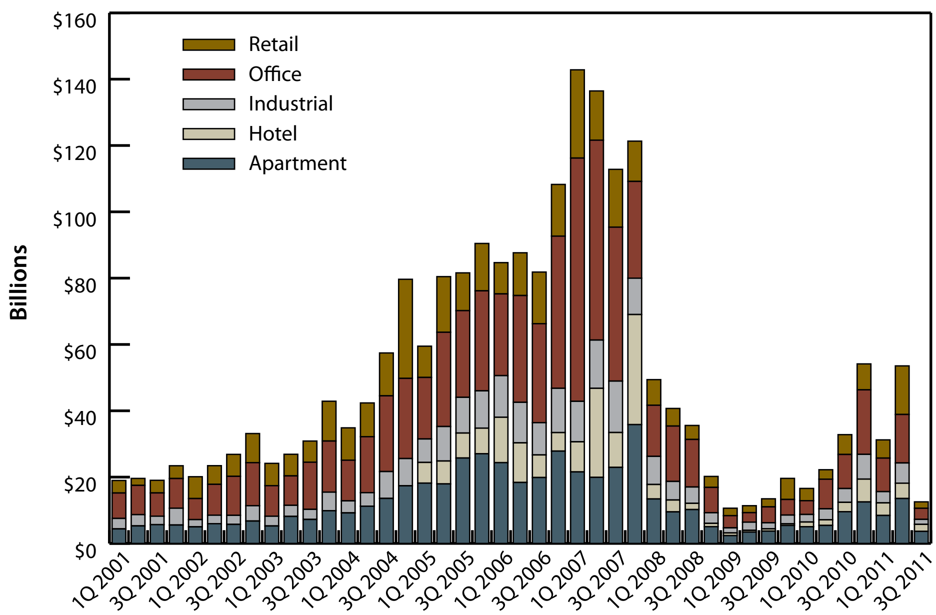
Perspective and Analysis

Commercial real estate markets generally advanced in 2011, despite a global economic environment marred by volatility and uncertainty. In fact, the shifting landscape appears to have been advantageous for commercial real estate, as many investors focused on asset diversification across global markets. In the wake of post-recession monetary policy actions undertaken in 2009 and 2010, capital availability and increased international trade have boosted demand for commercial property investments in 2011. While recoveries varied by continent and region, cross-border investors focused on high-quality assets in international metropolitan gateways.

With European debt issues casting a long shadow of uncertainty, the U.S. commercial real estate markets provided an alternative, despite the sluggish economic recovery. Consequently, as depicted in Exhibit 3-1, sales volume rose 117 percent in the first half of 2011, according to Real Capital Analytics, reaching $90.6 billion in transactions. Although the pace slowed considerably during the third quarter, sales volume surpassed 2010 totals by September 2011, and may close-in on the $200 billion threshold before December.

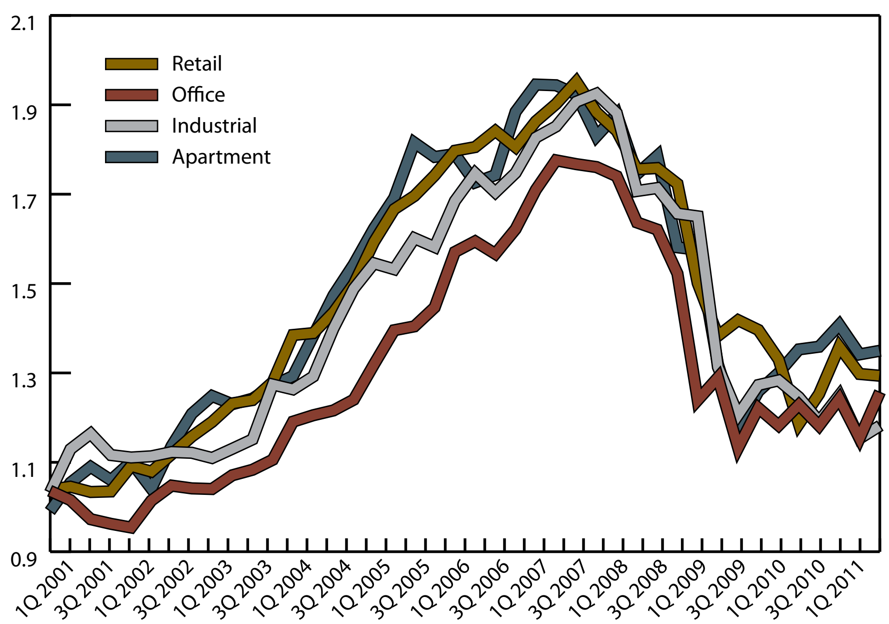
In addition, prices for commercial assets stabilized in 2011, as shown in Exhibit 3-2, with some properties posting noticeable gains. The bifurcation of commercial assets along location and value remained. Major markets with strong local economies—New York City, San Francisco, Washington, D.C., Boston, and Chicago—experienced a combination of higher prices and declining cap rates. The improved valuation landscape brought a rise in new offerings, with supply growing by

Exhibit 3-1. Commercial Property Volume Increases



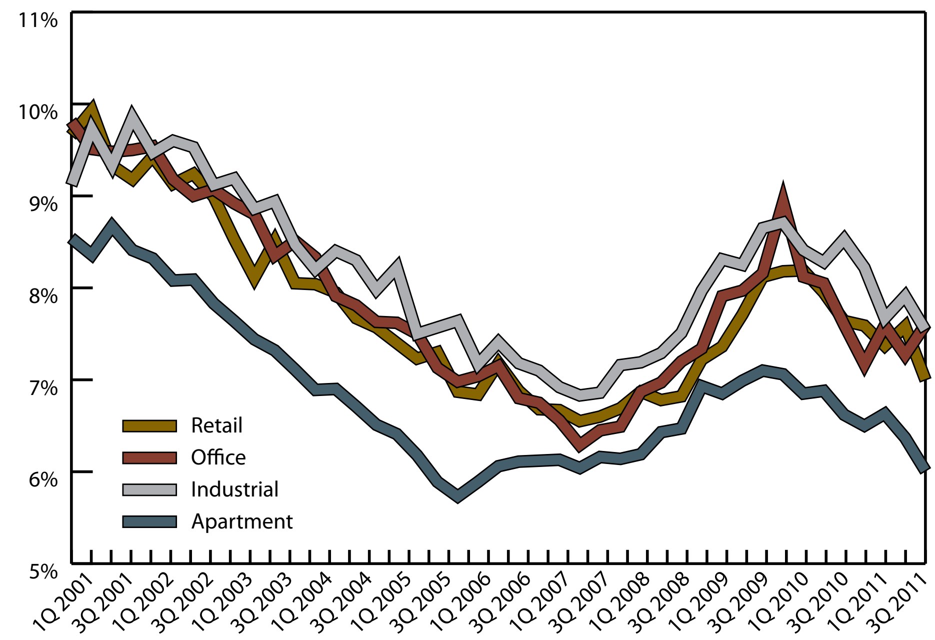
Source: Real Capital Analytics, September 2011.

Exhibit 3-2. Property Prices Level Out in 2011



Source: Moodys/REAL Commercial Property Price Index (CPPI), MIT Center for Real Estate, 2q 2011.

Exhibit 3-3. Most Cap Rates Declined in 2011



Source: Real Capital Analytics, 3q 2011.

double digits compared with the prior year. In the top-tier markets, most of the supply was easily absorbed by investor demand. While secondary and tertiary markets continued to struggle with higher prices, they may have started to become attractive to investors looking for higher yields.

During the first half of 2011, there were 25 markets which exceeded $1.0 billion in commercial sales, according to Real Capital Analytics. Manhattan retained the top spot with $9.7 billion in transactions, followed by Los Angeles and Chicago, with $5.9 billion and $3.8 billion, respectively. Rounding out the top five were Washington, D.C., which posted $3.2 billion in sales, and San Francisco, with transactions totaling $2.9 billion.

In addition, 39 of the 40 top markets registered year-over-year sales gains in the first half of the year. Some of the strongest performers in yearly gains were markets that had lagged in transaction volume, such as Atlanta, Phoenix, Las Vegas, and Philadelphia.

With many investors searching for higher returns in smaller cities, tertiary markets as a group recorded faster growth—129 percent year-over-year—than primary and secondary markets in the first half of 2011, and totaled over $16.5 billion in sales.

Cap rates for commercial properties maintained their downward trend in 2011, as demonstrated in Exhibit 3-3. Based on Real Capital Analytics data, average overall cap rates declined from 7.7 percent in the first half of 2010 to 7.2 percent in the first six months of 2011. A few trophy properties in markets like New York sold in the low 5.0-percent range, while those in secondary markets hovered around 8.0 to 9.0 percent. The higher rates proved to be the silver lining for secondary markets, as investors shifted capital into commercial properties offering better returns.

Commercial markets also witnessed the return of large deals and portfolio transactions during 2011. In the first half of the year, there were 130 transactions valued at $100 million or more, according to Real Capital Analytics data. This research showed that multi-market portfolio transactions also gained traction, indicating investors' optimism about the performance and outlook of entire property sectors.

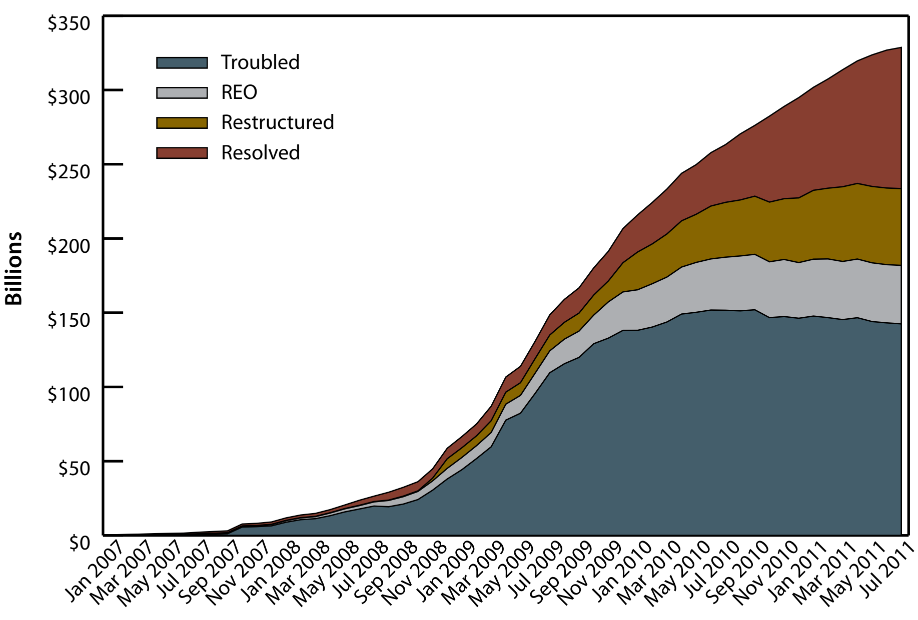
Distressed commercial properties provided a growing supply of inventory for investors in 2011. Distressed sales totaled $15.6 billion in the first half

of the year, based on data from Real Capital Analytics, double the figure recorded in the first half of 2010 and representing 17 percent of all sales in the first half of 2011. With outstanding distress having surpassed $180 billion by mid-2011 (see Exhibit 3-4), distressed sales may remain part of the landscape for the next few years.

Financial markets provided a volatile environment for investors in 2011, and kept financial institutions in a risk-averse posture, especially towards commercial real estate. While banks funded some projects, mortgage originations remained tepid and lending conditions continued to be tight. According to Real Capital Analytics, bond markets also traversed a jarring period, and CMBS conduits—which rebounded at the end of 2010 and into the first part of 2011—also maintained a slower pace of originations.

As noted in Chapter 2 of this report, the dominant buyers charging into commercial property markets have been REITs and private investors, along with a growing number of institutional and cross-border investors. Blackstone led the group of top buyers, with its acquisition of the $9.2 billion Centro portfolio. Vornado Realty Trust, Invesco RE, and Related Cos. followed close behind.

Exhibt 3-4. Distress Property Sales Continue



Source: Real Capital Analytics, July 2011.

International investors also boosted their participation in the U.S. market. According to Real Capital Analytics, cross-border investment accounted for 12.3 percent of total sales volume as of July 2011, a noticeable gain from the 8.4 percent registered during the same period in 2010.

These trends mirror positive developments in commercial real estate fundamentals. In spite of sluggish employment growth, the interaction between demand and supply for commercial properties has translated into stabilizing fundamentals. Absorption of commercial space turned positive in the first half of 2011, especially for apartments. Supplanting gains in demand, construction of new commercial space remained at record lows in 2011. As a result, vacancy rates and rents posted slow but steady improvements.

The overall direction for commercial real estate may be stabilizing. However, concerns remain about the pace of U.S. economic growth and the ability of Europe to manage worrisome debt issues.

THE OFFICE MARKET

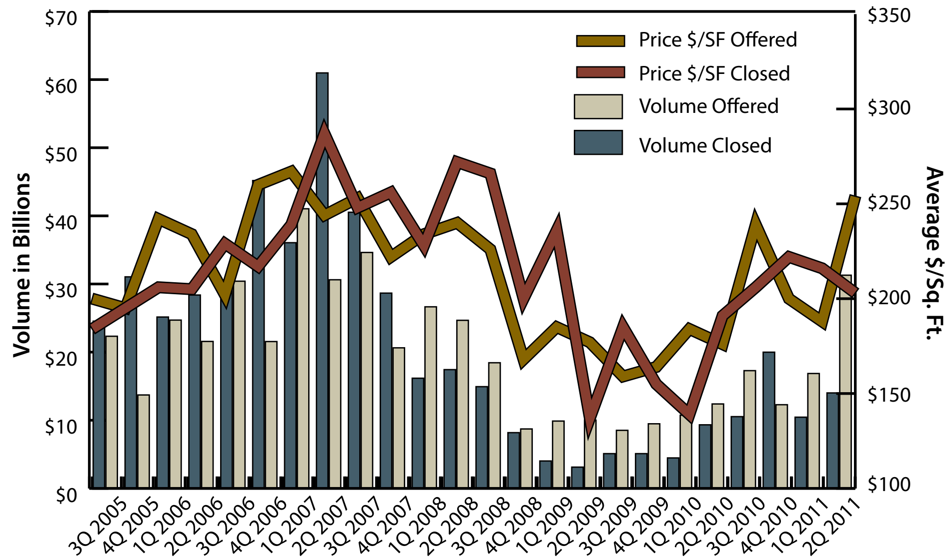
Market Overview

Building on the strong rebound of 2010, the office sector continued to recover in 2011. In the first half of the year, total transaction dollar volume advanced 77 percent, and cap rates declined by 48 basis points compared with the first six months of 2010, as reported by Real Capital Analytics. Keeping with the trend of the past two years, sales volume gained on a year-over-year basis in both the first and second quarters, and as shown in Exhibit 3-A1, sales volume rose to $24.5 billion in the first half of 2011 from $13.8 billion in the first half of 2010. The pace of sales tempered going into the third quarter, however, due to a slowdown in the overall economy.

With economic fundamentals dominated by uncertainty, office investors continued to favor high-quality, stable properties in the major markets—New York, Washington, D.C., Los Angeles, Boston, and San Francisco. Signaling an improvement from 2010, a few recovering inland markets made headway in the first half of 2011 as well, as many investors searched for enhanced returns. Phoenix and Denver moved into the top 10 markets by volume, unseating Chicago and Seattle. Volume rose across most major metros for stabilized properties, with only six markets posting negative sales activity.

A major factor in office investment trends during 2011 has been growth in the number of large deals. While sales volume on a dollar basis rose 77 percent in the first half, the number of properties sold rose by a smaller 45 percent, per Real Capital Analytics. Over the first six months, there were 57 properties or portfolios that traded at values exceeding $100 million. The average deal size rose from $32 million in the first half of 2010 to $37 million in the same period of 2011.

Exhibit 3-A1. Office Property Volume and Pricing

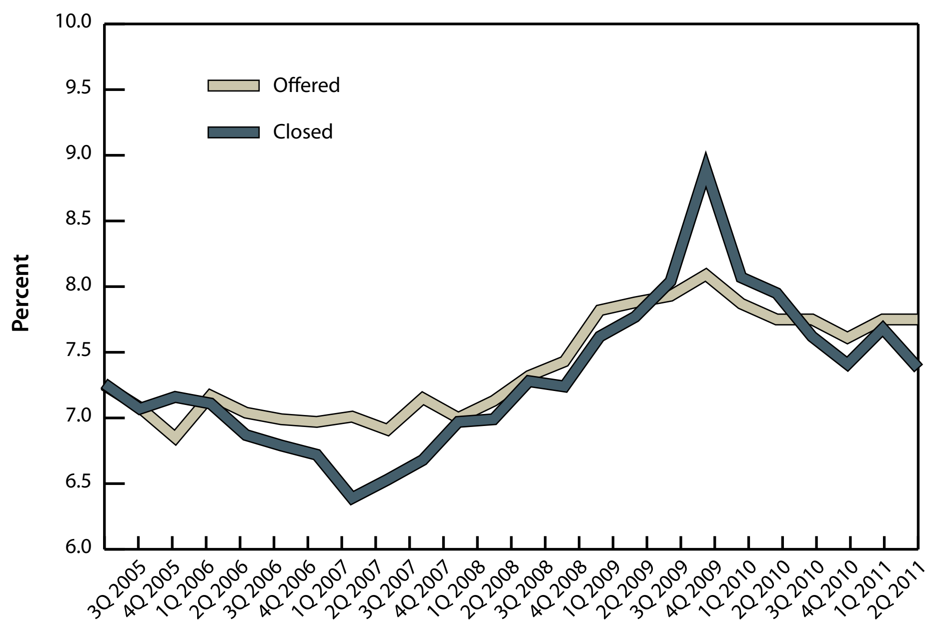


Source: Real Capital Analytics, 2q 2011.

In a change from 2010, office sales volume was distributed evenly between central business district (CBD) and suburban properties in the first half of 2011, at the $12 billion mark. The pace was stronger for CBD space, however, as it rose 112 percent from the first half of 2010. Suburban office sales advanced 51 percent, on a year-over-year basis, in the first half of 2011. Capitalization rates declined 70 basis points for CBD space, and 50 basis points for suburban offices (see Exhibit 3-A2).

Underscoring the potential growing investor demand, pricing for office

Exhibit 3-A2. Average Office Property Cap Rates



Source: Real Capital Analytics, 2q 2011.

properties advanced 27 percent in the first half of 2011, averaging $209 per square foot nationally. With stable economies and fundamentals, the Manhattan and Washington, D.C. markets led the field in both pricing and yield. Office cap rates averaged 5.7 percent in Manhattan and 5.9 percent in D.C., while average prices per square foot were at an elevated $409 in Manhattan and $500 in D.C.

In a sign of gradual improvement, office distress rose only 9 percent in the first half of the year, compared with the same period in 2010. According to Real Capital Analytics, cumulative distressed office reached $81.3 billion, with 47 percent of the total finding resolutions. The relative attractiveness of CBD properties translated into a quicker pace of resolutions compared to suburban space. Geographically, the distribution is similar to investment trends—stable markets, like Manhattan, Boston, and San Francisco posted significant contractions in outstanding distress along with high rates of resolutions. Markets with softer fundamentals, like Atlanta, Sacramento, and Los Angeles, recorded increases in office distress during the first half of the year.

Investor Composition

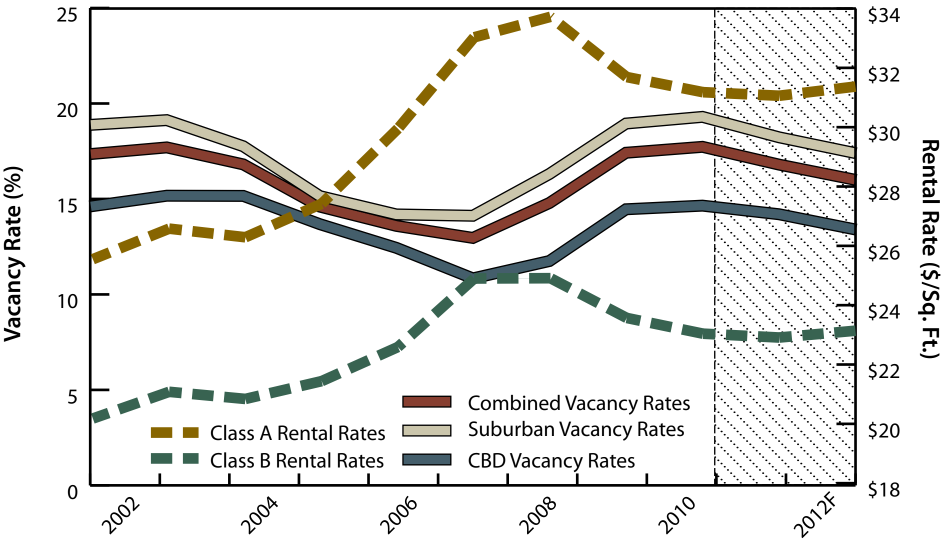
With investors seeking high-quality assets, the office landscape proved competitive in the first half of 2011. Private investors accounted for 30 percent of the market, according to Real Capital Analytics, with $7.2 billion in purchases. Institutional investors increased acquisitions by 182 percent in the first half of 2011, accounting for 23 percent of office sales volume. Equity funds increased their purchase volume by 341 percent in the first half of the year, accounting for $2.7 billion of acquisitions. Meanwhile, international and public investors made up 13 percent and 11 percent of the market, respectively, according to Real Capital Analytics. However, their level of interest diverged noticeably, with international investor purchases growing only 1 percent versus public acquisitions rising 101 percent in the first half of 2011.

During the first six months of the year, five major markets posted transactions exceeding the $1 billion mark in office sales. Manhattan and Washington, D.C. retained their top spots, with $4.7 billion and $2.6 billion in sales, respectively. Los Angeles joined the list with $1.5 billion in office sales, accompanied by Boston and San Francisco with $1.2 billion and $1.1 billion, respectively. However, in keeping with many investors shifting toward inland metros, several more markets are poised to cross that threshold by year-end 2011, including Houston, Chicago, Atlanta, Seattle, Denver, and Phoenix.

Office Market Fundamentals *(courtesy of Grubb & Ellis)*

With the economy grinding down over the summer of 2011, one might think that the office market is close to stalling out. One would be wrong, however, at least through the first half of 2011. Leasing activity surged in the second quarter, pushing net absorption to 12.0 million square feet—the strongest quarterly performance since the last boom. With minimal new completions, the vacancy rate plunged unexpectedly by a stout 40 basis points to end the quarter at 17.3 percent, as shown in Exhibit 3-A3. Some of the markets that

Exhibit 3-A3. Office Property Vacancy and Asking Rental Rates

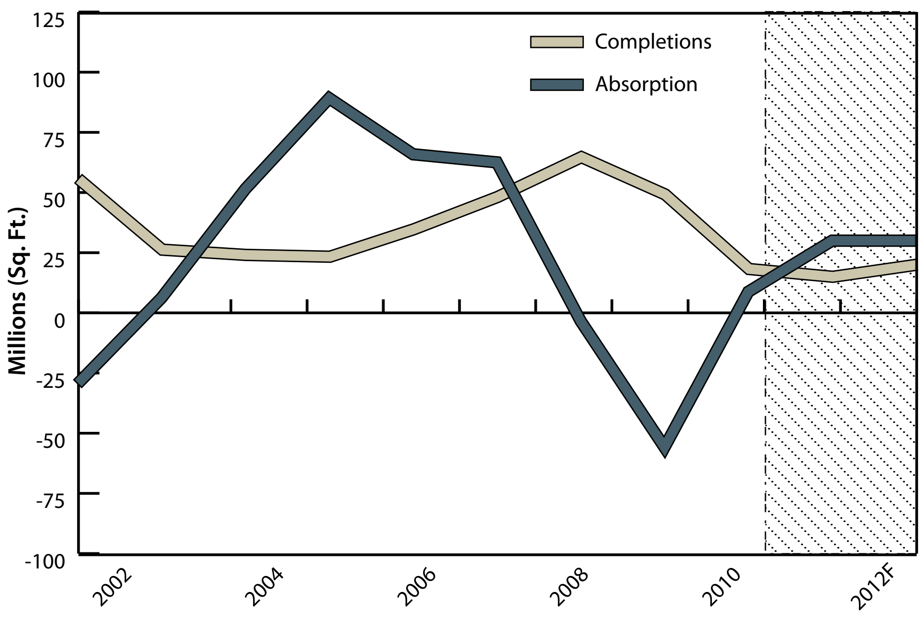


Source: Grubb & Ellis, 2q 2011,

flew the highest during the bubble years and fell the farthest when the Great Recession hit are now recovering the fastest. Since mid-year 2010, vacancy declines were led by Austin (-316 basis points), Orange County, Calif. (-252 basis points), San Francisco (-219 basis points), and Seattle (-206 basis points). The technology industry is a common denominator shared by these markets. With vacancy still at least two years away from equilibrium in most areas, however, rental rates have not begun to recover. Average asking rental rates set new lows in the second quarter, despite a noble assist from mini-rent spikes in a handful of tech markets. Concessions are less generous than they were a year ago for Class A space, but Class B and C buildings still are mired deep in a tenants' market.

Was the surprising second quarter absorption a delayed response to the stronger economy earlier in the year, or could it be that businesses, especially large and profitable ones, may be more willing to take on multi-year space commitments than the recent economic data would suggest? With the economy operating close to stall speed, the "second-quarter surprise" may not be repeated, but the market is not without hope. Most of the recent weakness has been focused on consumer confidence reports, on manufacturing, and on the stock and bond markets. The labor market has, so far, avoided the downdraft; weekly jobless claims have hovered around the 400,000 level—elevated, but stable. If the labor market can remain in the black, even marginally so, that may keep the office market firming at a gradual pace. A double-dip recession would likely hurt the labor market, and by extension, the office market.

Exhibit 3-A4. Office Property Absorption vs. Completions



Source: Grubb & Ellis, 2q 2011.

Outlook

With the economy progressing at an anemic pace over the first half of 2011 and with a sideways advance in the third quarter, job creation may continue to be weak. According to Grubb & Ellis, payroll employment is expected to be moderate for the remainder of 2011 and 2012. While that rate of growth may be sufficient to reverse last year's negative net absorption, it may not provide a significant boost to rents.

Office demand could close 2011 with about 30 million square feet of net absorption, as shown in Exhibit 3-A4. With new completions potentially remaining at roughly half the pace of absorption, the office vacancy rate will decline to 17.1 percent by the end of 2011, from 17.6 percent at the end of 2010. With growing demand possible in 2012, vacancies should reach 16.6 percent in 2012. Considering that during the last expansionary period of 2004 – 2007, absorption ranged between 40 to 60 million square feet, next year may provide a slightly more stable foundation for the office sector.

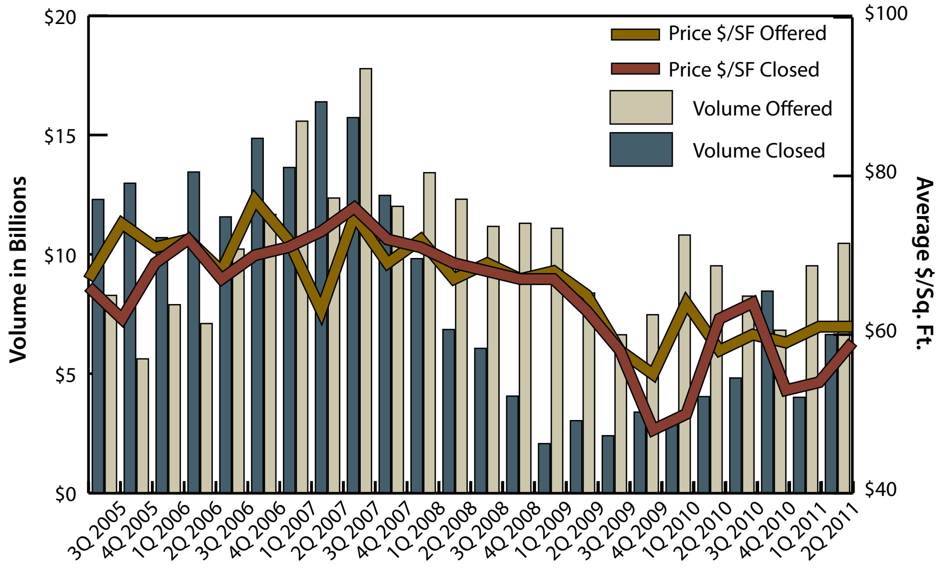
Having bottomed-out in 2010, office rents may grow 1.6 percent in 2011 and 2.0 percent in 2012. While Class A space has successfully attracted tenants, Class B and Class C properties will continue to be a tenants' market into 2012. With conditions in office markets stabilizing, tenants may also continue to find longer-term leases attractive, given current rates.

THE INDUSTRIAL MARKET

Market Overview

With the manufacturing sector focused on rebuilding inventories and international trade expanding, the industrial market advanced in 2011. Investment sales of industrial properties totaled $10.7 billion in the first half of the year, a 54-percent gain from the first half of 2010, reported Real Capital Analytics (see Exhibit 3-B1). Over the first six months, 1,087 industrial properties changed hands, with warehouses accounting for 63 percent of the total transactions. Portfolio transactions took center stage, with 40 deals making up over 20 percent of sales dollar volume. Cap rates declined an average of 32 basis points in the first half of 2011 compared with a year ago.

Exhibit 3-B1. Industrial Property Volume and Pricing



Source: Real Capital Analytics, 2q 2011.

The first half of the year recorded seven deals (mostly portfolio transactions) which exceeded the $100 million mark. The most expensive was a North Carolina showroom that sold for $275 million at $79 per square foot. Meanwhile, on a price-per-square-foot basis, the top deal was a 79,570-square-foot data center in Georgia, which sold at $764 per square foot. The volume of industrial offerings outpaced closed sales almost 2:1. In the first half of 2011, there were $20 billion industrial properties offered for sale, according to Real Capital Analytics.

While investors continued to favor major industrial markets, there were a few changes in the top 10 largest markets by sales during the first half of the year. Chicago became the largest market by dollar volume, followed by Los Angeles. In addition to industrial stalwarts such as Dallas, Atlanta, and the Inland Empire, several markets broke into the top 10—Las Vegas and Greensboro posted the strongest gains, accompanied by San Jose and Orange County. Sales volume rose across most metropolitan areas, with only five metros posting negative year-over-year changes.

Sales of industrial warehouses totaled $6.5 billion in the first half of 2011, a 62-percent gain on a year-over-year basis, according to Real Capital Analytics. Flex space accounted for $4.1 billion in sales, increasing 42 percent from the first half of 2010. Cap rates continued a downward trend for both property types. Warehouse cap rates declined at the same rate as flex cap rates—40 basis points lower in second quarter 2011 than at the end of 2010. On a positive note, in markets like Chicago and Los Angeles, there were a few industrial deals that broke the 6-percent yield floor.

Reflecting investor demand, pricing for industrial properties rose modestly during the first half of 2011, from an average of $54 per square foot to $59 per square foot. Per data from Real Capital Analytics, flex spaces commanded higher prices, averaging $71 per square foot in the first six months. San Francisco recorded the highest price per square foot in the first half, at $209, followed by the Washington, D.C.-Maryland suburbs, with an average price of $199 per square foot. Warehouses sold at an average price of $51 per square foot over the same period in 2011, up from $42 per square foot in the first half of 2010. San Francisco also took the top spot for the highest price—$147 per square foot. Flex space markets at the opposite end of the price spectrum included Detroit at $20 per square foot and Hartford at $12 per square foot, and Kansas City at $12 per square foot and Memphis at $9 per square foot of warehouse space.

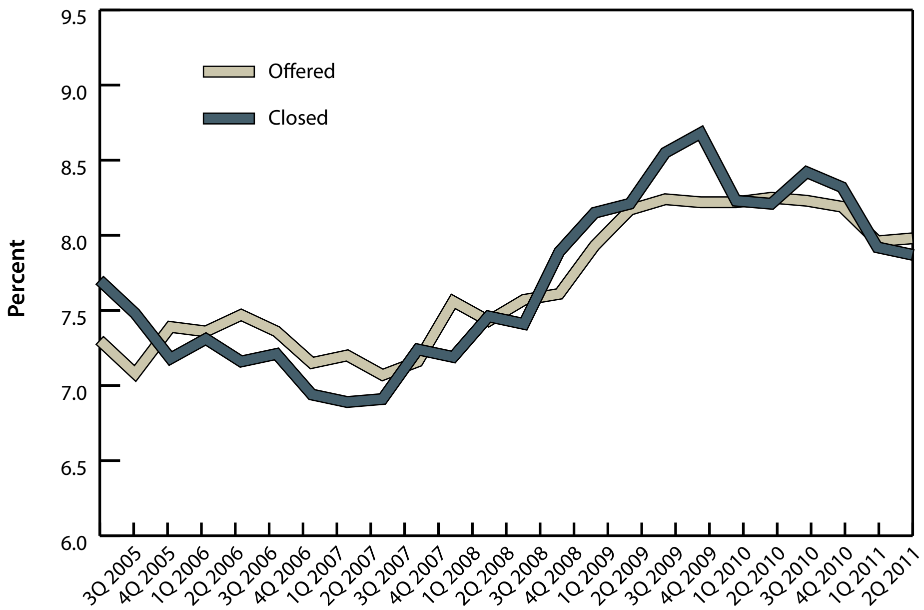
While cap rates averaged 7.9 percent in the first half of 2011 (see Exhibit 3-B2), they ranged across metropolitan markets from a low of 6.6 percent for warehouse space in Los Angeles to a high of 9.1 percent for flex space in Chicago. Generally, the lowest average capitalization rates were found in the West, in markets such as Phoenix, East Bay, Los Angeles, and San Jose.

Over the past few years, industrial properties accounted for the smallest proportion of cumulative commercial distress. At $10.7 billion for the first six months of 2011, outstanding industrial distress made up about 6 percent of the total. In a further positive development, industrial distress declined 1 percent year-over-year, as new additions to distress dropped below $1.0 billion in second quarter 2011.

Additionally, the number of distress-related sales has been rising through the first two quarters of the year, reaching 9 percent of total volume. The weak point in the process is the rate of work-outs, which averaged only 34 percent in the first half, the lowest among core property types.

Warehouses made up two thirds of outstanding industrial distress, at a cumulative total of $6.3 billion. The rate of work-outs was also smaller for warehouses (29 percent) than for flex spaces (40 percent). CMBS and domestic banks retain the largest share of industrial distress, and both entities recorded increased volume in the first half of 2011. In keeping with market size, Los Angeles and Chicago posted the highest industrial distress volumes, at $805 million and $652 million, respectively. With growing investment interest and activity, Las Vegas and

Exhibit 3-B2. Average Industrial Property Cap Rates



Source: Real Capital Analytics, 2q 2011.

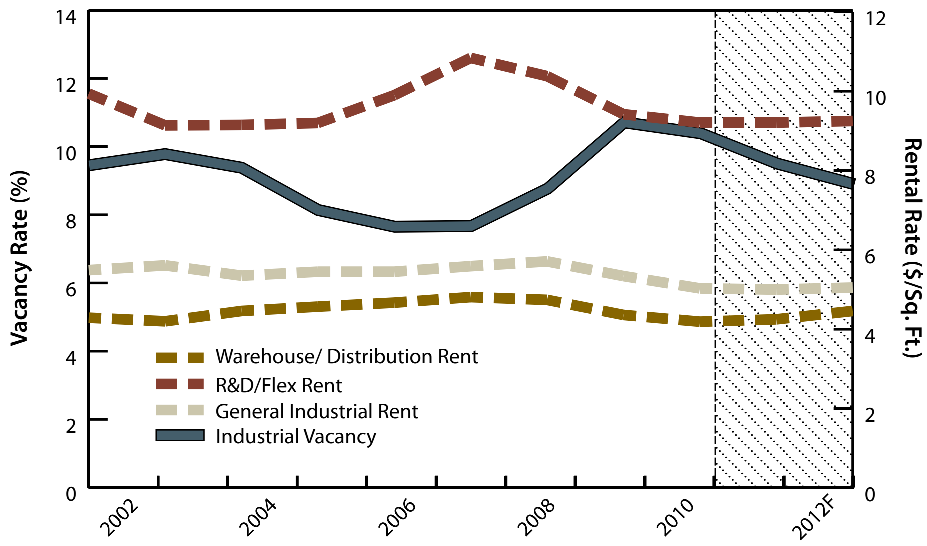
Dallas witnessed the largest declines in new industrial distress, while Austin and San Francisco topped the list of new distress gains.

Investor Composition

With portfolio deals dominating the industrial sales landscape, institutional and private investors accounted for two-thirds of the market in the first half of 2011. As investors returned to the industrial market, acquisitions totaled $9.1 billion, a 63-percent increase in purchases compared with the first half of 2010. Private investors accounted for 35 percent of the market, totaling $3.4 billion in purchases. Public and user/other investors captured 23 percent of the market. Cross-border investments made up just 3 percent of industrial acquisitions, but they posted the largest year-over-year gain in activity, rising by 373 percent.

During the first six months of 2011, five major markets posted sales exceeding the $400 million mark in industrial transactions. Chicago and Los Angeles retained their top spots, with $908 million and $834 million in sales, respectively. Las Vegas joined the list with $660 million in industrial sales, accompanied by Dallas and the Inland Empire with $498 million and $447 million, respectively. The other markets that will likely cross that threshold by year-end 2011 include Atlanta, San Jose, and Northern New Jersey.

Exhibit 3-B3. Industrial Property Vacancy and Asking Rental Rates



Source: Grubb & Ellis, February 2011.

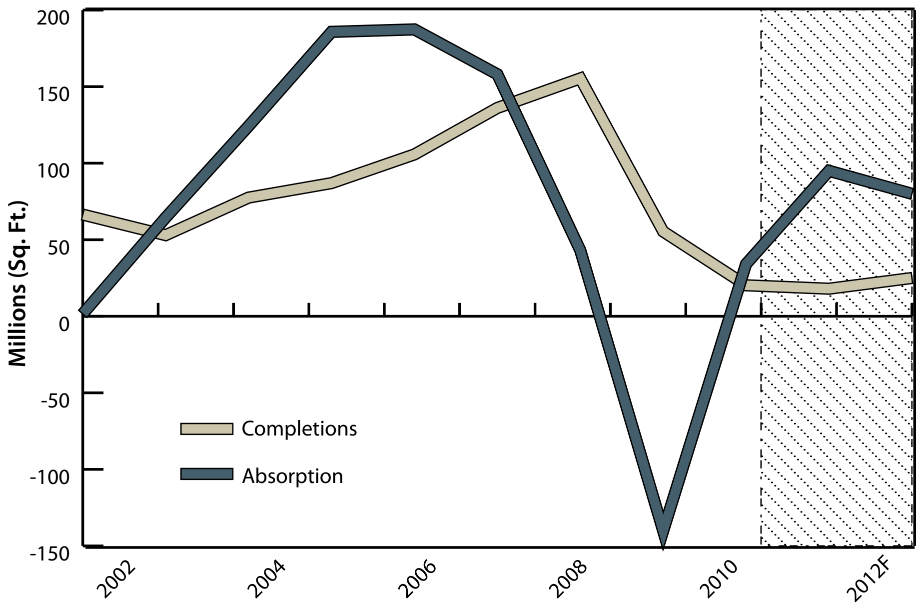
Industrial Property Fundamentals *(courtesy of Grubb & Ellis)*

The national industrial market performed well during the first half of 2011. Demand totaled 62 million square feet, the strongest six-month performance since 2007, while new supply remained extremely constrained at 7.4 million square feet, the lowest total on record. As a result, national vacancy declined 60 basis points to 9.8 percent by June 2011, as shown in Exhibit 3-B3. It is important to note that this performance occurred during a slowdown in the broad economy that included drivers of the industrial market, such as industrial production and containerized imports.

Although not captured by market statistics, the Second Quarter Grubb & Ellis Industrial Broker Sentiment Survey did record a slowdown in activity toward the end of second quarter 2011. This slowdown may translate into lower net absorption numbers during the second half of 2011. New construction may see a slight uptick in the second half, but most of it is built-to-suit, so it should not have a material adverse impact on market vacancy rates. Grubb & Ellis suggests that unless economic conditions deteriorate further, the national industrial real estate market could potentially end 2011 with approximately 100 million square feet of net absorption, 15 to 20 million square feet of total completions, and a vacancy rate below 9.5 percent.

Performance in 2012 could depend on the trajectory of the overall economy over the next few months. There are 10 markets across the nation where speculative construction may commence over the next 12 months. Vacancy rates in most of these markets remain elevated, but the Class A logistics segment continues to outperform the broader sector. This is the segment developers may target, but if demand weakens, overall market vacancy rates could change direction and move upward. For demand to remain positive in 2012 it would likely need a boost from the economy. According to Grubb & Ellis, by the end of 2012, vacancy could possibly decline to 9 percent. Net effective rents may have stabilized and appear to be increasing for large Class A distribution buildings, but broad-based rent growth is unlikely to begin for at least another year.

Exhibit 3-B4. Industrial Property Absorption vs. Completions



Source: Grubb & Ellis, February 2011.

Outlook

The manufacturing sector performed moderately well during most of 2011, with industrial production figures continuing on a positive trend. International trade also advanced, with both exports and imports growing.

Given the slow pace of new construction, net absorption could be modestly positive, as demonstrated by Grubb & Ellis in Exhibit 3-B4. Rent growth will move at a sideways pace of 0.7 percent by the end of 2011. With demand dependent on the broader economy, rents could possibly rise as much as 1.7 percent in 2012.

Regionally, while the large distribution centers could retain their market position, smaller distribution centers in secondary markets may become attractive. Several regional ports on the East Coast, including Savannah and Jacksonville, are vying for a larger share of the rising shipping traffic which may flow through the Panama Canal in 2014. As these ports invest in expansion plans, they could see positive returns, even as the bulk of shipping volume continues to flow through the ports of New York, New Jersey, Charleston, and Norfolk.

There are many downside risks that could affect the performance of the industrial sector. The high cost of fuel in 2011, coupled with continued unrest in the Mideast, could dampen demand. In addition, with unemployment in the U.S. continuing at a recessionary level of more than 8 percent, according to the BLS, consumer appetites for spending have been subdued. Based on the Commerce Department's December 2011 report of retail sales, consumers increased spending by a scant 0.1 percent compared with the previous month—mostly due to vehicle sales. When the data excluded motor vehicles, sales declined 0.2 percent.

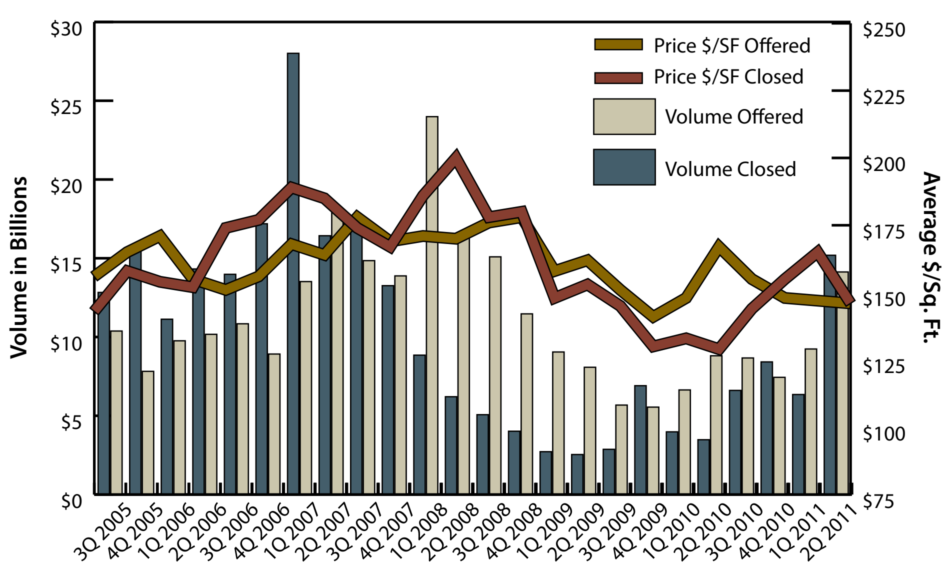
THE RETAIL MARKET

Market Overview

Consumer prices increased 3.8 percent on a 12-month basis (before seasonal adjustment) in August 2011, according to the BLS, making it even harder for people to afford goods. Although unemployment has declined to 8.5 percent at the end of 2011, from almost 10 percent at the beginning of the year, according to the BLS, consumer confidence remains weak. This dynamic can lead to a vicious circle of mediocre retail spending levels that are not strong enough to support any significant reduction in unemployment levels. However, even with retail vacancy remaining high and rent growth remaining flat in the projected near term, a significant amount of transaction activity took place in second quarter 2011. According to Real Capital Analytics, almost $15.2 billion in transactions took place in the second quarter alone. This is an increase of 337 percent over the same period in 2010. The majority of the deals involved strip centers and grocery-anchored community centers.

The largest transaction in second quarter 2011 involved Blackstone Group's acquisition of Centro Properties. This transaction alone accounted for $9.4 billion and was the second largest retail transaction of all time. The portfolio consisted of 29.4 million square feet across 585 community and neighborhood shopping centers, most of which are grocery-anchored centers. This property subtype is highly sought after due to its stability in the current economic environment.

Exhibit 3-C1. Retail Property Volume and Pricing



Source: Real Capital Analytics, 2q 2011.

In addition, Equity One sold its portfolio of shopping centers to Blackstone Group in December 2011. The well-occupied portfolio consists of 36 centers, which are mostly anchored by Publix Super Markets.

Another significant transaction includes Simon Property Group's increased ownership interest in the King of Prussia Mall in third quarter 2011. Simon increased their ownership from 12 percent to a 96-percent controlling interest. The property consists of approximately 2.4 million square feet, and is occupied by some of the country's most well-respected retail tenants.

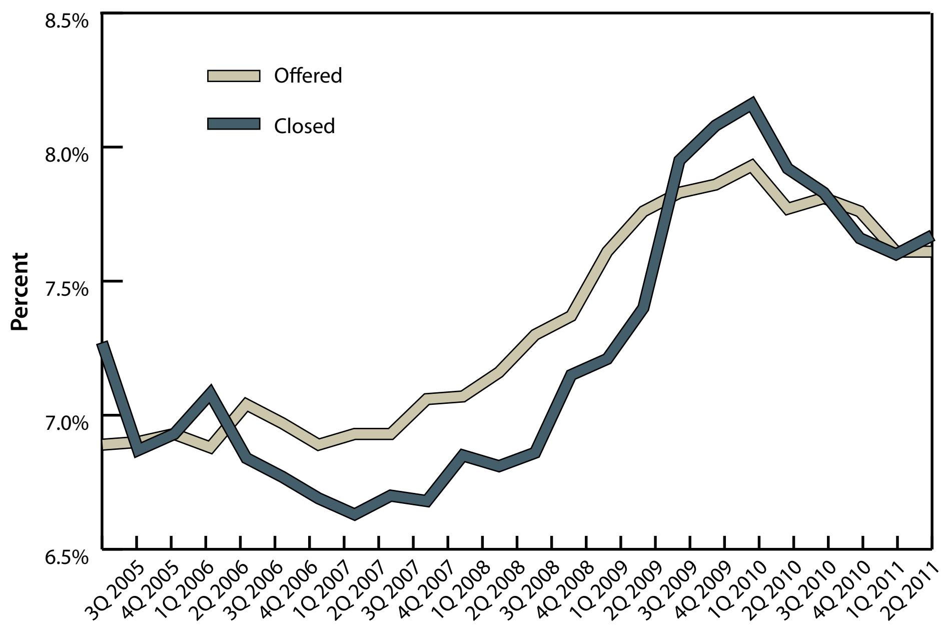
As illustrated in Exhibit 3-C1, second quarter 2011 transaction volume was the highest since third quarter 2007 when volume reached $16.8 billion. According to Real Capital Analytics, average price per square foot declined from $165 in first quarter 2011 to $146 in the second quarter. However, second quarter prices still managed to exceed the same period in 2010 when average prices were $129 per square foot.

Cap rates for strip centers and malls, averaging 7.67 percent in second quarter 2011, have remained relatively stable since year-end 2010 when the average rate was 7.66 percent, as reported by

Real Capital Analytics. It is important to note that due to the disproportionate volume of recent strip center transactions relative to other retail property types, more weight was placed on strip center cap rates. It appears that mall cap rates have trended downward over the first two quarters of 2011 and are approximately 50 basis points below the strip center cap rates. Furthermore, since this subtype has been struggling with occupancy due to store closures and downsizing amid online competition, many investors are still uncertain about power centers and some market participants appear to be avoiding this property subtype altogether. Power centers generally have cap rates above both regional malls and strip centers (see Exhibit 3-C2).

One theme is clear within the retail property market, however—investors continue to seek out quality assets in the upper tier of the spectrum. High occupancy, tenant quality, and location continue to command a premium. In fact, properties with these characteristics are often being held and operated and not offered to the market.

Exhibit 3-C2. Average Retail Property Cap Rates



Source: Real Capital Analytics, 2q 2011.

Investor Composition

During the first half of 2011, private equity investors were the most active buyers (with Blackstone leading the charge) of retail properties, and have been executing deals based on the availability of properties for sale and good pricing in the market. Since quality is still highly sought after, private equity investors have been willing to take on the risk of a larger portfolio with some mediocre assets to gain access to more desirable assets. According to Retail Traffic, private equity investors have tended to require higher returns, and are slowly beginning to identify value-add properties in the secondary and tertiary markets to add to their portfolio. Pension funds and foreign equity have also contributed to the growth in transaction volume in the first half of 2011, but they are entering the deal market more cautiously.

As for the top seller by volume, Centro Properties Group's disposition of its U.S. portfolio was the largest seller. REITs are among the largest sellers for a variety of reasons. Besides selling off weaker properties to reinvest in higher quality assets, some REITs need to reduce debt and raise net operating income. Others are looking to consolidate their geographic footprint to increase synergies. In the case of Centro, the REIT utilized proceeds from the sale to retire a significant portion of maturing 2011 Australian debt facilities.

According to Real Capital Analytics, CMBS and national banks were responsible for approximately 75 percent of mortgage originations for retail properties in the first half of 2011. CMBS specifically accounted for 38 percent of originations, which is similar to the second half of 2010 when CMBS accounted for 39 percent. These estimates are significantly up from 2009, when CMBS contributed only 11 percent of the lending for the entire year. National banks accounted for 36 percent of the lending in the first half of 2011, compared to just 11 percent in the second half of 2010.

Insurance companies appear to be backpedaling in their lending activities. Their reduced participation in the mortgage market over the past two years may be due to the overall decrease in volume in originations and their continued desire to upgrade their debt in quality assets.

CMBS are mainly focused on malls and single-tenant properties that are considered trophy assets in primary markets. National banks cover smaller properties such as anchored and unanchored properties, as well as strip centers. Insurance companies are generally active in anchored properties and strip centers.

Retail Property Fundamentals
(courtesy of Grubb & Ellis)

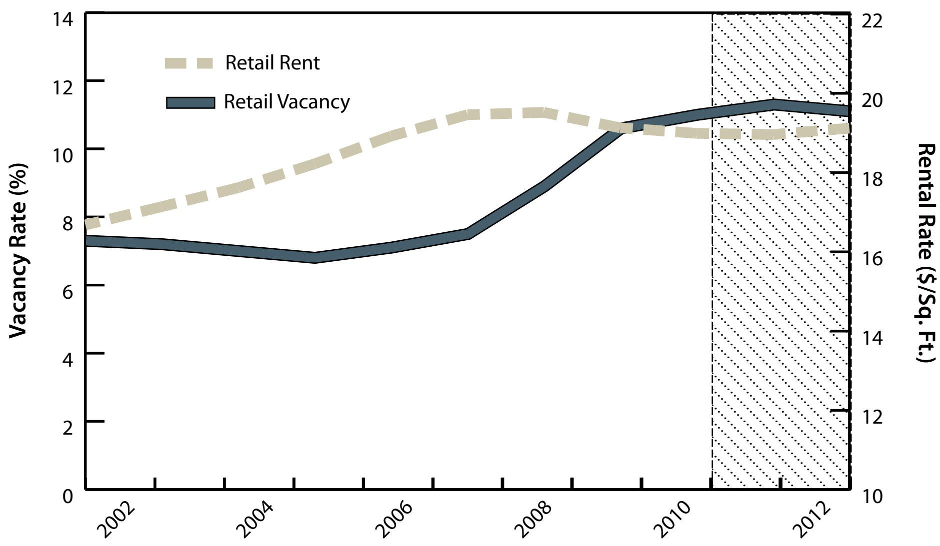
Of the major commercial property sectors, retail suffered the most from the housing collapse and the Great Recession that followed. It has embarked on a tentative recovery along with other property types, but the retail recovery has been uneven with some center types and locations outperforming others. Sales at neighborhood centers with a strong grocery anchor serving a mature, higher-income trade area have held up better than unanchored strip centers on the urban fringe where housing construction was halted. During the depth of the recession, discount stores and their respective centers outperformed their more upscale competition as consumers sought to conserve cash. But the stunning rebound in the equity markets emboldened higher income consumers, providing an early rebound for luxury brands. At the same time, discount retailers fared less well, given that many of those who frequent discount retailers have less disposable income.

The vacancy rate among retail center types peaked at 7.6 percent in first quarter 2010 and retreated slightly to 7.2 percent by mid-year 2011, according to CoStar; Reis, Inc.'s rates, as shown, vary slightly, although the trend is very similar. Rental rates remain under downward pressure (see Exhibit 3-C3). Both absorption and completions declined significantly in 2007 – 2009, as demonstrated in Exhibit 3-C4, after which time absorption finally began to increase. However, the number of completions continues to outpace absorption.

Outlook

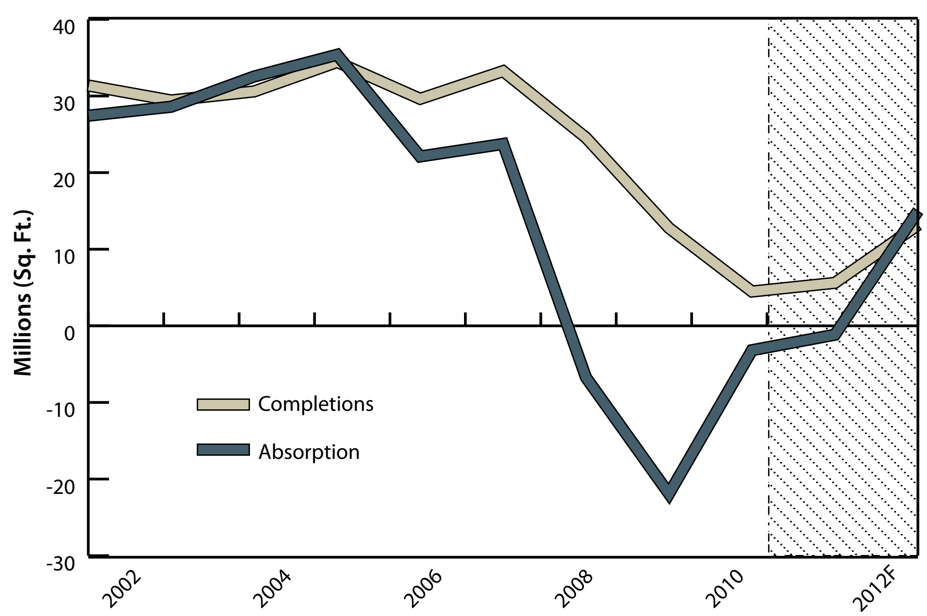
It appears transaction volume is on an upward trajectory for the most desirable assets. However, consumer spending levels have an important role to play in the pace of recovery of this property type. As of third quarter 2011, consumer expectations remained bleak due to the uncertainty in unemployment levels and global instability. Retailers may continue to reposition stores and to strategically leverage this sluggish environment to improve their store portfolio. Properties such as grocery-anchored centers may continue to outperform the rest of the retail property types due to consumer spending habits. In many cases, households have postponed major purchases over the past couple years with a wait-and-see approach, and once the economy begins moving forward, we may see a sudden surge of purchasing activity. The 2012 outlook for the retail property sector may continue trends similar to those of 2011; however, the positive improvements in 2012 may occur at a slower rate than in 2011.

Exhibit 3-C3. Retail Property Vacancy and Asking Rental Rates



Sources: Reis, Inc., Grubb & Ellis, February 2011.

Exhibit 3-C4. Retail Property Absorption vs. Completions



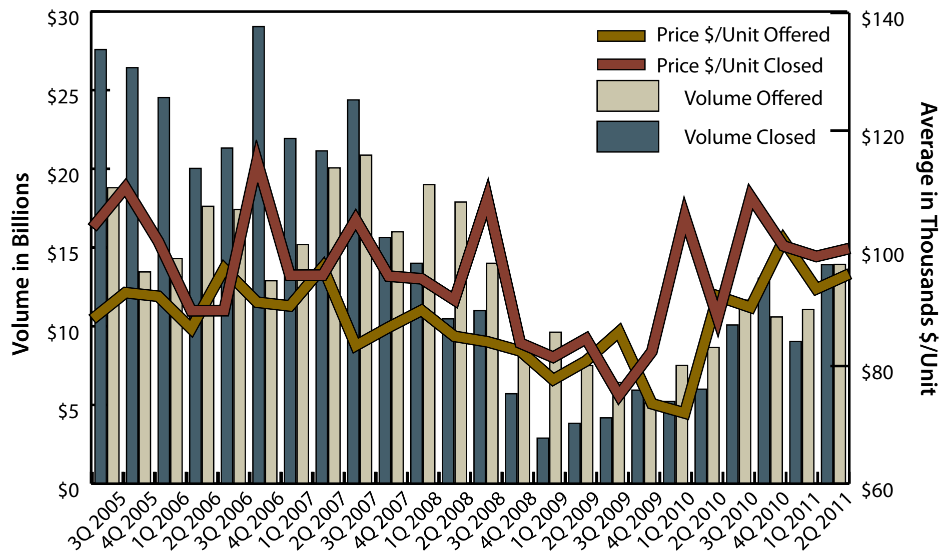
Source: Grubb & Ellis, February 2011.

THE APARTMENT MARKET

Market Overview

Building on the solid momentum developed throughout 2010, the apartment sector has continued to be one of strongest performers in commercial real estate in 2011. A total of $22.9 billion of significant apartment properties were sold in the first half of 2011, representing a 104-percent increase from the first half of 2010, according to Real Capital Analytics. Markedly, second quarter 2011 sales were $13.9 billion, a level not seen since the first quarter of 2008. Further, in terms of number of properties sold, apartment sales volume in the first half of 2011 increased 65 percent year-over-year. Broad growth in portfolio transactions, which has already exceeded the level reached in 2010, has contributed to the large gain in apartment sales volume in 2011. The increase in portfolio deals is particularly noteworthy given that portfolio sales tripled their 2009 pace in 2010. Although 2011 apartment sales volume is still well off its peak set in 2007, it certainly appears to be an indication of investors' sustained appetite for multi-family investments.

Exhibit 3-D1. Apartment Property Volume and Pricing

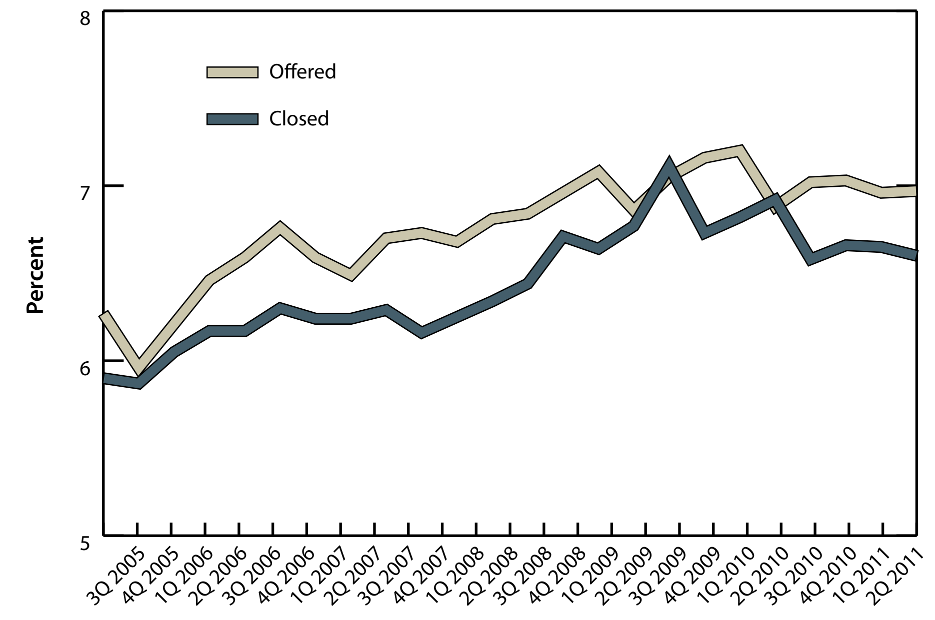


Source: Real Capital Analytics, 2q 2011.

As presented in Exhibit 3-D1, the fourth quarters of 2009 and 2010 have been the only periods since the end of 2007 in which the dollar volume of closed transactions actually outpaced the value of properties brought to market. In most quarters since that time, offerings have widely exceeded closed transactions, but that margin narrowed throughout 2010 and has continued to narrow into 2011. In the second quarter of 2011, the margin was negligible. This may be a positive indication that buyers and sellers of multi-family assets have been able to negotiate through the large bid-ask spreads that were prevalent in 2008 and 2009 and ultimately find a common ground on pricing.

Apartments have continued to outperform other major property types (by nearly double) in terms of pricing, with an annualized appreciation rate of 15.08 percent through the first half of 2011, per Real Capital Analytics. In part, the significant increase in pricing for apartments can be attributed to continued cap rate compression. As presented in Exhibit 3-D2, average apartment cap rates have continued to decline into 2011, dropping approximately 32 basis points from second quarter 2010 to second quarter 2011. It should be noted that cap rates for garden apartments are approximately 100 basis points above mid/high rise cap rates. Intense competition for the most highly sought-after apartment assets continues to put downward pressure on yields. In second quarter 2011 alone, a remarkable 10 percent of properties traded at cap rates of 4.7 percent or lower. Factors that have contributed to the lower cap rates include historically low interest rates, increased availability of capital, and the perceived safety of multi-family assets relative to other property types. Additionally, GSEs Fannie Mae and Freddie Mac provide apartments with a financing advantage relative to other property types. Further substantive declines in cap rates in the apartment sector, particularly in the primary markets, may not continue, although improving fundamentals would help to drive pricing upwards.

Exhibit 3-D2. Average Apartment Property Cap Rates



Source: Real Capital Analytics, 2q 2011.

Investor Composition

Throughout the first half of 2011, buyers of apartment properties have been relatively evenly divided between listed REITs and private equity funds. According to Real Capital Analytics, Equity Residential, a Chicago-based REIT, has been the second-most active buyer and the most active seller of multi-family properties. UDR Inc., TIAA-CREF, Vornado Realty Trust, and Westbrook Partners round out the top five most active buyers in this sector in 2011.

Continuing the trend from 2010, the majority of apartment transaction activity for institutional investors has been focused on core assets in major markets such as New York City, Los Angeles, Washington, D.C., and Dallas. While top-quality assets in major markets have clearly received the most attention and competition from major investors, rapidly improving fundamentals are drawing new investors into the apartment sector and beyond the primary markets. Furthermore, an extremely competitive bidding environment and sub-5.0 percent cap rates have begun to lead many investors (institutional and private alike) to secondary and tertiary markets in search of higher yields. This trend may continue through the second half of 2011 and into 2012.

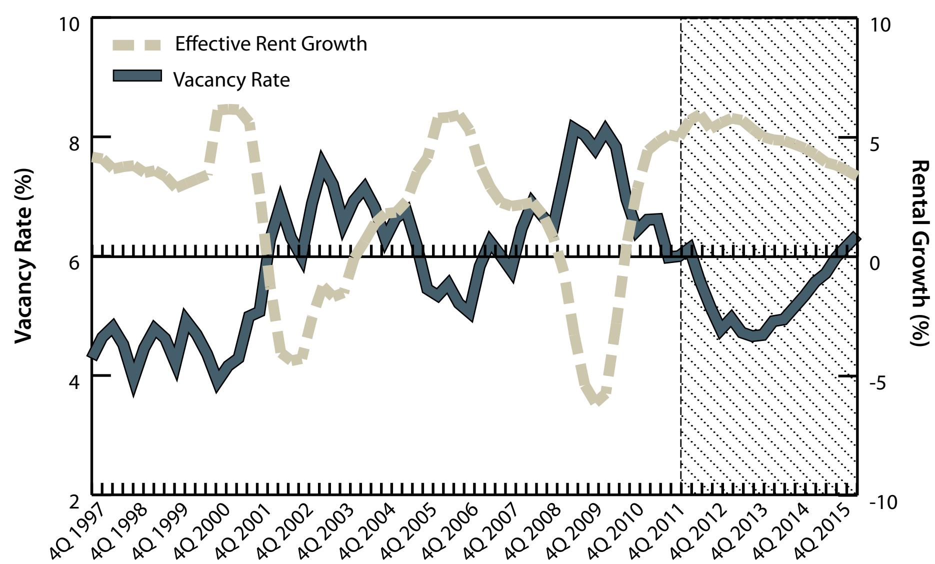
A diminishing supply of apartments, coupled with strong fundamentals, is leading a number of developers to accelerate plans for new apartment projects. Completions of multi-family properties occurred at a relatively anemic annualized rate of 112,000 units in first quarter 2011, as reported by CBRE.

In contrast, permits and construction starts, which are leading indicators of supply, increased by 143,000 and 135,000 units, respectively, over the same time period, according to CBRE. Any completions brought about by these new starts may not materialize until the late 2012 – 2015 timeframe or after, leaving a dearth of new supply in the short term and strong economics for existing apartments.

Apartment Property Fundamentals *(courtesy of Axiometrics Inc.)*

After one of the strongest performances in 15 years in 2010, the question became how strong the apartment market would be in 2011. The answer: even better. As of second quarter 2011, annual effective rental rates have increased by 5.1 percent, up from an annual growth rate of 4.5 percent in 2010. This is the strongest rate of effective rent growth since third quarter 2006 (5.3 percent) when the vacancy rate was lower and the effective rental rate was $951 per month, as shown in Exhibit 3-D3. Even with the increasing rate of rent growth, vacancies continued to decline from 6.6 percent in 2010 to 6.0 percent in second quarter 2011, resulting from 60 basis points of absorption.

Exhibit 3-D3. Apartment Market Vacancy and Effective Rental Rate Growth



Source: Axiometrics, Inc., 2q2011.

The annual increase in effective rental rates in second quarter 2011 was driven by a combination of an increase in asking rental rates and a decrease in concessions. Over the year, asking rental rates increased by 2.6 percent ($26 per month) and the value of concessions fell from the equivalent of 3.0 weeks ($59 per month) of free rent to 1.8 weeks ($37 per month) for an increase in effective rental rates of $48 per month or 5.1 percent.

Additionally, the level of effective rent of $980 ($1.07 psf) per month in second quarter 2011 is back to its peak reached in second quarter 2008, setting the stage for new construction, with even stronger rent growth forecasted at lower vacancy rates. According to Axiometrics, effective rent growth is expected to peak at an annual growth rate of 5.8 percent in 2012, slowing in 2013 to 4.9 percent and to 3.4 percent by 2015. The vacancy rate is expected to reach a low point of 4.9 percent in 2013, before increasing to 6.1 percent by 2015.

There are a large number of markets that may outperform the U.S. average in terms of cumulative potential

Exhibit 3-D4. Forecasts of Effective Rental Rate Growth, Vacancy, and Potential Rental Revenue for the Top 20 Markets (2011 to 2015)

	Effective Rent Growth						Vacancy						Potential Rental Revenue					
Market	2010A	2011A*	2012F	2013F	2014F	2015F	2010A	2011A*	2012F	2013F	2014F	2015F	2010A	2011A*	2012F	2013F	2014F	2015F
San Francisco	6.1%	14.9%	6.6%	5.7%	6.4%	4.6%	4.0%	3.1%	2.7%	3.4%	4.3%	5.0%	6.9%	**16.1%**	6.6%	4.4%	5.8%	3.8%
Charlotte	3.8%	8.6%	5.7%	4.8%	4.8%	3.5%	8.2%	6.5%	5.4%	4.8%	5.9%	6.7%	5.9%	**10.0%**	6.6%	4.9%	3.6%	3.1%
Austin	6.0%	9.3%	7.1%	4.7%	2.8%	2.6%	6.4%	5.1%	4.1%	4.9%	6.0%	6.5%	8.2%	**9.9%**	8.0%	3.5%	1.7%	2.4%
Dallas	3.7%	8.6%	6.4%	4.0%	3.5%	2.1%	8.3%	6.4%	4.7%	4.8%	5.6%	6.4%	5.9%	**9.9%**	8.1%	3.3%	2.7%	1.5%
Seattle	**5.4%**	**9.0%**	**6.4%**	**4.8%**	**2.9%**	**2.5%**	**5.1%**	**4.7%**	**4.2%**	**4.4%**	**5.7%**	**6.5%**	**6.6%**	**9.7%**	**7.0%**	**4.0%**	**1.7%**	**2.1%**
Orlando	2.6%	7.0%	6.0%	5.5%	4.9%	5.4%	8.1%	6.9%	4.8%	4.2%	5.1%	6.1%	4.1%	**8.3%**	8.0%	5.5%	3.8%	4.4%
San Diego	0.9%	7.3%	6.3%	6.2%	5.2%	3.4%	4.9%	4.3%	3.6%	3.9%	5.1%	5.6%	1.0%	**8.0%**	7.1%	5.5%	4.0%	3.0%
Orange Cty	1.3%	7.1%	6.8%	6.5%	6.3%	5.1%	5.5%	4.6%	3.7%	4.2%	4.7%	5.7%	2.5%	**7.6%**	7.9%	5.4%	5.9%	3.9%
Boston	7.6%	7.0%	5.4%	6.0%	5.4%	4.2%	4.4%	3.6%	3.2%	4.5%	5.6%	6.3%	8.9%	**7.6%**	5.4%	4.3%	4.6%	3.6%
Chicago	**6.0%**	**6.9%**	**6.5%**	**5.9%**	**5.0%**	**3.9%**	**5.5%**	**5.0%**	**4.1%**	**4.3%**	**5.3%**	**5.9%**	**7.5%**	**7.2%**	**7.4%**	**5.2%**	**4.0%**	**3.4%**
Houston	1.1%	5.4%	6.5%	5.6%	4.9%	2.6%	10.5%	9.1%	6.3%	4.7%	5.1%	6.1%	1.7%	**6.9%**	9.7%	6.5%	4.1%	1.7%
Atlanta	3.3%	6.0%	4.7%	4.1%	4.0%	3.9%	9.4%	8.8%	7.4%	5.8%	4.7%	5.5%	4.3%	**6.5%**	6.3%	5.6%	4.9%	2.2%
Denver	7.8%	6.1%	4.9%	4.3%	4.5%	4.3%	5.6%	5.0%	4.3%	4.5%	5.5%	6.4%	9.6%	**6.4%**	5.9%	3.3%	4.2%	2.9%
New York Metro	7.3%	6.0%	5.9%	6.6%	5.5%	3.8%	4.5%	3.4%	3.0%	2.5%	3.7%	4.8%	7.9%	**6.4%**	6.1%	7.4%	3.9%	2.7%
Riverside	**2.9%**	**5.4%**	**5.8%**	**4.5%**	**4.9%**	**3.8%**	**6.3%**	**5.6%**	**5.2%**	**4.5%**	**5.5%**	**5.9%**	**3.3%**	**5.7%**	**6.3%**	**5.0%**	**3.9%**	**3.3%**
Phoenix	5.5%	4.8%	7.1%	6.2%	5.6%	4.1%	9.1%	7.5%	6.9%	6.4%	5.8%	6.2%	8.8%	**5.4%**	8.0%	6.6%	6.3%	3.0%
Los Angeles	1.6%	5.2%	6.1%	6.1%	6.5%	5.5%	5.8%	5.5%	4.7%	3.5%	4.5%	5.6%	1.6%	**5.3%**	7.2%	7.2%	4.8%	4.8%
Tampa	2.8%	4.4%	5.8%	5.6%	5.3%	5.3%	7.7%	6.9%	4.6%	3.9%	5.1%	6.6%	4.1%	**5.3%**	7.9%	5.8%	3.8%	4.1%
Washington, DC Metro	7.6%	4.3%	6.9%	6.1%	4.4%	3.6%	4.6%	4.6%	3.7%	4.5%	5.7%	6.6%	9.0%	**4.0%**	8.0%	4.8%	3.1%	3.2%
Las Vegas	**-3.0%**	**1.4%**	**4.7%**	**5.9%**	**5.8%**	**5.1%**	**8.9%**	**7.9%**	**6.5%**	**4.8%**	**5.0%**	**5.9%**	**-1.9%**	**2.7%**	**6.3%**	**7.5%**	**4.7%**	**4.4%**
U.S.	**4.2%**	**5.0%**	**4.6%**	**4.1%**	**3.4%**	**3.4%**	**7.0%**	**6.2%**	**5.1%**	**4.7%**	**5.2%**	**6.1%**	**5.9%**	**6.3%**	**7.0%**	**5.0%**	**3.6%**	**2.6%**

*Actual to date, Oct. 2011.
Sources: Axiometrics, Inc., U.S. Bureau of the Census, U.S. Bureau of Labor Statistics, DataQuick, The National Association of Realtors, U.S. Department of Housing and Urban Development, Federal Housing Financing Agency, 2q 2011.

rental revenue growth from 2011 to 2015. (Potential rental revenue growth is the combined change in effective rental rates and occupancy.) Almost all of the Top 20 markets in Exhibit 3-D4 are expected to outperform the U.S. over the specified period, with San Francisco, Charlotte, Austin, Dallas, and Seattle leading in performance in the near term. The lower performing markets in 2011 are expected to be Las Vegas, the Washington, D.C. metro, and Tampa.

Outlook

The overall outlook for the apartment sector will likely be affected by the strong fundamentals, the decreasing homeownership rate (which fell 70 basis points from first quarter 2010 to second quarter 2011), the lack of new supply, and the relative availability of financing for multi-family investments. In addition to new supply, longer-term threats to apartments include housing

Exhibit 3-D5. Key Assumptions for U.S. Forecast

	Actual				Forecast				
Key Variable	**2007**	**2008**	**2009**	**2010**	**2011A&F**	**2012**	**2013**	**2014**	**2015**
Employment (000)	137,598.0	136,790.0	130,920.0	129,818.0	130,767.4	132,907.8	135,958.6	139,963.9	143,118.8
Job Growth (000)	1,512	-808.0	-5870.0	-1102.0	949.4	2140.4	3050.8	4005.3	3154.9
Job Growth %	1.1%	-0.6%	-4.3%	-0.8%	0.7%	1.6%	2.3%	2.9%	2.3%
Total Residential Permitting	1,398,415	905,359	582,963	604,610	615,473	1,252,295	1,782,889	1,971,436	1,597,221
Demand/Supply Ratio	0.8	-0.6	-6.5	-1.9	1.6	3.3	2.4	2.2	1.6
Housing Affordability Index	143.7	140.1	189.7	199.5	148.9	177.1	159.3	150.8	156.0

Source: Axiometrics, Inc., 2q 2011.

affordability, which may become a constraining factor if home prices continue to fall and if rents rise quickly. And, as presented in Exhibit 3-D5, slow job growth continues to be one of the biggest threats to apartments in the short-term. However, it should be noted that the BLS estimates that nearly 75 percent of employment gains since the beginning of the recovery cycle have been in the 20 – 34-year-old age group, the key renter demographic. This trend, along with changes in attitudes toward homeownership, has accelerated demand for apartments well above the modest employment gains. Based on the aforementioned factors, apartments are well-poised to possibly experience another strong year in 2012.

THE HOTEL MARKET

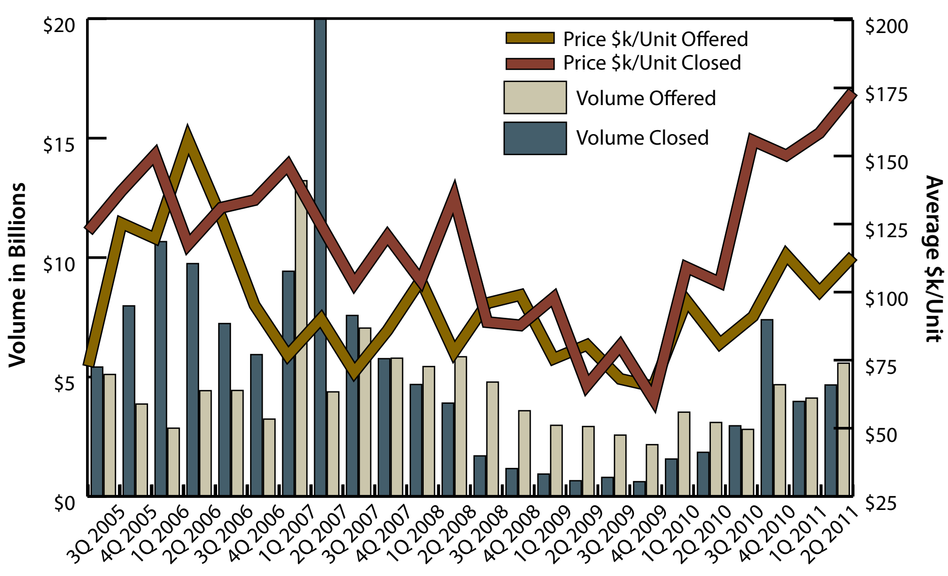
Market Overview

This year's transaction volume in the lodging sector continues to surpass 2010 volume with mixed results. After five consecutive quarters of transaction growth in excess of 150 percent, future increases appear to be losing momentum. In August 2011, monthly transaction volume slowed to 53-percent growth; however, August was overly influenced by two selective service portfolio transactions that accounted for 60 percent of the volume. Full-service properties dominated the 2011 transaction landscape in the first half of 2011, led by high-profile trades. However, with a minimal portfolio pipeline and a fall-off of CMBS lending, less transaction volume and pricing volatility is possible through the remainder of the year.

According to Real Capital Analytics, unit pricing of U.S. lodging properties has increased to an average of $175,000 per key, the highest quarterly average since 2005, as shown in Exhibit 3-E1. The average price per key for full-service hotels has reached elevated levels primarily influenced by the large number of Manhattan trades and by high-end trades in Florida and California. As a result, full-service pricing rose by approximately 9.8 percent to a level near $190,000 per key as of mid-2011. Surprisingly, the average price per key for selective-service hotels soared by approximately 35 percent to nearly $140,000 per key. However, the increase is less prolific due to the skewing effect of the two sales in Manhattan; the Yotel sale at $471,000 per key and the Hampton Inn sale at $349,000 per key.

Early results for third quarter 2011 suggest a downshift in lodging investment sales metrics. Results for August 2011 reveal that average unit pricing per room has decreased by approximately 15 percent, and appears to be a result of investor appetite for higher returns for

Exhibit 3-E1. Hotel Property Volume and Pricing



Source: Real Capital Analytics, 2q 2011.

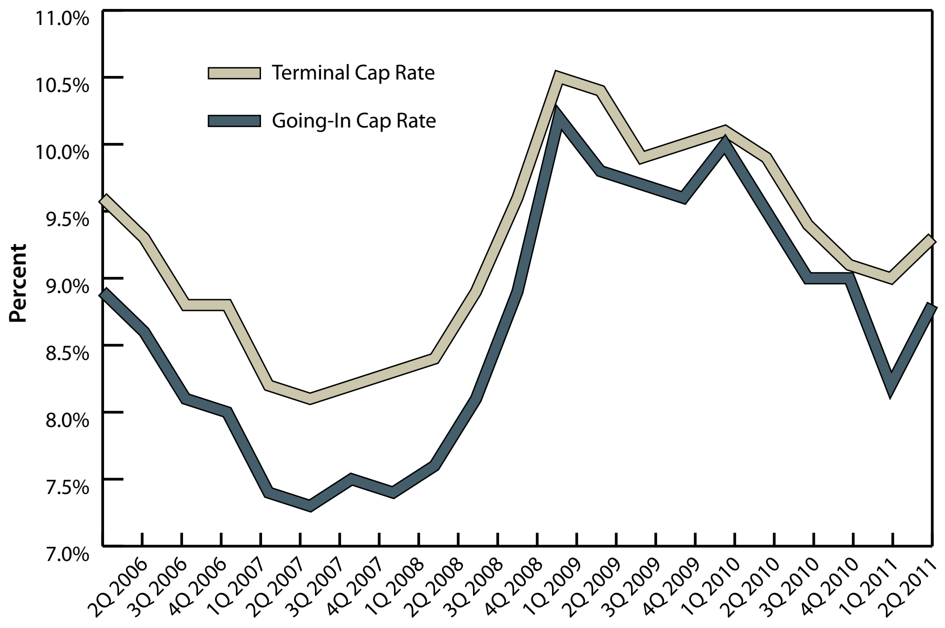
mid-market properties after a half-year of pricing build-up for top-tier, trophy assets. The lodging market may have slowed and future growth may not be as projected at the end of 2010, but the strength gained over previous periods helped 2011 end in a positive position.

Investor Composition

The influence of lenders was slightly less in 2011, but $7.8 billion in lodging assets have been sold. Seller composition for listed companies increased to 14 percent in 2011 from 3 percent in 2010, mainly due to dispositions by real estate operating companies such as Starwood Hotels and Morgans Hotel Group. Non-listed REITs witnessed their buyer market share fall to 4 percent in the first half of 2011 but remain purely net buyers. REITs continued to be the most dominant buyer, accounting for more than 40 percent of transactions, adding $3.0 billion to their portfolios during the first half of 2011. Most other investor groups contracted in 2011. However, institutional buyers and cross-border buyers focused on picking-off trophy assets were more active in 2011 than in 2010.

As of mid-2011, the appetite of REITs for new transactions appears to have moderated, as they absorb their new acquisitions into their portfolios and deal with stock pricing pressures.

Exhibit 3-E2. Average Required Cap Rates for Hotel Properties



Source: RERC, 2q 2011.

Investment Rates

Over the past year, we have frequently observed unusually low going-in capitalization rate quotes. What is apparent is the upside income assumptions that influence price. Certain investors believe that going-in capitalization rates are less useful to investors when estimating value. This may be true when analyzing property investment rates, where many investors are giving greater thought to yield rates applied to multi-year projections rather than to an application to next year's income estimate.

RERC's required pre-tax yield rate for the lodging sector increased by 10 basis points to an average of 10.7 percent from the first to second quarter in 2011. Likewise, RERC's required going-in cap rate for hotels increased by 60 basis points to 8.8 percent, and the required terminal cap rate increased by 30 basis points to 9.3 percent, as shown in Exhibit 3-E2. Providing downward pressure to average rates, the third-tier lodging sector reported investment rate compression of 20 basis points in both required pre-tax yield and terminal capitalization rates since the first quarter 2011. Third-tier lodging properties trade at approximately 200 basis points above first-tier lodging investment rates. Attractive pricing and the assumption that recovery in the second- and third-tier lodging sectors has been lagging the recovery in the first-tier market is driving investor interest.

Despite macroeconomic headwinds fueled by global economic issues, the U.S. lodging investment industry continues to outperform the broader market. Short-term considerations regarding managing the transaction pipeline fluctuations take priority; buyer demand, capital availability, and proper pricing may be the focal points going forward. However, for the longer term, many lodging investors are considering what the pace of the current recovery cycle will have on the overall lodging market.

Hotel Property Market Fundamentals

Through the first half of 2011, lodging demand continued to rise at a greater pace than expected, given the sluggish economy. According to Smith Travel Research (STR)[1], lodging demand in the U.S. increased by 5.8 percent during the first half of 2011, boosting occupancy in most lodging segments. Demand for rooms was primarily generated by transient business, however, at the continued expense of grudgingly poor increases in room rates. In August, following a weak jobs report, poor housing data, and Europe's percolating debt crisis, investors began to reconsider property markets that were considered economically sensitive. Although travel patterns and group bookings have shown little change thus far in 2011, investors have reconsidered their growth assumptions for the remainder of 2011 and 2012. Accordingly, PKF Hospitality Research (PKF-HR) lowered its demand forecast for the remainder of 2011 to settle at 4.5 percent for the calendar year 2011. Even with the current economic threats, PKF-HR's demand forecast far surpasses STRs long-run average of just under 2 percent.

The current economic environment continues to be adverse to new construction, primarily due to lending constraints and the lack of rate increases in most markets. The pace of new lodging property openings remained basically flat over the first half of 2011. Considering the development pipeline, PKF-HR is projecting equally flat supply growth of approximately 0.6 percent for the year, as shown in Exhibit 3-E4 (following page). Occupancy will benefit by the supply and demand inequity, and is expected by PKF-HR to rise by 280 basis points from the 2010 mark to a level of 59.8 percent for 2011, as shown in Exhibit 3-E3.

Although average daily room rates (ADR) continue to lag occupancy increases in 2011, ADR results have been impressive through second quarter 2011. As a result, PKF-HR has upped its 2011 annual ADR growth projections to 3.2 percent, slightly above the expected pace of inflation. Despite gains in both occupancy and ADR through mid-year, the second half is expected to be challenging in terms of maintaining corporate and transient demand. Considering the various negative influences, the lodging industry has appeared to improve.

In tandem, and based on the updated economic outlook and long-term pricing trends, PKF-HR is expecting slower ADR growth than originally expected and has lowered their ADR growth forecast for 2012 to 4.8 percent. Early indications are that negotiated corporate rates are beginning to rise; however, group rates are tepid as many meeting planners are continuing to use their leverage to mitigate group rate increases.

Outlook

Over the past year, there has been a significant reduction in mortgage rates providing investment leverage to lodging deals that are able to navigate the lending prerequisites. Debt is potentially available to lodging investors; however, more due diligence, equity commitments, and recourse guarantees are staggering lending approvals and providing a more limited buyer pool.

Despite the recent economic malaise that has tempered overall transaction activity, the lodging sector continues to generate positive results. As we move through 2012, very little change is expected in the lodging sector. However, we should not overlook the firming leisure and corporate traveler base provided by wage increases and increased corporate profits.

Exhibit 3-E3. National Forecast Summary

Year	Occ	Δ Occ	ADR	Δ ADR	RevPAR	Δ RevPAR
2006	63.1%	0.2%	$97.81	7.5%	$61.74	7.7%
2007	62.8%	-0.5%	$104.31	6.6%	$65.51	6.1%
2008	59.8%	-4.8%	$107.38	2.9%	$64.21	-2.0%
2009	54.5%	-8.8%	$98.19	-8.6%	$53.54	-16.6%
2010	57.6%	5.5%	$98.10	-0.1%	$56.47	5.5%
2011F	59.8%	3.9%	$101.28	3.2%	$60.54	7.2%
2012F	61.2%	2.4%	$106.16	4.8%	$64.95	7.3%

Sources: PKF-HR, September-November 2011 Edition hotel Horizons® report, STR.

[1] ***STR data provided as per PKF agreement.***

Exhibit 3-E4. National Horizon Profile

National Horizon Profile: Year When ADR Surpasses Previous Peak

This page showcases the Colliers PKF Hospitality Research *Hotel Horizons* ® forecasting universe. The map below displays the year when ADR levels (measured by four quarter moving average) are expected to surpass the highest levels previously reached.

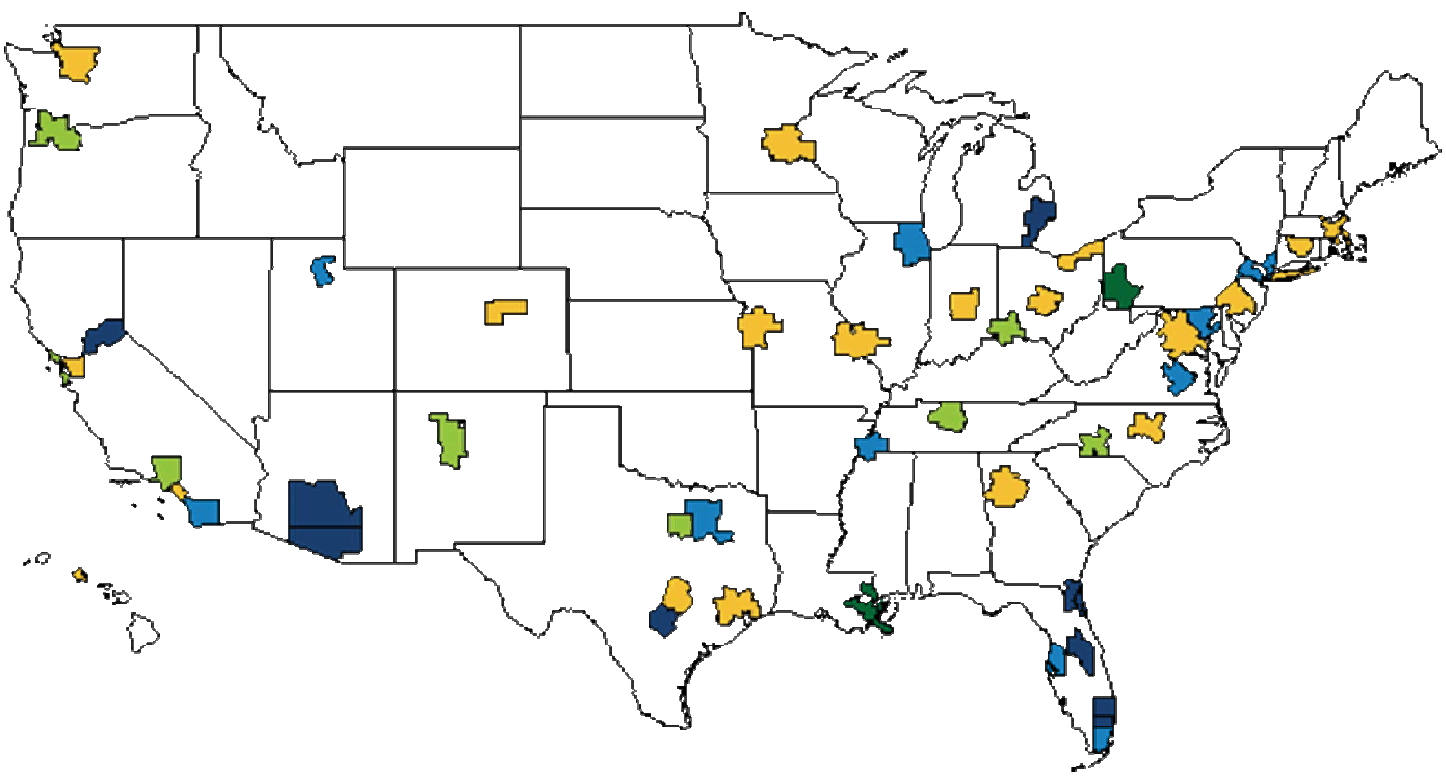
Albuquerque
Anaheim
Atlanta
Austin
Baltimore
Boston
Charlotte
Chicago
Cincinnati
Cleveland
Columbus
Dallas
Denver

Detroit
Fort Lauderdale
Fort Worth
Hartford
Houston
Indianapolis
Jacksonville
Kansas City
Long Island
Los Angeles
Memphis
Miami
Minneapolis

Nashville
New Orleans
New York
Newark
Oahu
Oakland
Orlando
Philadelphia
Phoenix
Pittsburgh
Portland
Raleigh-Durham
Richmond

Sacramento
Saint Louis
Salt Lake City
San Antonio
San Diego
San Francisco
Seattle
Tampa
Tucson
Washington DC
West Palm Beach

2011 | 2012 | 2013 | 2014 | 2015 Beyond



Source: PKF National Horizon Profile, September-November 2011.

4 | OUTLOOK FOR 2012 AND BEYOND

Grinding Through the Recovery: New Foundations Taking Hold

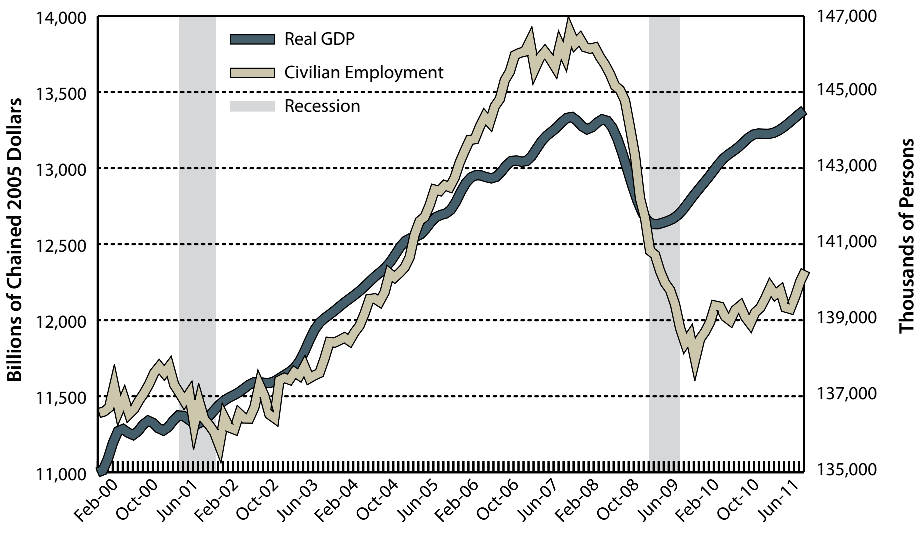
As we look to 2012 and beyond, global uncertainty seems to be intensifying. However, relative to the other economies in the world, the U.S. is holding its own. GDP is not increasing significantly, but may still be creating new foundations for the rest of the economy. According to the International Monetary Fund (IMF), the total U.S. economy was $14.5 trillion in 2010, which is approximately equal to the next three largest economies—China, Japan, and Germany—combined. In addition, the current GDP of the U.S. is approximately the same as it was in December 2007, even though there are millions fewer individuals employed. This is due to, among other things, increases in productivity and companies doing more with less.

However, recently productivity has begun to slow despite overall increases, and according to many of RERC's institutional investment respondents, if demand for goods and services increases, companies may be required to add employees. This may or may not present a problem to U.S. companies, some of which have amassed significant profits during the past couple years. With the exception of Walmart, the top American companies in the Fortune 500 list had higher revenues in 2009 than ever before (although they were slightly lower in 2010 and 2011). In addition, according to the Federal Reserve, nonfinancial services firms held more than $2 trillion in cash and other liquid assets at the end of June 2011. In fact, cash accounted for 7.1 percent of all company assets (from buildings to bonds), the highest level since 1963. These are critical foundations to our future growth, and critical to narrowing the gap between GDP and employment, as illustrated in Exhibit 4-1.

The unemployment rate remains stuck at more than 8 percent, and despite recent job gains, total payroll jobs are still 6.5 million below the peak employment of 2007, according to NAR's analysis of data provided by the BLS. Long-term unemployment remained at 6 million persons at the end of 2011, and will likely remain an issue, with roughly 4 in 10 of unemployed workers still jobless for 27 weeks or more, by far the highest proportion of long-term unemployment on record, according to the BLS, and three times the number of persons who normally remain unemployed following typical recessions.

As of November 2011, the U.S. has been out of the most recent recession for 29 months. The past two recessions have taken the longest for job growth to

Exhibit 4-1. GDP vs. Employment



Sources: BEA, BLS, October 2011.

begin, after those recessions ended, since World War II. Although employment has yet to see sustainable growth since the last recession ended in June 2009, the U.S. has experienced a jobless recovery before (see Exhibit 4-2), and this is part of the global environment of how, what, and when goods are produced and consumed. It may take longer to regain employment, but the dynamics of healthy companies, sustained GDP growth, and a work-force that is willing and able offers hope that the U.S. will be a powerful force in the world economy again.

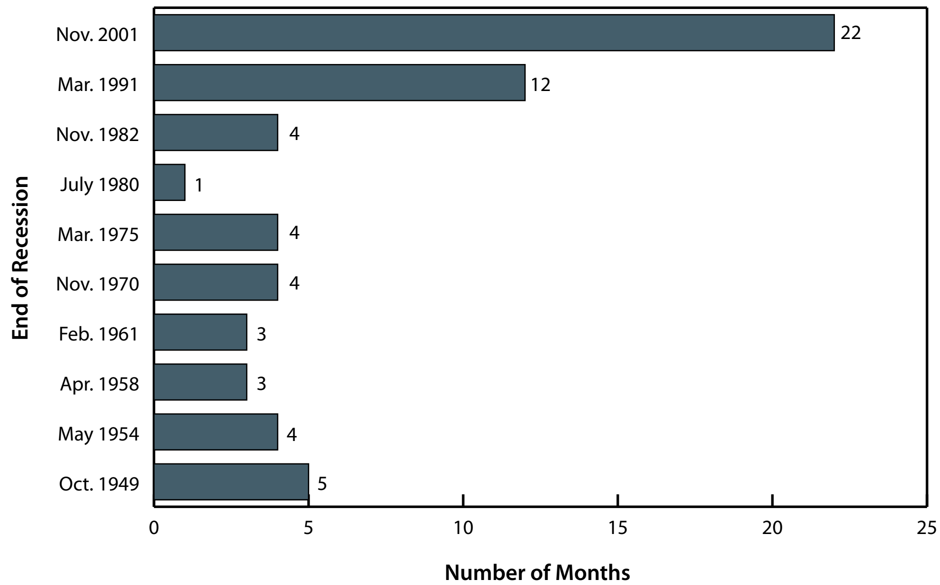
Accumulating debt problems in both the U.S. and Europe are adding risk to the global economy as well. In 2009, the U.S. was spending at the highest rate in history, and according to projections by the U.S. Department of the Treasury, spending in 2011 will be even higher. Since 1977, there has been only one short time period (approximately 1998 to 2001) when this nation's tax receipts were higher than its expenditures. However, as shown in Exhibit 4-3, after 2011, the Treasury forecasts that the gap between outlays and receipts will begin to narrow.

However, many consumers continue to deleverage and to save, with savings more than doubling to nearly $600 billion annually from only $250 billion annually prior to the financial crisis, according to the BEA. Many businesses and banks are also tightening their belts by reducing debt or holding onto excess cash. The good news is that further deleveraging may not be needed in the private sector, and businesses may be pressured by shareholders to either invest in new plants and equipment or pay out higher dividends. Tax revenues at state and local governments appear to have been rising slightly and may, at minimum, stop further job cuts.

In addition, the federal funds rate is already at zero and cannot go lower, but Federal Reserve Chairman Ben Bernanke has committed to keep it at zero until late 2014. "Operation Twist," in which the Federal Reserve buys long-term bonds by selling short-term bonds, is underway. Further, the low rates we see today can create a very favorable setting for commercial and residential real estate.

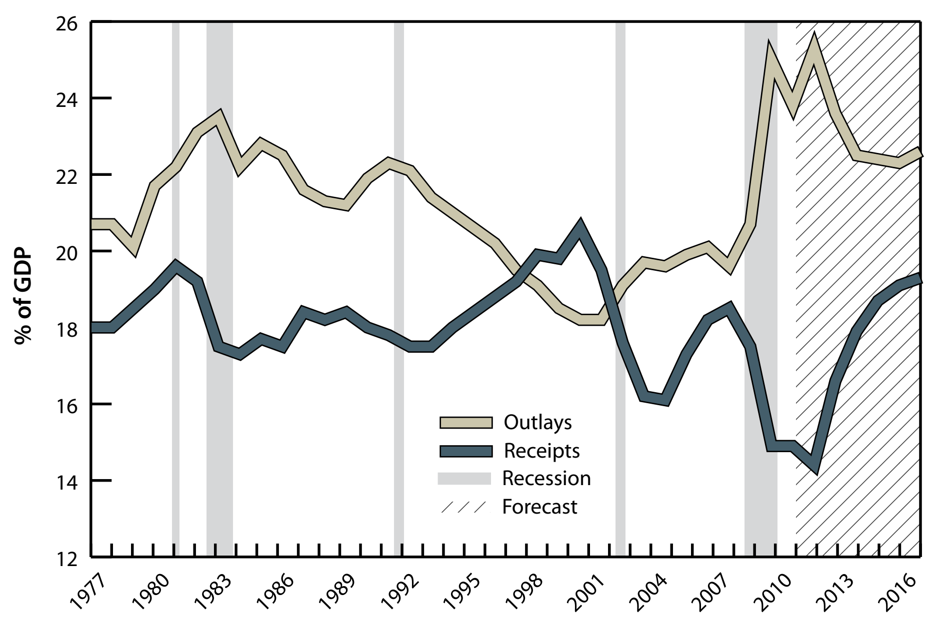
The housing market may need to lead the economy out of the slow growth rut it is currently in before the economy can have a sustained recovery. Since housing accounts for more than 15 percent of GDP and, according to NAR, a job is created for every two homes sold,

Exhibit 4-2. Months into Recovery and Sustained Job Growth



Sources: Congressional Research Service, BLS, NBER, Business Cycle Dating Committee, October 2011.

Exhibit 4-3. U.S. Spending and Receipts



Source: US Department of Treasury, 2011.

it is now believed by many analysts to have assisted in leading the U.S. out of six of the last eight recessions. Despite the struggles in the housing market in 2011, conditions may be ripe for a housing market recovery, including record-high home affordability, rising apartment rents, overcorrection in home price-to-income ratio, pent-up housing demand from the doubling-up phenomenon, and a 40-year low in newly constructed inventory.

CAPITAL MARKET TRENDS

More than two years after the credit crunch, some money is flowing (if selectively and in a disciplined manner for now) into commercial real estate. Commercial and multifamily mortgage originations more than doubled in the first half of 2011 compared to the same period a year earlier, although current activity remains subdued compared to the hyperactivity of 2006 and 2007.

In addition, investor-type loans for CMBS increased by 638 percent in second quarter 2011 compared to second quarter 2010, according to the MBA. During the past year, loans for commercial bank portfolios increased 150 percent, loans for life insurance companies increased 87 percent, and loans for GSEs increased 58 percent.

According to the NAREIT, the total market valuation of outstanding public REIT companies was $191 billion in 2008, rose to $271 billion in 2009, and increased to $389 billion in 2010. At the end of September 2011, the market capitalization value of REITs was at an all-time high of $435 billion.

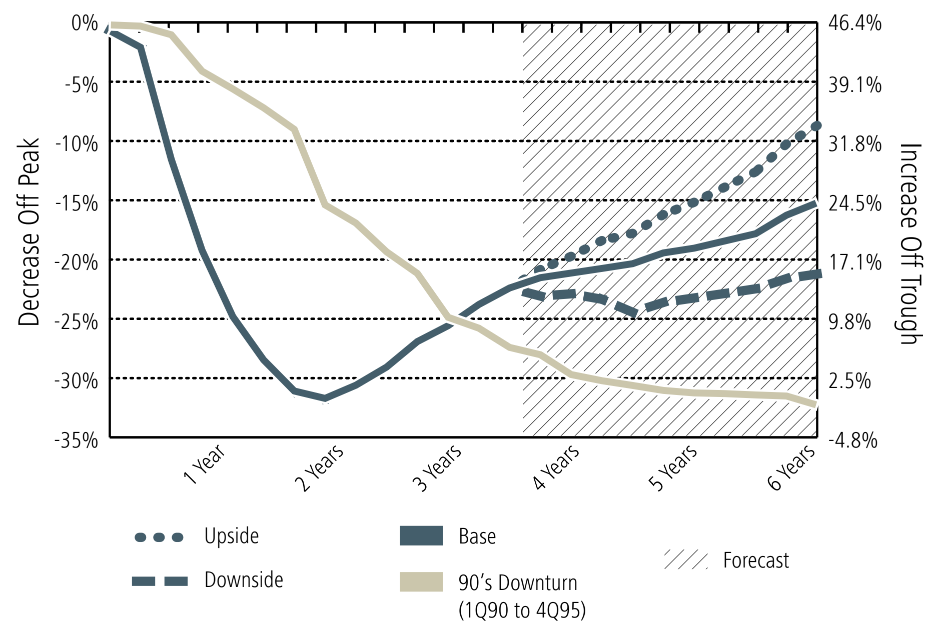
RERC'S COMMERCIAL REAL ESTATE VALUE OUTLOOK[1]

RERC forecasts aggregate National Council of Real Estate Investment Fiduciaries (NCREIF) values as presented in the NCREIF Property Index (NPI) to increase by approximately 7.5 percent throughout 2011. Exhibit 4-4 demonstrates a cumulative value increase from trough of approximately 15 percent (note that trough was reached in first quarter 2010). ***NOTE: It is important to understand that RERC's presentation in Exhibit 4-4 provides an aggregate view for the entire commercial real estate industry, and is not a projection specific to tiers of funds that exist throughout the industry.***

In addition, RERC's expectation is bracketed by upside and downside scenarios that reflect a projected value change between -1 percent and 6 percent in 2012, with the base case near 3 percent, with the current investment climate suggesting a higher probability of achieving the upside scenario versus the downside scenario. Adding an income return of 6 percent, total returns range from 5 percent to 12 percent, with the base case near 9 percent on an unleveraged basis for 2012. It is also important to note that RERC's estimates are unleveraged, and the use of debt (even prudent levels exhibited by core funds) has a compounding impact on value increases going forward. Thus, if positive leverage is added to these estimates, one can see that commercial real estate offers very attractive risk-adjusted returns for a core strategy.

If there is one message from the market today, it is that commercial real estate investment appeal going forward will likely continue to be the "assurity" of income (dividend) component versus the "speculative" value appreciation element—a back-to-basics approach as to why, for generations, funds have invested in commercial real estate. Further consideration of the back-to-basic investment strategies can be found by examining the historical NCREIF capital (value) index. NCRIEF, in combination with RERC's value projection, indicates that true value "appreciation" would have been just 1.3 percent over the 34-year reporting history of NCREIF, if one deducted the capital expenditures required to maintain the value of the assets during this period of time.

Exhibit 4-4. RERC Value Outlook



Note: The most recent downturn depicted above (base line) started in 2q 2008.
Sources: RERC, NCREIF, 3q 2011.

[1] ***This outlook and forecast is provided solely by RERC. Deloitte is not participating in this forecast in any way.***

MARKET EXPECTATIONS & REALITIES OUTLOOK

Certain indicators described within this report may point to a continued modest economic recovery.

- As mentioned in NAR's Commercial Real Estate Outlook, the estimate for GDP growth is +1.6 percent in 2011 and growth is forecast for +2.0 percent in 2012. Consumption is estimated to grow +1.6 percent in 2011 and is forecast to grow +1.8 percent in 2012, while NAR estimates government spending growth at -1.9 percent in 2011 and forecasts government spending growth at -0.5 percent in 2012.
- The federal funds rate is estimated by NAR in its Commercial Real Estate Outlook to remain at 0.1 percent throughout 2011 and 2012, and the prime rate is expected to remain at 3.1 percent during 2011 and 2012. The 10-year Treasury is estimated at 2.8 percent in 2011, and forecast at 3.1 percent in 2012, according to NAR.
- Office demand is expected to close 2011 with about 30 million square feet of net absorption, followed by 50 million square feet in 2012, according to Grubb & Ellis. With completions expected to remain at roughly half the pace of absorption, Grubb & Ellis expect the vacancy rate for the office sector to decline to 17.1 percent by the end of 2011 and to 16.6 percent by the end of 2012. However, with job creation potentially remaining weak, rents may not increase significantly.
- Unless economic conditions deteriorate further, the national industrial property market may end 2011 with a vacancy rate below 9.5 percent; by the end of 2012, vacancy is expected to decline to 9 percent, reports Grubb & Ellis. Net effective rents appear to have stabilized and are increasing for large Class A distribution buildings, but Grubb & Ellis notes that broad-based rent growth may not begin for at least another year.
- Retail sales may bump along at modest levels in 2011 and 2012, if retailers continue to reposition their stores to take advantage of potentially favorable rental rates or expansion plans. Properties such as grocery-anchored centers may continue to outperform the rest of the retail sector if consumer spending continues at current levels. It is possible that transaction volume may continue on an upward trajectory for the most desirable assets into 2012.
- The apartment sector may have another strong year in 2012, given strong fundamentals, a decreasing homeownership rate, lack of new supply, and the availability of financing for multi-family investments. However, apartment completions brought about by new starts may not materialize until the late 2012 - 2015 timeframe. Effective rent growth in the apartment sector may peak at an annual growth rate of 5.8 percent in 2012 and to slow to 4.9 percent in 2013, according to Axiometrics.
- As we move through the upcoming year, very little change may occur in the lodging sector, but lodging metrics in 2012 could possibly build on the success of 2011. Despite gains in both hotel occupancy and ADR through mid-year 2011, the second half of the year appeared to be challenging in terms of maintaining corporate and transient demand. PKF-HR has lowered their ADR growth forecast for 2012 to 4.8 percent.

With regard to the next year, the next 5 years, and beyond, commercial real estate is positioned to possibly deliver what it signaled so many decades ago when big institutions took an interest in this asset class. Of course we will still see cycles, external environmental factors will affect the asset class in as of yet unknown ways, and we will still experience the fundamental sentiments and raw behaviors of the investor, but, for some investors, commercial real estate can potentially serve as a foundation in a world of uncertainty.

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Sources: NAREIT, Retail Traffic, NREI, P&I, Builder on Line, ENR

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