What Is Up (or Down) With Cap Rates?

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Property Valuation Trends since 2007:

CRE assets have generally declined 35 – 40% since their peak levels in 2007.

Over $500B of over-leveraged CRE assets that are slowing reaching the market through lender dispositions or restructurings. This would indicate that CRE prices will continue to decline.

*Pimco US Commercial Real Estate Project

CAP RATE SURVEY
Office CBD | Current Cap Rates

		Class A			
		Stabilized	Trend*	Value Add	Trend*
EAST	Atlanta	7.75% - 8.50%	↓	8.75% - 10.00%	↓
	Baltimore	8.25% - 9.00%	↔	9.75% - 10.50%	↓
	Boston	6.50% - 7.00%	↓	7.00% - 7.50%	↓
	Charlotte	7.50% - 8.50%	↓	8.50% - 10.00%	↓
	Jacksonville	9.00% - 10.00%	↔	10.00% - 11.50%	↑
	Memphis	9.00% - 10.00%	↓	9.00% - 10.00%	↓
	Miami	6.50% - 7.50%	↓	7.50% - 8.50%	↓
	Nashville	8.50% - 9.50%	↓	9.00% - 10.00%	↓
	New York City	5.50% - 6.00%	↔	6.00% - 7.00%	↔
	Orlando	8.00% - 8.75%	↓	8.75% - 9.25%	↓
	Pittsburgh	7.50% - 8.00%	N/A	8.50% - 10.00%	N/A
	Philadelphia	7.75% - 8.75%	↓	8.50% - 9.50%	↓
	Raleigh	7.50% - 8.50%	↓	8.00% - 9.00%	↓
	Tampa	7.50% - 8.50%	↓	8.50% - 9.50%	↔
	Washington, DC	5.50% - 6.50%	↓	6.50% - 7.50%	↓
CENTRAL	Austin	7.50% - 8.25%	↔	8.50% - 9.00%	↔
	Chicago	6.25% - 7.00%	↓	7.25% - 7.75%	↓
	Cincinnati	9.75% - 10.50%	↓	10.00% - 11.00%	↓
	Columbus	9.50% - 10.50%	N/A	12.00% - 13.00%	N/A
	Dallas	9.00% - 9.50%	↑	9.50% - 10.00%	↑
	Detroit	8.50% - 10.00%	↓	10.00% - 12.00%	↓
	Houston	6.25% - 7.00%	↓	7.00% - 8.00%	↓
	Indianapolis	8.50% - 9.50%	↔	9.50% - 11.00%	↔
	Kansas City	8.50% - 10.00%	↔	9.50% - 11.00%	↔
	Minneapolis	7.25% - 8.25%	↓	8.50% - 9.50%	↓
	San Antonio	7.75% - 8.50%	↓	8.50% - 9.00%	↓
	St. Louis	9.00% - 10.00%	↔	11.00% - 12.00%	↑
WEST	Albuquerque	8.00% - 9.50%	↑	8.75% - 11.00%	↑
	Denver	7.50% - 8.00%	↓	8.50% - 9.00%	↓
	Los Angeles	6.00% - 7.25%	↓	6.50% - 7.50%	↓
	Orange County	7.25% - 8.25%	↓	7.75% - 8.50%	↓
	Phoenix	7.50% - 8.50%	↓	8.00% - 9.00%	↔
	Portland	8.00% - 8.75%	↓	8.50% - 9.50%	↓
	Sacramento	6.50% - 8.00%	↓	10.00% - 11.00%	↑
	Salt Lake City	8.00% - 8.70%	↔	8.50% - 8.75%	↔
	San Diego	6.50% - 8.00%	↓	7.00% - 8.50%	↓
	San Francisco	6.50% - 7.50%	↓	7.50% - 8.50%	↓
	Seattle	6.50% - 7.25%	↓	7.25% - 8.00%	↓

* Compared to 2nd Half 2009

So, with property values declining and the inverse relationship between values and cap rates, cap rates should be increasing.

Yet for 2010 Cap Rates have been DECLINING.
Why??

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What are the economic drivers that would affect Cap Rates?

* GDP
* Unemployment
* Home Sales
* Uncertainty – taxes, health care costs, financial restructuring, inflation

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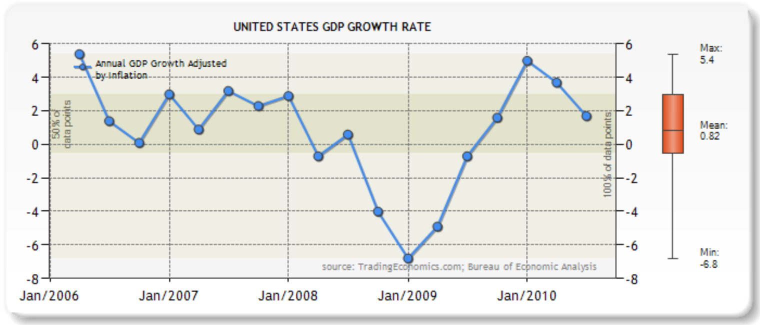

GDP – continuing to decline in 2010 after only 2 quarters of positive growth since January 2008.

Additionally **worker productivity** decreased as real output grew just 1.6% in the second quarter, marking the first decline in five quarters.
Higher productivity tends to result in higher wages for workers and bigger profits for companies, so it's seen as the key to a rising standard of living.

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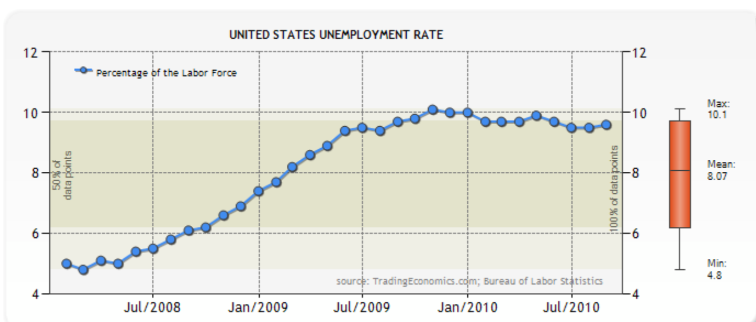

Unemployment – not improving, still around 10%

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Home Prices / Sales – continues to languish.

"We're going to see the housing market continue to languish over the next several months and bounce along this bottom," said Russell Price, a senior economist at Ameriprise Financial Inc. in New York. "There will be a stagnant environment until the economy recovers and people's credit profiles" and the labor market improve, he said.

Uncertainty – taxes, health care costs, financial restructuring, inflation – will be lower after elections but, will still continue due to the overarching re-regulation issues and proposals.

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What about the Real Estate economic drivers?

*** Occupancy**
*** Effective Rents**
*** Credit / Leverage / Maturities / CMBS**

Occupancy continues to remain high since the start of its decline in 2008 despite a small recovery in 2Q10.

Average effective rents for some 4 B SF of office space tracked by research firm Reis Inc. is at $22.05 / SF / YR, below the 2008 high of $25.07, a 13.7% average decrease.

Many areas have a higher decrease; a 40% decrease in effective rents was reported for NYC.

Table CBD-1
OVERALL VACANCY RATES
National CBD Office Market

Quarter	Average	Change (Basis Points)
2Q10	14.7%	– 30
1Q10	15.0%	+ 30
4Q09	14.7%	+ 40
3Q09	14.3%	+ 60
2Q09	13.7%	+ 120
1Q09	12.5%	+ 130
4Q08	11.2%	+ 60
3Q08	10.6%	+ 40
2Q08	10.2%	+ 30
1Q08	9.9%	+ 20
2Q07	9.7%	—

Source: Cushman & Wakefield

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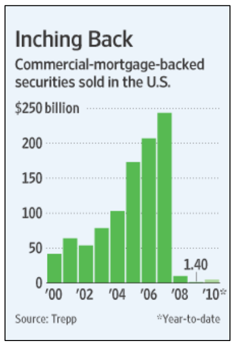
Credit / Leverage / Maturities / CMBS

*Credit remains tight.
* Leverage remains low at 40 -75% LTV as U/W standards tightened.
* CRE has $1.4 trillion of debt coming due by the end of 2014.
* CMBS is slowly picking up (a bit of good news!) yet only $2.4B issuances in the first half of 2010, much lower than the $250B peak.



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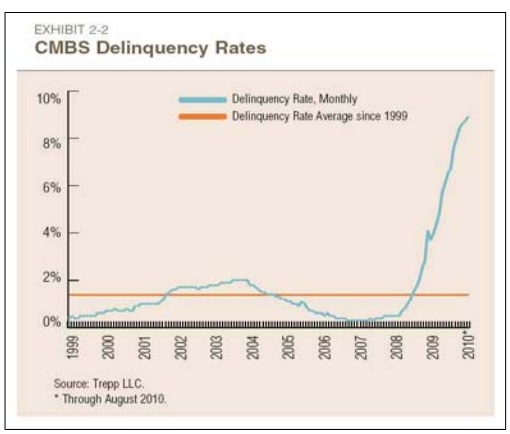
CMBS also has a high delinquency rate. This has increased from 0.5% in 2008 to almost 10% in 2010. The complex and potentially litigious CMBS structures will delay the de-leveraging of assets and prolong the recovery.



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With all of this bad news and weak fundamentals, why are Cap Rates declining?

Exhibit 1
OVERALL CAPITALIZATION RATES
Third Quarter 2010

National Markets	Average	Quarterly Change*
Apartment	7.12%	–56
Regional Mall	7.81%	–12
CBD Office	8.01%	–14
Strip Shopping Center	8.09%	–29
Power Center	8.38%	–32
Warehouse	8.38%	–22
Suburban Office	8.40%	–20
MOB**	8.58%	+5
Net Lease	8.88%	–10
Flex/R&D	9.15%	–23
Apartment Markets		
Pacific Region	6.90%	–39
Mid-Atlantic Region	7.15%	–25
Southeast Region	7.75%	–18
Office Markets		
Manhattan	6.23%	–35
Washington, DC	6.64%	–31
Northern Virginia	7.50%	–35
San Francisco	7.69%	–14
Suburban Maryland	7.75%	–11
Los Angeles	7.76%	+5
San Diego	8.26%	+1
Denver	8.29%	–11
Pacific Northwest	8.41%	–22
Boston	8.51%	–15
Chicago	8.57%	–4
Philadelphia	8.71%	–28
Charlotte	8.74%	–67
Dallas	8.76%	–1
Houston	8.82%	+3
Atlanta	8.95%	+1
Southeast Florida	9.19%	–1
Phoenix	9.23%	–3

* Quarterly basis-points shift
** Medical office buildings
Source: Korpacz Real Estate Investor Survey®

Exhibit 2
OVERALL CAPITALIZATION RATE FORECASTS
Third Quarter 2010

	CURRENT OVERALL CAP RATE	CHANGE OVER NEXT 6 MONTHS(a) (BASIS POINTS)	
MARKET	AVERAGE	RANGE	AVERAGE
National Regional Mall	7.81%	(150) – 0	(42)
National Power Center	8.38%	(b)	
National Strip Shopping Center	8.09%	(b)	
National CBD Office	8.01%	(100) – 75	(11)
National Suburban Office	8.40%	(b)	
Atlanta Office	8.95%	(b)	
Boston Office	8.51%	(b)	
Charlotte Office	8.74%	(100) – 100	15
Chicago Office	8.57%	(b)	
Dallas Office	8.76%	(b)	
Denver Office	8.29%	(c)	
Houston Office	8.82%	(b)	
Los Angeles Office	7.76%	(b)	
Manhattan Office	6.23%	(c)	
Northern Virginia Office	7.50%	(b)	
Pacific Northwest Office	8.41%	(b)	
Philadelphia Office	8.71%	(b)	
Phoenix Office	9.23%	(b)	
San Diego Office	8.26%	(b)	
San Francisco Office	7.69%	(100) – 0	(34)
Southeast Florida Office	9.19%	(c)	
Suburban Maryland Office	7.75%	(25) – 125	69
Washington, DC Office	6.64%	(b)	
National Flex/R&D	9.15%	(b)	
National Warehouse	8.38%	(b)	
Apartment			
National	7.12%	(b)	
Mid-Atlantic Region	7.15%	(b)	
Pacific Region	6.90%	(c)	
Southeast Region	7.75%	(b)	
National Net Lease	8.88%	(b)	
National Medical Office Buildings	8.58%	(b)	

(a) All changes are positive unless enclosed in parentheses and reflect the majority of investor responses.
(b) The majority of participants (over 55.0%) expect overall cap rates to hold steady over the next six months.
(c) Investor responses were equal between increase, decrease, and hold steady.
Source: Korpacz Real Estate Investor Survey®

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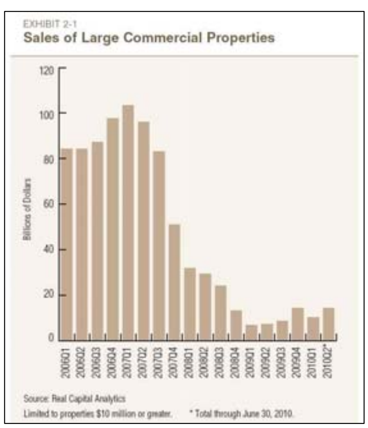
Market Equilibrium - This tells us that the market is not in equilibrium as fundamentals remain weak and could become even weaker yet, cap rates are increasing.



The market requires velocity, transparency and certainty to return to equilibrium.

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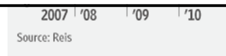
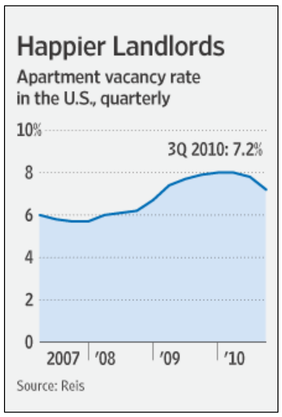


Apartment Markets – the exception is the apartment sector.
Nationwide, the vacancy rate measured 7.2% in the third quarter, down from 7.9% a year earlier-one of the sharpest declines on record.

*REIS.com



Still, progress could be halted or even reversed if employers don't add jobs sometime next year, industry watchers warn. Job growth is essential to filling apartments because many would-be renters typically double up or move in with family members during a downturn.

"Things are improving dramatically and ahead of schedule, but they can only continue for so long on the release of pent up demand without sizable job growth," said Hessam Nadji, managing director of Marcus & Millichap.

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Cap Rates are declining due to:

* Pent up Investor demand
* Insurance company / advisors – use it or lose it
* Non-US Capital seeking higher returns
*** Sales of Trophy Assets**

- Pent up Investor demand is high. According to Institutional Real Estate, Inc., there is approximately $135B of unspent equity sitting on the side lines.

- Non-US Capital investment is high. The weak U.S. dollar, along with diminished competition from domestic buyers, is providing a golden opportunity for foreign investors in the U.S. market.

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Sales of Trophy Assets

* Trophy assets have retained their value during the recession.
* Trophy assets values are GREATLY increased due to a **SCARCITY PREMIUM** as Investors are holding non-trophy assets, unless forced to sell, to preserve cash equity. The market is not in equilibrium.
* As the sales are recorded, the scarcity premium cap rate trends are used as support to decrease cap rate trends for all assets.

YET, THE SCARCITY PREMIUM CANNOT BE APPLIED TO ALL ASSETS, AS IF ALL ASSETS WERE ON THE MARKET, THERE WOULD NOT BE A SCARCITY PREMIUM.

Will Cap Rates continue to decline?   It depends.

It depends on:

* A sustained and growing economic recovery.
* Continued workouts or extend and pretend of underwater assets for a measured de-leveraging.
* Recovery of the CMBS markets to finance the current maturing CBSM debt.
* Continued high level of equity investment due to lack of attractive investment alternatives.

All of these will lead to a return in market activity and equilibrium.