Emerging Trends in Real Estate®

2010

PRICEWATERHOUSECOOPERS

Urban Land Institute

Emerging Trends in Real Estate® 2010

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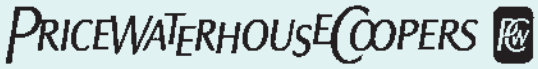

Emerging Trends in Real Estate®

2010

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Executive Summary

After more than a year spent in suspended animation lagging already shattered housing markets, the commercial real estate industry hits bottom in 2010, suffering a surge of painful writedowns, defaults, and workouts. Massive government infusions finally build up loss reserves in financial institutions to levels allowing them to foreclose or strike deals with many overleveraged borrowers. In turn, banks will start to dispose of real estate owned, and government regulators will package and sell more bad loans and real estate assets acquired in takeovers of increasing numbers of failed community and regional banks. Transaction markets will begin to thaw and value declines ultimately will average more than 40 percent off mid-2007 pricing peaks. These property market reversals likely will be the worst registered since the Great Depression, eclipsing the industry debacle of the early 1990s.

In a classic timing play, investors with cash should be poised to take advantage of highly attractive buying opportunities at cyclical lows. Stressed owners, meanwhile, gird to hold on if possible and try to maximize property cash flows by focusing on asset management and leasing strategies in a decidedly tenants' market. *Emerging Trends* surveys indicate that 2010 will be the worst time for investors to sell properties in the report's 30-year history, but will offer a much-improving environment to buy (with cash).

Debt markets will remain severely compromised—resuscitated banks will increase lending slowly, employing strict underwriting standards and requiring significant equity stakes from borrowers. Moribund CMBS markets remain entangled in complex workouts of failed multitranched structures with mounting levels of troubled loans maturing through 2015. Restoring confidence in a revamped CMBS model becomes a major priority for the government and financial industry, but a quick fix is unlikely.

A lackluster economic recovery characterized by problematic job growth will hamper the pace of any real estate market resurgence, which probably cannot gain much traction until late 2011 or 2012. In the meantime, rents and occupancies will continue to fall well into 2010, savaging the prospects of weakened owners struggling with financing issues.

Retail and office properties take the biggest hits—debt-burdened consumers continue to rein in shopping and companies delay rehiring while looking to shave occupancy costs and improve productivity.

Once hiring increases, apartments should rebound more quickly than other sectors thanks to pent-up demand from the expanding population of young adults—20-somethings get tired of living with parents and doubling or even tripling up with roommates.

The pummeled hotel sector also can benefit quickly once businesses start to loosen travel budgets.

First-to-hit-bottom housing markets stabilize further, despite more foreclosures, and show modest improvement in some areas as homebuyers look for generational deals. But restrained mortgage lenders and cash-poor purchasers limit the scope of any rebound.

Developers go on enforced holidays. Commercial property sectors generally avoided overbuilding, but slack demand pushes up vacancies and many new projects can't hope to meet leasing projections or debt-service obligations. Values sink well below replacement cost and any construction loans will be extremely expensive to negotiate. Development doesn't pencil out when investors can buy existing real estate in the bargain basement.

Metro market prospects decline from coast to coast, but investors expect the nation's premier 24-hour gateway cities to weather the ongoing turmoil better and recover more quickly than most interior locations and secondary cities. Value losses will be mitigated somewhat in the top-tier markets as institutional and foreign buyers look to acquire prime assets, keeping prices from free fall—cap rates in these cities rise close to or above historic norms from unsustainably low levels.

"Recession-proof" Washington, D.C., regains the survey's top position, but San Francisco, Boston, and New York maintain reasonably positive long-term outlooks despite carnage to key employers, especially in the financial industry. Other California markets, including Los Angeles and San Diego, lose some luster over concerns about government budget deficits, high costs, and increasing tax burdens. Texas metropolitan areas gain in relative standing—interviewees like their business-friendly environments and sustained population growth, and housing prices avoided sharp swings. Florida markets and Southwest desert citadels—Phoenix and Las Vegas—take it on the chin from housing meltdowns and condo/resort overbuilding. Sadly, ratings drop to new lows for many cities in the country's manufacturing belt—auto manufacturer woes amount to piling on.

Canada's "boring" real estate markets elude direct impacts of the U.S. credit market collapse, but can't escape fallout from lowered demand and global recession. Conservative banking practices and stricter regulation kept lending in better check and most investors were saved from overleveraging. Only hot-growth Calgary looks overbuilt—other major cities suffer rising vacancies and flattening rents, but sidestep significant distress. Total value losses will be manageable—10 to 20 percent off highs. Markets should enter a slow recovery phase by year-end 2010, but interviewees see better investment opportunities eventually in top U.S. and European cities, which could rebound more sharply after steeper declines. In the meantime, Canadians worry about suffering more economic shocks, if their primary trading partner south of the border can't get its financial house in order more quickly.

Latin American investment opportunities center on Brazil, a rising global economic power. Mexico's fortunes decline in lockstep with its U.S.-centric economy.

Preface

Emerging Trends in Real Estate® is a trends and forecast publication now in its 31st edition, and is the most highly regarded and widely read forecast report in the real estate industry. *Emerging Trends in Real Estate®*, undertaken jointly by the Urban Land Institute and PricewaterhouseCoopers, provides an outlook on U.S., Canadian, and Latin American investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

Emerging Trends in Real Estate® 2010 reflects the views of more than 900 individuals who completed surveys or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed over 275 individuals and survey responses were received from 710 individuals whose company affiliations are broken down as follows:

Private Property Company or Developer	55.8%
Institutional/Equity Investor or Investment Manager	13.0%
Real Estate Service Firm	9.1%
Homebuilder or Residential Land Developer	7.2%
Bank, Lender, or Securitized Lender	6.90%
Publicly Listed Property Company or REIT	4.6%
Other	3.3%

A list of the interview participants in this year's study appears at the end of this report. To all who helped, the Urban Land Institute and PricewaterhouseCoopers extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.


100
90

Timing Play

"Coping with pain."

More investors recognize massive losses—value declines will eventually total "40 to 50 percent" off market highs, propelled by lagging impacts of the deep recession. Concussed lenders increase writedowns in riddled portfolios, and many overleveraged owners finally get wiped out, either in foreclosures or by turning back keys to banks. The inevitable borrower capitulation follows in the wake of high unemployment and faltering demand for space—property cash flows won't improve fast enough to offer rescues from negative leverage purgatory. Constricted credit channels—hobbled lenders and a comatose CMBS market—leave more responsible and equity-rich investors without reliable refinancing options. Government loan supports and guarantees probably will be necessary to avoid greater carnage—even some of the most sophisticated and highly respected property players need lifelines.

Not surprisingly, the overwhelming sentiment of *Emerging Trends* interviewees remains decidedly negative, colored by impending doom and distress over prospects for an extended period of anemic demand and costly deleveraging. As we said last year: "There's no quick fix." Vacancies will continue to increase and rents will keep on decreasing across all property sectors before markets hit bottom sometime during 2010. Once a property market recovery begins and gains traction, probably before 2012, any rebound will be restrained by a lackluster economy and rising interest rates.

Despite this enveloping gloom and the dramatic fallout from the unprecedented early-2000s credit binge, 2010 and 2011 could be "the opportunity of a lifetime," a limited window to cash in on one of the best acquisition environments ever. "The overall negativity paves the way for winners playing against overall sentiment." A sense of nervous euphoria grows among liquid investors who can make all-cash purchases. If "patient," "daring," and "selective," they could score generational bargains on premium properties, once owners "cry uncle" and banks start to clear the decks of their rapidly expanding and unwanted bad loan and real estate–owned (REO) portfolios. Among real estate investors, the worst of times ultimately generate the biggest gains for savvy investors in what has become an increasingly cyclical, market-timing business. "Whoever's left standing will be in a great position."

In the midst of severe market impairment and dislocation, the prospects for outsized buy-low rewards highlight the importance of effectively playing the real estate market cycle and subordinating asset allocation models and risk-adjusted return strategies. Sandwiched between mammoth value busts—the early-1990s industry depression and today's "even worse" debacle—an unprecedented boom in real estate values produced huge gains for investors who cashed out early enough and used leverage wisely. But later entrants were savaged, especially when they overborrowed. "Those who play the cycle wrong lose every time," says a leading researcher. "Asset allocation analysis is great for looking at history, but can't stand up to the cycle."

Real estate's touted attributes—low volatility and steady income—require "reevaluation," says a top investment manager. "Over the past nearly 20 years, real estate has been highly volatile and the next several years will likely show compromised income flows. We sold the stability and the income, then got caught up in growth and opportunistic gains. Now all bets are off in the losses."

Leverage and easy credit arguably distorted real estate's risk/return profile. The flood of Wall Street capital, particularly from public debt markets, helped transform real estate into a commodity. "It became a trading game," dominated by momentum investors who transacted among themselves and bid up prices. If managed conservatively, real estate can retain its bond-plus risk/return elements, but that means buy, hold, and keep leverage manageable, and even then conservative core investors have suffered extensive losses, dragged down by the overall market. "Let's face it," says a veteran analyst, "without leverage, the asset class doesn't provide much opportunity for big upside. The difference in returns for core, value-add, and opportunity type funds is largely determined by how much leverage you put on, not particular property acumen unless you get into development."

Even those investors poised to jump in at the approaching market bottom guard against inflating expectations. "Real estate doesn't do 20 percent [annualized returns] real well," says a chastened public pension fund executive, and credit gridlock removes any near-term chance to use much leverage. Playing this up-cycle profitably will depend on buying right and operations—managing and leasing effectively.

Prepare for a monumental timing play.

Survival of the Fittest

In retrospect, the commercial real estate markets existed in a deeply unsettling suspended animation through 2009. For industry players, the year was all about "muddling through," waiting for a market bottom, putting off hard choices, and desperately praying for a sharp economic rebound. Banks and special servicers delayed dropping the hammer on flailing borrowers and recognizing their loan losses in order to shore up depleted reserves with the help of low-interest government funds and other federal bailout programs. Stricken borrowers grasped at "pretend and extend" offers from bankers, but only put off their day of reckoning. Deal markets froze and developers hibernated.

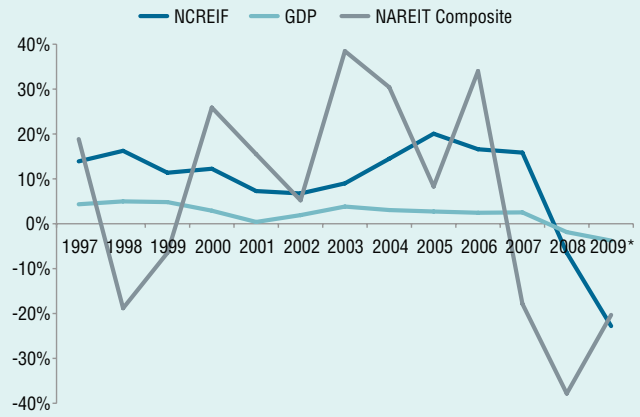
Time Runs Out Now. "Getting through 2010 will be the test" for who can survive. "Inertia starts to give way, the catalyst is simply time." "Underwater" borrowers will start making hard decisions about walking away or selling at big losses—they can't continue to incur capital costs while cash flows diminish from lowered rents. "Waiting is a bridge to nowhere since fundamentals won't come back fast enough." Banks will finally start to clear out bad loan portfolios and "take control of wasting assets to maximize proceeds." The Federal Deposit Insurance Corporation (FDIC) will step up disposition of loan portfolios from failed banks, using various government guarantees to entice buyers. A market bottom will form and sidelined equity capital will begin to reenter the markets, in some cases joint-venturing with banks to manage asset pools. In the meantime, values go down, fundamentals won't provide bumps in rents, and cap rates will stabilize or go up—"they're not coming down."

Dum-Da-Dum-Dum. Put another way—2010 looks like an unavoidable bloodbath for a multitude of "zombie" borrowers, investors, and lenders. Given the looming "train wreck" of escalating commercial mortgage–backed securities (CMBS) rollovers ($250 billion to $300 billion annually through 2015), the shakeout period may extend "several years" as even some conservative owners with well-underwritten loans from the early 2000s see their equity destroyed. "It's not just the unavailability of capital from damaged credit markets, it's also the decline in tenant demand—rising vacancies and declining rents."

Another Bailout. The refi bogeyman—"a doomsday without refinancing"—understandably sends chills through the industry. But well-placed banker interviewees expect the U.S. government "to put mechanisms in place" and help resuscitate securitization markets, "avoiding a fiasco." Their rationale is: after stanching big bank collapses and saving automakers, the government won't blow it all and let the economy tank from a total commercial real estate meltdown. Even with government intervention, the CMBS labyrinth traps borrowers and bondholders "in a limbo without good outcomes." Excessively complicated structures—multiple lenders, equity partners, mezzanine pieces, and securitized tranches—"could take years to resolve" in litigation nightmares and complex, not to mention costly, workout scenarios. And a government bailout inevitably entails short-term remedies that hamper longer-term economic soundness, potentially leading to larger federal deficits, more taxpayer stress, and rising interest rates.

Indeed, prospects for a tepid economic rebound now concern *Emerging Trends* interviewees as much as the ongoing credit market turmoil. "Real estate will be on the tail of any recovery, the longer the economy takes the tougher for us."

EXHIBIT 1-1
U.S. Real Estate Returns and Economic Growth



Sources: NCREIF, NAREIT, Moody's Economy.com.
* 2009 data annualized from second-quarter 2008 to second-quarter 2009.

The Economy: "A Big Hurt"

By late 2009, the U.S. economy may have entered a "statistical" recovery, but lingering high unemployment and massive deleveraging hamstring growth outlooks. For starters, the nation's consumer engine sputters under mountains of household debt—mortgage, credit card, car, and student loans—and the harsh reality depresses Americans at all income strata. Large and expensive lifestyles—McMansions, second homes, plush furnishings, SUVs, big-screen TVs, and shopping sprees—were mostly financed and now the sizable bills come due just as job security and confidence in future prosperity waver. Economic mainstays—financial services, homebuilding, and auto manufacturing—take direct headshots. With credit gone and people in savings mode, these jobs generators retrench, offering limited prospects for a quick resurgence. Lawyers, brokers, and other previously well-compensated transaction middlemen feel the bite, too.

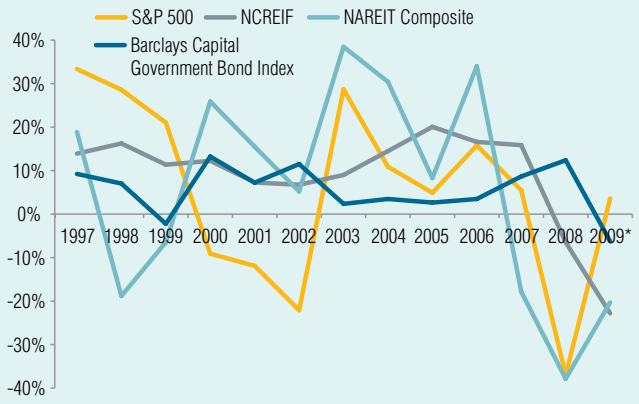
Everybody Borrowed Too Much. Consumers are just part of the debt cataclysm. While the Federal Reserve kept interest rates low and set off the credit bomb, government spending largesse coupled with tax cuts ballooned government deficits. The severe recession forced leaders to double down on government spending and leaves taxpayers with a gaping hole to fill. Printing money for various industry lifelines sets the stage for ramped-up inflation and higher interest rates—foreign T-bill buyers will want higher yields for taking on greater risk. And higher interest rates could deter business growth. "It all feels like a dead-cat bounce," says an investment manager. "We're past the panic stage thankfully, but the long-term impact of colossal government spending and national debt has yet to be felt."

"Not a Pretty Picture." Hovering over interviewees are big fears about a jobless recovery—"interest rates go up and the economy can't pick up fast enough to produce jobs that fill buildings." Recent experience on the employment front doesn't bode well—"we've had fake growth." The last two recessions effectively wiped out any income gains, the Internet and finance booms turned out to be bubbles, and Internet disintermediation shrinks media companies and starts to hit retail distribution. Manufacturing continues to migrate to cheaper offshore locations and now various service, financial analyst, and high-tech jobs can be poached by global competitors or transferred by U.S. companies operating overseas. Shockingly, America's standard of living may have begun to fall—wages quiver, health benefits shrink, and companies slash pension plans. Can anybody depend on their 401K for retirement? Everyone in our survey struggles to identify new high-paying employment incubators that will spur recovery and tenant demand, finding consensus in a few sectors:

- **Technology:** Engineers and scientists will be highly coveted to develop novel computer software and green energy systems, and revamp dated infrastructure. New high-tech products can increase U.S. exports to burgeoning global markets.
- **Health care:** An aging population will need more medical services from doctors, nurses, therapists, and caregivers. Biotech and drug companies benefit from increased demand for remedies and cures.
- **Education:** The country desperately needs more teachers to help educate engineers, scientists, and physicians for high-paying brainpower jobs that can lead to industry breakthroughs and innovation.
- **Housing:** Homebuilders will recover eventually—the U.S. population grows by 3 million annually and all these people need places to live.
- **Wealth management:** Everyone learns lessons about the need to save, but first we must pay off bills from all our borrowing.

EXHIBIT 1-2

Index Returns: Real Estate vs. Stocks/Bonds



Sources: NCREIF, NAREIT, S&P, Barclays Group.

* 2009 data annualized from second-quarter 2008 to second-quarter 2009.

The overall outlook doesn't suggest a wellspring of employment opportunity, particularly for many debt-strapped middle-class Americans, who had depended on well-paying blue-collar factory jobs. Some interviewees, meanwhile, grumble that "health care and teachers won't fill space on Park Avenue" and productivity gains by large U.S. multinational firms may boost their stock prices, but often come at the expense of domestic operations.

As the federal government tries to pick up the slack with stimulus, unprecedented deficits will constrain future spending unless taxpayers shell out more, a treacherous political prospect that cuts into consumer buying and business expansion. Alternatively, if the government really gets serious about cost cutting, many private sector jobs would be in the cross hairs. Federal contracts, including those for defense, could be curtailed and needed infrastructure improvements would be postponed. Budget-busted state and local governments confront reducing public employee workforces and benefits. Even the most optimistic, well-reasoned interviewees, who point to "overdone gloom," couch any enthusiasm and predict a "prolonged," "not very robust" U-shaped recovery.

The Long Road Back

Under any circumstances, real estate players resignedly steel themselves for a "difficult," "much-slower-than-normal" comeback, tracking behind the problematic economy. "We're only in the early innings and 2009 has been a rain delay." Here's how interviewees see the obstacles and map out the "hard slog":

Housing Leads. The peak-to-trough drop for housing took a painful three years, finally reaching its nadir in 2009. Bargain hunters ignite an uptick in home sales, but an absence of easy credit, the household debt overhang, and weak economic turnaround limit buyer appetites. At least the tailspin stops.

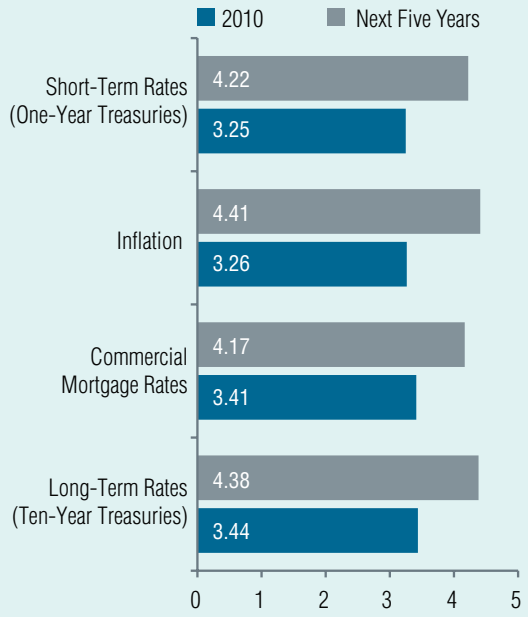
Huge Writedowns. Banks need to recognize losses on commercial real estate and overleveraged borrowers must lose their shirts. "Only then will we reach market bottom." Bankers have been dealing with housing, next comes credit cards, and then upper-tier lending platform problems like commercial paper and commercial real estate. Unfortunately, "the problems get bigger with larger consequences."

Government Intervention. In order to pave the way for rationalizing balance sheets, the feds will give more time for banks to build up loss reserves and provide some form of credit support for commercial properties, including TALF. "It's the only way out." Regulators must take steps to reform and resuscitate moribund CMBS, helping restore confidence in the bond markets. "Without capital from securitizations, real estate won't recover."

Cash Buyers. Liquid investors rule the real estate world in coming years, enjoying pricing power. Real estate investment trusts (REITs), equity funds, and high-net-worth individuals with dry powder will reenter at perceived market bottom, focusing on vulture deals for trophy properties in top markets, shoring up troubled borrowers who own prime assets in return for big equity stakes, and purchasing troubled loan portfolios at cents on the dollar. They try to sidestep the "dreck" in secondary and tertiary locations.

IPOs. Investment bankers pull out their early-1990s playbook to get back in the game. They structure public offerings to rescue failing equity funds and private real estate companies, and naturally they'll take big fees and a piece of the action along the way.

EXHIBIT 1-3
Inflation and Interest Rate Changes

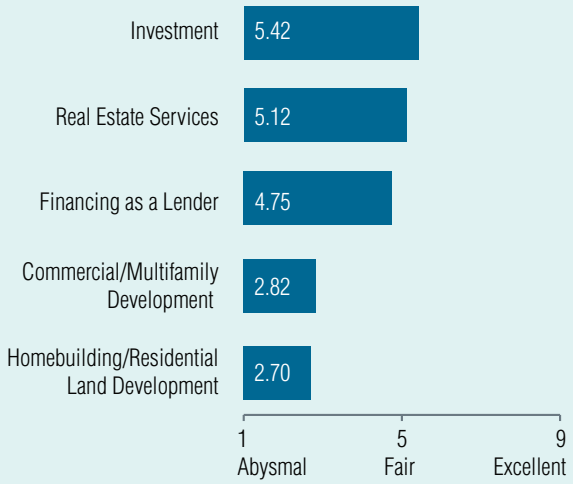


1 = fall substantially, 2 = fall moderately, 3 = remain stable at current levels, 4 = increase moderately, 5 = increase substantially.

Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

EXHIBIT 1-4
Real Estate Business Activity Prospects in 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

Litigation Mess. Workout specialists and lawyers enter a *Bleak House* of contention and confusion in trying to unwind "incomprehensible" CMBS and collateralized debt obligation (CDO) structures. Figuring out who owns what could take "an eternity" to resolve. In the end, lower-rated tranche positions may be worthless anyway.

Rate Hurdles. The specter of rising inflation and higher interest rates presents huge obstacles, and many interviewees predict that "rates have nowhere to go but up" to tamp down inflationary pressures from all the government borrowing. (See Exhibit 1-3.) On the other hand, "the only way out of our debt problems is inflation" since it increases the value of depreciated, highly leveraged assets and can rescue underwater borrowers. Inflation also makes hard assets like real estate more valuable. But inflation would be anathema to the Chinese, Japanese, and other T-bill buyers who might demand sharply higher interest rates to protect them from a depreciating dollar. If these governments and other investors balk at buying Treasuries, the United States could be forced into an austerity mode, some combination of high taxes and severe spending cuts. And higher interest rates not only would put downward pressure on property values, but also could constrain business expansion and consumer spending, which would curtail job growth. In sum, "it's a tough path," whichever way the federal government implements monetary policy.

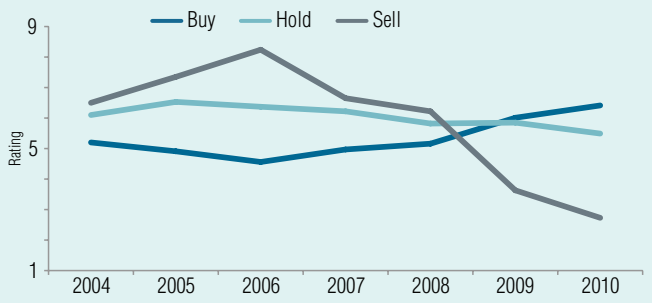
And it all means "any real estate recovery will be slow."

"Absolutely No Demand." Unlike 20 years ago, when massive overbuilding and a relatively mild recession combined to tip over commercial property markets, this time the absence of demand drivers has debilitated property owners who were counting on increasing cash flows to meet expensive debt service. Landlords, clenching mortgage statements, watch forlornly as tenants downsize and cut space costs to bolster their prospects coming out of the prolonged economic downturn:

- **Retailers** close weaker stores, concentrating on the strongest shopping centers.
- **Apartment renters** double up or move back in with parents or siblings.
- **Office tenants** look for productivity gains from lowering space-per-capita ratios and want big accommodations in rents and concessions.
- **Warehouses** suffer record vacancies—the consumer pullback and retail contagion constrict the goods distribution pipeline.

EXHIBIT 1-5

Emerging Trends Barometer 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

■ **Hotels** endure plunging "below break-even" occupancies—eliminating travel is low-hanging fruit both for businesses and families struggling to check spending.

"We're in an extremely weak operating environment where tenants are unable to pay decent rents," says an interviewee. "New construction is not our issue—we need new demand."

Nobody holds their breath for 2010 in light of the less-than-robust economic outlook. "Employment growth always follows the economy, and real estate typically is the last to benefit from any improvement." Once companies' earnings increase from productivity gains and sales start to pick up, then businesses get more confidence to hire. This time, the ongoing credit crisis won't help the process: bankers shore up reserves instead of helping businesses recapitalize, chilling expansion plans. "We're in a box," says a veteran investor.

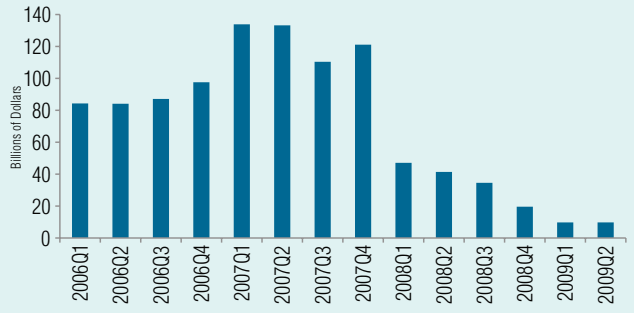
Development. "Largely dead." At least developers can avoid blame for the commercial market turmoil—"fortunately, nothing is overbuilt" (although let's not forget condos). But that's small consolation when recently completed projects careen immediately into defaults and opportunities for any new business may wait two or three years. "You can't be a developer today," says a longtime Texas builder. "The terminology just doesn't apply in this market." Given sharp value declines, the price of existing assets drops well below replacement cost, and the development pipeline dries up—"the smallest in history for all property types," according to a leading researcher. Why build anything when you can buy existing product much more cheaply? And in the highly unlikely event a developer finds a willing banker, any construction loans will come under stiff conditions and pricing, raising the stakes and risks. Longer term, inflation poses another challenge—ratcheting up construction costs for labor and material. "Right now, development is a joke!"

Facing "bleak" forecasts, a "Darwinian environment," and capital constraints, more "bulletproof names" will get shot down. Some players, who agreed to recourse construction loans in the recent lending mania, "may lose everything." Others "buy time" and "do what they can to survive," becoming workout specialists or asset managers, or taking receivership to complete somebody else's busted projects. If all else fails—"there's fishing and golf." Eventually, the construction shutdown leads to undersupply and helps speed recovery—any stepped-up demand can eat into vacancies more quickly. While they await the fallout, developers join a long line of other market victims.

Vultures Circle. Brokers and dealmakers also drop like flies in the unprecedented transaction freeze, but a thaw slowly materializes. Bid/ask gaps prepare to close—purchasers adopt traditional underwriting analysis using existing cash flows, while sellers "aren't there yet." And no wonder—the *Emerging Trends* transaction barometer signals the worst selling environment in report history. (See Exhibit 1-5.) Patient buyers can afford to hold out for some "fantastic opportunities." They won't rush to deal until they sense market bottom—maybe in late 2010, certainly by 2011, when motivated owners seek exits and banks finally start to clear their balance sheets. Wizened interviewees counsel against "moving too fast." Early deals may send prices lower—"some stuff will blow out at incredibly cheap prices." And first-to-market properties often are "the worst of the worst—stuff you shouldn't want." But others point out that "no one rings the bell at the low point, so move if you find a good deal."

In the meantime, anticipation steadily builds: "We're headed back to 1980s prices" and "a buy one get one free" market environment. FDIC-sponsored deals may lead the way—"a tidal wave of properties" heads into receivership from community and regional bank failures. The government eventually will also undertake portfolio sales of billions of dollars in bad loans under its control. In these deals, buyers can expect "generationally low prices" with federal guarantees. For all the giddy talk, cash investors should temper return expectations, especially in top markets where enough bidders will keep "more realistic floors" on prices for Class A

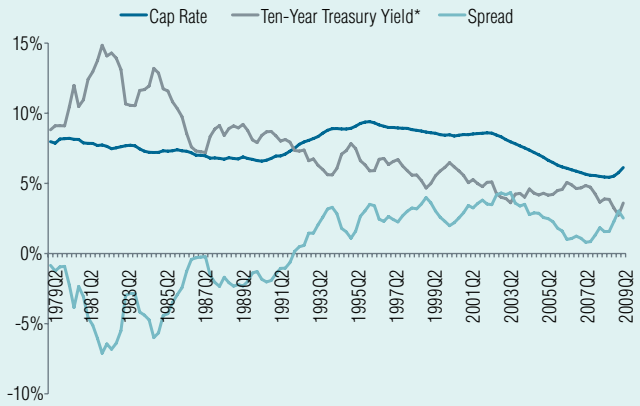
EXHIBIT 1-6
Sales of Large Commercial Properties



Source: Real Capital Analytics.

* Total through June 30, 2009. Limited to properties $5 million or greater.

EXHIBIT 1-7
NCREIF Cap Rates vs. U.S. Ten-Year Treasury Yields



Sources: NCREIF, Moody's Economy.com, Federal Reserve Board, PricewaterhouseCoopers LLP.

* Ten-year Treasury yields based on average of the quarter; 2009Q2 average as of August 21, 2009.

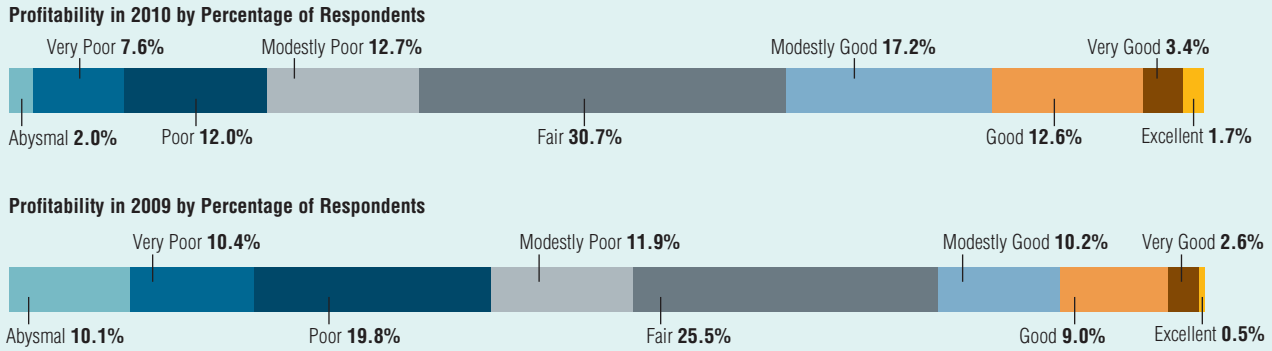
properties. Core yields will range in more traditional territory, the high single digits, while expected opportunistic yields for buying vacancy register in the mid to high teens. Forget 20 percent–plus unless you're still dreaming about 2006. The best deals may come under radar screens where compromised owners quietly restructure financing by taking preferred equity partners who garner attractive stakes in return for cash infusions. "I have plenty of new friends in the U.S. who want my capital," says an international pension executive. Many players just take comfort in the return of more normalized underwriting and analysis. "The old rules seem to be back; two years ago nothing made sense," says a portfolio manager. "Now I think I know what I'm doing again with my bearings back."

Cap Rate Bifurcation. Sadly, the 2000s turn into "a lost decade" for investors. Interviewees say they expect declines off peak 2007 values to total "40 to 50 percent," less for trophy assets, more for some B and C product. Extra dollops of leverage, which escalated returns in the rising market, now annihilate portfolios on the downside. After dropping into 5 percent–plus territory during 2006 and 2007, average cap rates for institutional-grade properties "will settle" in the 7.5 percent range, "a huge move" reflecting the depth of market declines. The consensus view shies away from underwriting "any growth in rents or decrease in cap rates for a long time." When interest rates increase, as expected, pushing up T-bill yields, cap rates could "go along for the ride." At the very least, "higher interest rates make it harder for cap rates to recover" even when property cash flows improve. Expect "huge spreads" between "higher-income-stream and low-to-no-income-stream properties" as transaction markets gear up. "Cap rates actually look more normalized for top core properties, back to income with small appreciation based on first-year cash flows [in-place tenants]—but there are no cap rates for distressed properties." Given the absence of recent deals, some investors choose to ignore cap rate analysis entirely, concentrating instead on occupancies, rents, and year-to-year cash flow changes. "That tells you more."

"We've All Laid Off at Least 20 Percent." Many real estate firms go into survival mode, attempting to convert lifeless acquisition, origination, and development platforms into asset management, special servicing, and workout businesses. "They keep the best talent and downsize the rest." But the transformation can be challenging given the dearth of knowledge and experience among personnel for unwinding deals and crafting settlements. "Anybody in the business since 1994 only knows from transactions and never anticipated this mess. They just don't have the necessary skills, and law firms are simply understaffed without the expertise." Demand intensifies for real estate executives who know property operations or who have strong tenant and client relationships. "Starving" brokerage companies rely on property management and corpo-

EXHIBIT 1-8

Firm Profitability Forecast



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

rate consulting to shore up bottom lines. "We shrink along with shrinking values." More conservatively run firms (they limited corporate debt and expensive expansions) "can take advantage of the chaos," picking up business from failing competitors "who had been more aggressive." Investment managers anticipate a shakeout—top performers with solid institutional backing and staying power take business from smaller "entrepreneurial" firms and underperformers. Pension plan sponsors start to consolidate separate accounts among their most favored advisers with strong asset management capabilities. Some limited partners in struggling opportunity funds cut deals to keep general partners in place when promotes evaporate, while other GPs are jettisoned or abandon their funds. "Compensation is a jump ball." For now, competitor practices and HR salary studies don't matter to CEOs and CFOs. "The only relevant metric is: did the firm make any money and how much can they afford to pay?"

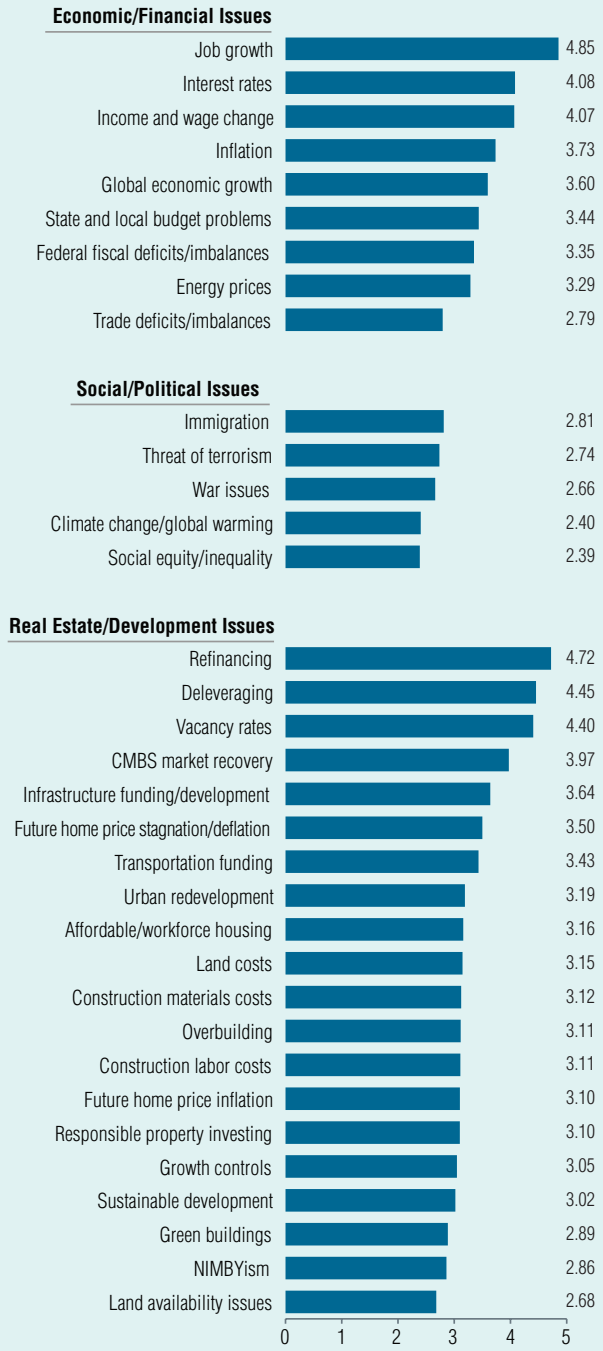
Ever hopeful, *Emerging Trends* respondents peg 2009 as the low point for real estate firm profitability, expecting modest improvement for 2010. (See Exhibit 1-8.) Not surprisingly, they forecast better prospects for investment and service companies and poor to abysmal outlooks for developers. Overriding concerns about the economy, particularly job growth, and industry deleveraging crowd out much consideration of socio-political problems—climate change and green buildings get short shrift in this year's survey. (See Exhibit 1-9.)

Starting Over. In the midst of dislocation, income destruction, and performance disasters, a paradoxical tension develops among real estate players. Interviewees talk about lessons learned and how survivors "will be more cautious and conservative." Real estate, they say, is "a good business for B students who work hard, not for PhDs with computer models." They perfunctorily reject the private equity paradigm based on leverage and promotes, which precipitated the downfall. But then in the next breath they say they want to make up the losses as quickly as possible. Nobody mentions investing in neighborhoods or place making for future generations anymore. Relationships among far-flung owners, lenders, tenants, and communities have disaggregated. "We used to talk about real estate as a local business," says an industry graybeard. "But it's not a local industry when borrowers don't know their lenders, and owners don't have a long-term stake in the places where they invest." Despite the ongoing havoc from overdone wheeling and dealing, the investor mind-set skews back reflexively to trading and maximizing short-term profits. "When leverage comes back into the markets, you should take out your equity." Flipping won't return anytime soon, because of the economy, but the principal cements—commercial real estate is viewed by many as a highly fungible commodity. What happens after you sell it is somebody else's problem.

For 2010, enormous problems will begin to morph into unique opportunities. It's all about timing the cycle.

EXHIBIT 1-9

Importance of Various Trends/Issues/Problems for Real Estate Investment and Development 2010



Source: *Emerging Trends in Real Estate 2010* survey.

1 = no importance, 2 = little importance, 3 = moderate importance, 4 = considerable importance, 5 = great importance.

Best Bets 2010

Investment

Deal with Cash. Over the past three years, *Emerging Trends* has counseled to "keep powder dry" and wait for a correction. Now you know why. "Cash is the only way to operate" and "only the most liquid" can take advantage "of the ton of emerging opportunities." Add leverage "for a bonus" once credit markets resuscitate.

Don't Rush. "Early is the new wrong." Although seller and borrower capitulation approaches at a bumpy market bottom, economic uncertainty will hamper any recovery and the absence of ready refinancing in lifeless debt markets adds more risk. In this murky environment, patience will be rewarded. Transaction trigger points include improving jobs numbers, visibility to asset pricing, and stepped-up tenant deals. "Ignore theory, require empirical evidence."

Focus on Quality and Be Selective. Buyers can be less cautious about timing when acquiring premium assets in the best markets where deal cap rates revert to the mean (or above) and values drop well below replacement cost. "Buy it, manage it, wait for recovery, and expect to hold for at least a five- to seven-year period, allowing fundamentals to slowly improve." Seek irreplaceable Class A properties with debt maturity problems in places like New York, San Francisco, and Washington, D.C. Recapitalize borrowers for joint venture stakes and preferred equity and make deals at discounts with lenders. "Anything Class A can come back"—that may not be the case with lesser properties.

Stick to Global Gateways. The dominant, 24-hour markets, which were the favored places heading into the collapse, will recover more quickly in the aftermath. Coastal cities and the handful of interior markets with primary international airports link to global commercial centers and concentrate the nation's business activity. These gateways will continue to attract a preponderance of high-paying jobs.

Buy Cash Flow and Real Yield. Anticipate creating value by filling vacancy and increasing rents over time. "Use a cash flow–driven model, not a leverage-driven model." "Without leverage you'll make money, just probably not as much as in the past."

Buy Public REITs. These stocks "come off the mat with a long way to go back up." Reequitizations dilute existing shareholders, but raise dollars to solidify balance sheets and enable accretive market-bottom acquisitions. "Public companies now gain a tremendous edge—their weighted cost of capital is well below private investors" and their perceived staying power will help retain and attract more tenants to their properties, augmenting cash flows. Stockholders, meanwhile, reap relatively attractive dividends and have liquidity. Index buyers gain instant diversity across property markets.

Provide Financing. While recap and lend-to-own gambits should score for equity investors, lenders can make "the best senior loans in their careers at relatively wide spreads, using very conservative assumptions." Focus on "boring" well-leased real estate—infill shopping centers, B apartments, and well-located office—owned by capital-constrained borrowers. "Three- to five-year loans can deliver low-teen returns."

Consider Distressed Debt. Eventually, the government will dispose of large loan pools from failed banks, providing guarantees or supports to lure investors. The collateral may be dregs and difficult to assess, but these should be classic cents-on-the-dollar transactions. Lenders will start to sell, too. Distressed CMBS packages will be extremely hard to value—legacy borrower and bondholder complications will make analysis "like unwinding balls of yarn." Excitement wanes over the expected transaction complexity.

Implement Asset Management. Assess what's worth protecting in portfolios and shed failing properties with insurmountable leverage problems—stop feeding losers. Focus capital and resources on retaining and attracting tenants in properties with better long-term value, and safeguard net operating incomes against tenant pirating by competitors.

Development

Write Off the Year, as Well as 2011 and Probably 2012. You can close up shop, hit the links, convert operations to asset and property management, or become a workout specialist like everyone else. Forget about construction financing—that's a pipe dream. Some bigger players take over half-completed condos and stillborn office projects in receivership from defaulting competitors. A few build-to-suit opportunities present themselves. At least, prospects for homebuilders can only improve, but that's not saying much.

Dream about the Future. Next-generation projects will orient to infill, urbanizing suburbs, and transit-oriented development. Smaller housing units—close to mass transit, work, and 24-hour amenities—gain favor over large houses on big lots at the suburban edge. People will continue to seek greater convenience and want to reduce energy expenses. Shorter commutes and smaller heating bills make up for higher infill real estate costs. "You'll be stupid not to build green." Operating efficiencies and competitive advantage will be more than worth "the minimal extra cost."

Property Sectors

Buy or Hold Multifamily. "It's the only place with a hint of hope, because of demographic demand." Scarce construction sets the stage for a strong rebound in any economic turnaround. "There could be a shortage of apartments by 2012." Pounce on cratered development deals and pick off

stressed assets at "rock-bottom pricing," including busted Class A condos and infill B apartments. Locations near transit corridors are prime.

Buy Hotels. Totally slammed, the hospitality sector "has the most potential to recover sooner," especially higher-end business hotels in major markets. "They've been beaten to a pulp." Values plummet—they "overshot on the upside, now overcorrect on the downside." Distressed owners litter the landscape—myriad late up-cycle deals collapse under adjustable-rate mortgages. "You'll be able to steal good hotels."

Buy Distressed Condos, Second Homes. Concentrate on prime resort areas where developers overbuilt. Beachfront condominiums in south Florida always bounce back. Despite recent financial reversals, plenty of baby boomers retain ample resources for weekend getaway places and future retirement retreats. You won't get better deals until the next crash.

Buy Land. Home in on "infill sites in top markets," but be careful of fringe locations. "You must distinguish between good and bad." And be prepared to hold for five to ten years. Given the feeble development markets, new projects may take time to ramp up. "But land prices may not get much lower . . . ever."

Buy or Hold Industrial. As inventories rebuild, warehouses can recover quickly. Institutional owners, who struggle to assemble large warehouse portfolios, will hunt for product, bolstering values against free fall.

Hold Office. Hope long-term leases can bridge the downturn. Prime properties in 24-hour nodes will attract tenants from more problematic B and C properties in a flight to quality.

Triage Retail. Infill grocery-anchored strips and fortress regional malls will survive the retreat by debt-plagued consumers. Store chains and shoppers abandon weaker centers and concentrate activity in the strongest malls. Expect more retailer bankruptcies to empty big boxes at some power centers.

Real Estate Capital Flows

"The key to **success** in real estate investing is to follow the capital flows, not the fundamentals. **Anticipate** what capital wants and be there."

Slowly, capital will flow back into commercial real estate markets during 2010, led by all-cash investors "looking for pop" in quality assets owned by distressed borrowers or sold by lenders out of growing REO portfolios. Debt markets will start to resuscitate, too, but will remain "far from normalized" in the wake of unprecedented deleveraging. Federal government backstops and guarantees allow lenders to build enough reserves so they finally can embark on dealing more proactively with boatloads of bad real estate loans—estimated at $138 billion as of September 2009, according to Real Capital Analytics; this number is expected to increase substantially in the year ahead. Inevitable writedowns, foreclosures, and borrower givebacks will help markets bottom during the year. Any lending will be conservative, expensive, and extended only to most-favored relationships. Dry powder investors—REITs, private equity funds, and even refashioned mortgage REITs—will also provide loans to battered borrowers at a steep price. "It won't be a hot market, but borrowers can get financing if they recognize and resolve their losses."

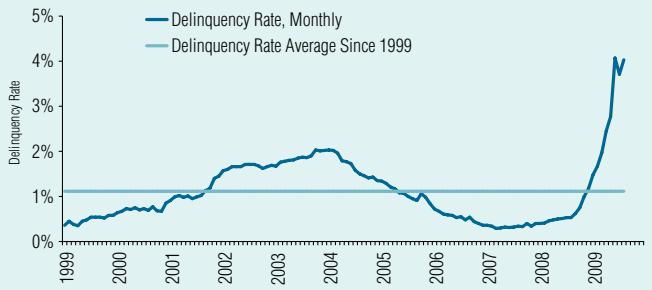
Blinders Off

In 2010, consensus builds among U.S. government regulators, lenders, borrowers, and investors that "kick-the-can-down-the-road" policies reach the point of diminishing returns. The Fed and U.S. Treasury spun a chorus of PR rhetoric about stabilizing banks and reviving credit markets, while transfusing bailout funds into depleted lenders, hoping to give cover and buy time for an actual recovery to materialize. Policy makers and finance industry leaders realized that any straight talk about the dodgy condition of banks or precipitous reconciling of their balance sheets would likely send world investment markets back into a dangerous slide. And so the government winked when lenders provided extensions to underwater owners with maturing loans and loosened mark-to-market rules in a game of mutual survival. No one got too upset when banks failed to step up lending appreciably or charged huge spreads above the government funds rate for loans they did provide. In addition, with little fanfare, bank regulators gradually stepped up the shutdown of broken regional and community banks, spreading out the pain. At some point during 2010, the stabilization efforts should pay off. Surviving banks will regain enough footing to act like banks again—first resolving balance sheet problems and eventually financing economic growth and credit-starved real estate investors.

Inevitable Shakeout. As a result, anticipated capital destruction begins in earnest, culminating in bloodletting—ugly headlines about big-name developers flaming out, rising defaults and delinquencies, a spike in foreclosures, and recognition of the magnitude of losses everyone has been well conditioned to expect. More firms fail, some general partners collapse, workouts escalate, and lender REO portfolios mushroom. Once this pattern of failure gains momentum, hovering vulture investors will descend and property transaction markets can reformulate, providing pricing visibility and leading

EXHIBIT 2-1

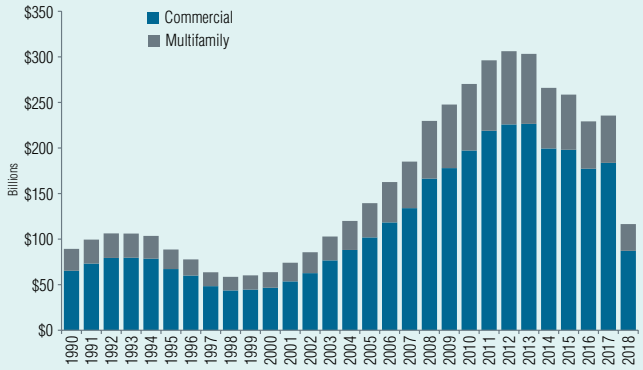
CMBS Delinquency Rates



Delinquency rates are for fixed-rate, conduit CMBS transactions and include loans 30, 60, 90 days delinquent; performing and nonperforming matured loans; loans in foreclosure; and REO.
Source: Trepp LLC, September 1, 2009.

EXHIBIT 2-2

Commercial and Multifamily Mortgage Maturities



Sources: Federal Reserve Board, Foresight Analytics LLC.

to greater liquidity. "Forced sales will help heal the industry." The government will facilitate the process by offering guarantees to investors in distressed loan portfolios.

Frankenstein's Monster. Assuming banks mend enough to permit writedowns, the financial sector and real estate industry will face an enduring problem—what to do with their Frankenstein monster, the collapsed CMBS market, a classic example of a good idea gone horribly wrong. "Ironically, CMBS was a solution for recovering from the last real estate debacle, but got us caught in a worse trap because the structures became too complex." For the past decade, *Emerging Trends* interviewees wondered whether CMBS markets could self-regulate successfully and warned that if loans ever soured, the system could break down in a litigation maze of special servicers and multitranched borrowers. More recently, everyone watched as lenders of all stripes loosened underwriting standards and off-loaded risky loans into securities markets, which fueled transactions, pricing run-ups, and overborrowing. Now, the industry gropes for ways to refinance hundreds of billions of dollars of CMBS loans maturing over the next five years when savaged bond buyers, holding near-worthless paper, express zero confidence in the CMBS underwriting process, rating agency oversight, and (lack of) government regulation.

Government Rescue. Since banks and other lenders nurse their own extensive portfolio problems and equity investors cannot possibly fill the yawning "CMBS debt gap," interviewees hope and pray the government intervenes through some form of credit support for commercial properties to back-stop all the loans coming due. "Otherwise, values will drop further and postpone any chance of a real estate market recovery." Such credit facilities like TALF raise federal exposure to the commercial real estate loan markets after rescuing existing government-sponsored housing lenders (Fannie Mae and Freddie Mac) to the tune of $400 billion. But the feds have no choice. "They'll do something for sure," says a bank executive. "The immediate alternative is too dire."

CMBS Makeover. *Emerging Trends* respondents voice virtual unanimity in asserting that overall real estate industry revival depends on reforming and reconstituting the CMBS market. They generally expect a return to simpler, more stringent early CMBS structures with issuers—including originating banks and insurers—required to retain stakes from offerings and higher reserves on their books. Rating agency conflicts need resolution and government regulators must play a role (partly to oversee rating agencies) in "cleaning up sloppy practices" so "bondholders don't get left holding the bag." Securities buyers and analysts, meanwhile, must assume greater due diligence responsibility beyond hastily scanning bond ratings. CMBS "worked best at ten-year fixed-rate loans; straight-forward A/B loan structures and overall

annual issuances in the $50 billion to $100 billion range," says a former conduit executive. "It got out of hand with floating rates, $6 billion deals, and leverage on top of leverage. When we were doing $230 billion annual volumes we thought we were bulletproof."

No Quick Fix. Reinventing a new detranched, "back-to-basics" CMBS model could take several years at least. Stricter underwriting standards "will have a negative impact on values" and loans will be more expensive. "The government may have to step in and offer guarantees for the AAA bonds to help rebuild confidence." Unwinding and working out legacy CMBS issues also may short-circuit attempts at a quick market resurrection. Complicated tranche structures result in chaotic disputes over who owns how much of whatever remains of any collateral. Special servicers, caught in the middle, are overwhelmed by the volume of problem loans and "paralyzed" by potential litigation tangles. "Nobody has control." Amid such turmoil, can anyone expect previously scorched bond buyers to rush back into the market?

Fannie and Freddie. Eventually, Congress and the president must confront what to do about Fannie Mae and Freddie Mac, the failed mortgage financing giants. Critics argue that these government-sponsored entities subsidized homebuyers to the point of effectively lowering mortgage rates below appropriate risk-adjusted levels—prices inflated unsustainably and helped shove the housing market into an abyss. Lawmakers were always a soft touch for these publicly owned companies, which effectively lobbied to lower their capital reserve requirements and keep precious federal guarantees in place. No congressman—or congresswoman—ever wanted to be accused of roadblocking the average American's path to homeownership. In 2009, Fannie and Freddie were practically the only financing game in town—helping prop up the multifamily market—thanks to emergency government intervention. Undoubtedly, recasting or restructuring these companies will take center stage in the government's attempts to reform fractured real estate securities markets, probably in 2010.

Debunking Myths. While scrambling to stay alive or grasping for government lifelines, investors absorb hard-learned capital markets' lessons from the ongoing debacle:

- Diversification doesn't overcome systemic risk.
- In the global marketplace, all regions and credit markets inextricably link.
- High credit ratings don't necessarily mean high-quality investments.
- Mathematical models cannot fully simulate or manage risk.
- Risk of borrowing short to invest in illiquid assets cannot be hedged.
- "Tails" on bell-shaped curves exist for a reason.

"When you justify a deal [based] on financial engineering, it's the kiss of death," says an interviewee. "The industry did leverage entirely wrong, putting increasing amounts of debt on riskier and riskier deals. For leverage to really work, you should put it on the least-risky deals in the early part of market cycles."

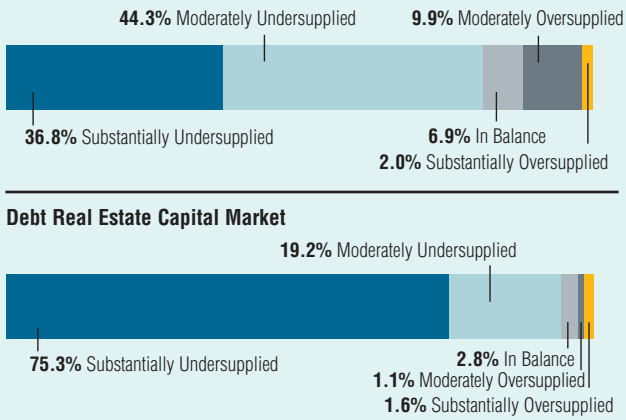
Condition Check. As noted in the past two *Emerging Trends* reports, the condition of various capital providers and investors depends on the amount of leverage in their portfolios and the timing of their investments.

- **On life support:** Owners who purchased late in the game (2005–2007) and used copious debt (75 percent–plus) are toast. Many developers and construction lenders for just-completed projects don't have a chance.
- **Critical:** CMBS bondholders on recent-vintage loans will experience major losses. Lower-credit CMBS tranches get wiped out. Lender REO portfolios swell from foreclosures and borrower give-backs.
- **Serious:** More conservative private equity owners—with well-leased portfolios and low leverage—suffer value declines, which mostly erase earlier heady advances. Refinancing constraints could set off capital crises for properties with maturing mortgages. But core-style investors with less debt exposure are better positioned to make tenant deals and sustain operating incomes. Property cash flows give them some traction in negotiating with lenders or special servicers.
- **Stabilizing:** Many public REITs avoided overleveraging and restrained acquisition activity in ripening markets. After huge stock market declines, they recapitalize and should lead a real estate recovery.

Capital Prospects. *Emerging Trends* surveys point to a continuing severe undersupply of capital, especially from debt sources, in 2010 (see Exhibit 2-3). Only opportunistic private equity investors step up activity, looking for vulture deals. Respondents expect the government will maintain its necessary role in supporting markets both on the debt and equity sides (see Exhibit 2-4). Interviewees puzzle over the

EXHIBIT 2-3

Real Estate Capital Market Balance Forecast for 2010

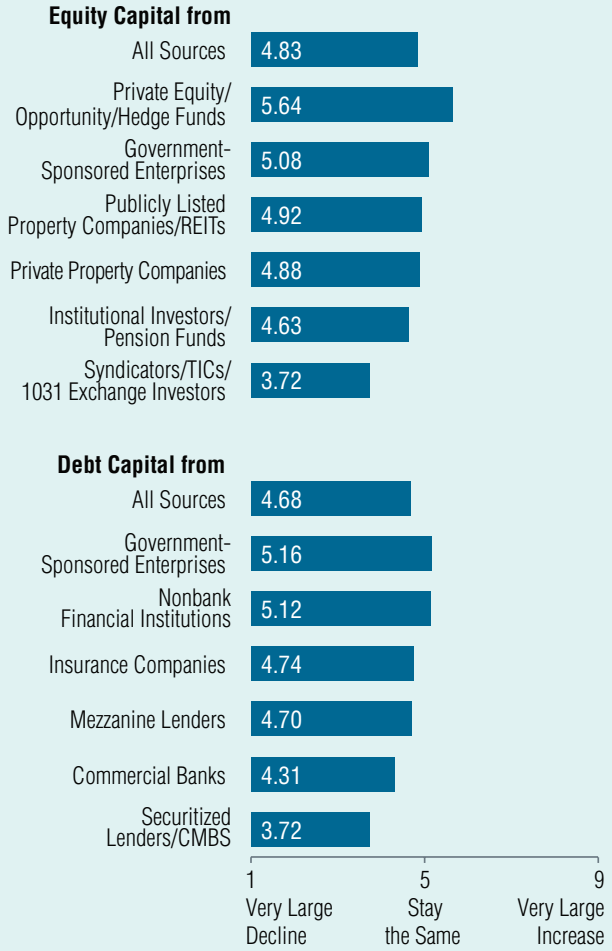


Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

EXHIBIT 2-4

Change in Availability of Capital for Real Estate in 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

dimension of capital in sidelined equity war chests, waiting for bargains. Opinions range from "a pile of money, though certainly not enough to make up for loss of debt" to "not as much as advertised." Many attractively priced investments in earlier correcting stock and bond markets potentially siphon off investments from the U.S. real estate arena. But stock market gains eliminate the denominator effect, giving room for pension funds to increase real estate holdings to meet allocation targets, and some "big state pension funds gear up." Then again, stories still reverberate about previously committed opportunity fund investors telling managers to hold off on capital calls. Many general partners and investment managers reel from fractured investments and losses, turning off clients to re-up. Don't expect a rush into acquisition markets from financial institutions, either—"they're still in too much of a hole." Many foreign investors already identify opportunities in more familiar home regions where markets have already begun to improve while "the U.S. continues to sink." In sum, everyone agrees that "capital forms to jump back into the market," but nobody really knows how much.

Wall Street Redux. In the wake of the mortgage securities market collapse and the demise of financial engineering strategies, Wall Street investment bankers "prime for re-creation" and try to figure out how to take advantage of the disaster they helped instigate. Investment houses must return to the more "boutique days" where they risk firm capital through balance sheet investing rather than maxing out on fees playing fast and loose with "other people's money." Interviewees agree that the currently "out-of-favor" private equity model—alignment of interests through promotes based on performance—can work and will return in "new and improved" opportunity funds. "What ruined it was overleveraging" and "losing sight of the market cycle." Bankers should find traction with managing IPOs to help recapitalize some private owners. Startup firms advise institutions and broken limited partnerships on workouts as well

as raise money for distressed acquisitions. They offer small salaries "to keep the lights on" and "if you create value, you share in it." In the meantime, "everybody makes far less." Big asset managers likely will tap into America's newfound desire to save by marketing low-leverage syndication products, offering steady income. And once they protect their bonus prerogatives and ward off greater regulator intrusions, Wall Street powerbrokers will be front and center in government deliberations over recasting the CMBS markets, maximizing their piece of the action. What else is new?

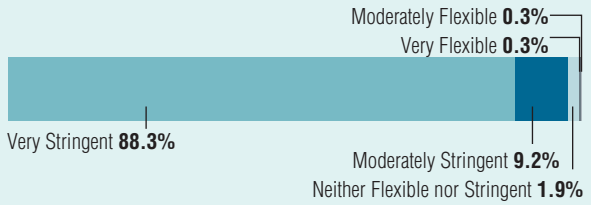
Banks and Insurers

"Banks will become willing lenders and sellers only when they have more equity or more earnings." In the meantime, an increasing number of "zombie banks" shoulder "portfolios full of zombie properties." For 2010, "it's survival of the most liquid—hundreds of banks could fail," particularly regional and community banks with significant exposure to homebuilder, land, and construction loans. During 2010, bankers will continue to "rope-a-dope" and buy more time to build reserves, managing their losses "astutely." They extend and modify their best loans on properties with solid cash flows, including assuming cash flow mortgages, and begin to repossess more of "the less than best." As the FDIC increases sales of loans following bank takeovers, a transaction market should establish with pricing floors. Appraisers will record substantial declines in value from government dispositions, forcing surviving banks to mark down appropriately and move more bad assets off their books. Healthier banks with larger reserves can sustain greater writedowns and "may hold onto premium foreclosed properties" to cash in on any recovery. Also, expect more borrowers to capitulate and stop "feeding wasting assets," further bloating REO portfolios.

Life insurers also buy time, and manage writedowns in quarter-by-quarter chunks. Their whole-loan portfolios tend to concentrate in higher-quality, large commercial properties, owned by investors with sounder balance sheets. And they avoided exposure to housing and subprime lending. "But they won't get taken out in refis, either." Some large life companies were more aggressive lenders, spurred by investment banking and asset management operations—"they stand to lose more."

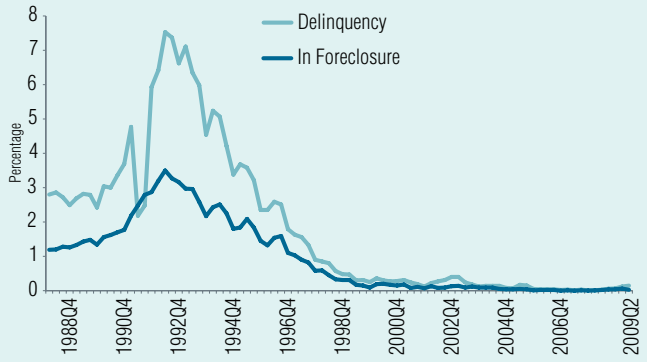
In a sliver of the market, borrowers can find loans, but at "expensive," back-to-the-future pricing—60 to 65 percent loan-to-value ratios, 7 to 7.25 percent interest rates, and 1.4 debt-service coverage. Interviewees expect stringent underwriting to limit transactions (see Exhibit 2-5). "Sponsorship" and longstanding, banker/borrower relationships hold sway—

EXHIBIT 2-5
Underwriting Standards Forecast for the United States



Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

EXHIBIT 2-6
U.S. Life Insurance Company Mortgage Delinquency and In-Foreclosure Rates



Sources: Moody's Economy.com, American Council of Life Insurers.

they "are as important as asset quality" in getting mortgages done. Interviewees just hope that five years from now "when we're past this mess," strict underwriting endures and "you still need at least 10 to 15 percent real equity on today's value, not value based on ten-year assumptions."

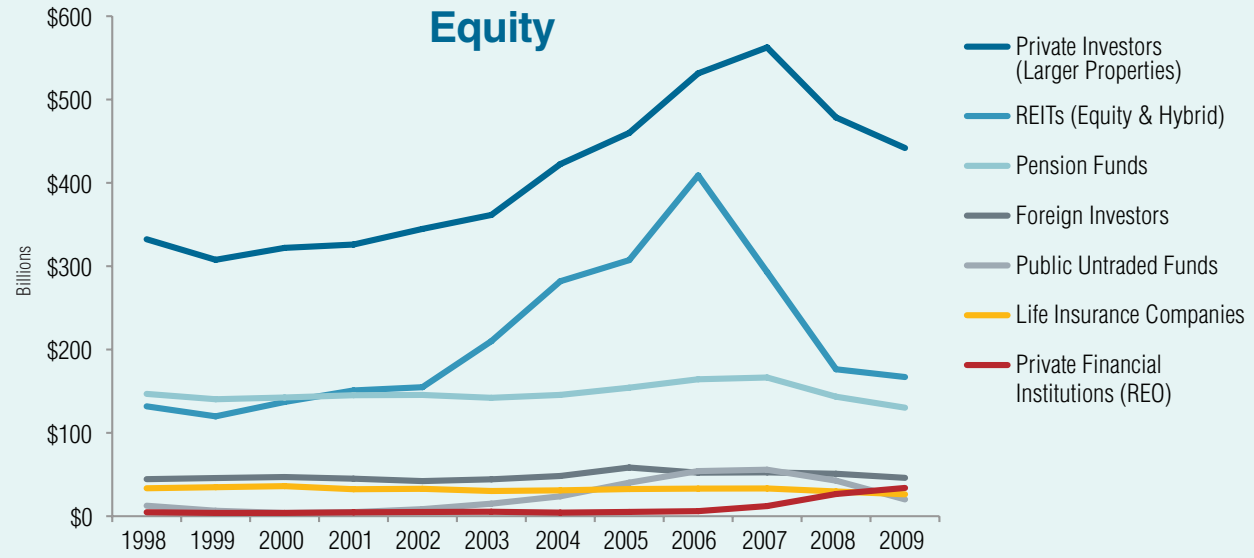
CMBS

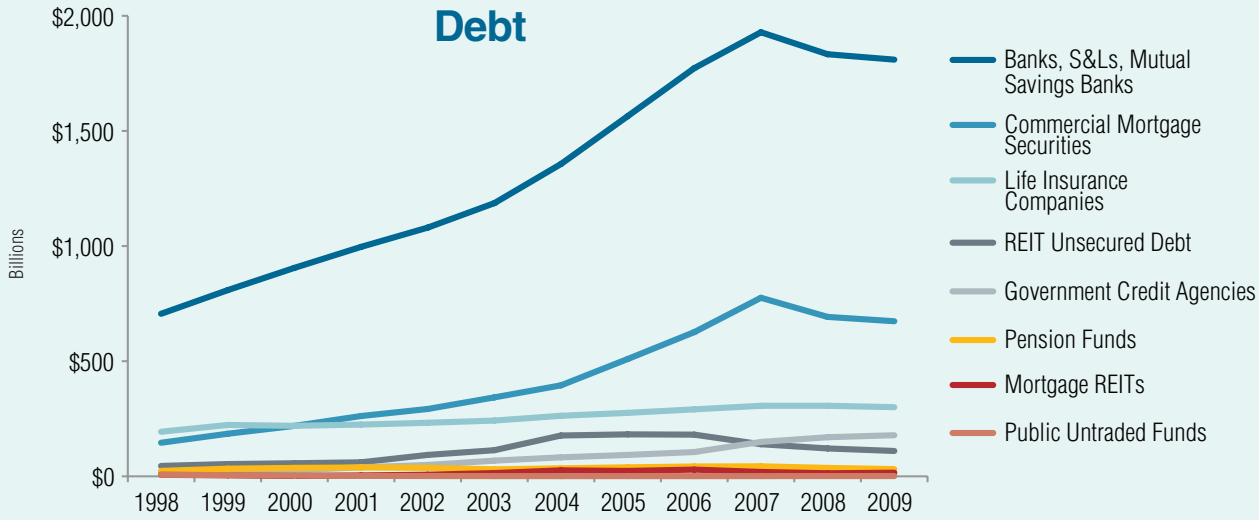
A "huge time bomb" wrapped in a "ball of confusion," the CMBS markets could take years to unravel. The bulk of badly underwritten, recent-vintage securitized loans won't refinance until after 2014, "but many of these loans will go into monetary defaults before maturities because of borrower financial

U.S. Real Estate Capital Sources

EXHIBIT 2-7

U.S. Real Estate Capital Flows 1998–2009





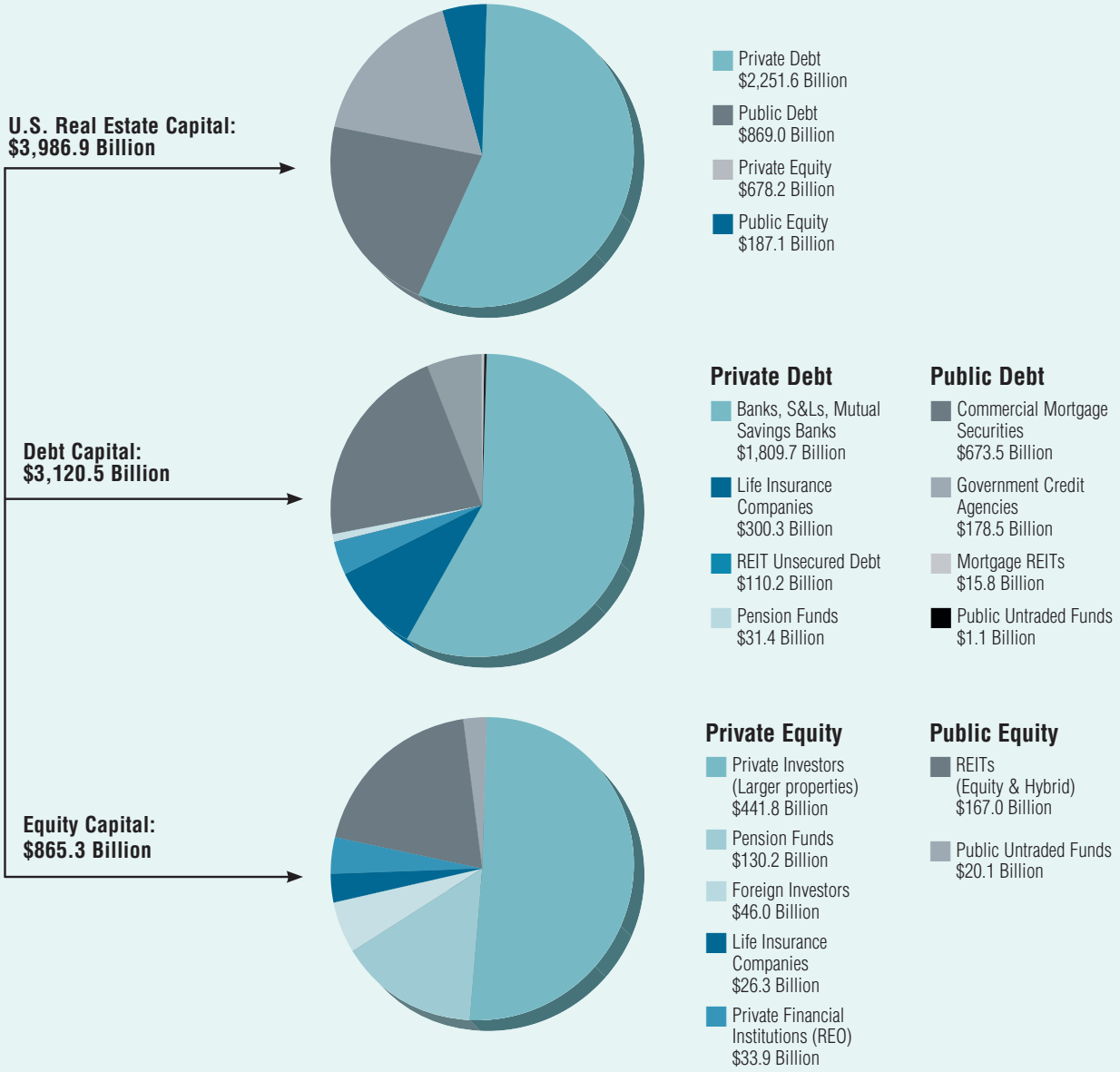
Sources: Roulac Global Places, from various sources, including American Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserve Board, FannieMae.com, IREI, NAREIT, PricewaterhouseCoopers, Real Capital Analytics, and Robert A. Stanger & Co.

Note: Excludes corporate, nonprofit, and government equity real estate holdings, as well as single-family and owner-occupied residences.

* 2009 figures are as of second quarter, or in some cases projected through second quarter.

EXHIBIT 2-8

U.S. Real Estate Capital Sources 2009

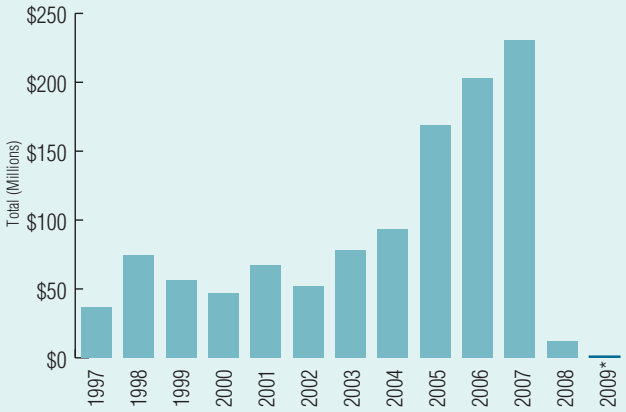


Sources: Roulac Global Places, from various sources, including American Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserves, FannieMae.com, IREI, NAREIT, PricewaterhouseCoopers, and Real Capital Analytics.

Note: Excludes corporate, nonprofit, and government equity real estate holdings, as well as single-family and owner-occupied residences.

* 2009 figures are as of second quarter, or in some cases projected through second quarter.

EXHIBIT 2-9
U.S. CMBS Issuance



Source: Commercial Mortgage Alert.
* Issuance total through August 24, 2009.

issues and lagging fundamentals." Earlier-vintage, better-underwritten CMBS loans set to mature in 2010, 2011, and 2012 also hit a wall of bad market timing—where properties and sponsors are strong, special servicers will try to extend maturities. That process could get complicated. A new tax rule allows borrowers to negotiate restructurings with special servicers prior to defaulting, but loan documents can impede the process. Then the special servicer has many masters—various layers of bondholders, each with their separate interests depending on level of exposure to losses. Mezzanine and preferred equity holders might also exercise their rights in potential litigation over particular collateral. "There are so many hands in every deal, you don't know where to begin to unwind," says a workout specialist. "No one has authority to make decisions without someone jumping in to block them. There will be a slugfest and the legal system can't handle it. In the end, all the parties will have no choice but to recognize their losses." Some special servicers get saddled with an additional conflict—they're owned by B-piece buyers with stakes in the deals—and many bondholders struggle just to figure out what collateral backs their securities. "No one knows who to talk to."

Mezzanine Debt

Most mezzanine debt lenders wring their hands—the downturn erases many investments, particularly from 2005–2007 transactions. "The market no longer exists," says an interviewee. "There's no such thing. 'Mezz' is gone. Today, the opportunity is senior debt—you can make big spreads and it's safer. We never should have leveraged the product and used CDO takeouts." In the new world order, mezz will reincarnate as a mid-tier product, at 400- to 500-basis-point spreads over equity "like it used to be."

Private Investors

Cloaked in secrecy behind walls of family offices, high-net-worth investors appear ready to form "old school" "jumbo syndicates to go after some great deals." "They'll move ahead of pension funds and form the leading edge of private investors coming back into the markets."

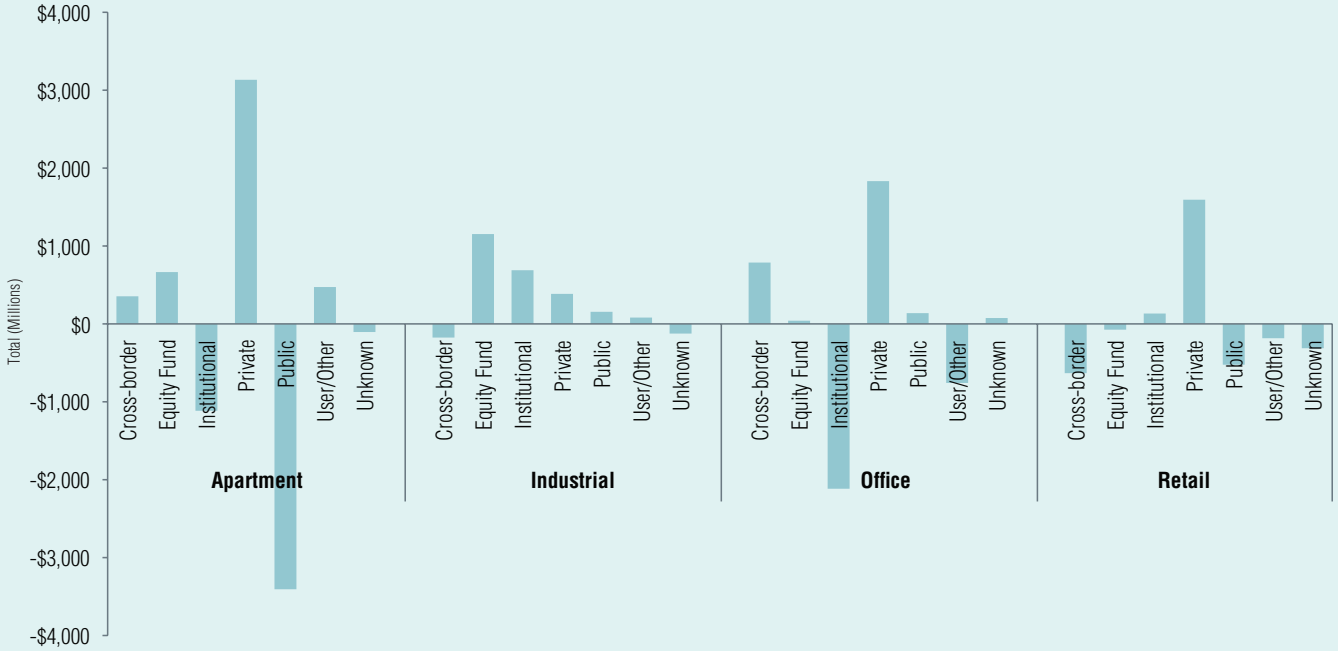
Fund managers have hit a brick wall, selling syndications or private REITs through broker dealers to small investors. Their target market reads in newspapers about how commercial real estate is "the next shoe to drop" and "stuffs money into their mattresses instead," says a portfolio manager. "It's one tough sell," especially since legacy fund returns suddenly show sharp declines after years of strong performance.

Opportunity managers try to retool fund strategies and gin up pro formas offering the usual giant returns without relying on as much leverage. The new opportunity model pays very low acquisition or recapitalization prices in cash and expects to lever up as much as possible when credit markets loosen. Holding periods necessarily lengthen to ride a recovery track—the buy-and-flip days are over (for now). Before new funds roll out, legacy portfolios present huge challenges for general partners as limited partners tally hideous losses. Forget the originally promised 20 percent–plus annualized returns—investors just hope to get principal back. Some GPs abandon ship—they have no chance to earn promotes—and limited partners jostle to take control and salvage something. New workout firms, often composed of laid-off bankers, step in as "white knights" to look after portfolios, which struggle under negative leverage and refinancing problems. "Undoing some of these ventures will be an arduous process."

Hedge funds head for the hills after their mistimed flirtation with real estate. Managed by financial engineer and deal guys, most of these shops don't have a clue about handling distressed properties, workouts, or asset management.

EXHIBIT 2-10

U.S. Buyers and Sellers: Net Capital Flows by Source and Property Sector



Source: Real Capital Analytics.

Note: Net capital flows from second-quarter 2008 through second-quarter 2009.

Many players attempt to raise capital for distressed debt funds from government bank takeovers. Interviewees expect the feds will push large portfolio sales to well-capitalized funds, controlled by major investment banks, in a virtuous circle of balance sheet cleansing. Smaller, less politically connected managers could have trouble competing in the market.

Pension Funds

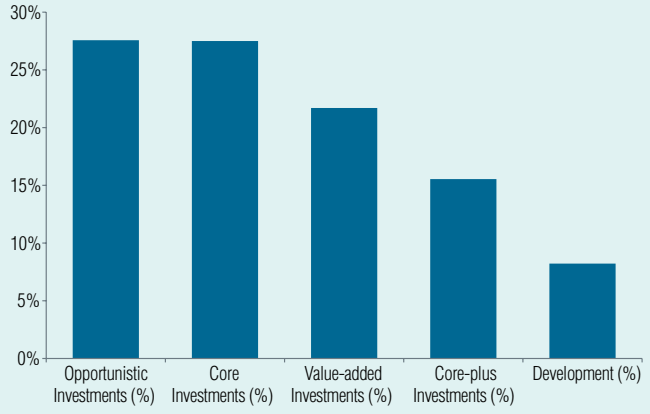
Plan sponsors tread water in a sea of failed investments, punctured asset allocation models, and rising beneficiary payouts. "Their portfolios have been burned everywhere—real estate is just a small part of their problems." Pension funds that stuck to core and lower leverage do better, but many institutional investors caught the yield bug and "suffer the consequences" for venturing heavily into value-add and opportunity funds or saddling extra leverage on core portfolios.

Despite having a steady stream of new capital to invest, most plan sponsors characteristically turn "very conservative" about new allocations. They "recognize the timing for opportunity strategies, but don't have the moxie to pull the trigger" after taking large writedowns. Some major public funds talk about doubling down at market bottom and making up lost ground quickly. These plan sponsors "want to take revenge on the markets" and investment advisers shopping new funds "need to show alpha to rouse any interest." Core fund pitches get blank stares, although ultimately pension funds need steady, predictable income with less volatility and some appreciation. "They require cash flow for payouts to increasing numbers of baby boomer retirees." An adviser despairs: "We're really back to square one. They want real evidence we're at bottom before they invest. They don't want to be embarrassed again."

While interviewees expect frustrated plan sponsors to stay committed to the real estate asset class, goodwill will not extend to underperforming investment managers. A big shakeout comes in a looming consolidation. "Everyone is in the pen-

EXHIBIT 2-11

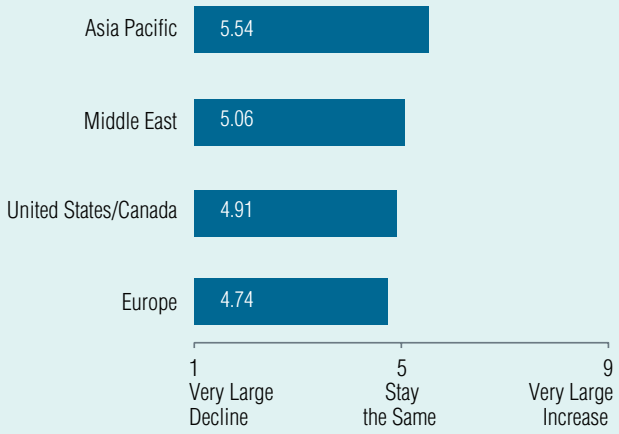
Strategic Investment Allocation Preferences for 2010



Source: *Emerging Trends in Real Estate 2010* survey.

EXHIBIT 2-12

Change in Availability of Capital for Real Estate by Source Location in 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

alty box." Separate accounts get transferred and new companies form to take over portfolios. "Only the top ten or 15 firms can be sure they'll survive, and some big boys could fall."

Given all the turmoil, pension funds actually stand in relatively good position. "They have cash and that's what everyone else needs." But then again, "they're always late to the party."

Public REITs

After REITs tripled in value from 2000 to 2006 and then precipitously lost 75 percent off market peaks, these volatile stocks appear fortified to sustain a rebound at the vanguard of any commercial real estate turnaround. Among interviewees, REIT executives certainly seem the most sanguine, a reversal from last year's ultra-pessimistic mood. "We took our lumps, we've deleveraged, and raised new capital in public offerings," says a CEO. "We can focus more on opportunities."

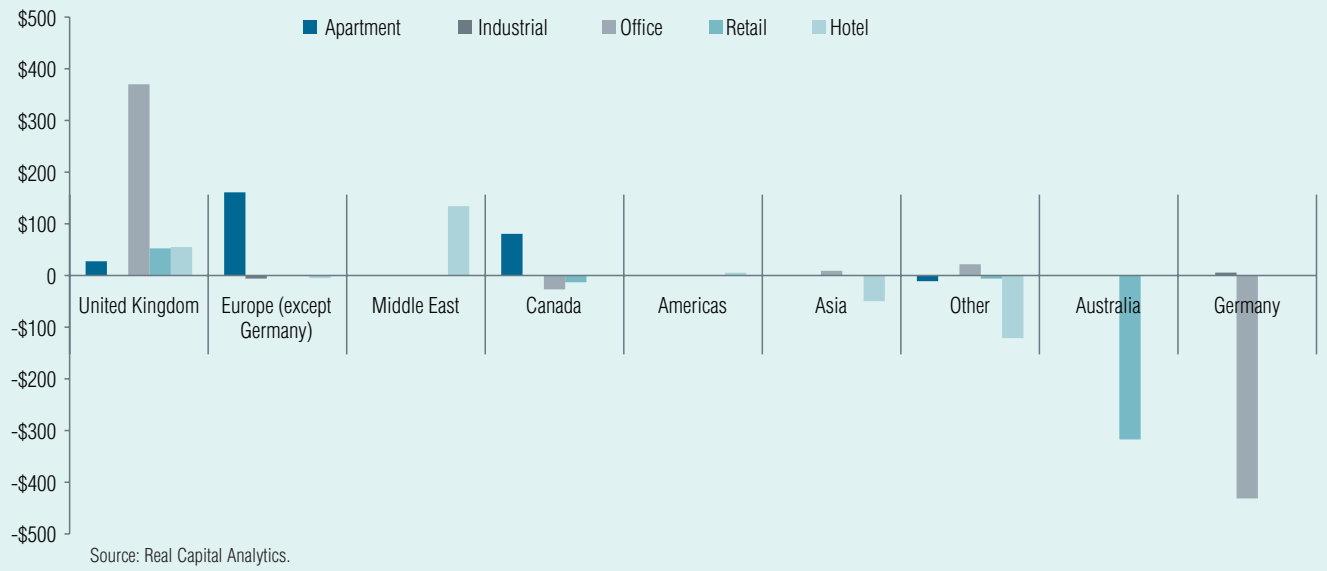
While acknowledging ongoing threats to markets from the refinancing wave and deteriorating fundamentals, stronger REITs prepare for cyclical-timing acquisitions and will take advantage of weakened borrowers and lenders. "We'll partner with banks to take stakes with promotes in foreclosed assets, assume operating control of troubled properties, and provide capital to distressed owners in return for equity."

Recent "reequitizations" through public offerings diluted existing shareholders, but build up reserves for acquisition sprees. Now, "REITs will emerge as bigger players." Ability to tap the public markets and reasonably leveraged balance sheets (50 percent or less) give many REITs a significant leg up on other investors distracted by mounting debt-service challenges and stymied by frozen credit markets. In fact, insurers and banks have enough confidence to renew REIT credit lines—"they didn't depend on the CMBS markets for financing." Overall, these companies also were net sellers before the crash and most did not try to compete for acquisitions late in the cycle against opportunity funds—"those that did got hammered." Some interviewees warn that REITs "are not out of the woods" since earnings could erode from lowered occupancies and rental rates. "They've got dividends and not much else" and their "catalyst for upside" is a coming attraction.

The REIT universe could expand. IPOs may provide rescues for drowning private equity funds, real estate operating companies, and developers. Similar Wall Street–engineered game plans worked in the early 1990s when many desperate developers gave up proprietary control of their companies to shareholders and exposed themselves to analyst scrutiny. "It's either go public or go broke."

Several billion dollars in new mortgage REITs raise headlines and may add some near-term liquidity to the markets. Previous iterations of these externally managed structures

EXHIBIT 2-13
Foreign Net Real Estate Investments in the United States by Property Type



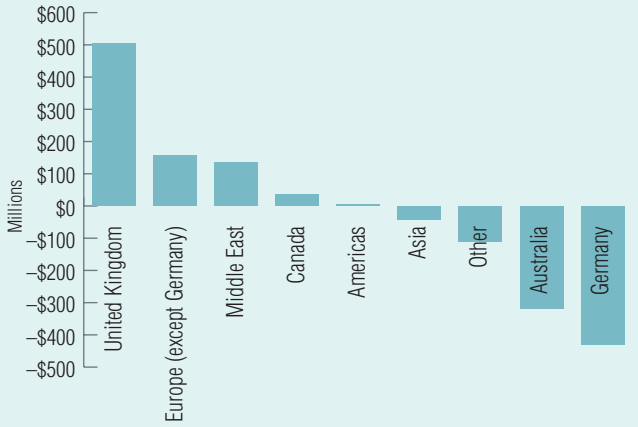
Source: Real Capital Analytics.
Note: Net capital flows from second-quarter 2008 through second-quarter 2009. All dollars in millions.

from the 1970s and 1990s "never turned out well." The verdict is out on their impact and performance, but they appear opportunistically positioned to invest at market lows.

Foreign Investors

Offshore players retreat to home regions while U.S. markets find a market floor. They suffer losses like everyone else and want to avoid a premature reentry. "Everyone's wary of new commitments after placing bad bets in 2005 to 2007," says an interviewee. Despite the hard licks, foreigners continue to view the United States as a safe haven, prefering high-profile coastal cities and urban centers over interior markets and suburban locations. "China and India are like riding a roller coaster; London got creamed more than New York; Portugal, Italy, Greece, and Spain are in tailspins; and eastern Europe is even worse." By the end of 2010 and into 2011, wealthy Asian and Middle Eastern buyers could be active bottom-fishers in 24-hour gateway cities like New York, looking for discounts and good core to core-plus returns. European investors have their hands full with backyard problems, and many Pacific players, notably Australians, view near-term investing as "all about China."

EXHIBIT 2-14
Foreign Net Real Estate Investments in the United States



Source: Real Capital Analytics.
Note: Net capital flows from second-quarter 2008 through second-quarter 2009.

Markets to Watch

"Not bullish on anywhere."

Dysfunctional global credit markets and a tottering U.S. economy subdue prospects for cities and suburbs from coast to coast in 2010. Job losses strike virtually every region and market. State and local governments suffer deficits—tax revenues decline sharply; expenses for unemployment, Medicaid, and other social welfare programs spike; and shortfalls in public pension funds require infusions. Officials strain to avoid cutbacks to police, mass transit, sanitation, teachers, and other essential services—they creatively attempt to use federal stimulus funds to plug budget holes temporarily. In "a flight to quality," *Emerging Trends* interviewees hunker down in familiar locations and don't anticipate major shifts in investment preferences or corporate real estate strategies, exiting the downturn. "Markets performing well before the crash will perform better coming out of it; markets lagging before will continue to lag."

Investors tend to favor the following:

- **Global gateway markets** on the East and West coasts—featuring international airports, ports, and major commercial centers.
- **Cities and urbanizing infill suburbs with 24-hour attributes**—upscale, pedestrian-friendly neighborhoods; convenient office, retail, entertainment, and recreation districts; mass transit alternatives to driving; good schools (public and/or private); and relatively safe streets.
- **Brainpower centers**—places that offer a dynamic combination of colleges and universities, high-paying industries—high tech, biotech, finance, and health care (medical centers, drug companies)—and government offices.
- **Barrier-to-entry markets** where geographic constraints—rivers, lakes, oceans, and mountains—limit development and help control overbuilding.

Often, the most coveted markets have most, if not all, of these elements. In this year's report, investors also showed a preference for some growth-oriented markets that did not get overheated or overpriced in recent years.

Investors shy away from:

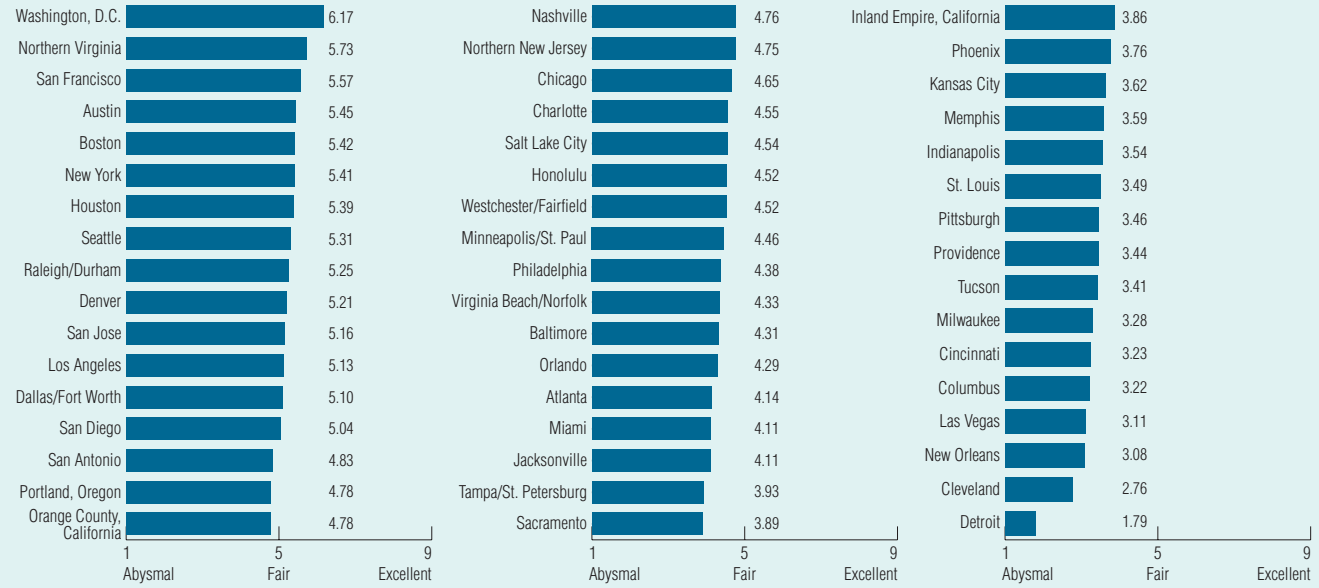
- **Midwest manufacturing centers**—automaker travail deflates interest to new lows;
- **Secondary and tertiary cities**—anywhere you can't fly direct to from the global pathway centers;
- **Hot-growth bubble-burst markets**, which collapsed under plunging housing prices; and
- **Fringe areas**—the exurbs and places with long car commutes or where getting a quart of milk means taking a 15-minute drive.

Shuffling

Bulletproof. Not surprisingly, the country's preeminent recession-proof market, **Washington, D.C.**, regains the survey's number-one ranking in all investment and development categories, except for industrial properties. The nation's capital lacks a primary distribution center, but features all the other attributes investors want—plenty of government jobs that don't get cut in slowdowns, high-tech and biotech

EXHIBIT 3-1

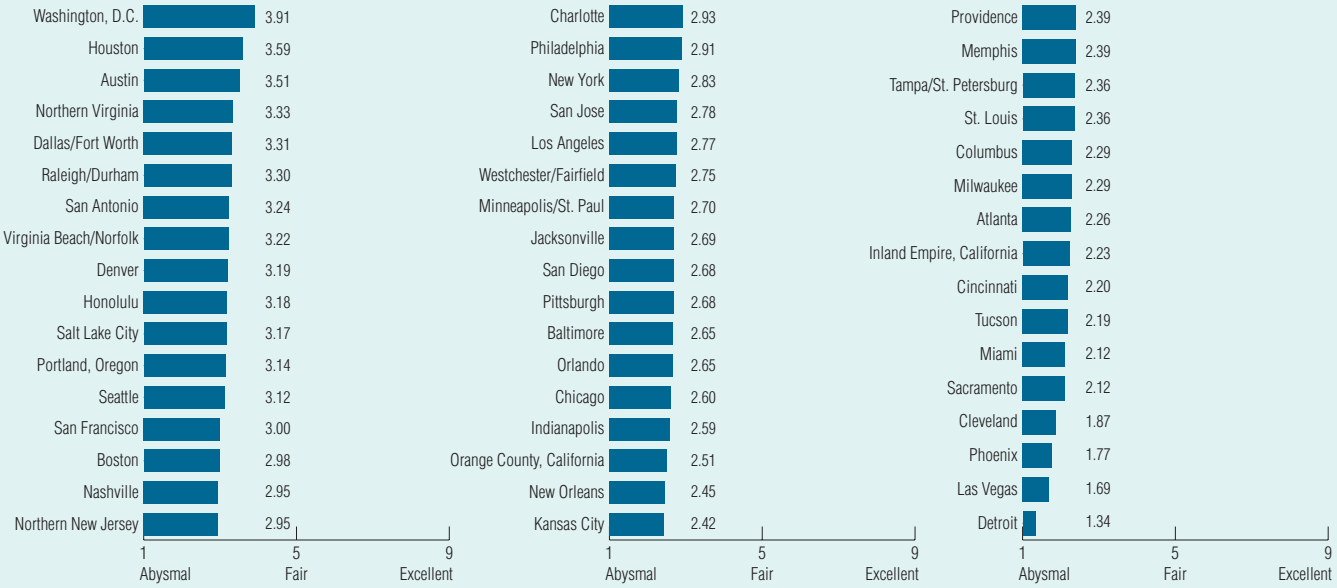
U.S. Markets to Watch: Commercial/Multifamily Investment



Source: *Emerging Trends in Real Estate 2010* survey.

EXHIBIT 3-2

U.S. Markets to Watch: Commercial/Multifamily Development



Source: *Emerging Trends in Real Estate 2010* survey.

EXHIBIT 3-3
U.S. Markets to Watch: For-Sale Homebuilding

Source: *Emerging Trends in Real Estate 2010* survey.

industries that feed off government programs, a slew of area universities, and, most importantly, a diversified 24-hour center linked to other global capitals and national gateway cities by three major airports. No wonder it's one of the few markets to register even a slight ratings gain over last year's survey.

Resilient. Long-term confidence holds for three other stalwart gateways: **San Francisco**, **Boston**, and **New York**. These cities retain a wealth of 24-hour attributes, brainpower jobs, and global pathway connections. San Francisco's multifaceted environment, proximity to high-tech Silicon Valley, and history of bouncing back from corrections bolster investor outlooks. Boston's universities and intellectual capital "create a compelling story," and despite financial industry downsizing New York remains one of the world's preeminent locations—"it's a place where you want to be." And the wealth "concentrated in Northeast markets just makes them more resilient."

High Cost. Two other West Coast gateways—**Seattle** and **Los Angeles**—suffer bigger ratings declines than San Francisco, but remain among the survey's top ten major markets. Relative sentiment for California cities, including **San Diego** and **Sacramento**, falls over concerns about government gridlock, rising taxes, and an inhospitable business climate.

Growth Bastion. After years languishing in the survey basement, Texas markets continue to show strength. Interviewees say low state taxes and a pro-business environment ensure future growth and continuing corporate relocations. In contrast to California, "the state's stronger government revenue picture really helps" and property prices never overshot. Energy and health care buoy **Houston**, while **Dallas** benefits from its expansive international airport and distribution hub. **Austin** fits the "brainpower" model with its state capital, large state university, and offshoot tech and software businesses.

Busted Florida cities take it on the chin, clobbered by a severe housing downturn and curbed population inflows, which had fueled decades of supercharged development. Hot-growth desert cities—**Phoenix** and **Las Vegas**—also cool off dramatically in the housing bust. "The places to avoid are hot, humid, [or] sandy—or make cars."

Further Decline. And that brings up the long-forsaken manufacturing Rustbelt, stretching from western New York State into the Midwest heartland. Survey ratings score record lows for many markets in this region, registering concern about their future viability in the

EXHIBIT 3-4

Leading U.S./Canadian Cities

Investment Prospects	Development Prospects

- Very Good
- Good
- Modestly Good
- Fair
- Modestly Poor
- Poor
- Very Poor
- Abysmal


Halifax
Ottawa
Montreal
Minneapolis/
St. Paul
Toronto
Milwaukee
Boston
Detroit
Providence
Northern New
Jersey
Cleveland
Chicago
New York City
Westchester/
Fairfield
Philadelphia
Indianapolis
Columbus
Pittsburgh
Baltimore
Kansas
City
Washington, D.C.
Cincinnati
Northern Virginia
St. Louis
Virginia Beach/Norfolk
Raleigh/
Durham
Charlotte
Nashville
Memphis
Atlanta
Jacksonville
New Orleans
Orlando
Tampa/
St. Petersburg
Miami

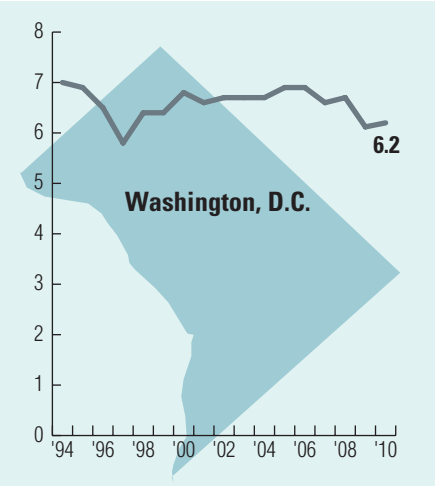
wake of automaker bankruptcies and widespread industry layoffs. **Chicago**, the region's diversified 24-hour citadel, can't escape a chill from the regional downdraft either. No one can sugarcoat how domestic manufacturers continue to relocate away from union-dominated areas in colder, northern interior locations and move to right-to-work, "more business friendly" states in the Southeast and Southwest.

Off the Beaten Track. Airline cutbacks to secondary cities hobble prospects and underscore investor concerns about the ability to link into the flows of global pathway commerce. Even fast-growing Sunbelt markets "can get cut off from global business strategies." The big corporations "don't have much reason to be there." **Charlotte** worries about retaining its banking center, while nearby **Raleigh-Durham** overcomes one-step-removed status by enhancing its research and development incubator. High-tech **San Jose** in Silicon Valley conveniently links to the nearby San Francisco gateway. Everywhere else wants to turn into a brainpower hotbed, but places that suffer through long winters without recreational resorts can't compete for intellectual talent against more temperate climes. In a tough economy, secondary markets also become more vulnerable to business contraction—if a big employer fails, the entire local economy "can take a head shot."

Infill vs. Suburbs. Road congestion, higher energy costs, and climate change concerns combine to alter people's thinking about where they decide to live and work. "It's a fundamental shift." The lifestyle cost-of-living equation starts to swing away more dramatically from bigger houses on bigger lots at the suburban edge to greater convenience and efficiencies gained from infill housing closer to work. These homes may be more expensive on a price-per-pound basis, but reduced driving costs and lower heating/cooling bills provide offsets. And time saved avoiding traffic hassles moderates stress and enhances productivity. "Two-hour commutes reach a tipping point with higher energy costs" and "near-in suburbs will do well especially if they link to business cores by mass transportation." Empty nesters and later-marrying echo boomers continue to flock to cities and urbanizing suburban areas. For aging baby boomers, infill apartment or townhouse living means less upkeep and proximity to cultural and entertainment attractions. The young singles crowd stays closer to the action, too—they don't need to worry about finding the right suburban school district for children. As 30-something couples have kids and consider schools, "more will orient to infill locations and less edge—increasing numbers of suburban school systems will lose advantages as tax bases falter."

Major Market Review

Washington, D.C. Count on it—the nation's capital always ranks number one in *Emerging Trends* market surveys during a recession. Its dominant employer—the federal government—never shrinks and often expands in bad times. "Love those buildings with government offices—they're the only credit tenants out there right now." A change in administrations hasn't hurt, either—"the GSA [Government Services Administration] searches for more space and lobbyists crawl around everywhere." Hard-pressed lenders pull back in most other cities but express long-term confidence in this market—major insurers and big banks actually provide financing for new deals. "All markets are not

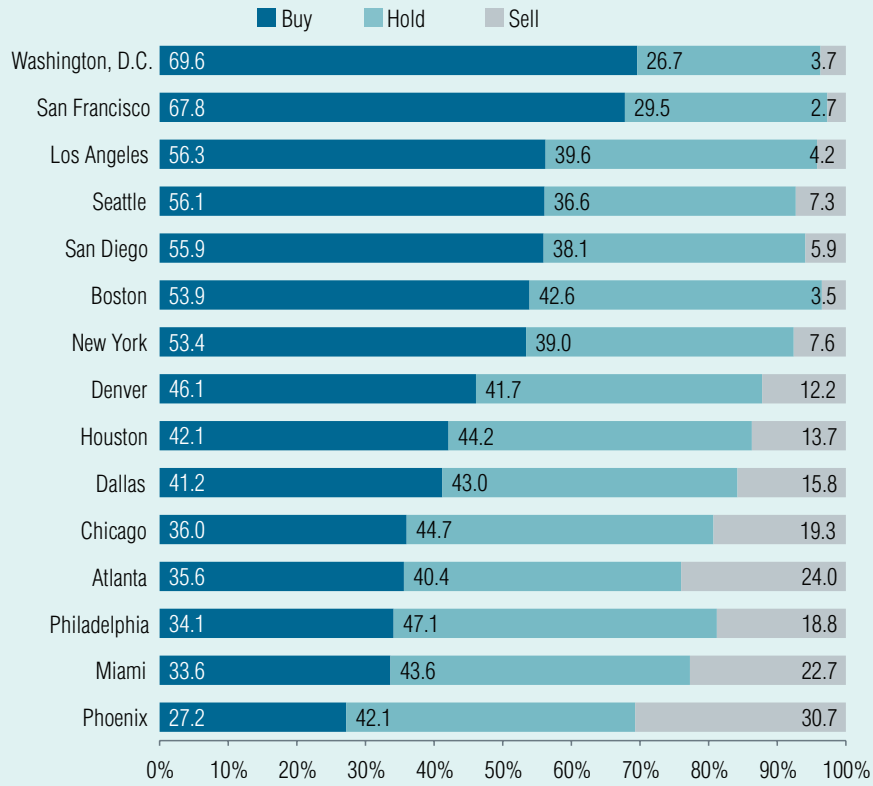


created equal," and Washington stands above all others right now. But owners lose value here, too—"just not as much as everywhere else" and supply/demand fundamentals will weaken into 2010. Office vacancies already increased above 10 percent as nongovernment employers slash jobs and more than 6 million square feet of new space is under construction. More shadow sublease space crowds into the market, concessions increase, and rents decline. Bethesda, Maryland, home to the National Institutes of Health, should benefit from increased biomedical spending, and Virginia markets, inside the Beltway, suffer only modest erosion relative to past downturns. Suburban vacancies advance well into the high teens further out.

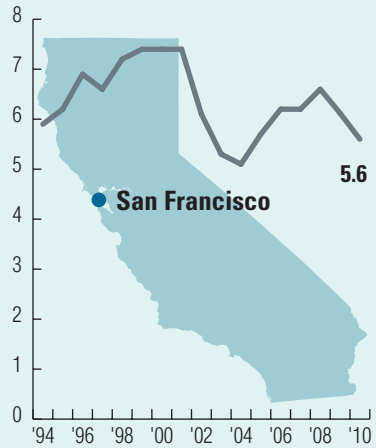
San Francisco. Despite its formidable barrier-to-entry attributes, this 24-hour gateway takes investors on a rock-and-roll ride of up-and-down pricing, occupancies, and rents. After a sudden run-up attributable to the late 1990s' Internet bubble, some financial district office rents approached $100 per square foot and then dropped precipitously by 2001. A solid recovery followed, but now the volatile pattern repeats itself. "Nominal office rates fall to 1982 levels." Interviewees expect another "quick" rebound—"the market

EXHIBIT 3-5

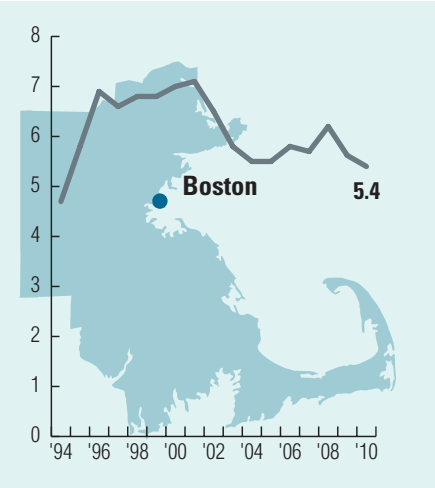
U.S. Apartment Buy/Hold/Sell Recommendations by Metro Area



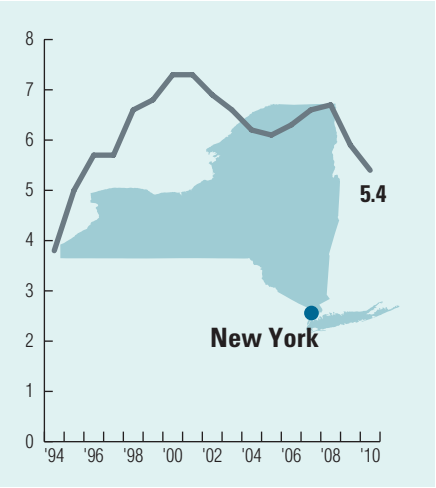
Source: *Emerging Trends in Real Estate 2010* survey.



doesn't look good now, but what's not to like? It's diversified, compact, beautiful, and where people want to live." An expanding regional tech industry, fed by Silicon Valley, should help. Housing leads the recovery after dramatic price declines. *Emerging Trends* surveys rank the market as one of the top buys for apartments, warehouse, office, and hotels. Cash investors set their sights on properties owned by late-cycle buyers, who purchased at the top and suffer the consequences.

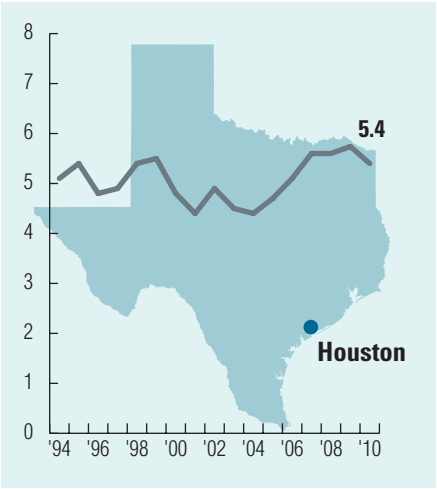


Boston. Locals express nervous optimism: "We're holding up better than most—it's not as bad as the last recession." Barriers to entry limit new supply in the financial district and office tenant demand falters only marginally. Recent negative absorption slows down—vacancies edge into the lower teens, "but that's no catastrophe." Asset management firms and mutual fund managers constitute most of the city's important investment-financial sector—these businesses dodged much of the fallout suffered by New York investment and money center banks. Compelling economic drivers—premier educational institutions, life science companies, and high-tech business—reinforce investors' long-term conviction. It's a solid core-hold market. Downtown apartment vacancy stays well under 10 percent and condo/house pricing "remains stiff." New residential development activity is dead in its tracks. Suburban markets characteristically soften more than downtown—they should fare better than they did during the early-2000s correction. "Even our regional and community banks look in decent shape."



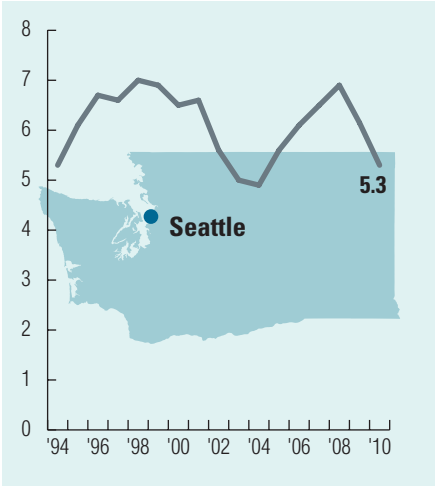
New York. As ground zero for the world credit cataclysm, the market "gets crushed." No, make that "crunched." About 250,000 jobs go *poof*, and the number of unemployed hits record highs. Midtown availability rates skyrocket from mid–single digits into the mid-teens and office rents plummet 40 percent or more. Co-op pricing sinks 25 percent, empty storefronts mar Madison Avenue's posh high-fashion streetscape, and tourists can book luxury hotel rooms for under $300 a night. The widespread value erosion drops prices from obscenely out of sight to merely expensive. Savvy investors see nothing but opportunity and more affordable costs—"the city is fantastic long term, everyone wants to be there, it's the place to play." Hundred-dollar-plus office rents and sub-4 cap rate transactions were ridiculous anyway. "Deals will feel better—we can get good yields again." A shakeout continues among condo developers who built million-dollar-plus apartments in fringe districts—unit sales won't close without substantial markdowns. City and state officials dance around redeveloping the World Trade Center site—market demand sags for any new space and why should taxpayers subsidize new construction when government budgets bleed red ink? The pace of market recovery depends on the hammered banking industry—"How long will it take for Wall Street to reinvent itself?" Already, some investment firms step up hiring. New York has fallen and risen before.

Houston. This hot-growth energy bastion and mega-suburban agglomeration achieves its highest ranking since the early 1980s, although its rating drops from last year. Whether the market maintains momentum largely depends on oil and gas prices—the higher they



go, the better its fortunes. "The city is all about energy and good timing, no matter what anybody says." Propelled by a surge in worldwide oil markets in 2007 and 2008, Texas skirted direct recessionary blows—unemployment remains well below the national average. But skittish energy markets take the edge off the local economy, and job losses accelerated in 2009. Except for retail where tenants consolidate, property sectors show reasonably good supply/demand balance. Values and rents fall "though not as bad as other places." Consistently strong population growth always makes Houston a leading market for apartment developers and homebuilders. The city now banks on a global economic recovery pushing up energy demand.

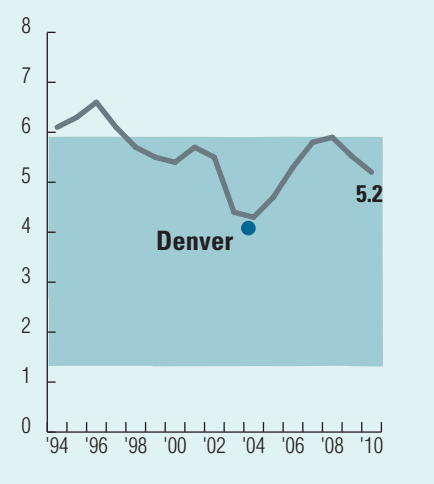
Seattle. Recession and bank woes harpoon Seattle, last year's number-one market. Washington Mutual's demise walloped the office sector and three late-in-the-cycle projects could send downtown vacancies above 20 percent. "Those office developers will be in a world of hurt." The city's diverse group of major employers—Microsoft, Boeing, Costco, Starbucks,



and Amazon—stabilize after layoffs and cost cutting, but offer no expansion plans. "There's just no demand." "Wolves lick their chops for bargains" in office and condos, where projects also missed the market. "Strong interest from institutions could cushion value declines." Apartments stand out as a relative bright spot—vacancy increases modestly, rents soften, and development has shut down. Slowed import-export traffic sends industrial vacancy

above 5 percent, high historically in this key West Coast port. Global pathway positioning should accelerate a market bounce back once the U.S. economy resuscitates. "We're down, but not out."

Denver. Not a barrier-to-entry market or a global pathway destination, Denver marshals its attractive Rocky Mountain lifestyle attributes and works hard to fortify its downtown core into a multifaceted, 24-hour commercial center. While avoiding financial industry implosions, the local economy gets a boost from green initiatives—the city is a national hub for companies in alternative energy, wind-farm manufacturing, and

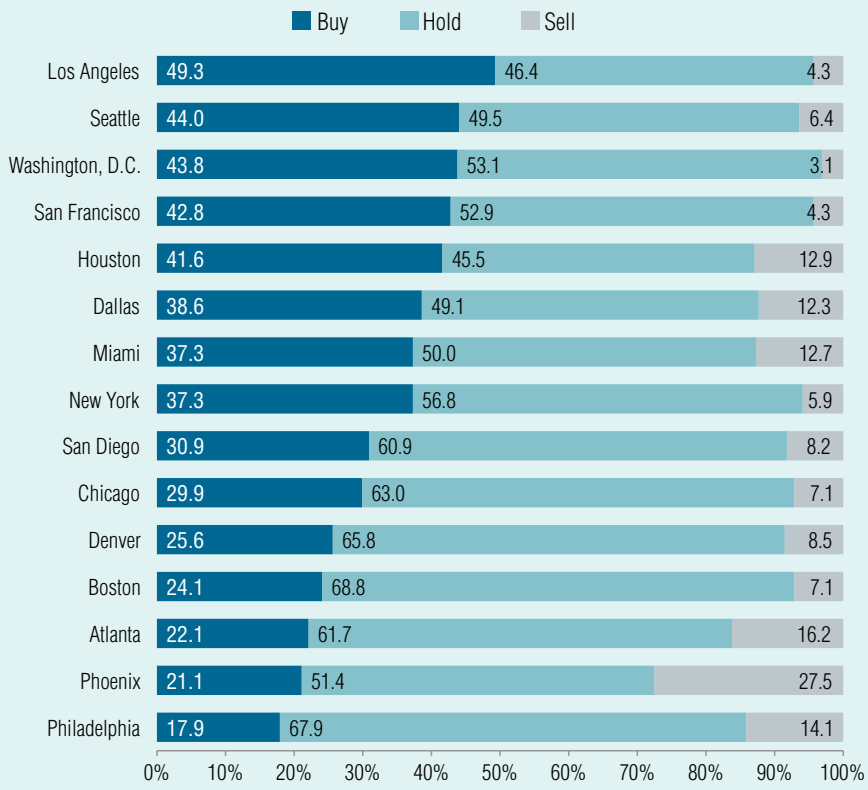


natural gas. All property sectors soften modestly. The metro area wins points for building out its light-rail network, encouraging transit-oriented mixed-use projects around stations.

Los Angeles. California's fiscal straitjacket, housing debacle, slowed import traffic, and the financial industry crash clobber the West Coast's predominant Pacific gateway—unemployment hits double digits, above the national average. Even Hollywood stars wonder about the future of multimillion-dollar-per-picture deals. Investors will think twice until the state government reins in scary budget deficits and reorients tax burdens. Political gridlock and blowback discourage business expansion and relocations. More companies threaten to move east to cheaper desert states—"the caravan is leaving." Office vacancies head into the mid-teens, not counting a mountain of sublease space on the market, and "tenants take control" negotiating rents down. Overbuilt Orange County and Riverside/San Bernardino office markets look worse. The formerly "white hot" warehouse sector turns lukewarm after an Inland Empire building binge and the recession flatten resort hotels. Once-stratospheric housing prices have

EXHIBIT 3-6

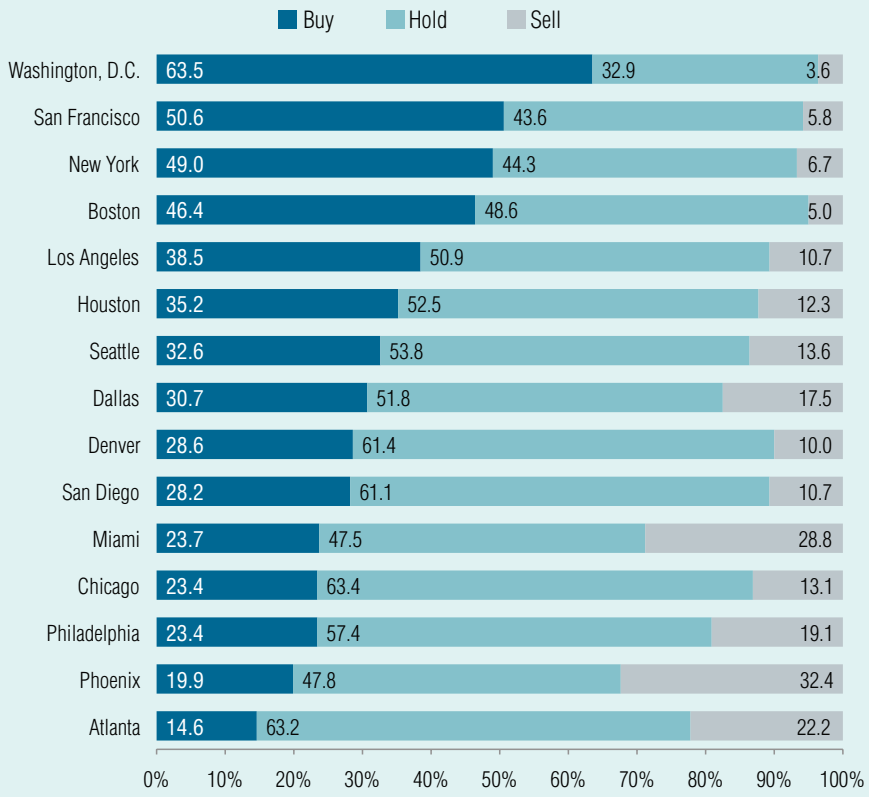
U.S. Industrial/Distribution Property Buy/Hold/Sell Recommendations by Metro Area



Source: *Emerging Trends in Real Estate 2010* survey.

EXHIBIT 3-7

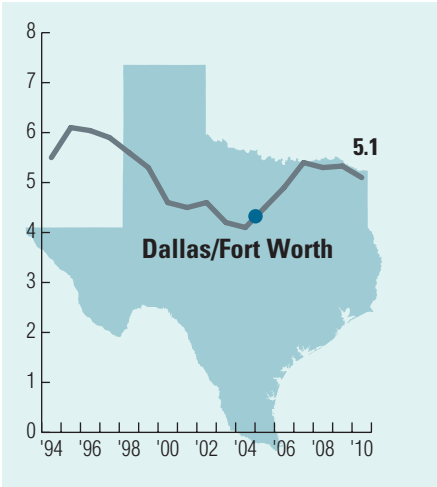
U.S. Office Property Buy/Hold/Sell Recommendations by Metro Area



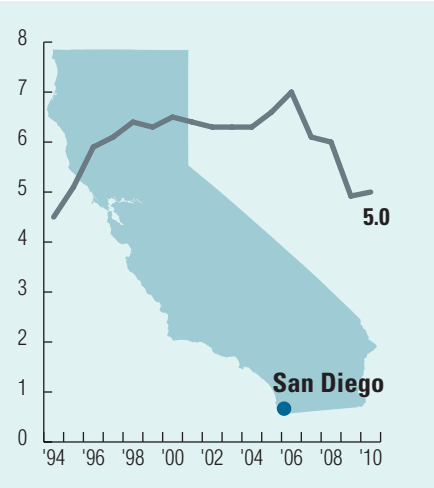
Source: *Emerging Trends in Real Estate 2010* survey.

hurtled back to more rational levels, and new homebuyers can make "great deals" among all the foreclosures—residential markets actually edge off bottom. Southern California looks like a developing opportunity play. Slowly, demand will rebound for premium assets, across all property types, especially in the top submarkets adjacent to the coast and near executive housing around desirable hillside valleys. For warehouse investors, the L.A.–Long Beach deepwater port and expansive regional distribution hub remains the number-one U.S. target. Homebuyers and businesses always will pay more for strategic commercial locations, Pacific vistas, and Mediterranean climate. At the end of the day (those gorgeous ocean sunsets), L.A. retains its considerable attractions. Inland Empire office and residential as well as other off-coast locations present another story—these desert areas won't bounce back nearly as quickly. Many debt-burdened middle-income residents face the double whammy of cratered housing prices and increased tax burdens. These folks may have no choice but to move out of state.

Dallas. "It may be better here, but it's still awful." Low cost of living and low taxes attract growth and limit downside. "We avoided the pricing boom, so we didn't suffer a pricing bust." Between a powerful congressional delegation and the last administration, federal dollars pour into the Metroplex. "A major gas field under Fort Worth doesn't hurt, either." The credit crisis shuts down hyperactive developers—"our equilibrium is 20 percent vacancy"—and continuing population inflows should make "for a great building environment after the current pause." This market offers "a pure timing play and timing will be good in the next few years." But you may have to hold to 2015 or later to realize any value.



San Diego. Without a major commercial harbor and lacking a gateway international airport, San Diego suffers more than other West Coast cities in the downturn. Although the area features an incredible year-round, balmy, blue-sky climate and attracts talent for high-tech and biotech jobs, the cost of living is California expensive and corporations don't get the advantages of proximity

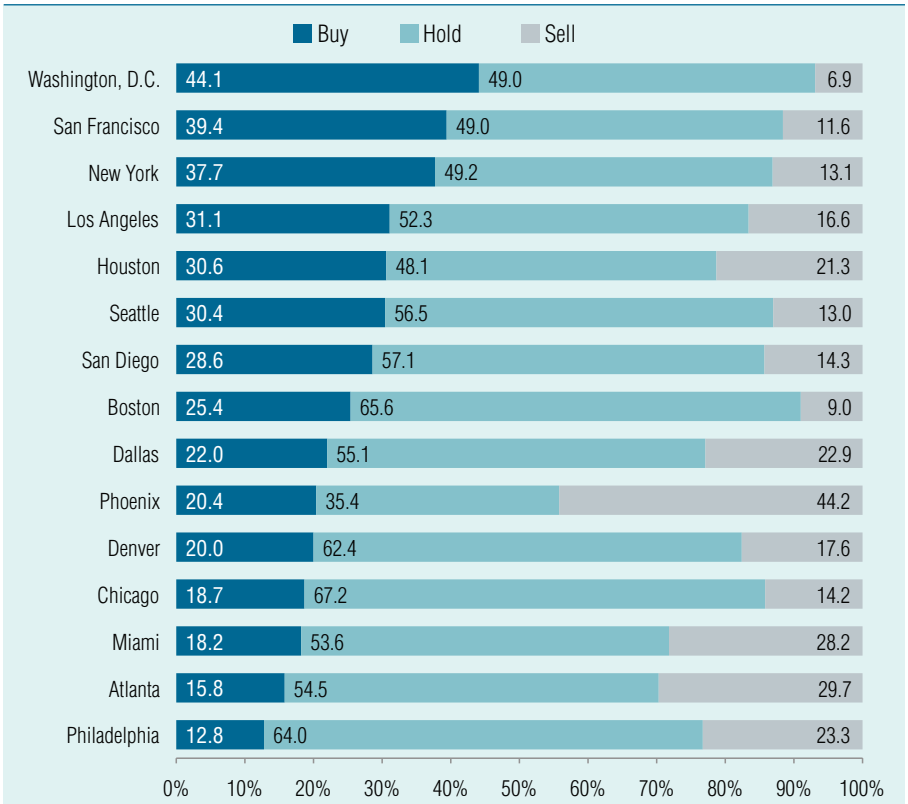


to international transportation hubs like L.A.'s or San Francisco's. Office vacancies approach 15-year highs at 20 percent. The housing swoon and homebuilding collapse knock local retail markets especially hard. But new homebuyers find great buys in neighborhoods that most couldn't touch three years ago, and commercial investors expect similar opportunities to percolate in their markets by 2011 or 2012. For 2010, the market is a pure hold.

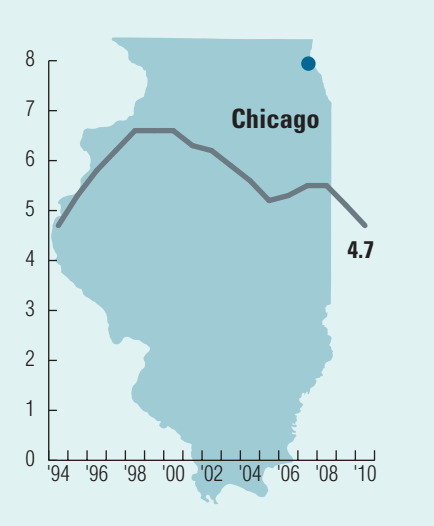
Chicago. Downtown office actually "looks healthy"—new projects lease up and the development pipeline runs dry. Twenty-four-hour amenities—particularly mass transit advantages—attract businesses to the Loop and North Michigan Avenue over suburban markets "where a bloodbath occurs" and "everything is under stress." But "disastrous" condo overbuilding traps downtown developers, who thought high-rise lakefront views would command an endless stream of buyers willing to pay large six-figure and million-dollar prices. Now, the shadow condo market softens rental apartments. Locals worry that Midwest malaise will stifle demand on all fronts. Deflated tourist and convention business nails hotels and the O'Hare industrial market suffers from shipping slowdowns. The dysfunctional state political system heightens the dread. "There's not much good to say."

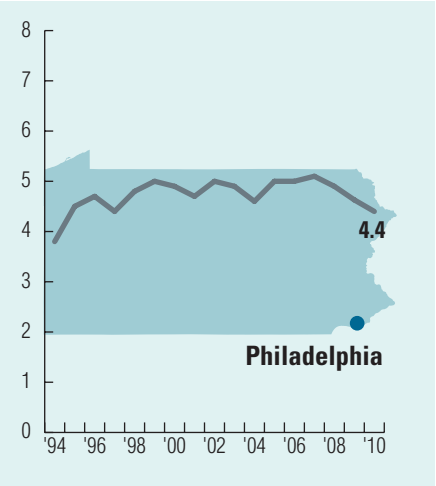
EXHIBIT 3-8

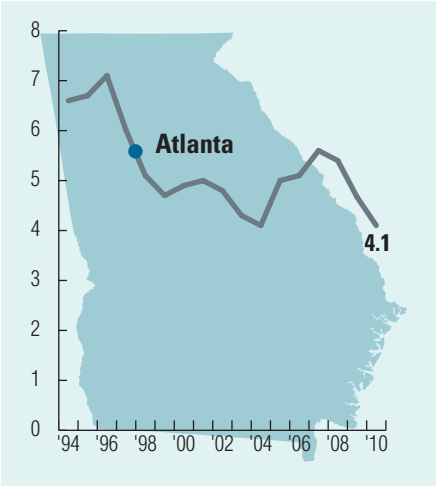
U.S. Retail Property Buy/Hold/Sell Recommendations by Metro Area

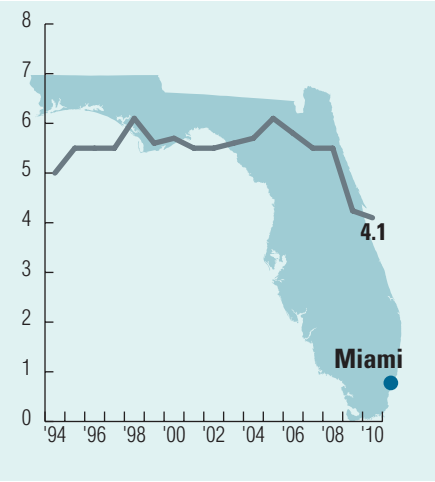


Source: *Emerging Trends in Real Estate 2010* survey.







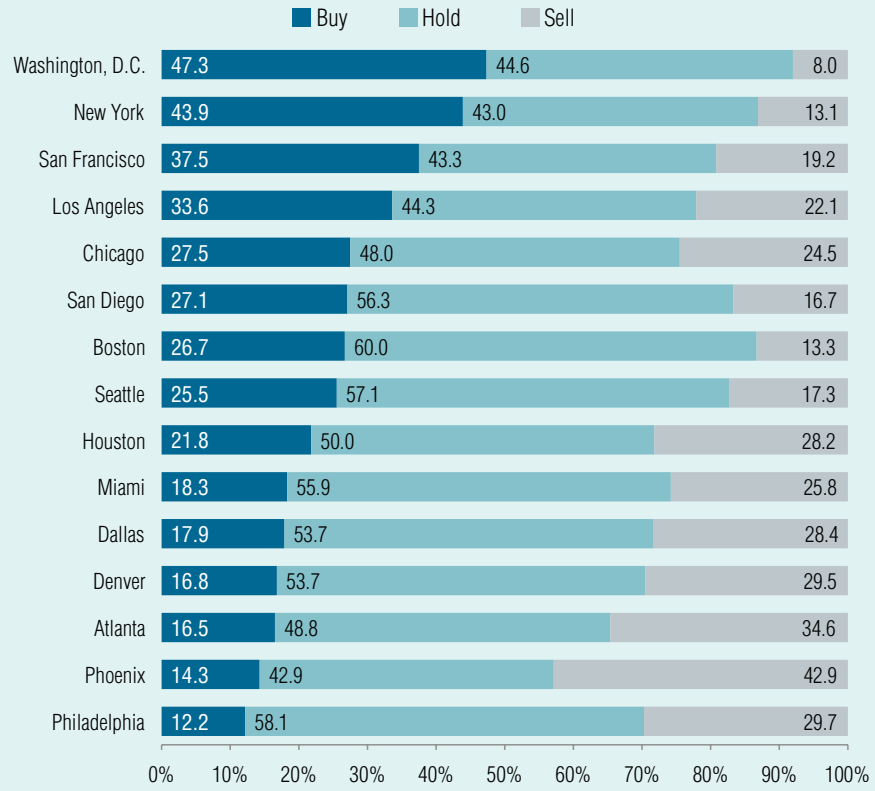


Philadelphia. This perpetually low-growth market suffers typical recessionary demand erosion, cushioned by the absence of any new construction. "We're holding up comparatively; that's better than the Sunbelt." Suburban office vacancy (20 percent–plus) increases ahead of Center City (mid-teens). Real high-speed rail lines (with trains that actually go 180 miles per hour) connecting 30th Street Station to New York and Washington, D.C., gateways might eventually boost Philly's prospects. Many survey respondents put it solidly in the "hold" category.

Atlanta. Urbanization and infill development will highlight future growth—after losing residents for decades, the city registers the largest percentage population gain of any surrounding regional county. Demographic trends take hold—young career-builders and empty nesters move closer to urban nodes. Apartment and townhouse living gains traction in a market reaching its sprawl limits. Midtown solidifies its healthy core around a 24-hour street grid of skyscraper offices, residences, and hotels. But once again, local developers go overboard and rush well ahead of market demand for infill space. "Disaster" strikes uptown Buckhead—now probably the nation's worst office submarket. Four speculative office buildings open with minimal leasing interest just as unemployment reaches quarter-century peaks. Condo projects stand mostly empty up and down Peachtree Road. "Everybody is always building and counting on growth to fill space," explains an interviewee. "Office tenants have hundreds of opportunities to find Class A space at rent levels of 20 years ago." Condo unit buyers can almost name their price. Ironically, outer suburban districts face fewer problems—developers all bought the infill story and slowed projects beyond the Perimeter. Interviewees complain about state government favoring rural interests and balking at expanding mass transit to support urban growth and reduce mounting road congestion. But in the next breath they stay bullish, pointing to continuing corporate relocations—"NCR is moving here." That's all the more reason to keep on building.

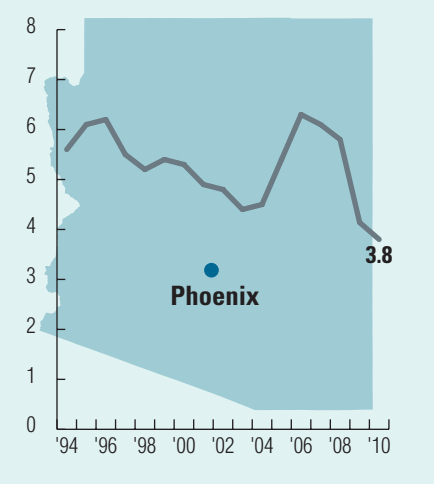
Miami. If you always wanted that South Beach condominium, looking onto the sparkling, blue Atlantic, start hunting for generational bargains in 2010. Winnowing down all the alternatives from among the scores of failed projects presents buyers with their greatest challenge. Historically in Miami, prime oceanfront and Biscayne Bay apartments escalate in value once demand finally absorbs oversupply from out-of-hand building booms. And this boom probably rates as the most overdone ever. Lenders not only tally all their botched condo construction loans, but also drown in a growing pool of failed hotel acquisition and redevelopment financings. Overleveraged resort owners bleed red ink—occupancies and room rates shrivel just when they needed a cash flow surge to pay for glitzy redesigns. Office and industrial investors do better—these sectors stay in relative balance thanks to more restrained development.

EXHIBIT 3-9
U.S. Hotel Buy/Hold/Sell Recommendations by Metro Area



Source: *Emerging Trends in Real Estate 2010* survey.

Phoenix. So much building and suddenly so little demand—Phoenix is the poster child for run-amok housing development hitting the wall when cheap mortgage financing evaporated. Once the building engine stopped, unemployment jumped, retail sales careened, property values dwindled, and new projects were dead on arrival when they opened. The important hotel and golf resort business also nosedives in the recession. "The best you can say is the population is still growing." Cycle timers will jump back in over the next couple of years, but there's no hurry.



Smaller Market Prospects

San Antonio benefits from Texas's good spin . . . . **Portland** plays second fiddle to Seattle, growth controls keep the market in reasonable supply-demand balance and help foster a 24-hour, urban environment . . . . **Nashville** office rates "steady" performance, boosted by the country music scene . . . . **Honolulu** drops with declining tourist demand . . . . **Minneapolis** boasts a diversified commercial sector, which buffers the city against the Midwest manufacturing depression . . . . Florida markets—**Orlando**, **Jacksonville**, and **Tampa**—can't get much worse. They should start to experience some uptick in housing activity after hitting bottom . . . . **Salt Lake City** always gains when people leave California in search of more affordable cost of living . . . . **Sacramento** sinks in lockstep with the standing of state politicos . . . . **Las Vegas** will suffer a long hangover after overplaying its development hand, building too much of everything just as American consumers and homebuyers tank . . . . Institutional investors effectively write off much of the low-to-no-growth Midwest manufacturing zone . . . . **New Orleans** rebuilds its tourist business, but corporations steer clear.

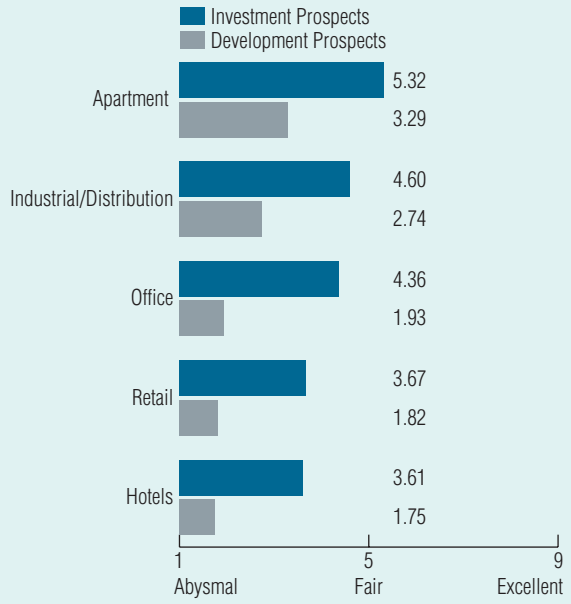
Property Types in Perspective

For 2010, investment outlooks dampen across all property sectors. Most markets approach a treacherous cyclical bottom where owner-borrowers and lenders digest widespread value losses and defaults, as well as confront problematic tenant demand and flagging net operating incomes. Landlords struggle to maintain occupancies and cash flows, as well as "wonder what good tenant credit means." Tenants nevertheless have the upper hand, seeking rent concessions and improvement capital, but they express angst over their landlords' financial viability—will properties go back to lenders or will new leases get hung up in special servicing tranche warfare? Deteriorating balance sheets may force the issue—underwater borrowers will give up feeding properties and better-capitalized owners will poach tenants. "The only way to secure value will be leasing the building so you do whatever you can to keep from losing tenants, then you try to deleverage and recapitalize." Interviewees expect many owners to curtail tenant services and wear-and-tear repairs. Property stock turns shabby from neglect—"landlords will let things go."

Emerging Trends surveys highlight the dismal state of play. They show declines in investment sentiment to record or near-record lows for most property types. Only rental apartments register fair prospects—all other categories sink into the fair-to-poor range. Hotel and retail record the most precipitous falls (see Exhibit 4-1). Development prospects, meanwhile, drop to new depths—close to "abysmal" levels for office, retail, and hotels. Warehouse and apartments score only marginally better at "modestly poor." No wonder developers close up shop.

EXHIBIT 4-1

Prospects for Major Commercial/Multifamily Property Types in 2010

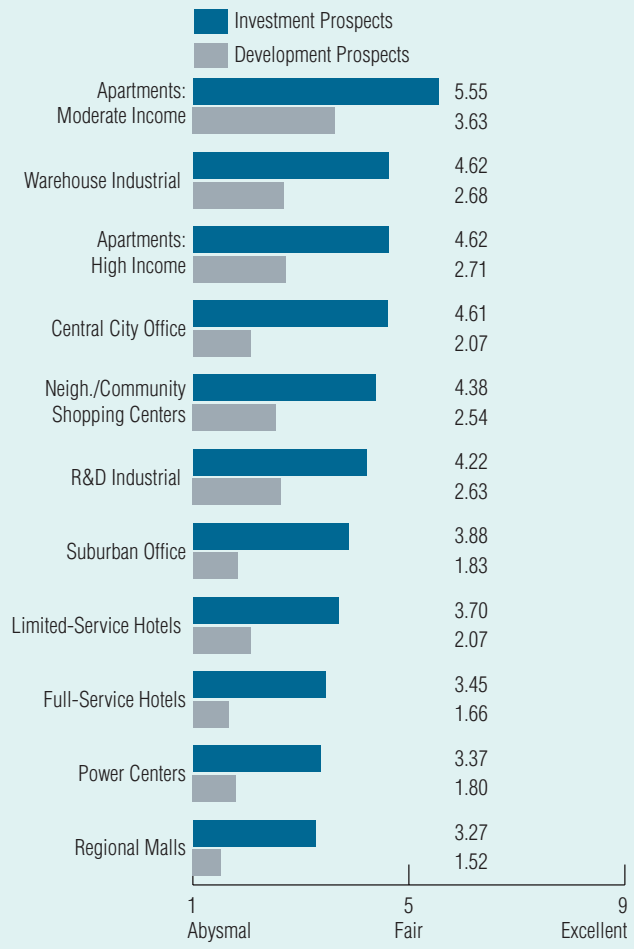


Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

EXHIBIT 4-2

Prospects for Commercial/Multifamily Subsectors in 2010



Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

■ **Apartments** show flickers of life. Fannie Mae and Freddie Mac provide a source of financing, buffering some borrowers and facilitating transactions. Interviewees figure that any improvements in the employment outlook will help leasing and stop rent declines. They count on increasing numbers of young adult echo boomers to help accelerate leasing demand and values in a recovery.

■ **Industrial/distribution** properties endure historically high vacancies and rent deflation. Any recovery waits for a pickup in consumer spending, resumed homebuilding, and restocked manufacturer inventories. Nobody expects sudden improvement, and certainly not in 2010.

■ **Office** markets head into an unsettled period of owner defaults and tenant musical chairs. Landlords juggle to keep face rents up and limit tenant improvements, while holding lenders at bay. But tenants have the upper hand in a flight to quality away from Class B and C properties. Twenty-four-hour infill markets generally outperform suburban districts.

■ **Shopping center** owners hang on for dear life. A likely cheerless 2009 Christmas season could doom additional chain stores and local mom-and-pops, creating more vacancies, especially in second- and third-tier properties. Debt-burdened shoppers scissor their maxed-out credit cards and spend less on more-sporadic mall trips.

■ **Hotels** hit bottom first among the commercial sectors. The good news is that "fundamentals really can't get any worse." Luxury resort properties "are the worst of the worst." Rates plunge to attract any business, but fading cash flows can't support the overheads for staffs and attention to guests' hoity-toity needs. Values spiral downward at full-service hotels suffering from slumping room revenues, and many overleveraged borrowers will just give up. Lower expense-side, limited-service hotels may weather the storm better.

■ **Housing** reaches cyclical lows. It's time to buy. Bottom-feeders move in—sales pick up marginally in the worst-hit markets with escalating foreclosures and bank sales. Lack of credit hurts activity in more affluent neighborhoods. Buyers need significant cash stakes to obtain any financing, and all income strata struggle without easy credit. Comatose homebuilders need to hang on until activity picks up, probably by 2012.

Top Buys/Sells/Holds. As markets regain footing at cyclical lows, don't sell anything in 2010 unless you have no other choice. *Emerging Trends* surveys also advise delaying purchases—at least until market visibility improves. Hold-and-pray strategies seem the order of the times—only moderate-income apartments score a fervent buy recommendation and

EXHIBIT 4-3
Prospects for Capitalization Rates

	Cap Rate August 2009 (Percent)	Expected Cap Rate December 2010 (Percent)	Expected Cap Rate Shift (Basis Points)
Full-Service Hotels	9.59	10.08	+49
Limited-Service Hotels	9.71	10.15	+45
Power Centers	8.66	9.11	+45
Regional Malls	8.25	8.70	+45
Suburban Office	8.85	9.28	+44
Neighborhood/Community Shopping Centers	8.32	8.72	+39
Apartments: High Income	7.54	7.91	+36
Central City Office	8.03	8.39	+36
R&D Industrial	8.70	9.03	+33
Apartments: Moderate Income	7.64	7.90	+26
Warehouse Industrial	8.30	8.54	+24

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

institutional investors might go after big-box warehouses or 24-hour office at the right price. For now, buyers know their time approaches and owners just hope they won't be forced into dispositions.

Cap Rates Spike. Overall, cap rates will continue to shoot up across all property categories from mid-2009 to year-end 2010, led by average increases of 45 basis points in the least-favored hotel and retail sectors, according to our survey. By year-end 2010, average cap rates will range from about 8 percent for moderate-income apartments to more than 10 percent for hotels. (See Exhibit 4-3.) These figures contrast with an approximate 7 to 9 percent spread in rates forecast for year-end 2009 in last year's report, revised upward to 7.5 to 9.6 percent in this year's survey. Interviewees suggest that cap rates for higher-quality institutional properties will settle in the 7.5 percent range, a sizable 200-basis-point jump from 2007 lows. Buyers will demand much higher yields from properties located in secondary and tertiary markets and for B- and C-quality product.

Green Buildings. Since the industry tailspin ices most development activity, momentum for eco-friendly, energy-saving buildings stalls. "Green has been tabled for now," says a leading institutional investor. "The recession makes it less of a priority and nobody has extra money to spend retrofitting." Most interviewees expect developers to seek LEED certification for any future projects. "Tenants want reductions in energy costs and big companies need cover for their corporate responsibility statements." Investors realize that "a green story" helps lease space faster even if "tenants won't pay more for it." They expect that "when they go and sell a property in five or ten years they can fetch a bigger price" than comparable space without green features. Climate change issues aside, office tenants gravitate to buildings with heating and cooling systems that provide healthier air flows and help create better work environments, especially when they cram more employees into tighter quarters. "Tenants will demand these systems once they experience the difference." Costs can be prohibitive for retooling and greening mechanical systems in older space and over time brown buildings risk obsolescence. At the very least, "owners can find savings and gain good PR by instituting recycling programs and entering performance contracts with lighting suppliers to share in energy reduction costs." A minority view holds that green amounts to "trendy," "overblown marketing": "Just be efficient managing your operations, the rest is BS."

Apartments

Strengths

Pent-up demand grows for apartments. Twenty-somethings, who moved back in out of necessity, want out of parents' homes as soon as their employment prospects improve. The roommate thing also gets stale for people who had their own space until the recession struck. A huge generation Y cohort of young adults should be avid renters—they delay marriage and kids to build careers and many won't think about buying suburban houses until they have families. Lack of available mortgage financing and requirements for larger cash downpayments "take the bloom off housebuying" anyway. Demand for apartments should ramp up with the first signs of increased hiring, "especially in underserved markets." Access to Freddie/Fannie financing cushions apartment owners and enables transactions—values slide, "but it could be much worse." On the supply side, the apartment development pipeline runs dry.

EXHIBIT 4-4

U.S. Moderate-Income Apartments

2010	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.55	1st
Development Prospects	Modestly Poor	3.63	1st
Expected Capitalization Rate, December 2010		7.9%	

Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

EXHIBIT 4-5

U.S. High-Income Apartments

2010	Prospects	Rating	Ranking
Investment Prospects	Fair	4.62	3rd
Development Prospects	Poor	2.71	2nd
Expected Capitalization Rate, December 2010		7.9%	

Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

Weaknesses

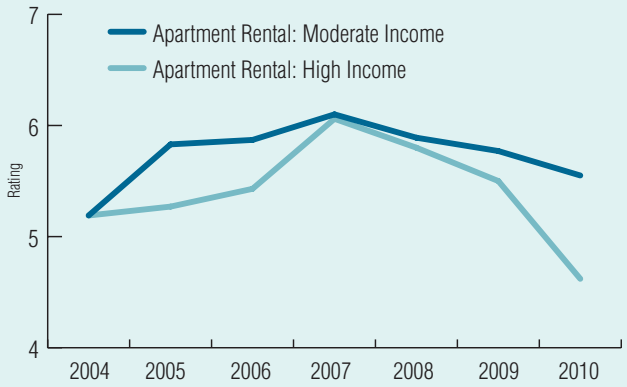
The jobs outlook hardly looks bright, delaying a pickup in renter demand. Shadow condos flood some multifamily markets with new supply, hurting occupancies and dropping rents, especially for upper-income apartments. National vacancy rates climb to record highs. Late-in-the-game buyers and developers must face the music—softened rents and a 150-basis-point rise in cap rates strikes a one-two punch.

Best Bets

Early buying opportunities may appear in higher-density infill markets convenient to commercial districts and mass transit. Concentrate on B and C "entry-level" product with opportunity for cosmetic upgrades and modest fix-ups. When increasing demand kicks in, short lease terms enable quick boosts to cash flows by raising rents.

EXHIBIT 4-6

U.S. Apartment Investment Prospect Trends

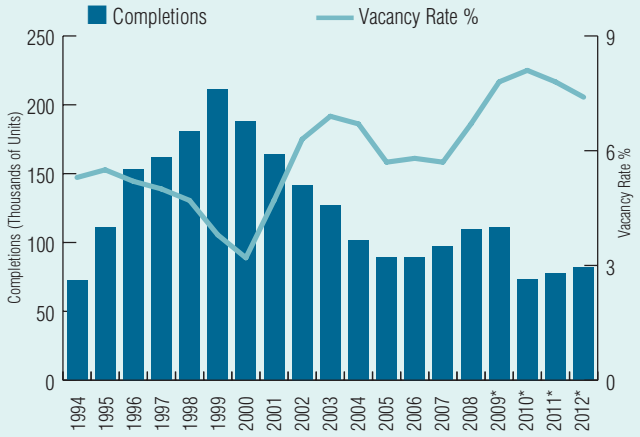


4 = modestly poor, 5 = fair, 6 = modestly good, 7 = good.

Source: *Emerging Trends in Real Estate* surveys.

EXHIBIT 4-7

U.S. Multifamily Completions and Vacancy Rates



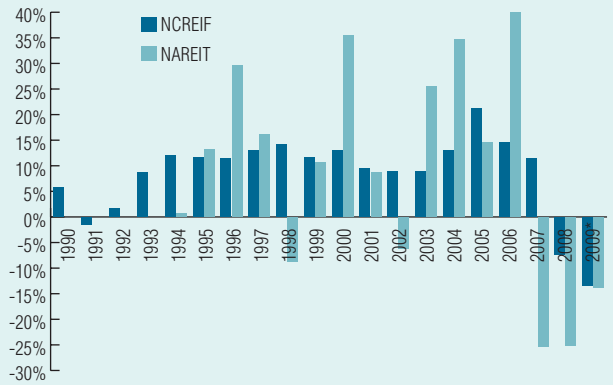
Source: REIS.

* Forecast.

Avoid

Avoid formerly hot-growth housing bust metro areas, particularly where developers overbuilt condominium projects. Until the for-sale residential market improves, owners and lenders will try to rent empty houses and condo units, further softening multifamily leasing and weakening property cash flows.

EXHIBIT 4-8
U.S. Apartment Property Total Returns



Sources: NCREIF, NAREIT.
* Data as of June 30, 2009.

Development

Building could resume "quickly" in underserved, urban infill markets once employment growth returns. It will be the first sector to come back for new construction—"maybe by late 2011." Projects may feature larger common areas—recreation and laundry rooms—and smaller units—people take less space in return for more building amenities.

Outlook

Multifamily investments historically provide the best risk-adjusted returns among property types—and current market experience reinforces investor views of the sector's relative resiliency. The expected early rebound in demand trends, supply constraints in many markets, and institutional investor appetite for income-producing properties add up to a solid, albeit not immediate, recovery track.

Industrial

Strengths

"The worst is over." Government statistics point to economic growth—import and export activity can't get any lower, and businesses build inventories again . . . finally. "Any increase in global trade will help." Tenants "begin locking in lease deals," a sign of markets finding a floor. Credit markets resume trade financing, which helps move more goods in and out of the country. Pension funds love the income from warehouse distribution properties in the top port and interior gateway-hub markets, bolstering prices. The big institutions will augment holdings in this sector once they get comfortable about markets bottoming.

EXHIBIT 4-9
U.S. Warehouse/Industrial

2010	Prospects	Rating	Ranking
Investment Prospects	Fair	4.62	2nd
Development Prospects	Poor	2.68	3rd
Expected Capitalization Rate, December 2010		8.5%	

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

EXHIBIT 4-10
U.S. R&D Industrial

2010	Prospects	Rating	Ranking
Investment Prospects	Modestly Poor	4.22	6th
Development Prospects	Poor	2.63	4th
Expected Capitalization Rate, December 2010		9.0%	

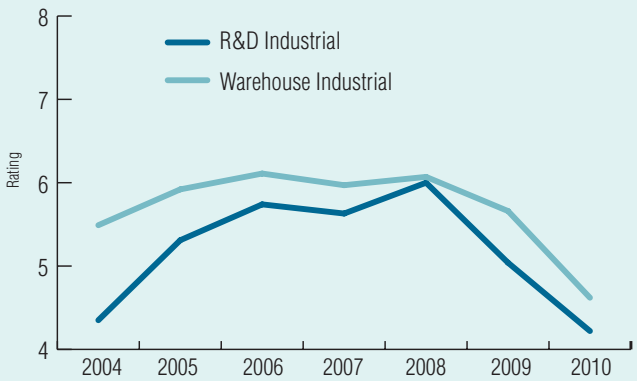
Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

Weaknesses

Ugh . . . . This highly economic-sensitive property type "gets slammed" by the worst recession since the Great Depression. Availability levels rise to record highs from "lack of imports," the "consumer deep freeze," and "dead housing" markets. Rents suffer "unprecedented declines" as demand "turns incredibly soft." Some key markets overbuilt—the Inland Empire, Chicago O'Hare, Atlanta, and Dallas. Beware of shadow space—"there's a lot of it." Manufacturing areas (the industrial Midwest again) simply tank. Until consumers start buying more and homebuilding resumes, warehouse markets will struggle. "Employment growth is essential."

EXHIBIT 4-11

U.S. Industrial/Distribution Investment Prospect Trends

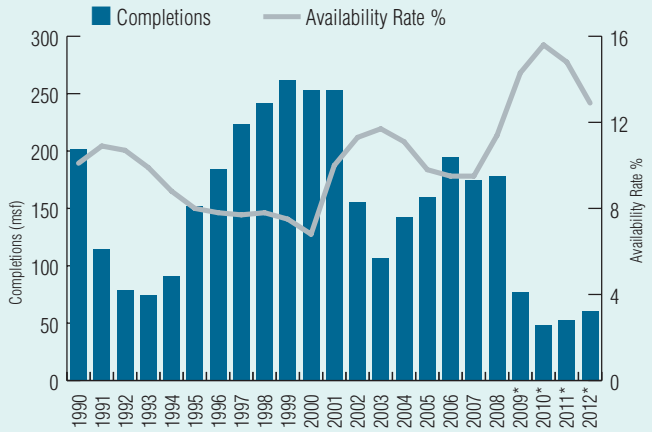


4 = modestly poor, 5 = fair, 6 = modestly good, 7 = good.

Source: *Emerging Trends in Real Estate* surveys.

EXHIBIT 4-12

U.S. Industrial Completions and Availability Rates

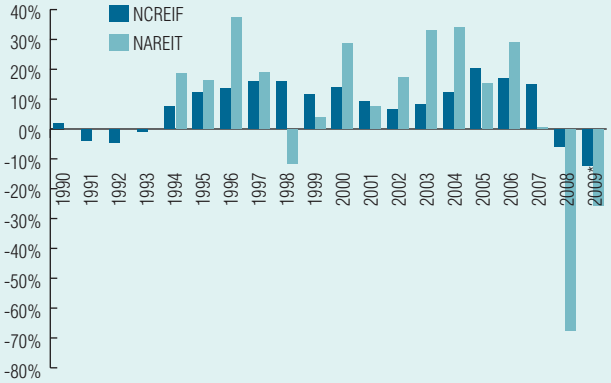


Source: Torto Wheaton Research.

* Forecasts.

EXHIBIT 4-13

U.S. Industrial Property Total Returns



Sources: NCREIF, NAREIT.

* Data as of June 30, 2009.

Best Bets

Investors should continue to focus on gateway ports, the key entry points for global trade—L.A.–Long Beach, San Francisco, Seattle, and New York–New Jersey. "That's where the action will be." Savannah may pick up some market share, too. Investors need to understand and accommodate supply-chain logistics strategies built around getting goods to market faster and keeping lean inventories. Properties require greater pass-through capacity for quick distribution and pads to accommodate larger trucks.

Avoid

Avoid smaller markets, which shippers could remove from streamlined distribution routes. Older storage-oriented warehouse properties increasingly look obsolete to tenants interested in distribution. As noted in past reports, "warehouse" slowly becomes an anachronism in major distribution centers.

Development

An absolute nonstarter! For the future, green initiatives, pioneered in Europe and Asia, allow for more warehousing closer to ports and within cities. These concepts may finally gain traction at severely site-constrained U.S. global gateways. Stacked warehouses, multiple levels as opposed to sprawl configurations, can accommodate four to five times more capacity on

sites at or near ports in contrast to single-story facilities 50 to 100 miles away from entry points (like the Inland Empire). Stacked configurations require less trucking, cause less pollution, and improve distribution efficiencies. Proponents argue that "it's an industrial extension of smart growth." But budget-stressed local governments must rethink zoning and infrastructure needs—residents and many businesses in infill areas resist warehouses close to neighborhoods and these buildings don't produce coveted sales tax revenues.

Outlook

Shipper logistics and pipeline controls (inventory tracking, consumption pattern analysis) anticipated the recession and led to rapid deceleration in tenant demand. "That never happened before—we always lagged." Once the economy improves, "trade can react more quickly to meet increased business and consumer demand and pick up faster." Warehouses could have "an above-average recovery," starting in late 2010 or 2011. New distribution systems will change and streamline goods delivery, slowing growth in demand for space and making certain locations and facilities obsolete. Rail freight should increase its market share as trucking costs (gas, tolls, user fees) increase—new interior railroad hubs may develop into key regional distribution centers. Increased Internet retailing also requires a different take on locating and organizing fulfillment centers. "Five years ago, you had multiple links in distribution chains—manufacturer, master distributor, regional wholesaler, and retailers," says an interviewee. "Now, when you order online, you can pay less, eliminating distribution costs. Up to three links don't need to be there and middlemen get eliminated."

Research and Development

Traditionally, high-tech areas exhibit sharp swings in vacancies and investment performance. Research and development (R&D) markets tend to overbuild in economic expansions and many failed startup company tenants are tough to replace in down times. Indeed, values plunged after the Internet bubble burst in 2000. But software- and tech-related businesses didn't overheat entering this recession and layoffs have been more restrained. Rising expectations for resumed economic growth around science and technology enterprises bode well for increased demand in this sector. Notably, important R&D markets—San Jose, Austin, and Raleigh-Durham—score relatively high ratings in *Emerging Trends* surveys. R&D also buoys outlooks for Boston, Seattle, and San Diego.

Office

Strengths

Well-leased, multitenant buildings with staggered lease rollovers "help smooth investor pain" despite overall rent and occupancy declines. Owners with low leverage have more options to maintain cash flows and can take full advantage of distressed competitors. They can bargain to hold or pirate higher-credit tenants, looking for landlords with staying power. Unlike in past cycles, most markets did not overbuild—"new supply is not our problem."

EXHIBIT 4-14
U.S. Central City Office

2010	Prospects	Rating	Ranking
Investment Prospects	Fair	4.61	4th
Development Prospects	Very Poor	2.07	6th
Expected Capitalization Rate, December 2010		8.4%	

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

EXHIBIT 4-15
U.S. Suburban Office

2010	Prospects	Rating	Ranking
Investment Prospects	Modestly Poor	3.88	7th
Development Prospects	Very Poor	1.83	8th
Expected Capitalization Rate, December 2010		9.3%	

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

Weaknesses

"It's never been so bad—there's just no demand." Many overleveraged properties head for foreclosure—borrowers give up as high contract rents roll off into a tenant's market and shrinking revenues make servicing debt undesirable or impossible. Increasingly, landlords can't afford tenant improvements to stay in the leasing game and risk losing even more occupancy. Property managers "don't see any internal growth from tenants for expansion, maybe some musical chairs between buildings and shopping for better rents at or near market bottom." Tenants have their own credit issues—unoccupied shadow space grows from all the layoffs and huge amounts of sublease space enter the market. Interviewees "don't like office anywhere" and their views grow less favorable about the sector's long-term risk-return profile: "Office is not a core investment." Returns are highly volatile—"not nearly as steady and solid as advertised." If a big tenant fails or moves out, "you're cooked." Suburban markets deteriorate more quickly than central business districts.

Best Bets

For cash investors, prepare to buy "the best product in top [24-hour] markets" like D.C., New York, and San Francisco by late 2010. "They will enjoy substantial gains over the next cycle." Demand may be "slow to come back, but it will." "Be contrarian and countercyclical—it's the only way to win in office."

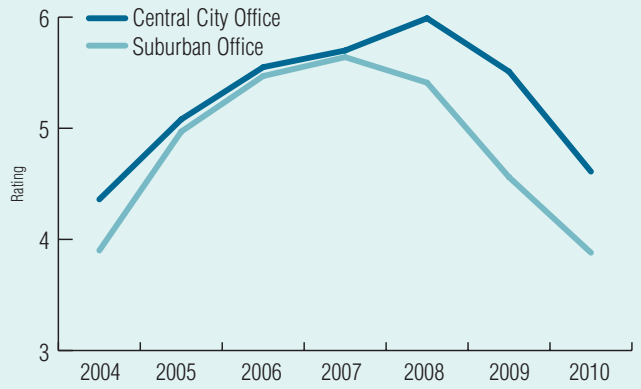
Tenants shouldn't sign new leases unless they extract healthy concessions on longer terms, and should steer clear of negotiations, if owners look like default candidates. Landlords may preserve cash flows through new leases at lower rates, but could impair properties' long-term value. In some cases, they'll do better standing pat.

Avoid

Avoid suburban markets. Urban and infill areas should benefit from demographics changes and economic shifts working against many suburbs. The "move back in" by echo boomers and empty nester baby boomers continues, and office tenants migrate toward suburban nodes with more urban amenities. Rising car-related costs (gas, insurance, user fees, loans) and increased congestion don't help the suburban office story, either. In particular, obsolescence threatens older office parks.

EXHIBIT 4-16

U.S. Office Investment Prospect Trends

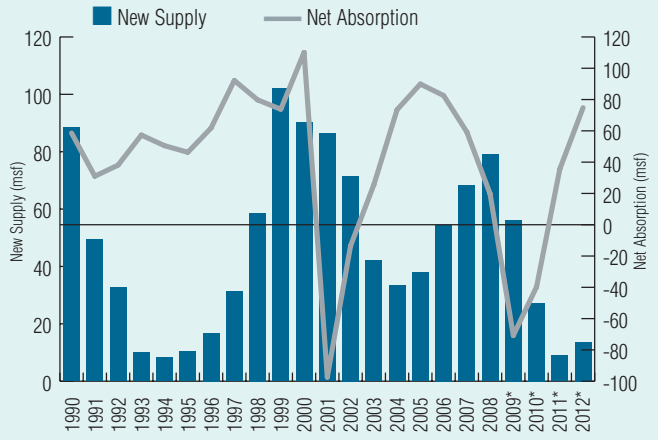


3 = poor, 4 = modestly poor, 5 = fair, 6 = modestly good, 7 = good.

Source: *Emerging Trends in Real Estate* surveys.

EXHIBIT 4-17

U.S. Office New Supply and Net Absorption



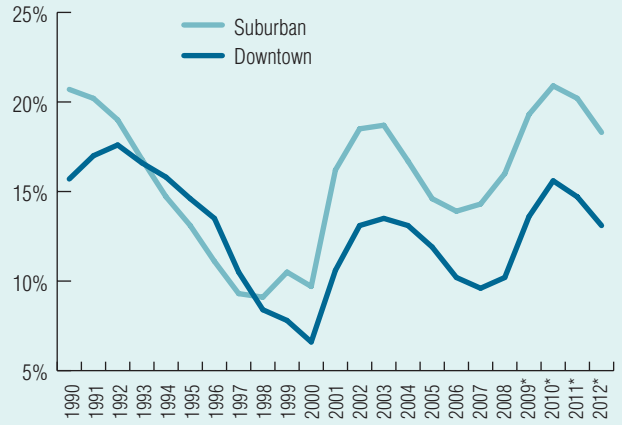
Source: Torto Wheaton Research.

* Forecast.

Development

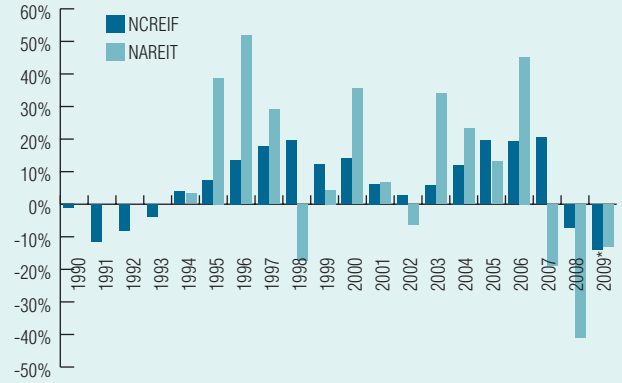
Builders can leave on long sabbaticals. Replacement costs won't justify new projects for four or five years in many markets unless job growth accelerates beyond forecasts to sop up excess supply. "The reality is only a brief window exists where rents justify new office construction during any cycle," says a developer. And that window is firmly shut.

EXHIBIT 4-18
U.S. Office Vacancy Rates



Source: Torto Wheaton Research.
* Forecast.

EXHIBIT 4-19
U.S. Office Property Total Returns



Sources: NCREIF, NAREIT.
* Data as of June 30, 2009.

Outlook

Don't expect any spikes in this recovery given the dearth of employment generators and rising vacancies. New demand could stall well into 2011 or even 2012. Employers continue to seek outsourcing and productivity gains, especially in the financial industry. Big companies pursue various options to reduce costs, use space more efficiently, and increase "people-per-seat metrics." "They count on young employees to adapt to paperless environments as well as more work-at-home and open space hoteling strategies." These secular trends could "mitigate any office rebound."

Retail

Strengths

Top-tier fortress malls and infill grocery-anchored shopping centers attract prime retailers, consolidating space in the best centers. Long durations in leases signed with national chain stores also help insulate mall owners. Outlet centers and dollar stores outperform—value-driven shoppers seek to stretch their dollars. Optimistic mall owners count on the demographic bubble of young people to jump-start consumption eventually—"these kids haven't been brought up on denial." Household formation, driven by echo boomers and immigrants, certainly should help reinvigorate store sales at some point—the U.S. population increases by about 3 million annually . . . . Admittedly, we're groping to find any near-term positives.

Weaknesses

"Worse than office"—ouch, that's bad! Shopping center owners operate in Darwinian mode. "We're seeing triage among the B and C properties" trying to retain tenants. "It's back to the early 1990s when stores abandon weak centers" and investors have

EXHIBIT 4-20
U.S. Neighborhood/Community Centers

2010	Prospects	Rating	Ranking
Investment Prospects	Modestly Poor	4.38	5th
Development Prospects	Poor	2.54	5th
Expected Capitalization Rate, December 2010		8.7%	

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

EXHIBIT 4-21
U.S. Power Centers

2010	Prospects	Rating	Ranking
Investment Prospects	Poor	3.37	10th
Development Prospects	Very Poor	1.80	9th
Expected Capitalization Rate, December 2010		9.1%	

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

EXHIBIT 4-22
U.S. Regional Malls

2010	Prospects	Rating	Ranking
Investment Prospects	Poor	3.27	11th
Development Prospects	Very Poor	1.52	11th
Expected Capitalization Rate, December 2010		8.7%	

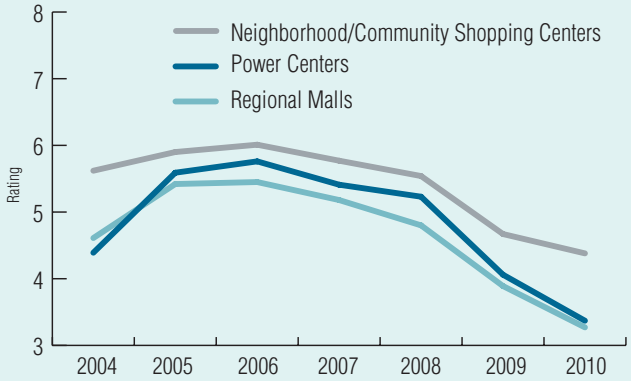
Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

limited options. "Back then, you could dump properties; today, there's no sales market without financing available, although you see some seller-financed mortgages." Everything heads lower, "much lower"—values, occupancies, and rents. Some centers "in secondary and tertiary markets will be worthless soon." Malls struggle to replace anchors—"department stores are a disaster, only a relative handful are left to serve some markets." Upscale centers have limited options—"you can't replace a Saks or a Neiman Marcus with a TJ Maxx or a Target." Local mom-and-pop retailers close when they can't get credit to buy inventories. We could go on and on . . . .

Best Bets

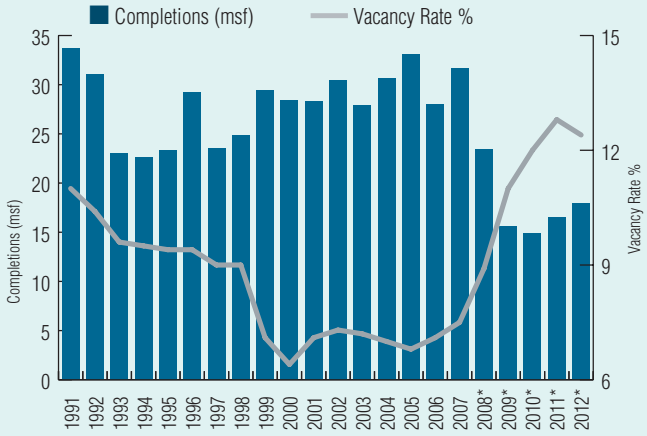
Neighborhood retail strips anchored by dominant supermarkets and drug chains attract necessity shoppers in established suburban districts. The big mall REITs own most fortress regional centers—they'll be left standing, too.

EXHIBIT 4-23
U.S. Retail Investment Prospect Trends



3 = poor, 4 = modestly poor, 5 = fair, 6 = modestly good, 7 = good.
Source: *Emerging Trends in Real Estate* surveys.

EXHIBIT 4-24
U.S. Retail Completions and Vacancy Rates: Top 50 Markets

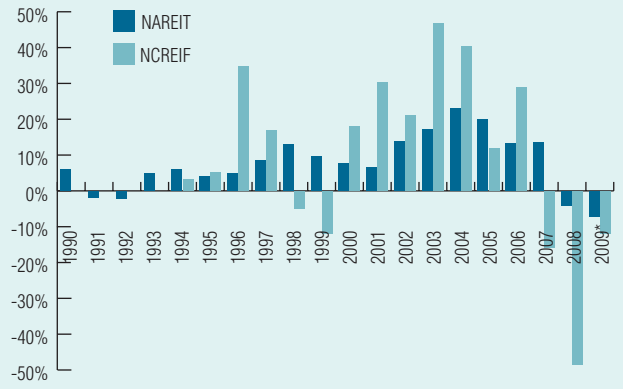


Source: REIS.
* Forecasts.

Avoid

Avoid C-malls abandoned by anchor retailers—"they're scarier than ever and unsafe at any speed." Power centers may endure another round of "big box" failures after Christmas and owners can't "backfill" with other tenants, who "don't exist." Forget about grocery retail in housing bubble markets where half-empty strip malls serve half-empty new subdivisions. Wealth destruction has pushed lifestyle centers out of fashion.

EXHIBIT 4-25
U.S. Retail Property Total Returns



Sources: NCREIF, NAREIT.
* Data as of June 30, 2009.

Development

Two decades of consumer bingeing on easy credit fostered an overstored America—malls, strips, big boxes, and leisure centers crowd together along every major suburban road. Does anybody know a market that needs any more retail space? Developers regroup to focus on reuse strategies—many malls and strip centers will be bulldozed for new town center projects and mixed-use development. Closed car dealer lots also provide fertile opportunities for more productive neighborhood planning. These projects will take years to conceive and construct. In the meantime, "It's Deadsville."

Outlook

Retail markets won't heal quickly. Even when jobs come back and wages increase, the American consumer will face new realities—tighter credit, leftover debt, and imploded house values. "They can't count on pulling dollars out of homes anymore through equity lines." Savings rates and taxes are bound to increase, eating into shopping budgets. New distribution systems and inventory controls mean retailers won't store as much merchandise on site—they can lease less space. The Internet slowly and inexorably takes market share from bricks-and-mortar retailers. Tech-oriented younger shoppers and time-constrained moms do more online purchasing. Shopping centers won't disappear—we just need fewer stores per capita and a wrenching shakeout ensues.

Hotels

Strengths

As usual, the lodging sector hit the skids early in the recession, and interviewees anticipate hotels to lead the commercial real estate industry in recovery. Economic improvement should produce better year-over-year performance numbers in 2010—occupancies and room rates will increase from "unnerving" lows. Although new supply added to overall market distress in 2009, construction activity effectively shuts down in 2010. Limited-service hotels should hold rates better and suffer less occupancy erosion despite cannibalizing competition from upper-end properties. "Even if the luxury brand drops its rates, I don't want my CFO breathing down my neck for staying in a ritzy place."

EXHIBIT 4-26
U.S. Hotels: Limited Service

2010	Prospects	Rating	Ranking
Investment Prospects	Modestly Poor	3.70	8th
Development Prospects	Very Poor	2.07	7th
Expected Capitalization Rate, December 2010		10.2%	

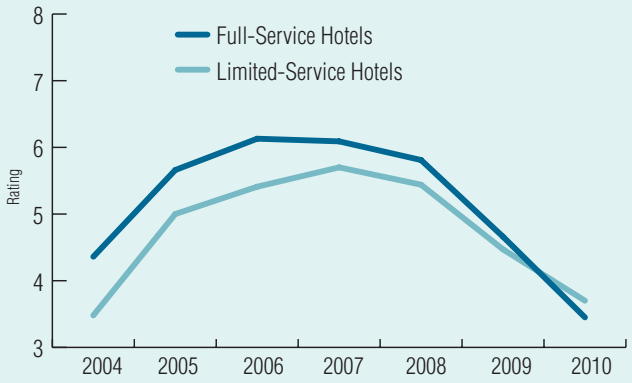
Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

EXHIBIT 4-27
U.S. Hotels: Full Service

2010	Prospects	Rating	Ranking
Investment Prospects	Poor	3.45	9th
Development Prospects	Very Poor	1.66	10th
Expected Capitalization Rate, December 2010		10.1%	

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on U.S. respondents only.

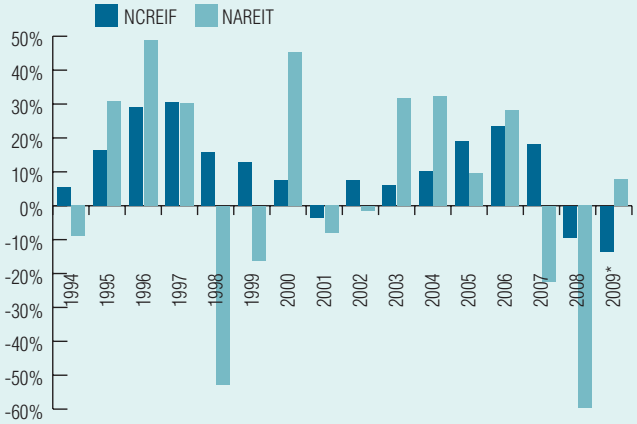
EXHIBIT 4-28
U.S. Hotel Investment Prospect Trends



3 = poor, 4 = modestly poor, 5 = fair, 6 = modestly good, 7 = good.

Source: *Emerging Trends in Real Estate* surveys.

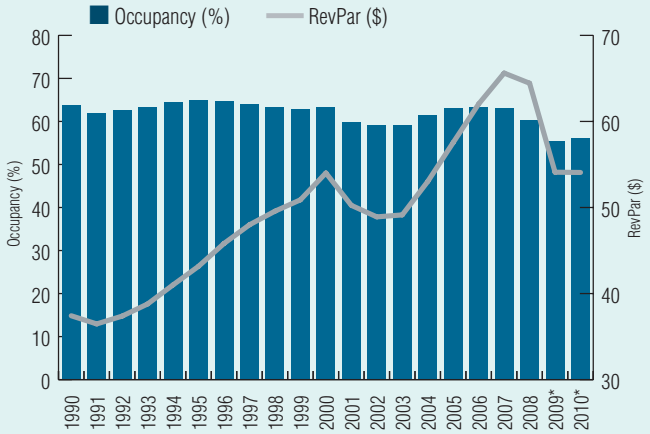
EXHIBIT 4-29
U.S. Hotel/Lodging Property Total Returns



Sources: NCREIF, NAREIT.

* Data as of June 30, 2009.

EXHIBIT 4-30
U.S. Hotel Occupancy Rates and RevPAR



Sources: Smith Travel Research (1987 to 2008), PricewaterhouseCoopers LLP (2009 and 2010).

* Forecast.

Weaknesses

Companies slash travel budgets and just about everybody postpones vacation plans. Industry-wide occupancies sink close to the 55 percent break-even point, and many recent buyers who overpaid near the market zenith live on borrowed time with large adjustable-rate mortgages. Developers and renovating owners, who finish projects started before the Lehman collapse, come to market at the worst possible time. Red ink steadily increases up the hotel service scale. Full-service and luxury brands suffer the biggest falloff in business. "High-end hotels turn into bottomless pits—they're labor intensive with huge debt service and nobody can afford to stay in them." Businesses also drastically curtail convention and group meetings, many of these hotels' bread and butter. Some operators skimp on upgrades and maintenance, threatening brand reputations, but what choice do they have?

Best Bets

Opportunities loom for investors to pick off prime downtown full-service hotels in gateway markets at basement pricing. When the economy perks up, property revenues can soar. Hotels present another "pure timing play." Always prepare to sell before the cycle gets too frothy.

Avoid

Pessimism clouds prospects for "love-to-look-at-them" luxury resort properties. "As wallpaper peels and pool tiles crack, RevPAR and occupancies will continue to decline. Tons of new capital will be needed to refurbish them."

Development

Huh?

Outlook

More properties head into lender REO portfolios just as property cash flows stabilize and improve marginally. Any revenue increases won't be enough to ameliorate widespread borrower distress. "More hotels will change hands than any other property type." The pace of recovery in occupancies and rates depends entirely on how fast the overall economy advances—corporate bottom lines, employment growth, and consumer spending. Expect special weekend rates and generous discounts to continue through 2010.

Housing

Strengths

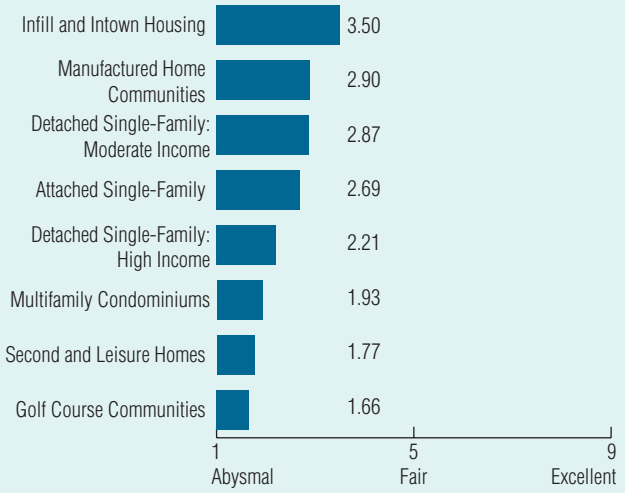
Housing markets hit bottom in most markets—bargain hunters with enough cash score deals, mostly on foreclosed properties in fringe neighborhoods and on new homes—builders' heavily discounted inventories steadily decline. Low interest rates and government incentives help some buyers—"it's ironic that's how we got into this mess." Homeowners won't sell unless they must. Over the next decade, the bubble of baby boomer progeny will start families and steadily drive demand.

Weaknesses

"Credit restrictions," problematic employment trends, and existing household debt loads slow sales and impede recovery. ARM balloon payment stipulations trigger more borrower defaults and foreclosures. Mortgage lenders stringently underwrite new loans at healthy spreads above the Fed Funds rate and require buyers to have ample equity stakes (at least 10 percent down on fixed-rate loans). Distress and foreclosures extend from subprime and lower-income neighborhoods into more affluent areas where the McMansion phenomenon—oversized houses purchased using jumbo-sized mortgages—"runs out of gas." "Many private homebuilders face bankruptcy or close down"—their inventoried land goes back to lenders, worth a small fraction of the prices they paid. Condo markets are simply "awful" unless you're a cash buyer.

EXHIBIT 4-31

Development Prospects for For-Sale Housing in 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

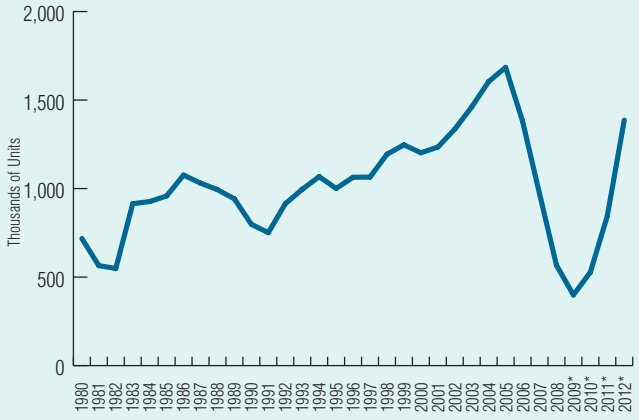
Best Bets

If you can marshal the dough, it's definitely time to house hunt in a classic buy-low market . . . . Resort-area condos could be prime targets—acquire that dream ocean-view apartment or comfy ski hill chalet at a fraction of 2007 prices . . . . Infill land sites present alluring opportunities, too—hold until demand rebuilds and then resell or develop . . . . Better-capitalized homebuilders can acquire damaged competitors—"they're ripe for the pickings."

Avoid

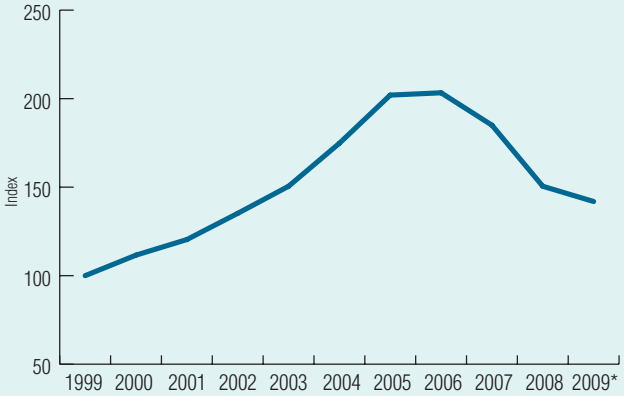
Avoid neighborhoods wracked by foreclosures, especially in outer suburbs—these places may have no staying power.

EXHIBIT 4-32
U.S. Single-Family Building Permits



Source: Moody's Economy.com.
* Forecast.

EXHIBIT 4-33
The S&P/Case-Shiller Home Price Index



Source: Standard & Poor's.
* Data as of June 30, 2009.

Development

When homebuilding does finally resume, housing and development patterns will become more urban focused—incorporating smaller lots, townhouses, and town-center mixed-use projects, which include single-family housing and condominium buildings. Developers also will construct more affordable housing options—European-scale layouts with smaller kitchens and bathrooms (no more whirlpools). More-frugal Americans realize they don't need all that space, especially if it saves on energy and taxes. "The extra bedroom, family room, recreation room, and three-car garage go by the boards."

Outlook

In 2006, the American dream collided with reality. Now, many homeowners and homeowner wannabes understand that "not everybody can afford or should own a home," and a bigger house isn't necessarily a better house to buy, especially if you're overextending on debt. Markets will take several years to clear, and many Americans must deleverage before they regain their appetite to buy houses again. Banks and regulators also need to recalibrate underwriting and reserve requirements to check out-of-hand lending practices. The Fannie/Freddie concept must undergo revamping, too—ample credit and market liquidity have their limits, especially when based on government guarantees.

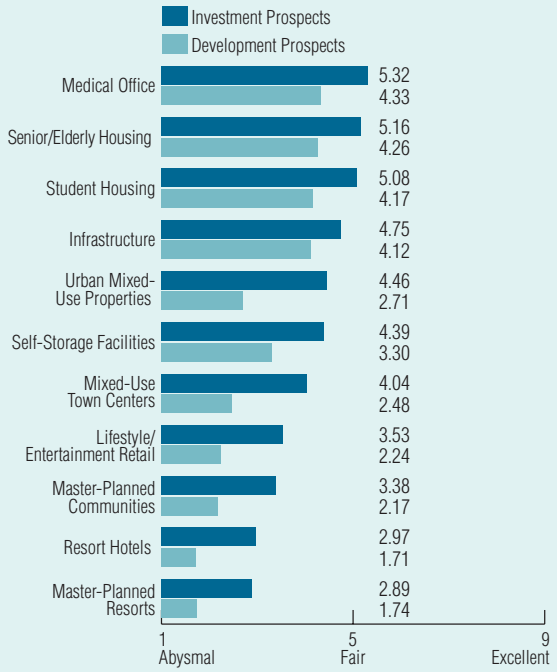
Niche Sectors

Niche real estate sectors generally drop from investor and developer radar screens—they have too many overwhelming problems in the primary property "food groups" and emerging buy-low opportunities in the major property types will draw most attention (see Exhibit 4-34). Complicated mixed-use and master-planned development projects, including town centers, get tabled or shelved entirely in the current inhospitable environment. All distractions aside, the following four niche categories retain significant long-term appeal driven by changes in demographics:

Medical Office. A steadily aging population will require more doctoring and health care—at least we learned something from the recent policy debate. Demand will grow for more physician, therapist, and hospital-related facilities, especially in gateway cities and regions where the elderly settle—the Southeast and Southwest in particular.

EXHIBIT 4-34

Prospects for U.S. Niche and Multiuse Property Types



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on U.S. respondents only.

Housing for Seniors. The same graying baby boomer population cohort, which pops more pills and suffers through more aches and pains, drives demand for over-55 residences, assisted living communities, and ultimately nursing homes. The country's 60-plus population more than doubles over the next 30 years—that blossoming demand translates into huge opportunities for investors and developers.

Student Housing. For the next decade, echo boomers will flock to university campuses in record or near-record numbers, augmenting demand for housing.

Infrastructure Needs. The United States desperately needs more private/public financing of outmoded and dilapidated infrastructure—transportation systems, water/sewage systems, dams, and electric grids. Federal, state, and local governments have failed to enact formulas, incentives, and procedures to attract greater private investment. But government budget shortfalls and trillion-dollar funding gaps should force solutions out of necessity. A federal infrastructure bank would help.

Emerging Trends in Canada

"The U.S. and Canada will be like night and day, and [the latter's] property markets will perform much better."

The United States could learn from Canada. The government has kept a lid on spending and slowly recovered from huge early-1990s budget deficits. Higher taxes help pay for health care and infrastructure improvements, and regulators clamp down on banks, discouraging high-risk lending. A wealth of natural resources—gas, oil, and water—helps buttress the nation's economy, too. The conservative, careful approach to managing government and markets pays dividends now for Canadian real estate players. Sideswiped by U.S. fallout, they experience a manageable market correction mostly from slackened tenant demand rather than a full-blown credit crisis–precipitated market meltdown. "Canada's problems are like Bud Lite compared to the United States."

Investment Prospects

Mild Recovery. Canadian interviewees exhibit little smugness about the relative lack of distress in their regions since some suffer big losses in U.S. real estate investments—pension funds in particular bought into the south-of-the-border froth. But Canadians take comfort and satisfaction "in steady as she goes" local markets, even if they are "boring, incestuous, and parochial, with lending activity governed by cautious bank credit departments and little trading of prime properties even in the best of times." For 2010, expect "flat to modestly improved" operating performance, after top-to-bottom value declines ranging from 10 to 20 percent for most investors. Softened markets generally avoid distress, except for "small pockets of condos," built by undercapitalized developers.

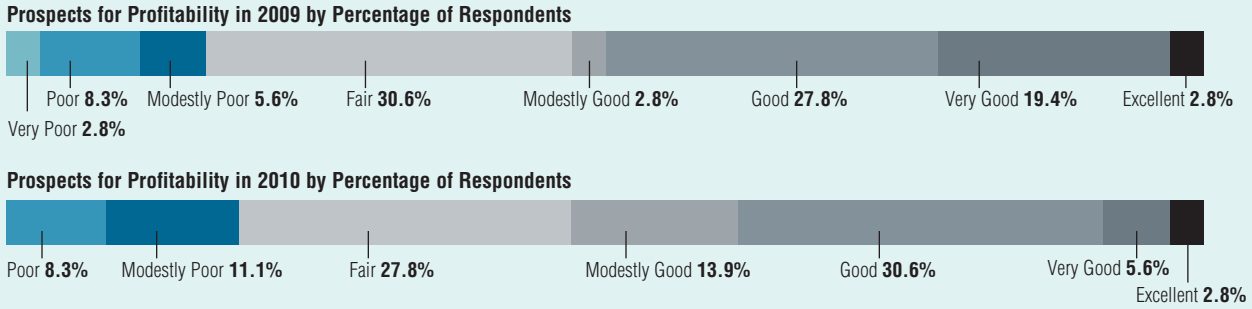
Little Opportunity. Relative market stability in Canada's "safe haven" removes the opportunity for most timing play bets in a moderate—"okay, not stellar"—cyclical upswing, which should get underway before 2011. Canada's dominant institutional investors implement core-style, buy-and-hold strategies, controlling most Class A downtown office buildings and fortress regional malls. This "handful" of companies and pension funds prizes income over short-term buy-appreciate-and-sell gambits. "Real estate retains its attributes; it's not commoditized like in the U.S." Canadian investors seek portfolio pop the old-fashioned way by developing projects or heading into foreign markets—Brazil and India are current favorites. "It's too soon to go back into the U.S."

Minor Distress. Most owners rest easy—"they won't face negative leverage" and major markets entered the downturn with record-low vacancies and limited new supply (except in Alberta). Defaults and foreclosures will concentrate in smaller properties in secondary markets and outer suburban districts—that's where any vulture investors congregate. "There won't be forced sales in primary markets."

Cross-border Concerns. Interviewees raise cautionary signals about the parlous state of the economy in the United States, Canada's principal trading partner: "We may look good by comparison, but we're very dependent on U.S. markets for our job growth." The auto industry collapse bleeds into Ontario's important manufacturing sector and lower demand for energy products knifes at western Canada's gas and

EXHIBIT 5-1

Firm Profitability Forecast

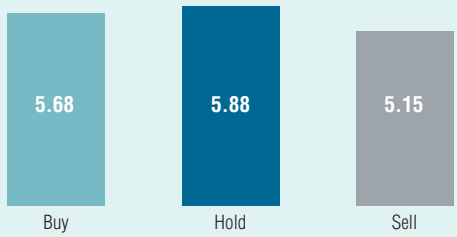


Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

EXHIBIT 5-2

Emerging Trends Barometer 2010



5 = fair, 6 = modestly good, 7 = good.

Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

energy centers. "We can catch U.S. pneumonia very easily." Sound federal and provincial government fiscal outlooks and stable financial institutions form the cornerstone of recovery. "We have minor government deficits compared to the U.S.—it helps not paying for wars." The big Canadian banks grow North American market shares and avoid any need for bailouts while the country's natural resource bounty hedges against higher commodity prices. The potential for rising interest rates, triggered by U.S. fiscal problems, "could stall out our recovery, but that's not all bad for real estate since higher rates place a governor on development and new supply. That's what usually gets us in trouble."

EXHIBIT 5-3

Prospects for Capitalization Rates

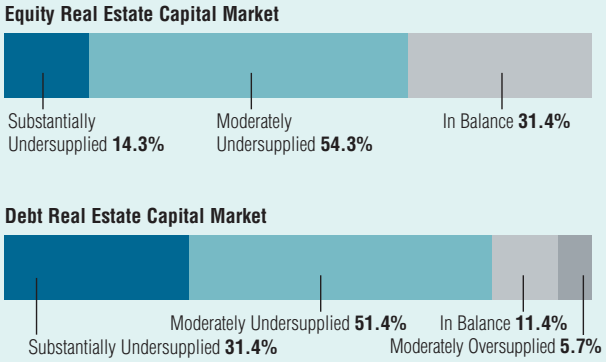
	Cap Rate August 2009 (Percent)	Expected Cap Rate December 2009 (Percent)	Expected Cap Rate Shift (Basis Points)
Power Centers	7.87	8.37	+50
Central City Office	7.11	7.56	+44
Suburban Office	8.14	8.51	+38
Apartments: Moderate Income	6.78	7.11	+33
R&D Industrial	8.10	8.43	+33
Warehouse Industrial	8.04	8.32	+28
Apartments: High Income	7.32	7.54	+22
Full-Service Hotels	9.52	9.70	+19
Regional Malls	7.48	7.66	+17
Neighborhood/Community Shopping Centers	7.74	7.88	+14
Limited-Service Hotels	9.47	9.42	-5

Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

Improving Mood. The *Emerging Trends* 2010 investment barometer forecasts a relatively stable transaction market, slightly better for buyers than sellers (see Exhibit 5-2). According to surveys, average cap rates will increase modestly by year-end 2010, ranging from about 7 percent for moderate-income apartments to 9.5 percent–plus for hotels. Power centers and central city office will register the sharpest increases. Hotels, malls, and neighborhood shopping centers will record the smallest bumps. "Nothing comes cheap—we

EXHIBIT 5-4
Real Estate Capital Market Balance Forecast for 2010



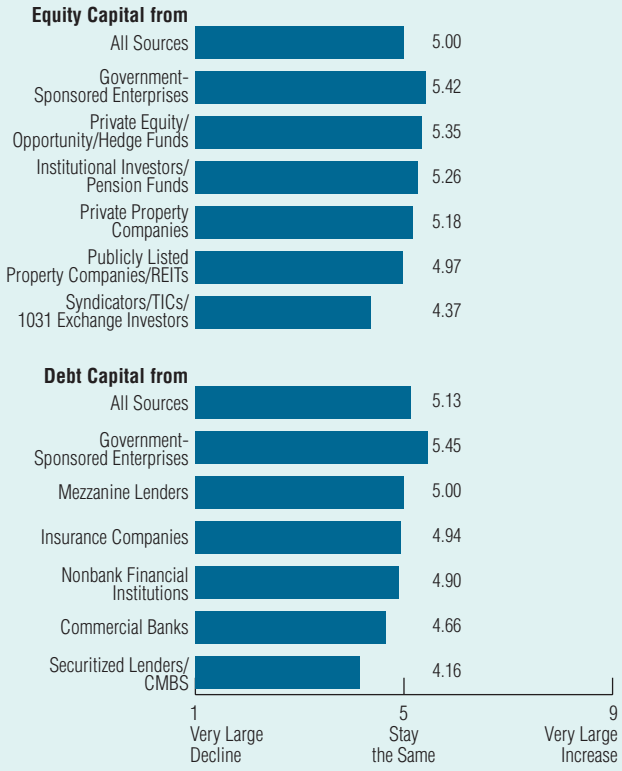
Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

should see value increases by the end of the year after a period of slowing declines." Hotels and secondary retail suffer the biggest depreciation—off as much as 30 percent—while Toronto office loses 10 percent from peaks. A sizable bid/ask spread should narrow, if tenant demand picks up as expected and nervous banks increase financing to buyers. "A growing confidence lifts the market psyche"—some borrowers can obtain more credit, REITs have raised capital, owners aren't distressed, and the number of bids on deals shows slow improvement.

Construction Time-out. Developers must curb activity in light of softened demand as bankers rein in construction loans. Condo projects stall out until residential prices firm up in Vancouver and Toronto. Concern grows about Calgary office builders—a supply splurge meets waning demand from deflated energy companies. "Developers got ahead of themselves in Edmonton, too, stockpiling land for inventory." In Toronto, where some smaller developers got in over their heads in residential construction, bigger players with more experience and lender relationships take over struggling projects.

Capital Reticence. Banks and large pension funds took their licks in the world economic crisis, but remain solvent and well capitalized. Real estate lenders pull back out of caution and *Emerging Trends* surveys anticipate that debt markets will remain undersupplied in 2010 (see Exhibit 5-4). Bankers favor established borrower relationships—refinancing

EXHIBIT 5-5
Change in Availability of Capital for Real Estate in 2010

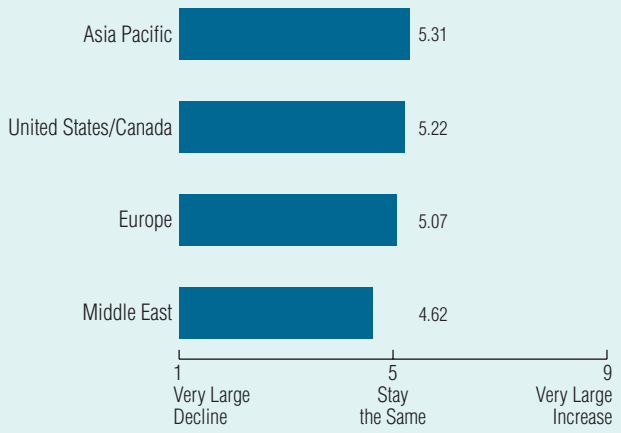


Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

should not be a problem. But they temporarily shut doors on developers and unproven investors. "Healthy" life insurers maintain their whole-loan business, somewhat offsetting the loss of securitization markets. Equity markets retain their share of reasonably capitalized and cash-rich investors. REITs "got whacked, now bounce back"—they will be early cash buyers, followed by "in-for-the-long-haul" pension funds. Plan sponsors may suffer value declines on their prime holdings, but will ride out the rough spots since "they're not

EXHIBIT 5-6

Change in Availability of Capital for Real Estate by Source Location in 2010

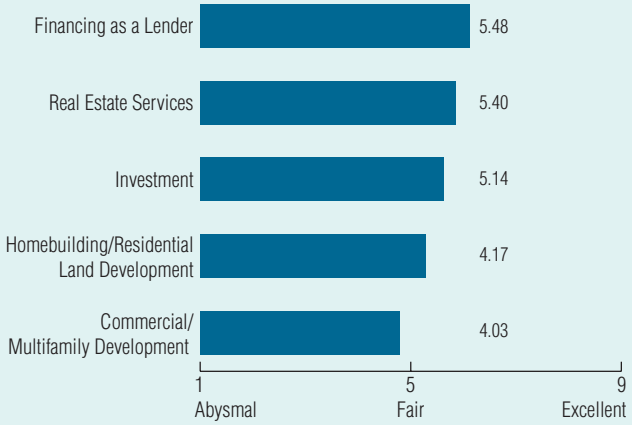


Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

EXHIBIT 5-7

Real Estate Business Activity Prospects in 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

interested in selling." High-net-worth families, buttressed by lender ties, will focus on acquiring "workout product" in secondary markets. But "disappointed" foreign investors may shy away. "They don't see enough big gains"—a 5 percent return with low risk isn't compelling enough compared to what's coming in the United States and the U.K. The big Canadian institutions prepare to increase foreign allocations, too. "Canada isn't as attractive even to Canadians—we'll find better returns elsewhere" in recovery. "Why buy Vancouver at a 6 cap when you can buy in London at a higher rate?"

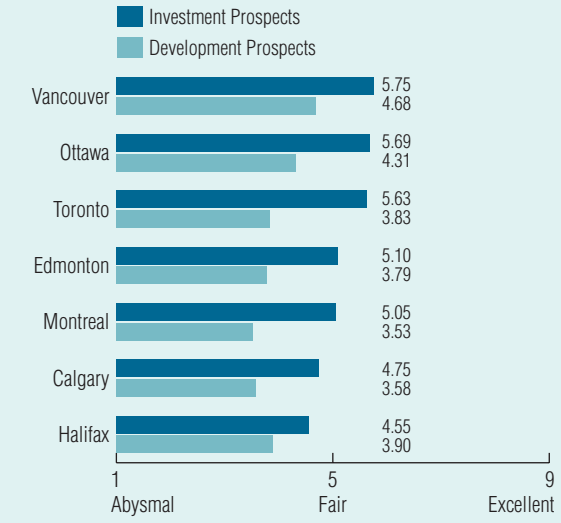
Markets to Watch

After a hot-growth wave, western Canada—especially Calgary—cools down. Plummeting natural gas prices take a "brutal" toll. Eastern Canada girds for more potential fallout from manufacturing woes—automaker bankruptcies and slack U.S. consumer demand inflict pain in Ontario, "the real engine

EXHIBIT 5-8

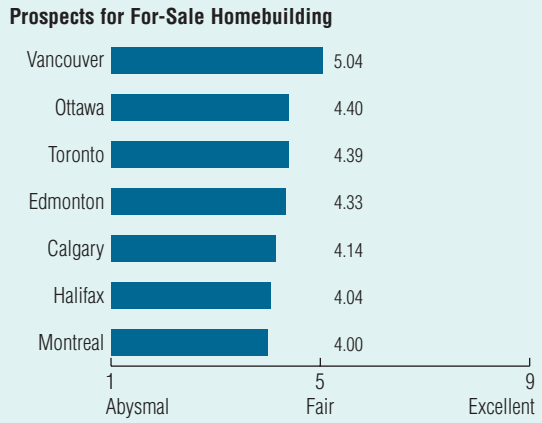
Canadian Markets to Watch

Prospects for Commercial/Multifamily Investment and Development



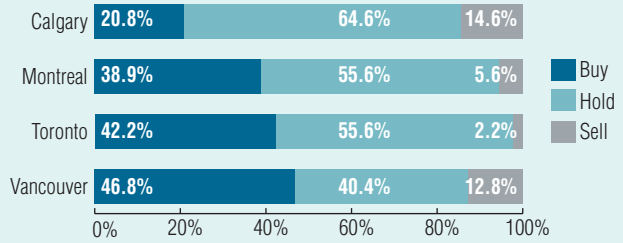
Source: *Emerging Trends in Real Estate 2010* survey.

EXHIBIT 5-9
Canadian Markets to Watch



Source: *Emerging Trends in Real Estate 2010* survey.

EXHIBIT 5-10
Canadian Apartment Buy/Hold/Sell Recommendations by Metropolitan Area

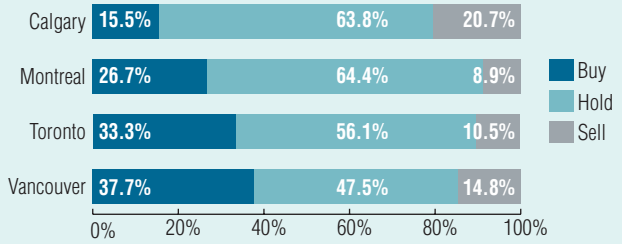


Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

of the country." Development prospects drop from coast to coast, although most markets stay in relative equilibrium—vacancies increase from low levels and rents continue to soften, especially in office and industrial.

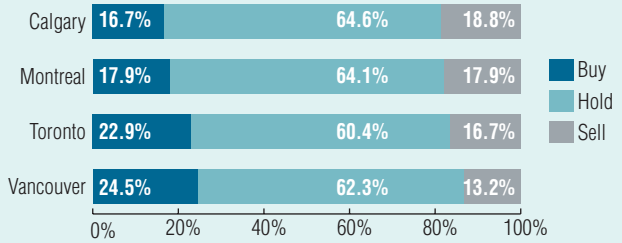
Vancouver. A classic barriers-to-entry story, this metro area's constrained property market always trades at "surprisingly" high price points, "defying gravity." Cap rates for prime properties "stay in [the] mid 6s" when "everywhere else is 7.5 percent." Interviewees wonder what happens after

EXHIBIT 5-11
Canadian Office Property Buy/Hold/Sell Recommendations by Metropolitan Area



Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

EXHIBIT 5-12
Canadian Retail Property Buy/Hold/Sell Recommendations by Metropolitan Area

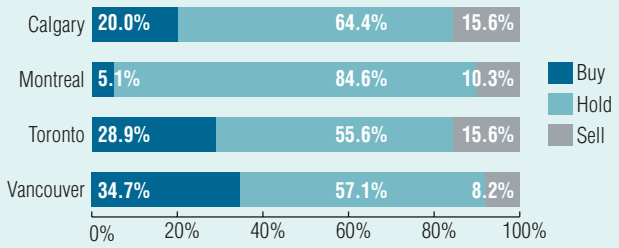


Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

the Olympics—will the city take on "global darling" status or endure "a big sucking sound?" Don't bet against the market—"It does bloody well under any circumstances." Condo development decelerates—banks and developers anticipate a demand slowdown after the games. Prohibitive replacement costs and few land sites shut down office development. Most institutionally owned properties don't trade and outsiders can't find many investment opportunities.

EXHIBIT 5-13

Canadian Industrial/Distribution Property Buy/Hold/Sell Recommendations by Metropolitan Area

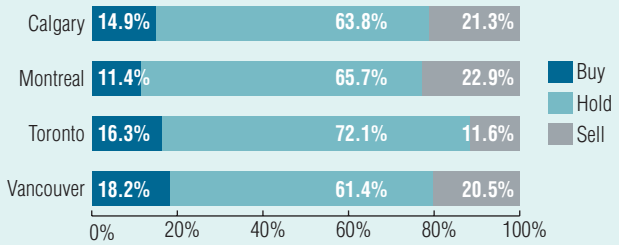


Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

EXHIBIT 5-14

Canadian Hotel Property Buy/Hold/Sell Recommendations by Metropolitan Area



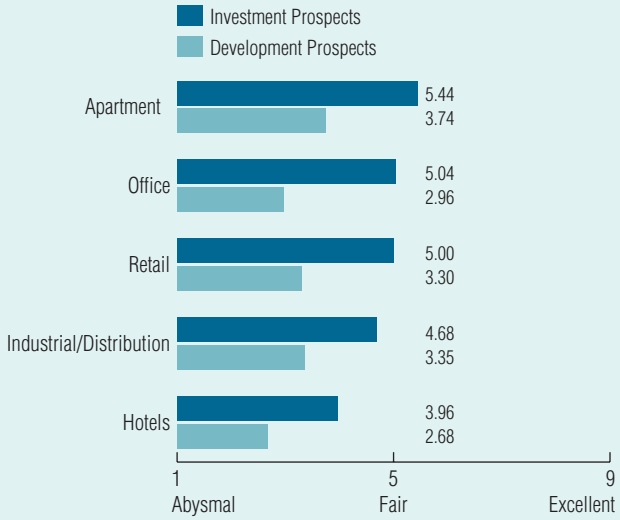
Source: *Emerging Trends in Real Estate 2010* survey.

Ottawa. Sentiment improves for this low-key national capital. Like Washington, D.C.—when recessions strike, investors seek refuge in government centers. Unlike Washington, a thin market doesn't offer much cover or opportunity. But at least owners of existing property won't notice much turbulence.

Toronto. Canada's global gateway is the country's "place that matters." Glistening new condominium high rises and office tower projects adorn downtown streetscapes, raising concerns about too much construction in a problematic economy. More than 4 million square feet of new Class A office space will spike downtown vacancies from comfortable 5 percent levels. "Tenants in older Class A space will move into new projects, leaving hard-to-fill holes." Affected institutional owners sport "deep pockets, can ring-fence issues, upgrade,

EXHIBIT 5-15

Prospects for Major Commercial/Multifamily Property Types in 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

and get by." Over the past decade, the city grows into North America's biggest condominium market. Now, banks wisely pull back funding on larger projects—"they see too many cranes." Weather—"people don't like shoveling snow," and driving-related costs—gasoline, time lost in congestion—spur more vertical, intown living. An immigrant influx—about 100,000 annually—helps keep apartments full. Single-family home and condo buyers surge to make deals before a new harmonized sales tax (HST) takes effect on July 1, and developers fear a demand drop-off afterward. The HST will add 8 percent to the purchase price of a new home to the extent it exceeds $400,000, and will not apply to resale homes; this perhaps will create a market bias in favor of smaller, lower-priced new homes, and provide a boost to the resale market. Warehouse markets stumble—rents decline 25 to 30 percent. Blame the U.S. car companies. "It's not Ontario's finest hour" and "a really tough leasing market." Watch for "further weakening on the demand side."

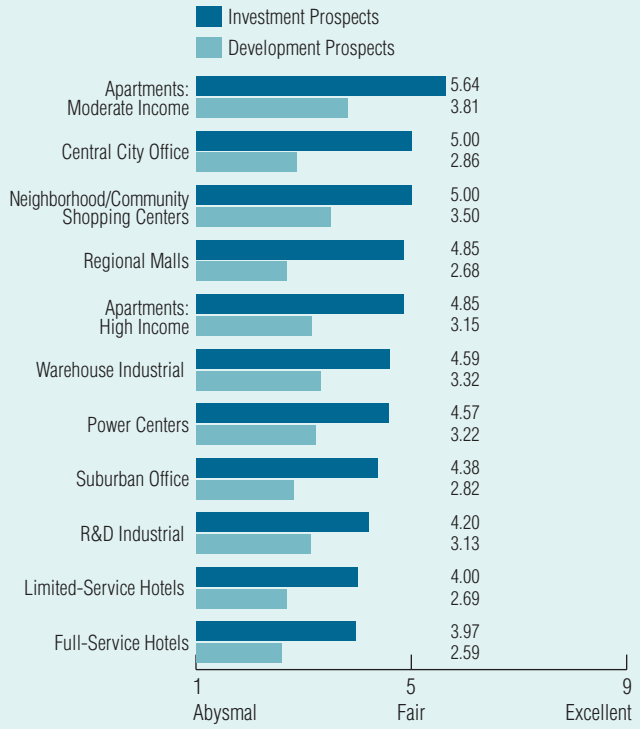
Edmonton. The provincial capital of Alberta dips with declining energy business fortunes—you can squeeze only so much out of oil sands and from gas extraction when volatile prices turn down. Developers didn't go overboard, so the demand drop won't hurt dramatically. "It's more steady as she goes and boring"—not so bad.

Montreal. Built up and around the mighty St. Lawrence River, Montreal stands out as one of North America's most beautiful cities, but companies find "no particular reason to be here." The real estate market sleepwalks through a boring equilibrium—measured development and limited demand growth. "It's a good place to live, but nothing's happening."

Calgary. Alberta's largest city suffers the biggest rating decline for any North American market in *Emerging Trends* surveys. About 6 million square feet of mostly speculative office comes online at just the wrong time. Condos and housing are overbuilt, too. Only higher natural gas prices can bail out developers. "It's a boom/bust market in a bit of bust phase, but good for the long term." Time to buy land—prices slip.

Halifax. Local developers and owners do well, especially in multifamily markets, but the Maritimes stand well off the beaten track and don't attract much interest from institutional investors.

EXHIBIT 5-16
Prospects for Commercial/Multifamily Subsectors in 2010



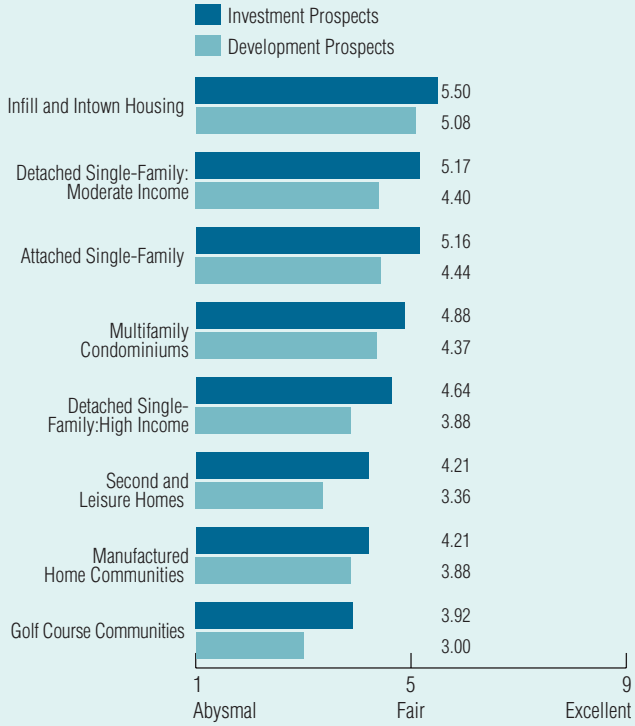
Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

Other Markets. Saskatchewan and Manitoba sustain housing booms . . . . Detroit's problems infect the adjacent Windsor industrial corridor—"it's hard to see a comeback." Quebec City doesn't register much interest.

Property Types in Perspective

For 2010, *Emerging Trends* surveys rate only fair investment outlooks for most property types and predict generally poor conditions for development. Limp demand threatens to soften property cash flows across all sectors and most markets. "Fundamentals will get worse before they get better, people shouldn't be fooled."

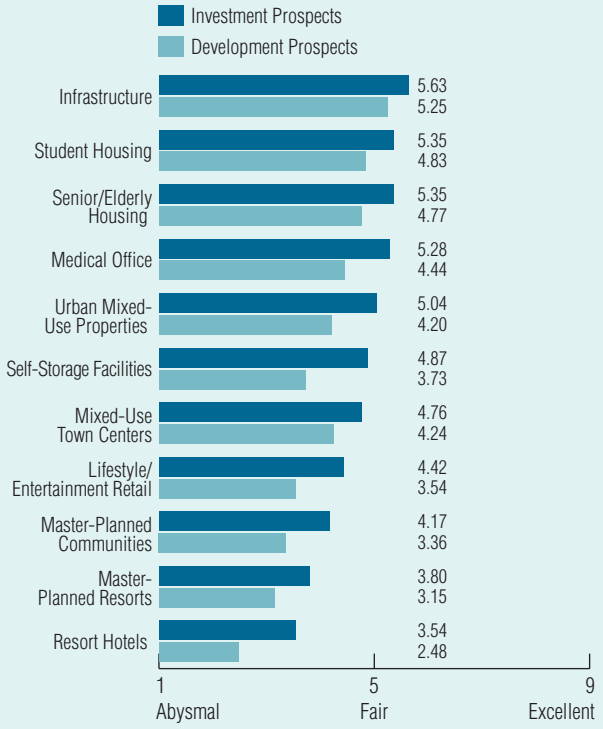
EXHIBIT 5-17
Prospects for For-Sale Housing in 2010



Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

EXHIBIT 5-18

Prospects for Niche and Multiuse Property Types in 2010



Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

EXHIBIT 5-19

Canadian Apartments

2010	Prospects	Rating	Ranking
Investment Prospects	Fair	5.44	1st
Development Prospects	Modestly Poor	3.74	1st

Expected Capitalization Rate, December 2010 7.0%

Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

EXHIBIT 5-20

Canadian Office

2010	Prospects	Rating	Ranking
Investment Prospects	Fair	5.04	2nd
Development Prospects	Poor	2.96	4th

Expected Capitalization Rate, December 2010 8.1%

Source: *Emerging Trends in Real Estate 2010* survey.

Note: Based on Canadian respondents only.

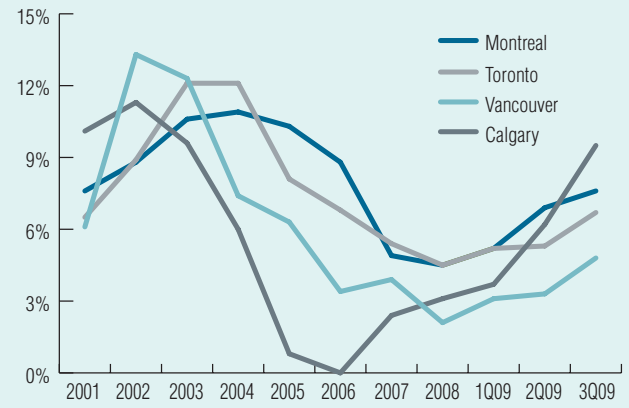
Apartments. Steady immigration and move-back-in trends bolster moderate-income multifamily properties located in or near metro cores. Properties close to mass transit lines almost can't miss. Condo building in most major cities takes the edge off higher-income apartment product.

Office. Stick to the prime downtowns and avoid the suburbs. People and business favor urban cores for convenience and multidimensional environments. Vast underground passages, which link to subway stations, help workers avoid dealing with too much winter chill. New construction dampens rental rates in downtown Toronto and could plaster Calgary. Confronting weak demand, landlords will prefer to keep face rents high and maintain income streams, making capital concessions like tenant improvements to retain tenants.

Retail. Consumers didn't overload their credit cards, so retail spending "never got frothy." Overbuilding and overstoring aren't problems, but slackening demand arouses concerns among shopping center owners and developers back off. So far, sales slow (off 5 to 10 percent) to levels "better than imagined." Steer clear of "malls in secondary cities with shrinking, aging demographics." Sound familiar? Shopping activity will concentrate in infill areas in major urban markets. Grocery-anchored retail is pretty stable, but power centers could be a weak spot if any more U.S. big-box chains go belly up.

Industrial. Problems center in Ontario, where rental rates "drop like rocks on rollovers." Some property values "could lose 30 to 40 percent." But "well-capitalized" owners should weather the downturn. "Quebec must be happy since the province doesn't have as much auto exposure as it used to."

EXHIBIT 5-21
Canada: Downtown Office Vacancy—Class A Properties



Source: CB Richard Ellis.

EXHIBIT 5-22
Canadian Retail

2010	Prospects	Rating	Ranking
Investment Prospects	Fair	5.00	3rd
Development Prospects	Poor	3.30	3rd

Expected Capitalization Rate, December 2010 7.9%

Buy	Hold	Sell
21.1%	78.9%	0.0%

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

Hotels. Travel from U.S. tourists and business goes south. High-end hotels suffer the most—"their profits are way off." Sellers can't find takers, but most owners don't have leverage problems—they can manage through the tough times.

Housing. While low mortgage rates help homebuilder sales, prices correct modestly as buyers turn cautious and bankers tighten already stringent underwriting. Financial industry regulators haven't been asleep at the switch and lenders couldn't adopt exotic U.S.-style mortgages. "We like downpayments here." Interviewees don't expect defaults and foreclosures to increase dramatically—"well-underwritten loans help most borrowers stay current." That Ontario sales tax could "hurt the high-end market" and the British Columbia government moves to follow suit with its own version of the HST.

EXHIBIT 5-23
Canadian Industrial/Distribution

2010	Prospects	Rating	Ranking
Investment Prospects	Fair	4.68	4th
Development Prospects	Poor	3.35	2nd

Expected Capitalization Rate, December 2010 8.3%

Buy	Hold	Sell
18.2%	63.6%	18.2%

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

EXHIBIT 5-24
Canadian Hotels

2010	Prospects	Rating	Ranking
Investment Prospects	Modestly Poor	3.96	5th
Development Prospects	Poor	2.68	5th

Expected Capitalization Rate, December 2010 9.9%

Buy	Hold	Sell
15.0%	60.0%	25.0%

Source: *Emerging Trends in Real Estate 2010* survey.
Note: Based on Canadian respondents only.

Best Bets

- Sell low-yielding Canadian assets, and buy in the United States when markets hit bottom.
- Prepare to buy distressed assets in secondary markets—"that's where you'll hear small owners and developers scream uncle" and then trade out in the up cycle. "No such opportunities exist in prime markets."
- Purchase new apartments near primary urban cores—"It's a good defensive play—you don't have capex issues and immigration flows help fill them up." Stable, secondary government/university markets like Halifax also make sense.
- Buy neighborhood shopping centers, anchored by state-of-the-art supermarkets in infill areas, for secure income streams.
- Grab full-service center city hotels at cyclical lows, but don't plan to hold forever.

Emerging Trends in Latin America

"Why go to emerging markets when you'll be able to get equally good yields at home?"

Historically, global recession and financial market turmoil would hammer weak South American economies dependent on exports and foreign investment. And usually, regional problems were homegrown—often the residue of corruption and financial mismanagement. This time, a world financial crisis reduces property values and rattles markets, but key countries emerge "relatively unscathed," particularly Brazil, the continent's fast-developing economic power. Now, major nations in the region—Chile, Colombia, and Peru—"have their financial houses in order" and show greater resiliency in responding to crisis. "Governments aren't overleveraged—they have significant reserves and strong local currencies."

Foreign investors see a checkered pattern of conditions and opportunities—growing middle classes, burgeoning populations, increasing demand for housing and shopping centers, as well as unpredictable governments, high crime, ever-changing rules, and advantaged local players. "Transparency issues have more ghosts than realities in major markets," claims an interviewee. "But you can't just parachute in, make investments, and have success without local partners. That's no different for an outsider coming into New York or London." Office presents slim opportunities—Class A product is limited to small districts in a few capital cities. Investors own apartment units scattered about different apartment houses, rather than entire buildings, so "it's hard to build scale." "Apartment managers are a new concept." Retail is understored throughout the region.

EXHIBIT 6-1
Latin America Economic Growth

	Percentage Real GDP Growth			
	2007	2008	2009*	2010*
Peru	8.9	9.8	3.5	4.5
Chile	4.7	3.2	0.1	3.0
Brazil	5.7	5.1	-1.3	2.2
Uruguay	7.6	8.9	1.3	2.0
Colombia	7.5	2.5	0.0	1.3
Mexico	3.3	1.3	-3.7	1.0
Ecuador	2.5	5.3	-2.0	1.0
Argentina	8.7	7.0	-1.5	0.7
Venezuela	8.4	4.8	-2.2	-0.5

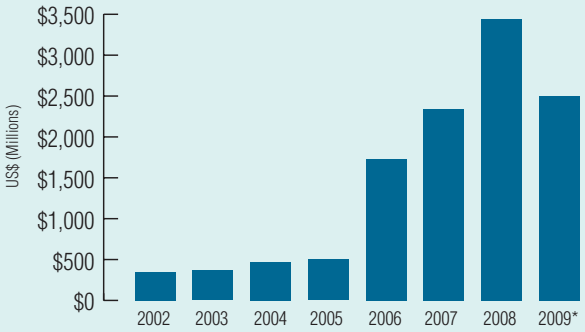
Sources: International Monetary Fund, World Economic Outlook Database, April 2009.
* Projections.

EXHIBIT 6-2
Latin America Inflation and Unemployment

	Unemployment	Inflation
Argentina	8.6%	7.2%
Brazil	7.6%	4.0%
Chile	7.8%	3.0%
Colombia	13.4%	3.6%
Ecuador	N/A	2.5%
Mexico	4.8%	3.1%
Peru	7.7%	2.0%
Uruguay	N/A	6.5%
Venezuela	8.7%	45.0%

Sources: International Monetary Fund, World Economic Outlook Database, April 2009, Moody's Economy.com.

EXHIBIT 6-3
Brazil: Foreign Direct Real Estate Investment



Sources: Central Bank of Brazil, Capright Property Advisers, LLC.
* Projection.

For now, most investors steer clear of Argentina, Ecuador, Venezuela, and Bolivia—they are not reliable and can change on a whim. Chile may be the continent's most stable and evolved economy, but small markets, controlled by local institutions and developers, restrict investment possibilities. Americans and Canadians concentrate their attention on Brazil and Mexico, countries with the biggest potential and divergent near-term outlooks.

Brazil "Powerhouse"

"If you want real estate value drivers—growing markets, an emerging middle class, expanding population, and rich resources—Brazil fits the bill." The country "understands free enterprise," "more people have more money to spend, and investors can make money now." As a bonus, corruption is less of a concern than in any of the other high-profile, emerging BRIC (also Russia, India, and China) nations. Brazil's economic managers "have a fixation" about tamping down inflation (which once reached 2,500 percent) after decades of runaway prices and a deflated currency. Investors find leverage in short supply, and homebuyers depend on cash—"Brazil had no credit crisis, because there is little debt." Fiscal discipline pays off starting with a sub–5 percent inflation rate. After a global finance crisis–caused hiatus, foreign investments pour back into the country and its currency, the *real*, turns into a dollar hedge. Investors like the diversified export-based economy (not dependent on U.S. markets) as well as food and energy self-sufficiency—nationally produced ethanol fuels cars and oil companies discover offshore reserves.

Housing. Interviewees tap housing development as investors' best bet—markets are underserved and the growing population desperately requires more apartments and single-family homes. The government wants a million new units built, and establishes subsidies and extends more leverage to middle- and lower-income homebuyers. "Demand is locked in," enabling 25 to 30 percent returns. "Developers almost have a certainty of success if they can keep costs under control and deliver on time."

Retail and Warehouse. Pent-up consumer demand also creates a need for more strip-style shopping centers and malls—only 400 exist (one per 500,000 people) in the entire country. Outsiders have trouble breaking into a market effectively controlled by an oligopoly of local mall companies. "They make it difficult to assemble land and get zoning." More shoppers and malls inevitably will lead to more warehouse and distribution center development.

Office. Multinational companies, hurt by recession, retrench in Sao Paulo, which suffers chronic overbuilding. Site-constrained Rio de Janeiro offers few opportunities to invest in prime properties. "Dangerous crime" plagues both cities, further diminishing investor appetites.

Mexico Retreat

While Brazil turns into a magnet, investors turn away from Mexico. The latter's economy is too U.S. centric—in the wake of the recession, Mexican immigrants send less money to families back home and U.S. consumers buy fewer Mexican manufactured goods. Stepped-up drug violence and economic woes combine to deter U.S. tourists and business investments. After pouring "a ton of dollars" south of the border in 2006 and 2007, "nobody touches Mexico now—everybody pulled the plug."

Real estate markets try to find their floor—values drop 30 to 40 percent. Industrial parks tied to U.S. auto manufacturers struggle, newly completed facilities sit empty, and "build-to-suits are dead." Mexico hopes restructured automakers and other U.S. manufacturers transfer more plants south of the border to cheaper sites. Plunging consumer spending hobbles retailers and mall owners, who offer huge rent discounts in a "zero leasing" environment. Mexico City and Monterey offer the only office plays, but not much prime product. Avoid hotels and second-home development—drug gang warfare "doesn't impact tourist areas," but many Americans "put off that trip to Cancun" anyway. Demand holds up well for entry-level residential—both rental apartments and for-sale housing.

Other Markets

Argentina fails to rectify political gridlock and high inflation, or cure anemic internal demand. Potential investors find "a lack of transparency."

Chile matures beyond emerging-market status. Domestic institutions own-to-hold most prime properties, keeping prices high. Despite the closed market, outside investors can benefit from ties to Chile's players, who have strong relationships in other countries like Colombia and Peru. Relatively strong GDP growth is projected for 2010.

Colombia's drug cartel reputation belies a "Brazil-style economic dynamic," tracking "five to ten years behind" its neighbor. Most investors want more progress before testing the market.

Peru experiences strong expansion of GDP. For 2010, growth is projected at 4.5 percent, the highest rate among major countries in Latin America.

Venezuela is a definite no-go. "Hugo Chavez."

Interviewees

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