



CYCLE FORECAST — Real Estate Market Cycles

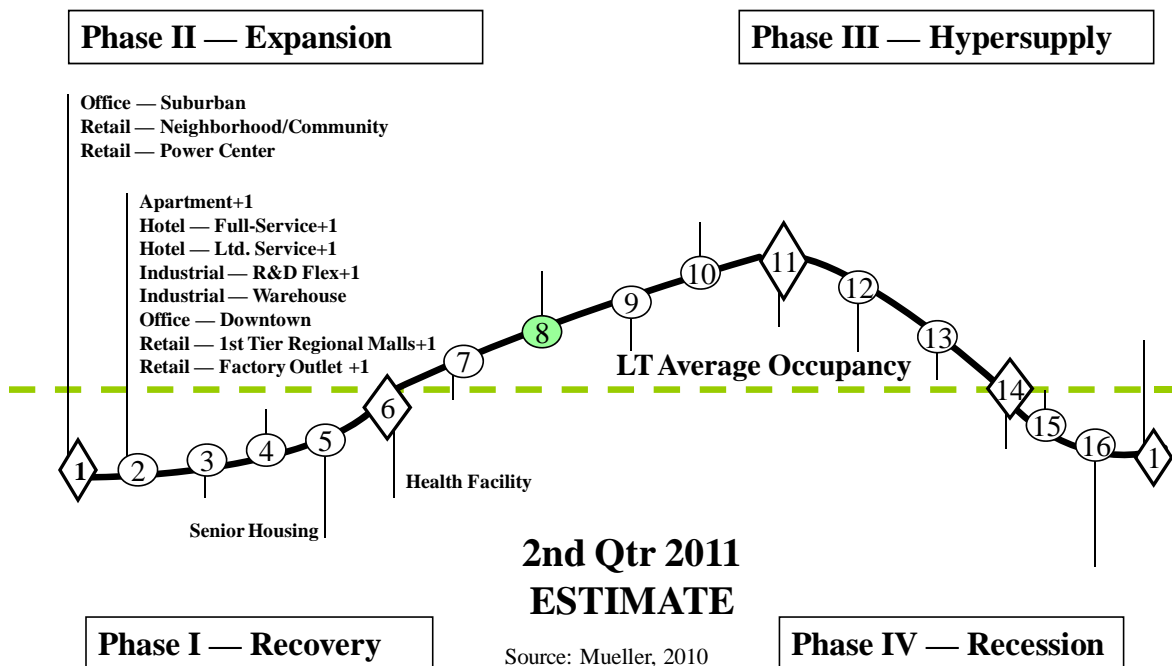
**Second Quarter 2011 Estimates
August 2010**

Four of five property types hit their occupancy bottoms in 1Q10 and showed improvement in 2Q10. Our forecast models now show that four of the five property types' national occupancy averages should move up to point #2 on the cycle graph — the recovery phase — one year after their bottom. Surprisingly, very moderate rent growth is also forecast to begin in 2Q11.

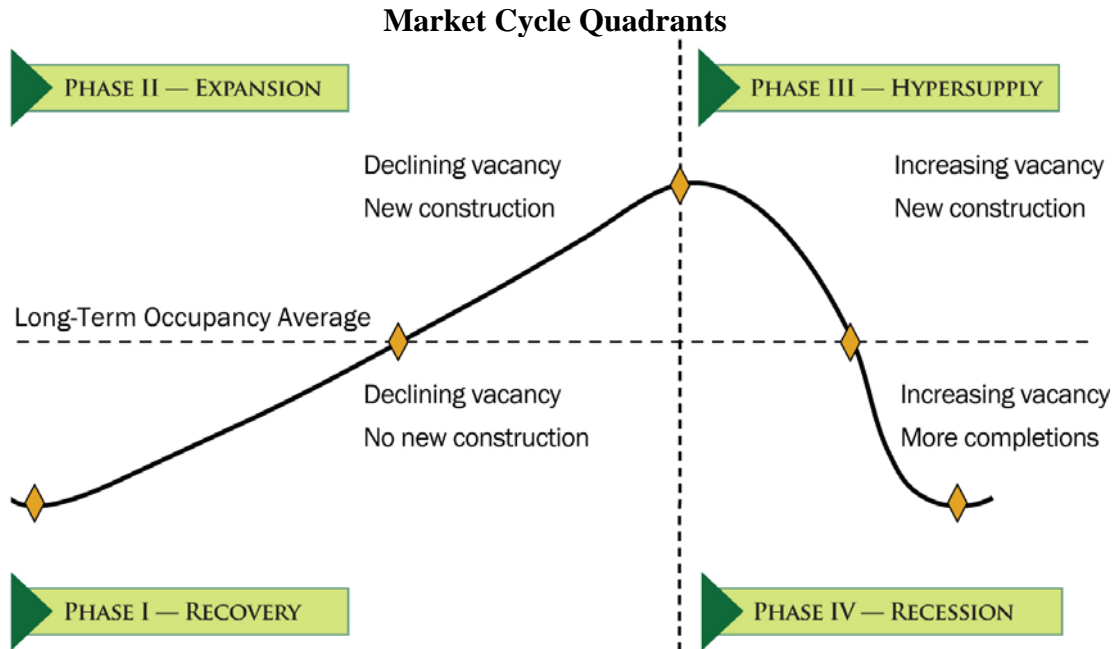
- Office occupancies are forecast to improve 0.3% in 2Q11, with rent improving by 0.1% quarter-over-quarter.
- Industrial occupancies are forecast to improve 0.3% in 2Q11, with rents improving 0.1% quarter-over-quarter.
- Apartment occupancies are forecast to improve 0.1% in 2Q11, with rents improving 0.2% quarter-over-quarter.
- Retail occupancies are forecast to improve 0.3% in 2Q11, with rents improving 0.1% quarter-over-quarter.
- Hotel occupancies are forecast to improve 0.3% in 2Q11, with RevPAR improving 1.4% quarter-over-quarter.

The National Property Type Cycle Graph shows relative positions of most sub-property types — major markets are reviewed inside.

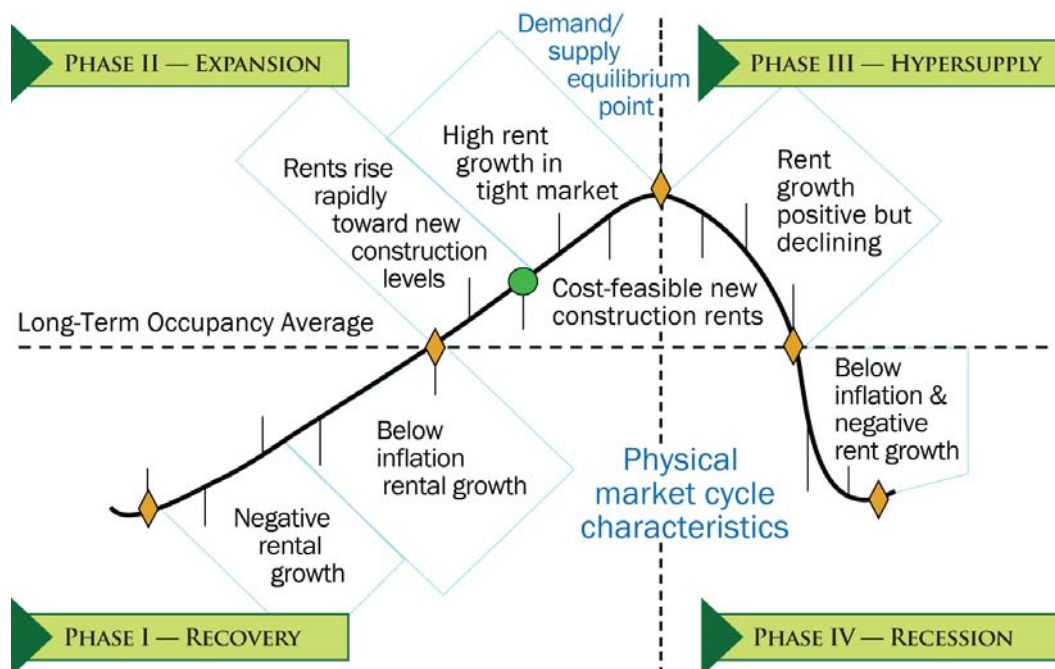
National Property Type Cycle Forecast



The cycle forecast analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). The market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that analyze occupancy levels and rental growth rates to provide the foundation for long-term investment success. Real estate markets are cyclical due to the lagged relationship between supply and demand for physical space. The long-term occupancy average is different for each market and each property type. **Long-term occupancy average** is a key factor in determining rental growth rates — a key factor that affects real estate returns.

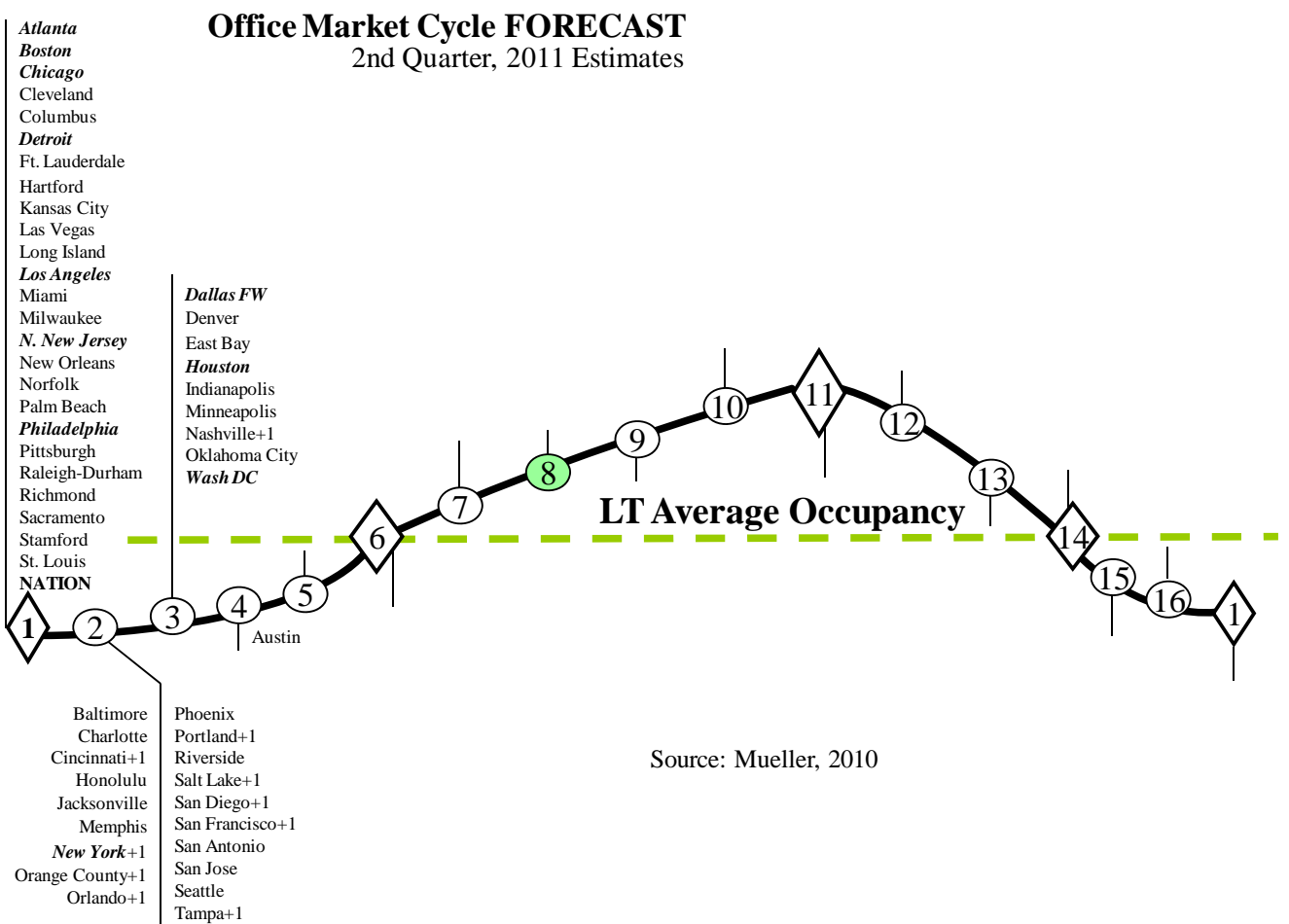


Rental growth rates can be characterized in different parts of the market cycle, as shown below.



OFFICE FORECAST

Office occupancies are forecast to improve 0.3% in 2Q11 — a very slow improvement — based upon the sluggish employment growth forecast combined with very little new construction. Year-over-year occupancies are expected to improve by 0.8%, which is still not enough improvement to move occupancies up to cycle point #2. Both sub-lease and shadow space are expected to be consumed slowly and should dampen occupancy improvement. Renters are expected to still be in the driver’s seat and negotiating hard on both rental rates and concessions. We forecast national average office rents may rise 0.1% in 2Q11, but still be down 1.9% year-over-year.



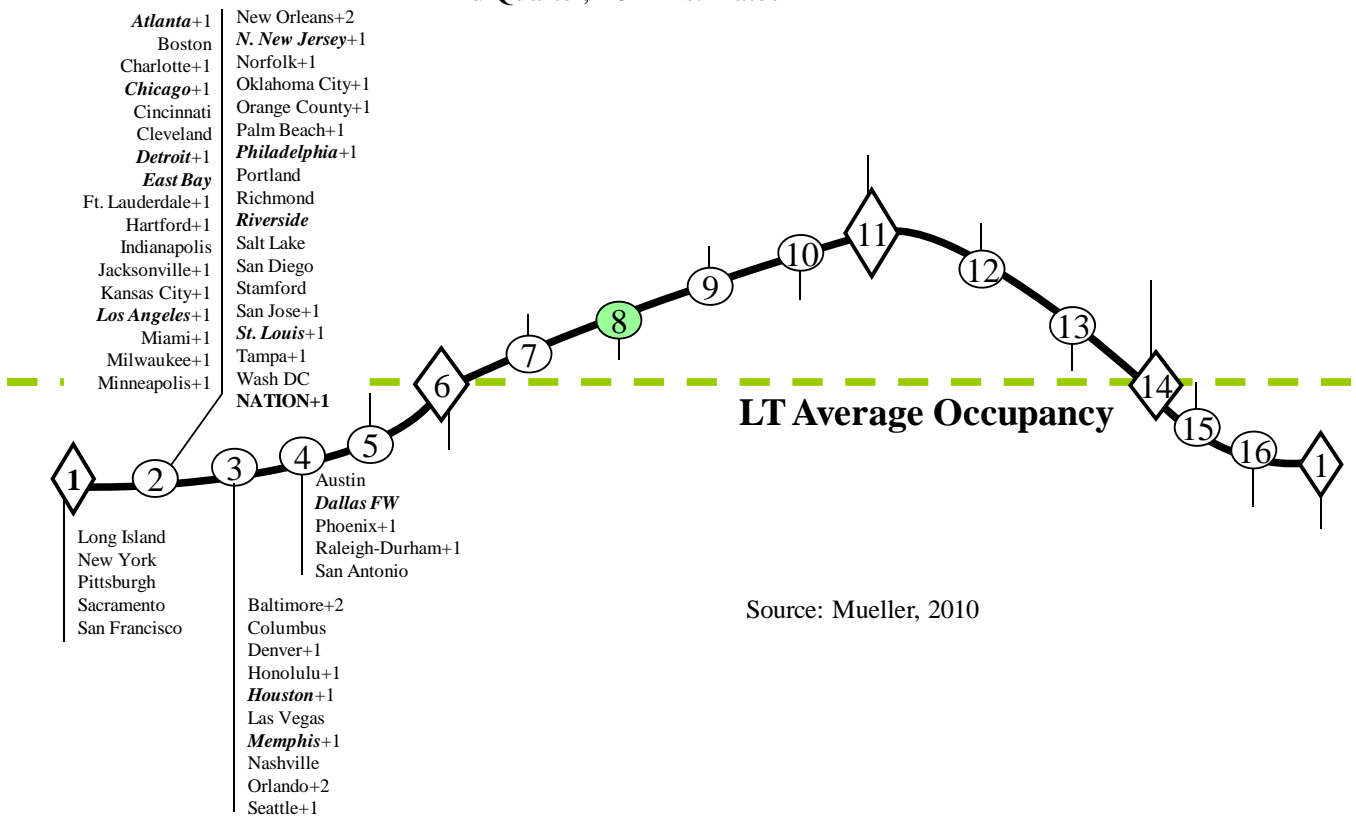
Note: The 11-largest office markets make up 50% of the total square footage of office space that we monitor. Thus, the 11-largest office markets are in **bold italics** to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

INDUSTRIAL FORECAST

We forecast another 0.3% improvement in industrial occupancies in 2Q11, and a 1.4% improvement year-over-year. This occupancy improvement moves the national average forward to point #2 on the occupancy cycle. Both the manufacturing and trade areas are forecast to continue their 2010 growth that should create demand for warehouse and R&D/Flex industrial space. We also expect rents to have their first quarter of improvement by a mere 0.1% in 2Q11, but still be down 0.7% year-over-year.

Industrial Market Cycle FORECAST 2nd Quarter, 2011 Estimates



Source: Mueller, 2010

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

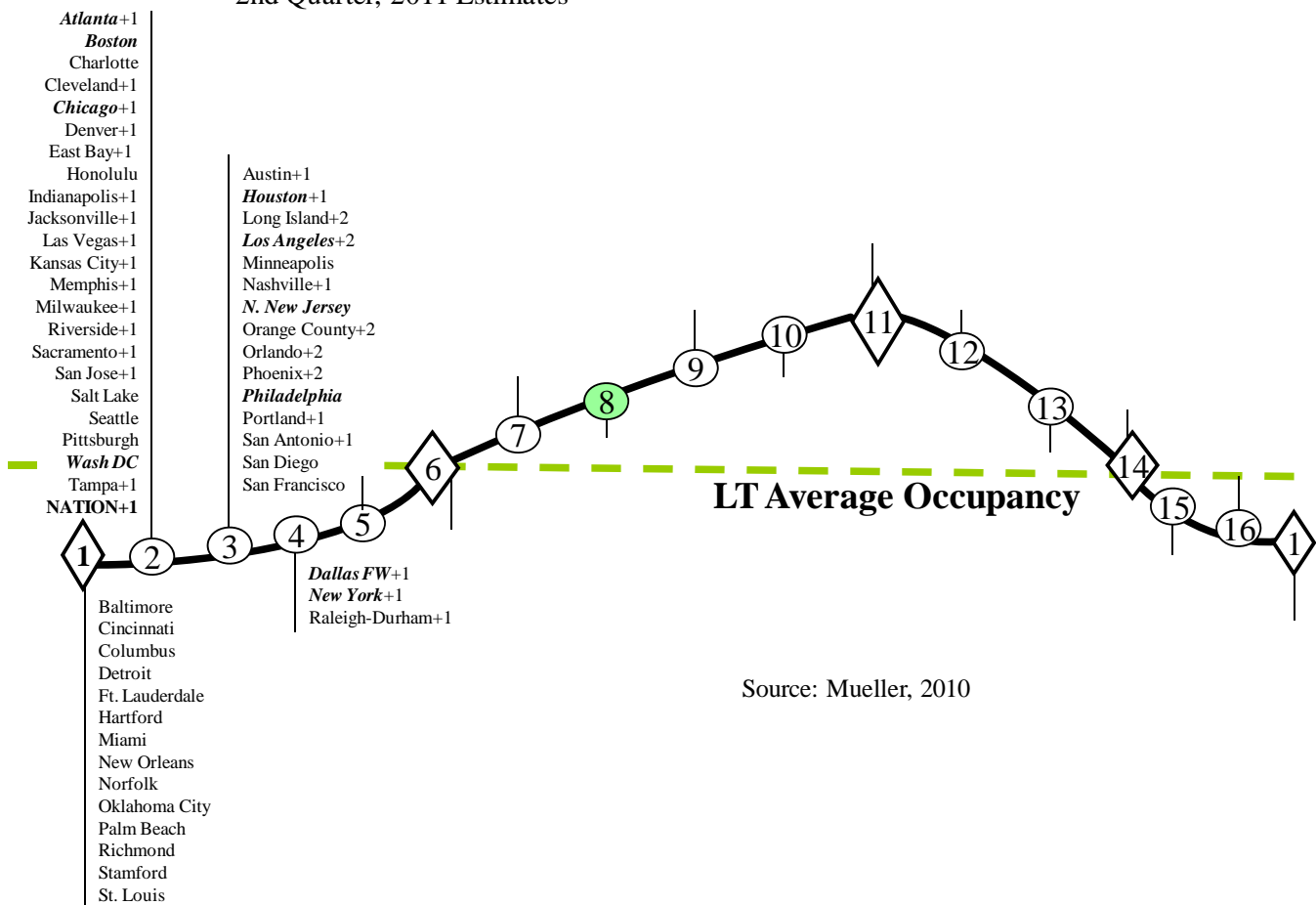
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

APARTMENT FORECAST

We forecast an occupancy increase of 0.1% for 2Q11 and a year-over-year increase of 0.3%. This weak improvement is just enough to move the national apartment occupancy level up one position to point #2 on the cycle graph. A number of apartment markets are expected to have occupancy levels that are 3.0% to 4.0% higher than their bottoms, which started in mid-to-late 2009. New apartment supply is expected to be moderate and static housing prices that do not appear to have a lot of upside potential may keep many people in rentals longer than the historic norm. Some economists are projecting continued low interest rates, but this may not be enough to motivate first time home buyers. We estimate the national apartment rental rate to increase 0.2% in 2Q11, the first increase in this cycle, but expect to still have a year-over-year decline of 0.6%.

Apartment Market Cycle FORECAST

2nd Quarter, 2011 Estimates



Source: Mueller, 2010

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

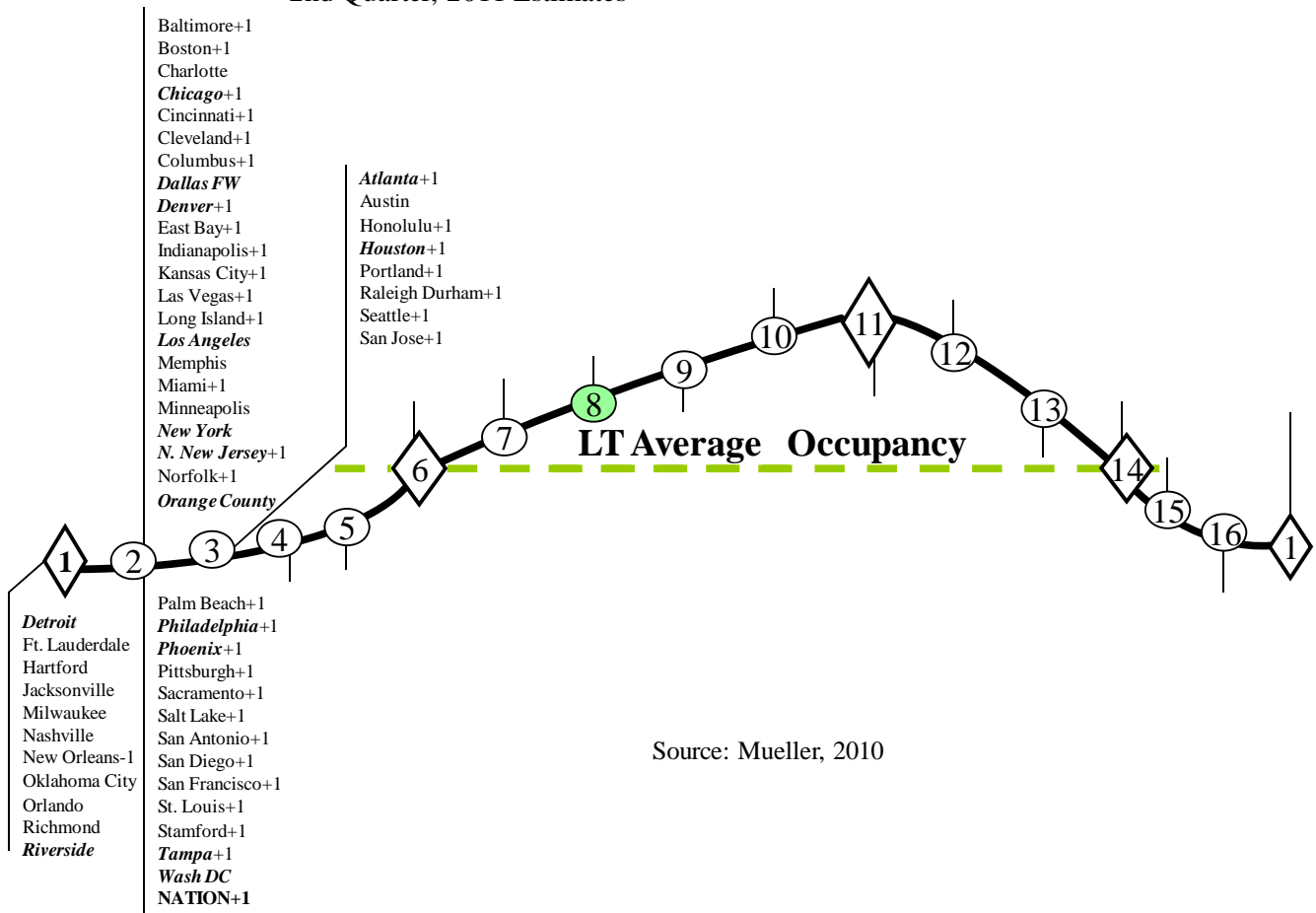
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

RETAIL FORECAST

Retail occupancy is forecast to improve 0.3% in 2Q11 and be up 1.4% year-over-year. This occupancy improvement is just enough to move the national retail average off the cyclical bottom to point #2 on the cycle graph. The continued slow economic recovery is expected to stabilize consumer confidence in 2011 and this should allow retailer expansion plans to materialize in 2011 and 2012. We expect retail rental rates to improve 0.1% in 2Q11 but still have a 1.6% year-over-year decline.

Retail Market Cycle FORECAST

2nd Quarter, 2011 Estimates



Source: Mueller, 2010

Note: The 15-largest retail markets make up 50% of the total square footage of retail space that we monitor. Thus, the 15-largest retail markets are in **bold italics** to help distinguish how the weighted national average is affected.

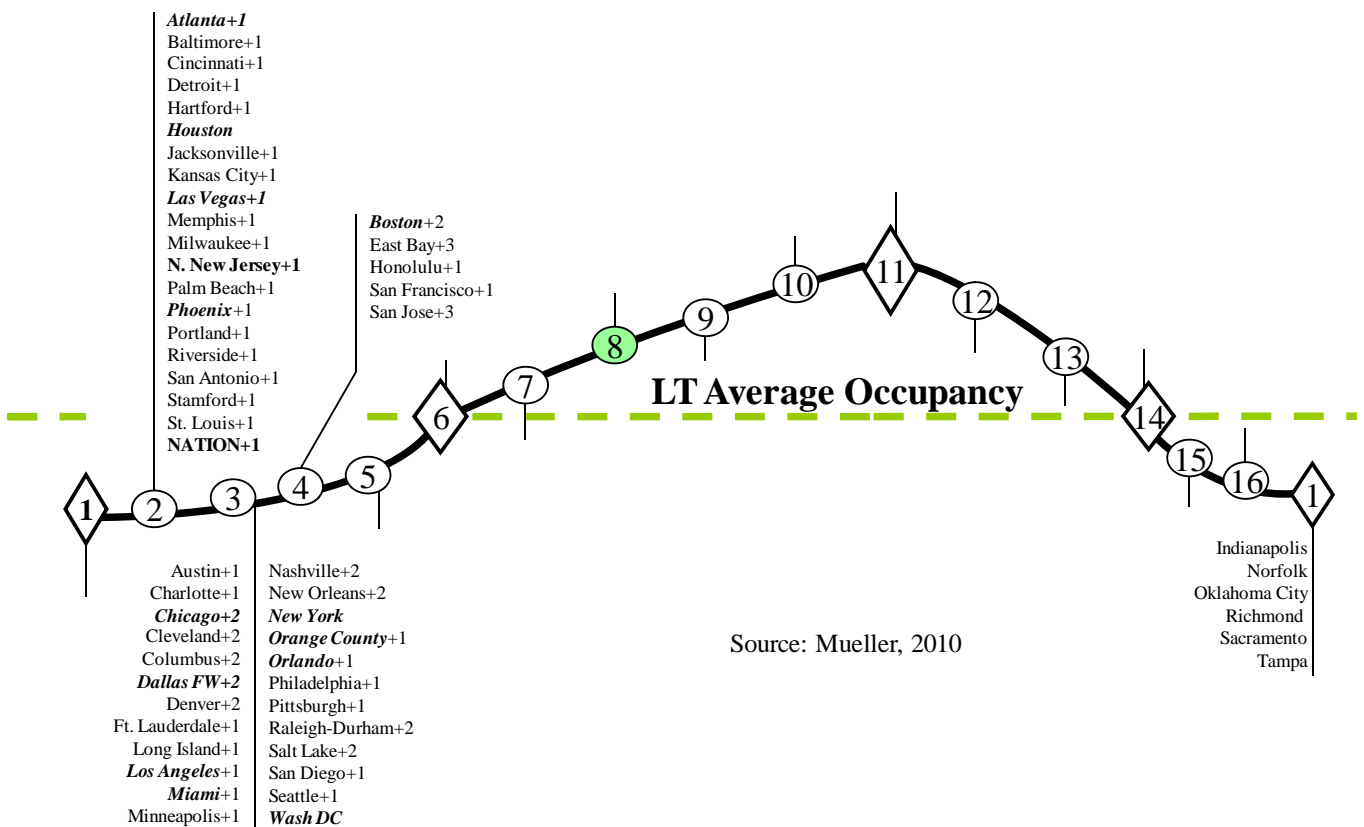
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

HOTEL FORECAST

Hotel occupancy is forecast to increase 0.3% in 2Q11 and improve 0.8% year-over-year. This is enough to move the national hotel occupancy level to point #2 on the cycle graph. Both businesses and vacationers are expected to resume their travel habits as the economy improves. Airlines are taking delivery of new planes in 2011 and increasing flight options. Many opportunity funds are focusing on hotel purchases as they expect both revenues and prices to improve over the next few years. We estimate RevPAR to increase 1.4% in 2Q11 and be up by 3.2% year-over-year.

Hotel Market Cycle FORECAST

2nd Quarter, 2011 Estimates



Note: The 14-largest hotel markets make up 50% of the total square footage of hotel space that we monitor. Thus, the 14-largest hotel markets are in **bold italics** to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

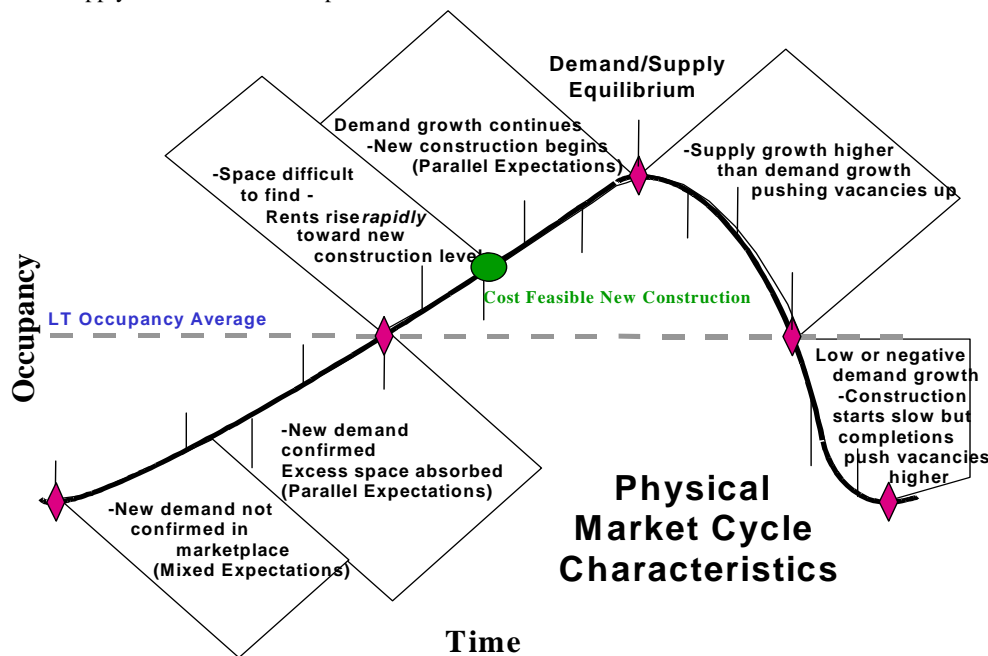
MARKET CYCLE ANALYSIS — Explanation

Supply and demand interaction is important to understand. Starting in Recovery Phase I at the bottom of a cycle (see chart below), the marketplace is in a state of oversupply from previous new construction or negative demand growth. At this bottom point, occupancy is at its trough. Typically, the market bottom occurs when the excess construction from the previous cycle stops. As the cycle bottom is passed, demand growth begins to slowly absorb the existing oversupply and supply growth is nonexistent or very low. As excess space is absorbed, vacancy rates fall, allowing rental rates in the market to stabilize and even begin to increase. As this recovery phase continues, positive expectations about the market allow landlords to increase rents at a slow pace (typically at or below inflation). Eventually, each local market reaches its *long-term occupancy average* whereby *rental growth is equal to inflation*.

In Expansion Phase II, demand growth continues at increasing levels, creating a need for additional space. As vacancy rates fall below the *long-term occupancy average*, signaling that supply is tightening in the marketplace, rents begin to rise rapidly until they reach a "cost-feasible" level that allows new construction to commence. In this period of tight supply, rapid rental growth can be experienced, which some observers call "rent spikes." (Some developers may also begin speculative construction in anticipation of cost-feasible rents if they are able to obtain financing.) Once cost-feasible rents are achieved in the marketplace, demand growth is still ahead of supply growth — a lag in providing new space due to the time to construct. Long expansionary periods are possible and many historical real estate cycles show that the overall up-cycle is a slow, long-term uphill climb. As long as demand growth rates are higher than supply growth rates, vacancy rates will continue to fall. The cycle peak point is where demand and supply are growing at the same rate *or equilibrium*. Before equilibrium, demand grows faster than supply; after equilibrium, supply grows faster than demand.

Hypersupply Phase III of the real estate cycle commences after the peak/equilibrium point #11 — where demand growth equals supply growth. Most real estate participants do not recognize this peak/equilibrium's passing, as occupancy rates are at their highest and well above long-term averages, a strong and tight market. During Phase III, supply growth is higher than demand growth (hypersupply), causing vacancy rates to rise back toward the long-term occupancy average. While there is no painful oversupply during this period, new supply completions compete for tenants in the marketplace. As more space is delivered to the market, rental growth slows. Eventually, market participants realize that the market has turned down and commitments to new construction should slow or stop. If new supply grows faster than demand once the long-term occupancy average is passed, the market falls into Phase IV.

Recession Phase IV begins as the market moves past the long-term occupancy average with high supply growth and low or negative demand growth. The extent of the market down-cycle will be determined by the difference (excess) between the market supply growth and demand growth. Massive oversupply, coupled with negative demand growth (that started when the market passed through long-term occupancy average in 1984), sent most U.S. office markets into the largest down-cycle ever experienced. During Phase IV, landlords realize that they will quickly lose market share if their rental rates are not competitive; they then lower rents to capture tenants, even if only to cover their buildings' fixed expenses. Market liquidity is also low or nonexistent in this phase, as the bid-ask spread in property prices is too wide. The cycle eventually reaches bottom as new construction and completions cease, or as demand growth turns up and begins to grow at rates higher than that of new supply added to the marketplace.



Source: Mueller, Real Estate Finance, 1995

This Research currently monitors five property types in more than 50 major markets. We gather data from numerous sources to evaluate and forecast market movements. The market cycle model we developed looks at the interaction of supply and demand to estimate future vacancy and rental rates. Our individual market models are combined to create a national average model for all U.S. markets. This model examines the current cycle locations for each property type and can be used for asset allocation and acquisition decisions.

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