

Emerging
Trends
in
Real Estate®

2008

Emerging Trends in Real Estate® 2008

A publication of:



Emerging Trends

in
Real Estate®

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Executive Summary

■ In 2008, U.S. real estate markets face greater downside risk in a repricing environment precipitated by tightening credit markets and increasing concern over a slowing national economy. Recent buyers who paid at pricing peaks using ample leverage may be susceptible to reversals if supply/demand drivers weaken.

■ Wall Street now dominates real estate markets, funneling global capital flows into securitizations and opportunistic private equity funds. Financing structures and flipping strategies helped bid up pricing and values, and the resulting trading maelstrom overheated property markets. Investment bankers and private equity players, who benefited from fee bonanzas and a long run of superior returns, may take a few lumps and will shift gears to more vulture-oriented investing.

■ Lenders and fixed-income investors retrench, and stricter underwriting takes hold after credit crisis hiccups. Debt costs more and cash investors regain their footing. Equity capital sources, not dependent on leverage strategies, should help sustain funds flow into real estate and cushion pricing as cap rates edge up. Pension funds, REITs, and foreign investors will step up activity. The market shifts away from sellers and toward buyers. Long-term holders can comfortably sit on recent gains.

■ Development should remain relatively controlled as increasingly more risk-averse investors back off new projects. High land, labor, material, and entitlement costs also continue to temper new construction. Concern focuses on ebbing tenant demand—rent growth and absorption rates weaken in most sectors after healthy spikes. Interviewees hope that rising exports can sustain economic growth and buttress recent property market gains.

■ Housing reversals threaten to torpedo consumer confidence and upend the entire economy. Adjustable-rate mortgage resets and

increasing defaults and foreclosures dampen housing market outlooks through 2008, possibly into 2009. Any recovery will be slow and fitful. Opportunity investors seek bargains as homebuilders sell down land inventories.

■ Global pathway markets will continue to concentrate business and investment activity at the expense of other cities and regions. Twenty-four-hour coastal gateways—featuring multifaceted environments, major international airports, and shipping ports—remain the most coveted locations. New York predominates—its aura of Wall Street financial power captivates investors' attention and sets the tone for deal making elsewhere. Seattle's star has risen. Hot-growth Sunbelt suburban cities soften, while Midwest manufacturing and agricultural centers fade. Transaction activity declines most markedly in second- and third-tier markets.

■ Property sectors show modestly good prospects, assuming the economy holds together. Income-generating industrial and apartment sectors remain favored investment categories. Office in dominant downtowns will perform better than in suburban-oriented markets. Hotels slide past peak. Tapped-out consumers may restrain their spending at malls. Ratings fall most dramatically for housing-related categories—condos land in the basement.

■ Canada benefits from a more conservative investment environment than the United States, avoiding consequences of lax underwriting. Institution-dominated markets skirt transaction mania, but values reach record highs and a strong economy accelerates tenant demand for space. Interviewees remain positive about sidestepping any serious impacts of a possible U.S. correction. Western provinces showcase the strongest growth trends and lowest vacancies in North America. All property sectors share positive prospects, especially industrial and retail. Housing prices skyrocket toward new highs without overdoing mortgage financing.

Preface

A joint undertaking of the Urban Land Institute (ULI) and PricewaterhouseCoopers, *Emerging Trends in Real Estate*® is a trends and forecast publication in its 29th edition, expanding this year to cover real estate markets in Canada. It is the most highly regarded and widely read forecast report in the real estate industry. The report provides an outlook on U.S. and Canadian real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

Emerging Trends in Real Estate® 2008 presents a consensus outlook for the future and reflects the views of more than 600 individuals who completed surveys and/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 236 individuals, and survey responses were received from over 380 individuals whose company affiliations are broken down as follows:

Private Property Company or Developer	41.3%
Real Estate Service Firm	17.9%
Institutional/Equity Investor or Investment Manager	15.2%
Other Entity	11.2%
Bank, Lender, or Securitized Lender	5.6%
Publicly Listed Property Company or REIT	5.3%
Homebuilder or Residential Land Developer	3.5%

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.



*“It was too good
to be true, business was
just too easy.”*

A Dose of Fear

Wobbly from the credit market knockdown, real estate players hope the U.S. economy can sustain reasonably strong property fundamentals in 2008, and prevent lowered-return realities from turning into portfolio red ink. Recently overleveraged buyers come to terms with dicey prospects for managing their way through cash flow shortfalls as markets reprice and quick, profitable exits vanish. Some development projects short-circuit, helping control supply. But demand drivers need to overcome shocks from the bloodied housing market and from consumers stretched by low savings rates, increasing mortgage payments, rising health care expenditures, and high energy costs. “Real estate had been priced like a ten-year Treasury without risk factored in.” The party clearly got out of hand—now the year ahead metes out the inevitable punishment for some transcendently reckless underwriting and “greater fool theory” investment bets. As *Emerging Trends* proclaimed last year: “Nothing lasts forever.”

Emerging Trends interviewees cross their fingers: their hopeful consensus view recognizes that “the industry will be walking on eggshells for a while,” leading to a “healthy,” “long-overdue

correction.” They recognize that risk will be repriced and capitalization rates will rise. “Too much debt was in the system.” Longer-term investors refocus on income benefits and steady yields, taking solace in a decade of steep appreciation. Some traders and speculators just get whipsawed. Values should hold up better in global pathway 24-hour cities than in commodity, secondary markets. “This turmoil could be good for the industry,” says an institutional investment adviser. “It will stop a lot of development, a flight to quality will flush out low-quality investors, and trash will get repriced so buyers can get more upside.” But possible “recession and erosion of rental expectations” would be a double whammy on top of repricing, warns a less stalwart research veteran. Retail, hotel, and office markets would be particularly susceptible to tenant retrenchments and consumer belt-tightening.

Where capital goes will be telling. The morphine of easy money from global wellsprings and low interest rates drove commercial market euphoria into blind lending and the pricing stratosphere. Suddenly, “the momentum game is over” and debt

Exhibit 1-1 Firm Profitability Forecast

Prospects for Profitability in 2007 by Percentage of Respondents



Prospects for Profitability in 2008 by Percentage of Respondents



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

strategies have become compromised. Hedge funds, flip artists, and financial engineers head for the hills. Still, most interviewees expect ample capital sources to help cushion the property markets, hoping to find better value. “Liquidity is key to success.” But since debt will cost more and be available in lesser amounts, “cash is king.” Investors “with dry powder” and low-leverage investors, particularly pension funds and REITs, could be well positioned. Foreign investors also may pick up some of the slack, increasingly attracted to U.S. markets by the investment bang they get from the weak dollar. Investment banks will lick wounds, but seem ready to deploy bulging fund stores into any dislocation opportunities. “They always make money out of others’ pain.”

Housing will be a basket case, threatening to upend the economy and poison the commercial markets. While homebuilders and condo developers wallow in oversupply and dropping prices, the market fallout from rising residential delinquencies, defaults, and ultimately foreclosures just begins. Subprime borrowers are merely the leading edge. Lowered home values and higher mortgage rates will raise refinancing hurdles for everyone. Home prices may drop further once moti-

vated owners put their houses up for sale and foreclosure auctions increase. At least multifamily investors should benefit—the pool of renters promises to swell, shoring up leasing rates.

Uncertainty and challenges characterize 2008, with greater downside risk than real estate markets have faced in close to two decades. Finally, a dose of fear has slapped a necessary sense of reality back into investors, maybe not a moment too soon.

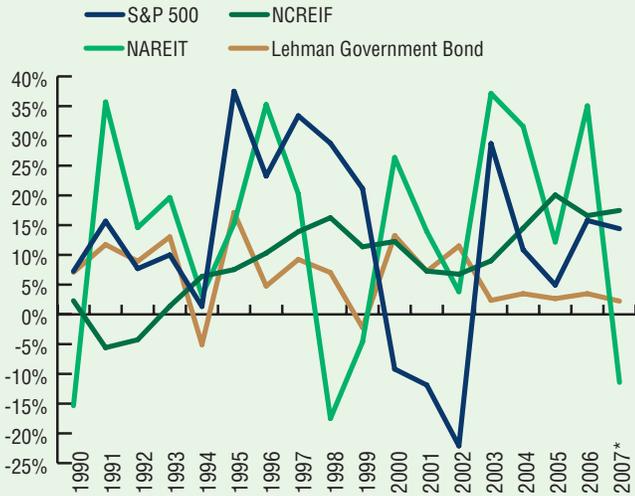
Real estate players need to get a fix on three obviously inter-related areas to navigate property market uncertainty in 2008: supply/demand fundamentals, capital flows, and, most importantly, the economy. All could be in a state of flux during the year.

- **Supply/demand fundamentals:** All eyes focus on a potential slowdown on the demand side of the equation. Except for apartments, upward pressure on occupancies and rents has peaked, although supply/demand remains in reasonably good balance across all sectors. A surfeit of new commercial space isn’t in the cards—development costs continue to spiral upward and capital players generally will be less inclined to fund new projects in a more risk-adverse credit environment (see Chapter 4).

- **Capital flows:** Global fund flows into real estate were fanned by Wall Street debt securitizations, which connect U.S. property markets to vast fixed-income investment pools. Emerging from the credit crisis, fixed-income investors become more rational, while lenders tighten underwriting and debt costs more. Cash buyers appear ready to cushion possible market declines, but the billow of undisciplined capital buying any-

Exhibit 1-2

Index Returns: Real Estate vs. Stocks/Bonds



Sources: NCREIF, NAREIT, S&P, and Lehman Brothers.
*2007 data annualized through second quarter.

thing with a yield sticker evaporates. Recent high-leverage buyers could get hammered, making for some unsettling headlines, and uncompleted deals retrade with lowered price tags (see Chapter 2).

■ **Economy:** Since 2001 consumers have driven the economy, fed by skyrocketing home values. Now, sinking house prices and higher monthly mortgage payments threaten to torpedo consumer spending. Financial companies and investment banks need to weather the credit crunch without too many layoffs. Global growth markets—particularly China and India—must keep expanding to fuel prospects of U.S. multinational corporations and deliver on burgeoning overseas investment bets. A majority of interviewees expects that the U.S. economy can struggle through the housing turbulence, helped by mounting business activity overseas and exports.

Decent Demand, Controlled Supply

Strong Demand Ebbs. Interviewees point to improving occupancy rates, rising rents, and improving net operating incomes (NOIs) in commercial and multifamily markets as support for “soft landing” forecasts. No question demand has been

solid, especially in coastal, global pathway markets. New York, West L.A., Seattle, and Washington, D.C., have boomed as office rents spike to new highs, while San Francisco and Boston rebound vigorously from respective early-decade tech wrecks and corporate consolidations. If prospects for key financial company tenants plummet coming out of the credit crunch, these markets could suffer reversals. Demand for apartments escalates, especially in higher-cost coastal corridors with barriers to entry, as young adult echo boomers proliferate and mortgage rates frustrate would-be buyers and debt-burdened homeowners. High-growth suburban agglomerations in Sunbelt regions also have strengthened, but well short of equilibrium in most places. Office vacancy rates in many of these metropolitan areas oscillate in the mid teens or higher—not particularly comfortable territory when markets may have crested.

Too Aggressive. Accepting “phenomenal” leasing gains in the top office markets, interviewees question recent buyer and lender projections of continued steep rent hikes to support pro forma assumptions on income and debt service coverage. “Fundamentals may be fine, but trees don’t grow to the sky.” Even before the subprime mess hit the fan, interviewees noted “slowing absorption outside of major markets.” “Buyers will need spectacular rent growth and require operations efficiencies without major capital demands for recent investments to turn out satisfactorily.”

Development Harnessed. Buyers cited skyrocketing replacement costs to rationalize some acquisition pricing. High construction costs—materials, labor, a scarcity of contractors, entitlement hangups, and NIMBY pressures—help temper development nationwide. Unlike in the late 1980s, before the last commercial real estate downturn, “no glut of space exists.” “Banks haven’t found a way to securitize construction loans, so they have been much more prudent in financing projects.” But despite higher costs, discipline showed some signs of cracking during the first half of 2007 as cap rates for acquisitions seemed stuck at or near record lows, and yield-hungry investors sought juiced performance. Private equity money and hedge funds stepped up their bankrolling of select projects and architects reported increased demand for their services. Tighter credit and more stringent underwriting will likely put the brakes on some projects until capital providers get more comfortable with the economy and future demand.

“The heightened focus on **risk premiums** means there’s no more cushion between

Caution Signals. A few yellow flags appear. Retail development—especially for in-vogue lifestyle centers and suburban-edge strip centers—has been worrisome in light of potential consumer fatigue and housing woes. Easy-to-build limited-service hotels in suburban markets also ramp up. Condos wallow in oversupply and turn into rental pumpkins in markets like south Florida, San Diego, and Las Vegas. And then there is housing. Except in a very few select high-barrier-to-entry markets, homebuilders discount their way through large inventories.

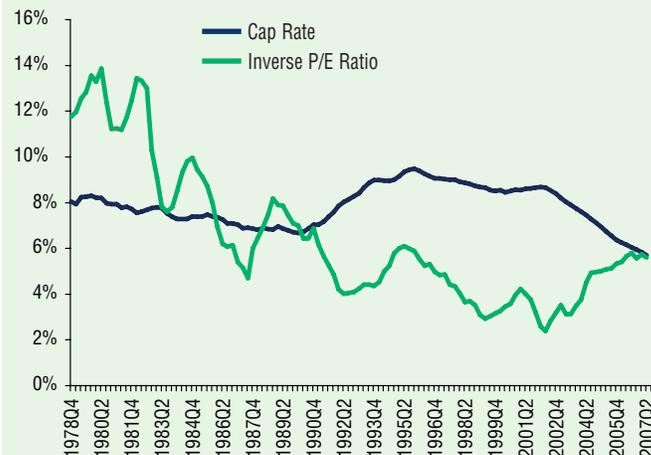
Debt Backs Off, Equity Lines Up

Too Much Debt. Capital, particularly mounds of ultra-cheap debt, drove the most vigorous bull real estate market in history over the past decade. The great facilitator has been Wall Street. Starting with the Resolution Trust Corporation (RTC) bailouts of savings & loans in the early 1990s, the rise of mortgage-backed securities (MBS), and then equity REITs, Wall Street investment bankers created new pipelines and conduits, injecting huge global capital pools into real estate markets, while extracting generous fees at every step of the transaction process. Commercial mortgage-backed securities (CMBS) and more recent collateralized debt obligation (CDO) structures allowed lenders to push risk off into far-flung bond markets, enabling value-add and opportunistic strategies, which attracted private equity and hedge funds into markets. “The rush of capital resulted in excess appreciation” and disconcertingly high tolerances for risk in underwriting. “That’s ending.” “At some point, you pay the piper for all the debt.” “Credit markets are the key [to 2008], strong fundamentals aside. Liquidity needs to go to work to take advantage of any dislocation and limit the downside.”

Equity Backstops. If leveraged players retreat for a while, pent-up demand from low-leverage investors should fill much of the void. Pension funds, REITs, and foreign buyers had been shut out of many frenzied auction wars won by bidders, putting little equity down while ratcheting up deal prices. Now, most buyers will need more equity, pay more for leverage, and borrow less. Cash investors operate from strength—they can also wait out any financial market turmoil, and refinance later

Exhibit 1-3

NCREIF Capitalization Rates vs. S&P 500 Inverse P/E Ratio



Sources: NCREIF, Moody's Economy.com, PricewaterhouseCoopers, and S&P.

when rates become more favorable. The high-stakes trading mentality, looking for quick value gains, takes a hit in favor of traditional, longer-term institutional investment strategies focused on attractive income returns and inflation protection.

Cap Rate Moves. Cash investors with more of their own equity at stake will be more restrained dealmakers—they will hunt for attractive (lower) prices now that leveraged investors can't get traction. “The heightened focus on risk premiums means there’s no more cushion between cap rates and interest rates.” Risk repricing will increase cap rates as investors turn more cautious—higher-quality properties in top markets will be affected less and still earn pricing premiums. Expect modest cap rate increases averaging 25 to 50 basis points, more if NOIs show signs of faltering. Most interviewees are counting on fundamentals holding up and improving property revenues to offset cap rate bumps.

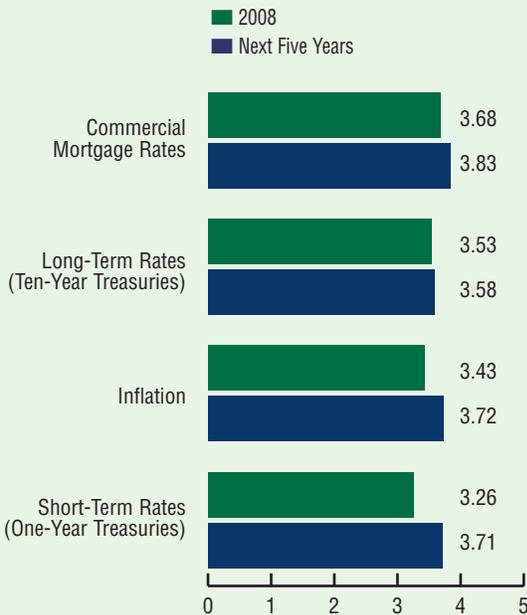
Interest Rate Wild Card. Interviewees still forecast interest rates edging ahead over the next five years, “but don’t see them getting out of hand” as the Federal Reserve juggles inflationary concerns against housing market jitters and recession fears (see Exhibit 1-5). If rates ever rise above 5.5 percent and into the 6 percent range, “all bets are off.” Some interviewees rail against the Fed “bailing out” irresponsible hedge funds and lenders by going overboard in lowering its funds rates to protect

Exhibit 1-4 U.S. Interest Rates and Spreads



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

Exhibit 1-5 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 2008 survey.

Note: Based on U.S. respondents only.

the economy. “That just rewards bad behavior and prevents a necessary correction.”

Coveted Income. Appreciation will be hard to come by in 2008, given the repricing environment. Gains will derive from “true growth in NOI, not capital market pressures.” Best-case scenario, but unlikely: low-teens performance is still possible if fundamentals hold up and the economy chugs along. More likely anticipate a sharp but acceptable reversion to the mean—mid-single-digit returns from income, but little or no appreciation. Worst-case scenario: if the economy tanks, some properties face depreciation scenarios, with lower-quality assets more vulnerable to declines. In this environment, leverage weighs down performance. “The more debt you’ve got, the more problems you may have.”

Sellers Lose Their Edge. Selling sentiment decreases further on this year’s investment barometer as survey respondents realize they missed the market top for dispositions. The “modestly good” sell rating (6.22 compared with last year’s 6.65 and with 2006’s 8.24) still registers ahead of scores for hold (5.82, down from last year’s 6.22) and buy (up marginally to 5.16 from 4.97 last year and 4.56 in 2006). (See Exhibit 1-6.) The “fair” buy signal indicates that froth has been eliminated from pricing, but unsettled markets cloud outlooks for where values

Exhibit 1-6 Emerging Trends Barometer 2008

Buy/sell/hold rating prospects on a 1-to-9 (abysmal-to-excellent) scale.



5 = fair, 6 = modestly good, 7 = good, 8 = very good.

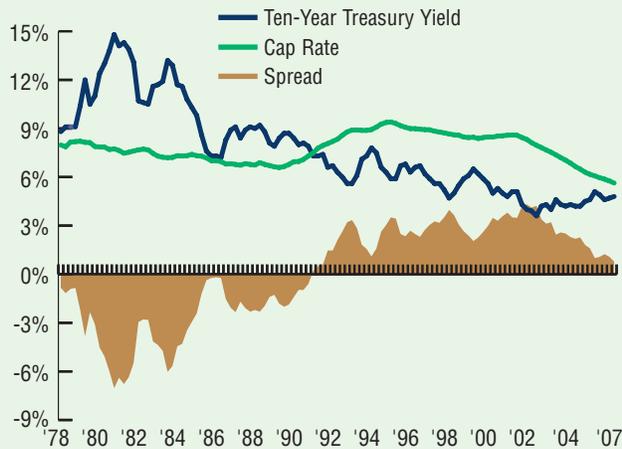
Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

“Real estate will remain a **preferred asset** class, it’s broadly accepted, there’s no

Exhibit 1-7

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



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

will settle. Long-term holders sit pretty—they racked up significant appreciation, and healthy fundamentals have helped push rents and NOIs. A shallow correction from repricing won't hurt them much and they are better protected against a sharper downturn.

In the Cross Hairs. Unless the economy catches fire, invigorating space demand and increasing rental rates, some 2005–2007 vintage buyers, loaded down by debt, could take lumps. Their lenders or the bondholders who own CMBS or CDOs backed by these loans may rue the day even more when defaults occur. In 2008, some of these transactions will start to blow up when equity owners walk away from feeding debt service on negative leverage, their plans for quick flips eclipsed. Other highly leveraged owners may face insurmountable roadblocks to refinancing at acceptable rates. Risk is spread out among myriad securities' tranches, but bondholders may need Sherlock Holmes to figure out what collateral they own and George Patton to safeguard their positions. Workout specialists prepare to get back in the saddle after a long hiatus, while special servicers could test their mettle for the first time. And here come the attorneys.

Victims or Vultures? Workouts and owner travail could cut both ways for value-add and opportunity investors. Some properties in their portfolios face overleverage/refinancing quandaries, and higher mortgage rates will crimp their ability to boost returns in new transactions. But investment banks and institutional managers have raised tens of billions of dollars in second- and third-generation funds poised to feed on motivated sellers or bail out struggling owners. An investment banker interviewee admitted that his existing fund's residential lot investments had lost significant value, but anticipated buying homebuilder land inventories “at cents on the dollar” in his new fund. “We have a lot of dry powder,” he said. Remember vulture funds?

Solidly Positioned. Core fund managers' biggest challenge may be resetting investor expectations back to single digits. Recent acquisitions at rich pricing also could be subject to any cap rate backup, but fund leverage (at 25 to 30 percent) leaves core investors less vulnerable to potential reversals than value-add or opportunity funds (at 75 to 90 percent-plus). Striving for yield, some core investors strayed from the four food groups—industrial, apartment, retail, and office—into riskier hotels and even some development. “They need to be careful and maintain a core focus, but at the margins, these investments are acceptable,” says a researcher. “Any losses wouldn't move the battleship significantly.” Core looks like a better risk-adjusted return than value-add, but a leading consultant worries about how the impact of pricing, a slowing economy, and interest rate moves position core against Treasuries. “The cash return doesn't measure up given the risk.” Funds with seasoned holdings in top markets should be prime income generators, especially if the economy steadies. That's what pension investors crave—they will continue to queue up to get into these vehicles.

Refocus on Operations. Property operations got backburnered by many new buyers who reveled in how rapacious capital appetites lifted valuations without much assistance needed from property enhancements or new leasing activity. As long as these traders could assume they had a ready exit—namely, a buyer willing to pay (a lot) more than they just did—why bother much with day-to-day management or finding tenants? Just move on before it becomes an issue. The credit crisis finally helped reorder priorities back to bread-and-butter real estate formulas relying on watching expenses, prudent maintenance and capital improvement programs, as well as sound leas-

ing strategies to boost values through higher NOIs. Owners realize that with repricing and increased debt service hurdles, they have their work cut out for them to meet operating pro formas. “The days of creating value from leverage finance are over. It’s time to get back in the trenches.” Some hedge fund and private equity investors, new to the real estate game, will need to staff up on the operations side. Old pros get back to “basic blocking and tackling.” Brick-and-mortar expertise is suddenly back in style.

Recession Concerns

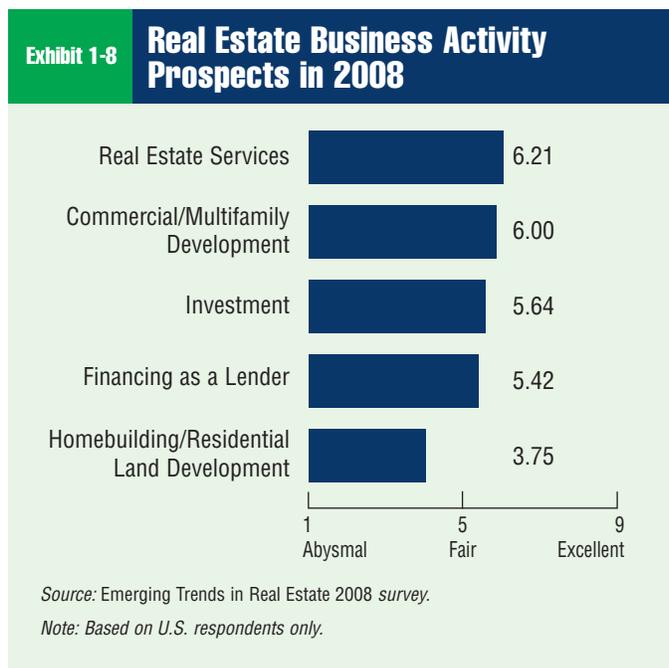
So, fundamentals appear reasonably sound at or close to equilibrium. Demand may ease, but development is in check in most sectors. Unsettled capital won’t be gridlocked indefinitely. Chastened lenders pull back and speculators realize the game is over, but plenty of cash buyers and loaded investment funds stand ready. “Real estate will remain a preferred asset class, it’s broadly accepted, there’s no going back.” “Investors will not turn away.” “Lots of capital wants to invest and build up allocations.” For 2008, what would upset outlooks? Well, obviously the economy could falter, cratering slowing demand. After the credit thumping, “It’s more possible anything can happen now.”

The Achilles’ Heel. The Achilles’ heel for the economy and commercial property markets lies close to home—the housing markets. Housing also exemplifies what happens when cheap debt, fee greed, shoddy underwriting, and sky’s-the-limit expectations combine to send prices soaring, leaving overleveraged owners vulnerable to inevitable reversals. The players never see it coming—witness the summer of 2005. That’s when Joe and Sylvia homebuyer told the real estate agent they had sticker shock and walked out of the demo home. Euphoric over record profits, homebuilders kept erecting subdivisions and warehousing land inventory until it was too late. Joe and Sylvia weren’t coming back.

Interviewees try to look past the similarities in underwriting mind-sets and unrealistic expectations that the commercial markets also experienced. But fears intensify over whether the housing crisis could be the final blow to the consumer spending largesse that has fueled retail sales and domestic economic expansion. “Credit tightening and lower housing prices will [affect] consumers. They could go into a hole, changing the job picture and recession ensues. Wall Street’s problem could go mainstream.”

Consumer Angst. Buoyed by inflating home prices, consumers confidently used home equity loans to finance residential renovations, buy new cars and appliances, and take expensive vacations. Household debt, meanwhile, has increased to a discomfiting 136 percent of disposable income, including credit card bills, and many individuals have spent all the cash from refinancings. Now, some homeowners face mortgage resets, higher monthly debt service, stiffer refinancing impediments, and the reality of falling home values. Two million-plus homes may be foreclosed on and personal bankruptcies may escalate. Many more homeowners, most with good credit, will hunker down and pay heavier debt costs on their adjustable-rate mortgages (ARMs), sacrificing trips to the mall, dinners out, and leasing a new minivan. Others may be forced to sell their houses into a declining market. More motivated sellers will signal that housing prices have more room to fall than some observers would like to admit. “Expect a delayed reaction to the defaults and foreclosures.”

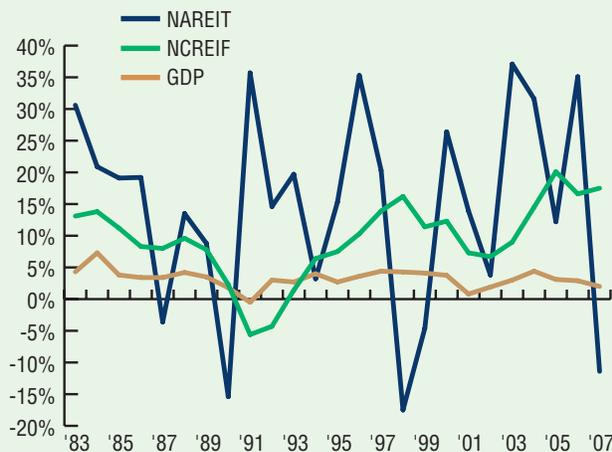
Employment Uncertainties. The job outlook could be most concerning. “We really need employment numbers to hold up.” The mortgage industry already contracts and homebuilders cut back. Retailers and manufacturers could feel the



“A slow rot in the debt markets could cause a **momentum shift** away from real estate.”

Exhibit 1-9

U.S. Real Estate Returns and Economic Growth



Sources: NCREIF, NAREIT, and Moody's Economy.com.

*2007 data annualized through second quarter.

pain next. Wall Street and financial company mainstays, meanwhile, won't hesitate to slash jobs, if the credit crisis and related investment havoc crimp profits and threaten the bonus pool. "They are notorious for moving on a dime." When businesses restrict travel budgets, an easy target in any downturn, hotels and restaurants can hit the skids quickly.

Low unemployment has masked stagnant wage growth since 2001. While the nation's overall income has grown, gains concentrate among the thin sliver of people earning more than \$1 million annually. Investment bankers make ten times more than the person with the average private sector job. Average annual income has actually declined over the past five years by 1 percent when adjusted for inflation, a marked change in the upward trend registered during the post-World War II period. No wonder worries about consumer confidence intensify.

Global Growth. Despite storm clouds, "cautiously optimistic" interviewees suggest the "unprecedented global economic boom can't be stopped," sustaining large U.S. multinationals and other businesses that operate internationally. In addition,

the weak dollar helps spur U.S. exports. "Infrastructure requirements and the rapidly growing middle class in China and India feed this expansion." "These countries need American credit and financial expertise to evolve." Besides stepped-up global initiatives, interviewees point to quick recoveries from credit market gridlock in 1998 (Russian credit crisis) and 2001 (following 9/11) to allay concerns about an economic downturn. But real estate demand was better insulated in 1998 in the midst of the high-tech dot.com boom, which would continue for another two years. After the terrorist attacks, Fed actions lowered interest rates and ignited housing markets, a primary economic driver until the recent bust. The domestic economy looks for its new growth engine, but so far comes up short. In the meantime, "we can muddle through again, if the system is flooded with capital from the Fed."

As such, 2008 may simply boil down to: "If the economy is okay, real estate is okay."

Wall Streetization

"Real estate is two things," lectures a veteran developer, "capitalism at its finest and cyclical." And who understands capitalism and plays cycles better than Wall Street? Entrepreneurs, banks, insurance companies, and pension funds had been the principal real estate cogs before overbuilding crashed the markets in the early 1990s. At the time, a few investment banks operated sideline real estate brokerage businesses. Into the breach, Wall Street bankers opportunistically rescued the industry, creating an equity REIT market and revolutionary securitization platforms. Real estate was "Wall Streetized." Surviving regional developers, banks, and institutional investors went along for the ride and, until now, everyone made a ton of money in a torrent of sometimes increasingly sophisticated, financially engineered transactions.

"The real estate business has changed fundamentally over the past 15 years." "Few people today put their own money into deals. Now, Wall Street attracts other people's money and makes fees off investing it." "Real estate markets are viewed through a trading prism," property assets have been transformed into commodity assets with yield coupons, bought and sold like stocks, or sliced and diced into bonds. "Everything is lumped together, pooled to spread risk—there's been little dif-

ferentiation between markets, whether a property is located in a Dallas suburb or in Pasadena. The bond buyers just look at income streams.” And “Wall Street has become the dominant force in the transactions markets.”

Fee-for-All. The heads of wizened real estate pros really started to spin in the wake of the Equity Office/Blackstone transaction when more buildings flipped ownership in six months than pancakes at a church breakfast. “Properties were moving like stocks on the exchange.” They were bought, sold, financed, refinanced, bought, and sold again with new financing all in a relative blink of an eye. Brokers, bankers, lenders, conduits, and asset managers all took their cuts at every transaction stage, while “OPM” (other people’s money) greased the process and enabled ever more generous pricing. Lawyers and appraisers got a piece of the action, too. After the giant fee-for-all, the real estate looked the same—same buildings, same tenants, and mostly the same rents. But the intermediaries were sure a lot richer. Who wouldn’t want to keep this game going?

Securitization vehicles transformed real estate into “a more fixed-income product, directly correlated to interest rates.” A broad disconnect developed between the ultimate source of the capital and the real estate investments. “Most bondholders buy paper with no idea of what they own.” They look at the yield, rate spreads, maybe asset diversification, and the credit rating. “Nobody kicks the bricks.” The rating agencies, meanwhile, get paid by the investment houses structuring the bond offerings. Real estate had become one of their biggest growth profit sectors.

Shifting Risk. Securities structures morphed from RMBS into CMBS and more recently into CDOs, giving lenders and even MBS buyers the ability to offload balance sheet risk and take proceeds to plow back to new borrowers, who could then make more acquisitions. Risk shifting emboldened lenders to loosen underwriting standards and make more questionable loans, giving borrowers the firepower to bid up property prices. The virtuous circle increased lending and fee volumes, fattening bottom lines for all the broker-banker middlemen. Everything could get securitized, including subprime residential debt and covenant-free, interest-only commercial mortgages, which might wend their way into highly levered CDOs. “Can anyone be surprised about meltdowns when questionable credit-quality loans

are pooled and then leveraged at nine to one for higher returns?” Indeed, capitalism reached to bold, maybe gluttonous, extremes.

Cyclical, not Secular. Investing excess—overspending, overleveraging, overdeveloping—typically signals market peaks. Now this Wall Street–driven cycle plays itself out. “We’re learning a whole new vocabulary thanks to Wall Street,” says an investment adviser. “There was alpha, velocity, momentum, and now contagion.” “There have been just too many fee-driven deals!” “You can defy the laws of gravity for only so long.” “There are cycles and history tends to repeat itself,” sums up a REIT executive. “Everything has a life cycle. It looks like we will need some level of correction.”

Changing Tactics. Most interviewees expect that Wall Street will remain “the center of the game. They will flush out problems and move on” to the next opportunity. “Securitization is here to stay full scale” with all its benefits of liquidity and risk diversification, but “investors need to be more careful” and selective. A few more hedge funds are bound to go under, fodder for the business pages and cable shows. Some commercial bankers warn of regulatory backlash and tighter oversight, which could restrain capital flows. “A slow rot in the debt markets could cause a momentum shift away from real estate.” But most interviewees expect “a backlog of capital” in investment bank fund coffers to keep Wall Street engaged. “Now they’ll shift from relying on large asset management fees to buying cents on the dollar.” “People have made too much money along the way to leave the game.”

Right of Passage. Choppy markets, investment losses, lowered transaction volumes, and dare we say layoffs have long been absent from real estate markets. Any downturn would be a new experience for the under-40s, who have known only good times. “It will be a real shock,” says a 40-plus mortgage banker. “These younger guys will be crying, ‘What do you mean I can’t drive a Mercedes?’” Many of today’s dealmakers and Wall Street financial engineers have no institutional memory of the early 1990s’ real estate debacle and pushed the envelope accord-

“Green projects should have a **big advantage**, but we haven’t seen it in cap rates yet.”

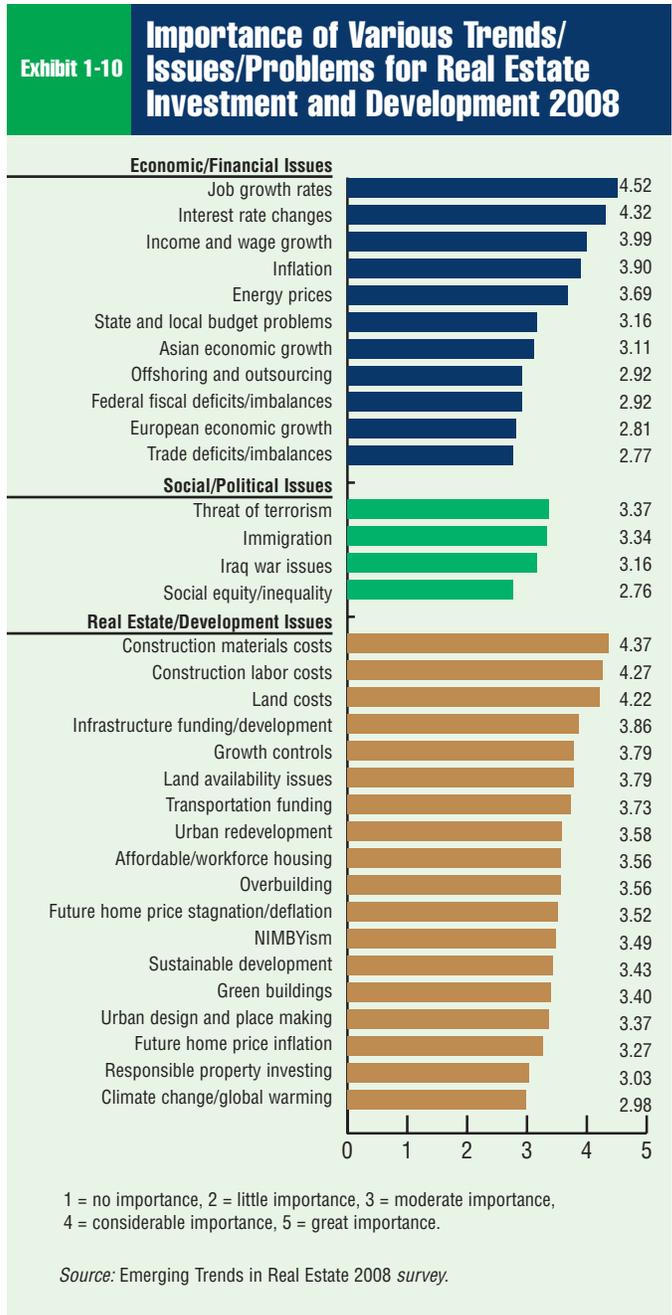
ingly. “I had to give a workout guide to the new head of the real estate practice at a top New York law firm,” says an almost-50 asset manager, shaking his head. “This guy has no idea what’s coming.”

Finding the Green in Green

Real estate developers and investors haven’t gravitated toward greater environmental consciousness (“going green”) just to save the planet, although reducing carbon footprints and harmful emissions sounds fine. “This is not about Al Gore and global warming,” insists an interviewee. “It’s good for business and it’s good for marketing.” In other words, green makes sense if green makes cents—well, more than cents. Right now, the industry is trying to figure out just how much sense/cents green makes.

Not the Flavor of the Day. On the list of important issues, *Emerging Trends* respondents rank green and sustainability behind more traditional bottom-line influencers like interest rates, jobs growth, and construction costs, but ahead of terrorism and hot-button political tempests like immigration (see Exhibit 1-10). The interviewee consensus contends that green is “here to stay and not a fad,” and advises developers and building owners to “wise up” and get on the bandwagon. “You’re just stupid not to build green office,” says a Denver developer. “Extra costs [about 2.5 to 3 percent] can be recouped quickly in energy and other expense savings. Tenants want it. Their employees are happier, healthier, and more comfortable. It gives you a big competitive advantage.” In ecologically friendly places like Seattle, “all the new building is green, period.”

Certainly, green plays into many corporate social responsibility initiatives, which make heightened environmental awareness a priority. “Tenants have started to differentiate and will increasingly demand it.” “Some appear willing to pay more.” Green also “gains significant traction among institutional investors, particularly public pension funds, who like how good PR melds with sensible investment strategy.”



New Standards. For starters, developers follow Leadership in Energy and Environmental Design (LEED) guidelines, issued by the U.S. Green Building Council, which measure the degree to which buildings incorporate environmentally efficient systems. Some states like California and major cities like New York and Chicago have set stringent sustainability requirements for new construction, which raises hackles among some builders and investors. “If a project pencils out at LEED-Silver and the city wants a platinum standard, we’re going to fight that,” says a private equity fund manager. But cities are also providing tax and zoning incentives to landlords who go green in order to jump-start initiatives for reducing pollution and energy consumption.

Green office developments incorporate under-floor HVAC systems with multiple heating zones so workers can control their own workspace environments and also so energy costs in unoccupied space can be managed more efficiently. New lighting systems with more reflective fixtures, triple-glazed windows, and nontoxic construction materials help reduce utility bills and/or create more work-friendly environments.

Competitive Obsolescence. Most existing buildings (“60 to 70 percent”) face retrofitting impediments that will make it hard to compete against new projects. Single-pane glass, outdated mechanicals, and interior wall configurations can present daunting challenges for landlords to overcome in older structures. Savvy buyers analyze whether “buildings have the opportunity to become Energy Star” and factor obsolescence considerations into underwriting. Over time, “green projects should have a big advantage, but we haven’t seen it in cap rates yet.” In older central business district (CBD) office markets—e.g., midtown Manhattan, the Boston financial district, and Chicago’s Loop—most existing inventory (including trophy skyscrapers) cannot be updated to green standards. The good news for owners on Park Avenue is that “location still trumps all” and new green buildings will be a tiny part of inventory in large, high-barrier-to-entry markets, at least in the near term. In smaller CBDs and high-growth suburban markets, green projects will

leech tenants more easily from older product. “Stay on top of green,” counsels a pension fund manager, “or eat everyone’s dust.” “There will be differentiation.” “Over the long term, adopt or get crushed.”

Cool Roofs. Large industrial users “demand green” in big-box space. They want white roofs and less blacktop pavement to lower cooling costs. “The extra expense is not that great, [and] you get better tenants, quick absorption, less turnover, and possible rental premiums.” To reduce common-area expenses, some apartment owners make easy fixes, replacing incandescent lighting with fluorescent lighting and installing computer monitoring systems to regulate HVAC systems. But one interviewee balked at trendy grass roofs, which can reduce heat island effects in big cities. “That’s a recipe for leaks.”

Best Bets 2008

Investment

Husband Capital, Build Relationships (Dry Powder)

Investors with liquidity can score home runs feasting on motivated sellers who may need lifelines. “Seek good real estate with bad capital structures.” Overleveraged owners and lenders in workouts make prime candidates. Some funds may need capital infusions. Pain can mean gain. “Gather liquidity,” “draw on relationships,” “be agile and ready to bid.”

Buy Distressed Loans

B pieces and mezzanine debt will provide good relative value, emerging from the credit market upsets. Take advantage of discounts and focus on the quality of collateral.

Hold Core

Prices on the best properties in the best markets will increase over time. “The Japanese who bought Rockefeller Center in the 1980s would have hit a grand slam if they had just stuck to their business plan.” New York, D.C., and southern California may face hiccups, but always sustain gains. If markets sour, expect capital “flight to quality.”

Focus on Global Pathway Markets

The traditional 24-hour megacities have “better liquidity” (i.e., more buyer demand) and upside potential under any circumstances, but especially when capital gets nervous. Brainpower businesses cluster to tap educated workforces drawn to their multifaceted places. “Growth is embedded.” Completed development projects almost can’t miss in high-barrier-to-entry dis-

tricts. No wonder—sites are few and far between, and the entitlement process can be like war. If financial companies take a breather, buyers might even find some relative bargains.

Concentrate on Operations

Deal brokers had their day; now, property management and leasing businesses have a chance to shine. Owners will earn value from working properties and attracting tenants. Finding efficiencies and building tenant relationships become priorities.

Buy Public REITs

These companies got beat up when their dividends diminished after their stock prices raced ahead. Look to buy companies paying out 6 percent dividends or better. Coming out of any correction, well-managed firms will be among the best positioned to make accretive deals and take advantage of any dislocation. Buyers also get identifiable assets and development pipelines. As such, 2008 may be a good time to accumulate these stocks.

Buy Broker, Homebuilder, and Mortgage Company Stocks

Bide your time to see if the market heads further south. These “murdered” stocks will eventually recover. Take the opportunity to acquire them at or near market lows. “Battered financial companies, the well-run conservative lenders that got caught up in the flight from mortgage companies,” will also be good plays.

Use Demographic Strategies

Seniors’ housing, baby boomer resorts, second homes, and medical office buildings all play to the rapidly graying population. Even student housing feeds off this trend, as boomer parents buy condominiums for their echo boomer college students. Despite inevitable aches, pains, and illness, people are living longer than ever. Many boomers “have resources to spare” and seek “comfortable retirements.” These investments “have long legs.”

Staff Up the Workout Teams

Brush off the cobwebs. Special servicers, workout loan specialists, and lawyers will all be in demand. Transaction brokers might need to learn a new skill set.

Avoid:

- Construction loans—“too much risk.”
- Condominiums—unless buying distressed assets.
- Taking on extra debt.
- High-growth markets with soft fundamentals—“they’ll only get softer.”
- Second- and third-tier markets—investors need higher risk premiums.

Development

Think Green

Development of state-of-the-art sustainable buildings fills increasing demand. “If it’s brown versus green, green has the competitive advantage.” Buyers need to weigh obsolescence issues more carefully, especially in markets where new projects can affect market equilibrium quickly.

Focus on Mixed Use and Infill

Fringe subdivisions without amenities lose appeal. Increasingly, people want 24-hour residential environments closer to where they work. Inspired by new urbanist concepts, these projects have pedestrian-friendly layouts, offering varied living options—condo, single family, apartments—and service retail, including grocery stores, pharmacies, cleaners, and restaurants. The move back in continues—especially among empty nesters and career starters.

Build Transit-Oriented Development

Congestion mounts everywhere and people get sick of losing time in traffic jams and car-dependent lifestyles. Higher gas prices, global warming issues, and pollution just add to frustration levels. Condominiums, apartments, and retail near light-rail or subway/train stops become “increasingly attractive,” almost can’t miss.

Property Sectors

Buy Multifamily

Focus on well-worn strategies acquiring B and C properties for upgrade in markets with relatively high housing costs. “You can always get to a B+ price point. Mortgage rate dyspepsia forces more people into rental markets.” Echo boomer demographics trends offer another incentive. “Cities with immigration inflows and high homeownership/rent differentials will be phenomenal over the next decade.”

Buy or Hold Industrial

Invest into the burgeoning global economy and focus on prime East and West Coast gateways: Los Angeles–Long Beach/Inland Empire, San Francisco, Seattle, and northern New Jersey. Demand never lets up and revenues just keep flowing. Overseas import/export markets expand over time.

Buy Residential Building Lots

“Incredible asset plays exist on residential land tracts,” inventoried by overly aggressive homebuilders. “All the big guys are shedding lots.” “Distress is building.” “It’s 30 to 40 cents on the dollar.”

Exercise Caution in Office and Hotels

The dodgy economy dampens business enthusiasm for expanding office space, especially after heady rent spikes in major markets. Hotels top out—they are immediately vulnerable to economic downturns and the development pipeline looks full, especially in the multitude of limited-service and mid-market categories.

Chill on Retail

Fortress malls and infill grocery-anchored centers are strong holds. B and C malls could have some rough sledding if consumers bail out, and too many lifestyle and strip centers have been built recently.



Unbridled capital flows have left undisciplined investors susceptible to rude reversals.

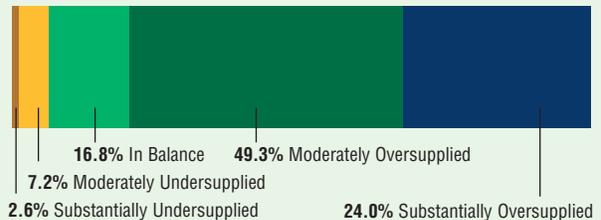
Real Estate Capital Flows

Giddy no longer, real estate players wonder how deep the credit crisis bites. Will it merely crimp leverage strategies and encourage reasonable repricing of risk or lead to a substantial market correction? Most interviewees hope for soft landings and realize those warnings about shoddy underwriting and priced-to-perfection transactions came true. Indeed, unbridled capital flows have left undisciplined investors susceptible to rude reversals.

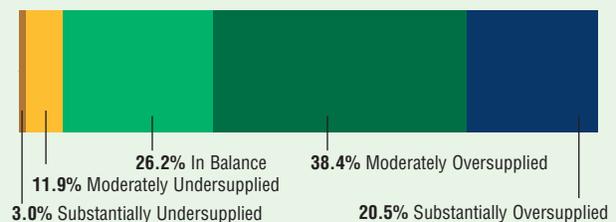
Capital overwhelmed the commercial property markets in the late 1980s, too—first from syndicators and then from institutional investors. Back then, the industry grossly overdeveloped everything from condos and hotels to office buildings and shopping centers. Everyone saw too many cranes and marveled at all the new towering steel- and stone-clad monoliths popping up in cities and fast-growing suburban nodes. Construction data and leasing information lagged by months, and nobody paid much attention to the emerging gap between increasing supply and lowering tenant demand. Developers convinced banks, insurers, and pension fund advisers that their unique projects would corner the market no matter what was going up across the street.

Exhibit 2-1 Real Estate Capital Market Balance Forecast for 2008

Equity



Debt



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

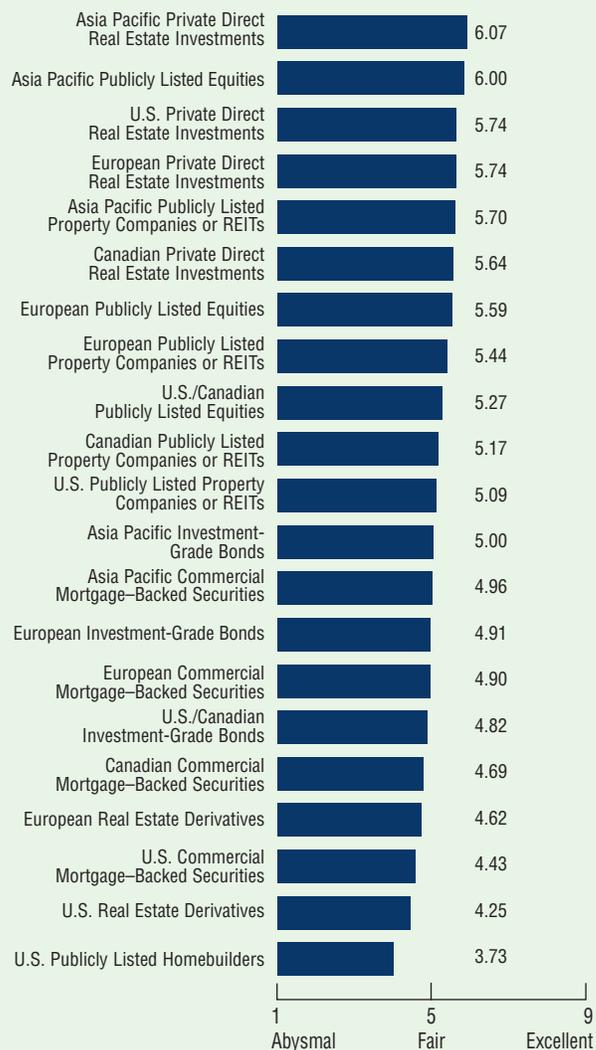
Credit Market Correction

Overdoing It. In the latest round, investors merely over-spent and overleveraged. Only recently had they begun to stoke building construction. Today, thanks to research providers, REIT analysts, and CMBS data, everybody focused on market numbers showing reasonably decent fundamentals in commercial markets. Rating agency imprimaturs provided extra comfort for bond buyers, who funded a lending orgy. Using cheap money—mostly “OPM”—investors kept bidding up prices well beyond what reasonable revenue forecasts could support. Blasting past stop signs (read last year’s *Emerging Trends*), they ignored obvious risks and assumed that “ample liquidity” would fuel transactions as long as reasonable equilibrium existed. In particular, they failed, like everybody else, to pay attention to the potential consequences of overbuilding and a shocking collapse in demand, which were toppling the housing markets in a combo-punch knockout similar to what happened to commercial real estate in 1990–1991. “Subprime may have accelerated the debt market blowup, but the blowup was coming anyway.”

Backyard Problem. Interviewees point to quick rebounds after the 1998 and 2001 credit crunches, and crave another speedy recovery. But that could be wishful thinking. “1998 was a more isolated problem, bailing out a single hedge fund and restoring confidence quickly.” “We also knew collateral was good in 1998; today, it’s hard to know what its value is due to poor underwriting.” Capital markets calmed down in 2001, once investors realized the horrific terrorist attacks were isolated events and normal life could resume. But today’s dislocation was set off directly by perceived problems in real estate–related investments—mortgage bonds—and involves millions of people in nose-diving U.S. housing markets, a pillar supporting the world’s dominant economic power. It also extends to leveraged buyouts and corporate lending. “This problem will be more difficult to work out.”

For sure, money markets learn more from hard knocks about capital flows’ behavior in a highly integrated global economy where computer-driven quant trading strategies increase worldwide stock market volatility and German banks need rescues because they bought too many mortgage bonds, backed by

Exhibit 2-2 Investment Prospects by Asset Class for 2008

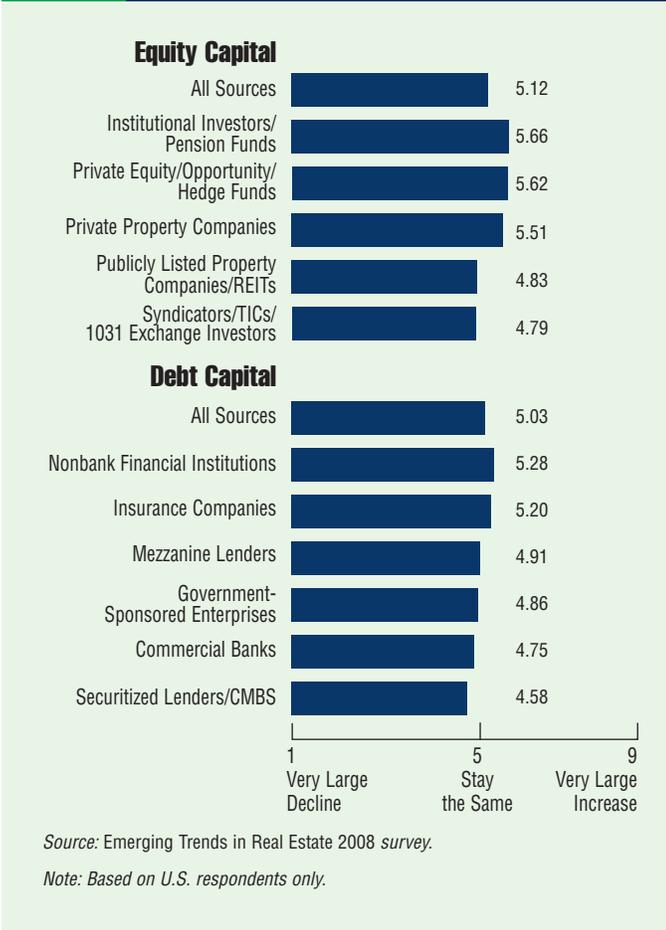


Source: Emerging Trends in Real Estate 2008 survey.

poorly underwritten tract housing loans in the San Diego or Phoenix suburbs. At the very least, investors now realize that diversification and spreading risk through securitized instruments “do not offset systemic risk.” They receive another lesson in the industry’s vulnerability to “capital market crisis,” and understand they must cope better with “non–real estate–related risk.” In last year’s *Emerging Trends*, they feared “exogenous shocks.” But they were blindsided when the shock precipitated, if not in their own backyard, then right next door.

was coming anyway.”

Exhibit 2-3 Change in Availability of Capital for Real Estate in 2008

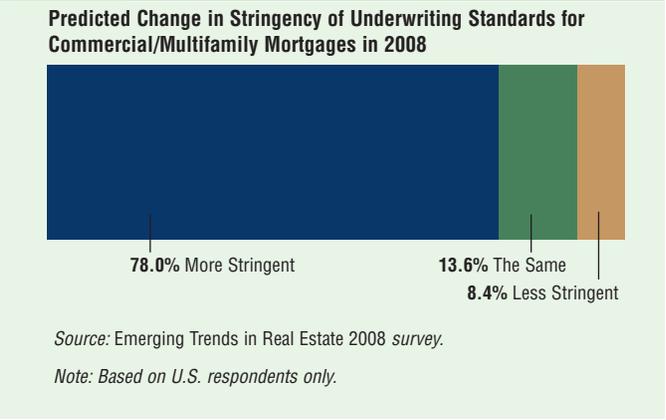


Relative Strength. Emerging Trends interviewees express reasonable confidence in expected 2008 performance for U.S. private direct real estate investments, compared with stocks and bonds. Only Asia Pacific real estate and stocks rank higher (see Exhibit 2-2). U.S. REITs manage a “fair” rating, while CMBS, real estate derivatives, and homebuilder stocks suffer “modestly poor” scores. Through 2012, they expect their investing will continue to concentrate overwhelmingly on U.S. markets, but anticipate rising stakes in both Europe and especially the fast-growing Asia Pacific region. “Real estate will continue to look good compared to volatile stocks and low bond returns. Even with a performance pause, the last decade has proven real estate can be counted on to deliver excellent risk-adjusted returns over time. Investors will stay with the asset class.”

Capital Cushion. When the dust from credit market “over-correction” settles, capital should resume steady flows into real estate, pricing risk more appropriately. Equity capital will remain reasonably plentiful, but lending sources will be more restrained through 2008, according to surveys. Pension funds and a host of offshore investors will replace high-leverage private investors in the equity markets. “A tremendous amount of capital waits to come in when they believe the time is right.” Securitized lenders and commercial banks will lead the retreat in debt markets, although life insurers and other balance sheet lenders may increase activity. Despite a mediocre score and recent stock price declines, public REITs may be active buyers in the private markets as well—these companies do not depend on leverage and many are well capitalized.

More Discipline. In last year’s report, 70 percent of respondents predicted that investors would adopt “more stringent underwriting standards” during 2007. They turned out to be right, but crisis rather than self-discipline forced the change. “Standards had become as lax as they ever had been” until sub-prime headlines appeared. “People were making a lot of money off of doing stuff they were very uncomfortable doing at first, and then tulip mania set in,” says a broker. “It works as long as you can unload to the next guy.” For 2008, surveys even more emphatically forecast more stringent underwriting (see Exhibit 2-4). “Covenant light, 90 percent-plus leverage, anticipating future rents, weak credit, overnight due diligence doesn’t com-

Exhibit 2-4 Underwriting Standards Forecast



“We will see greater prudence and less debt, and **equity capital** will be more precious.”

pute anymore.” “We will see greater prudence and less debt, and equity capital will be more precious.” “Don’t be surprised if you see a return to 1.25 debt service coverage and plenty of money available to do 70 percent to 75 percent loan-to-values.”

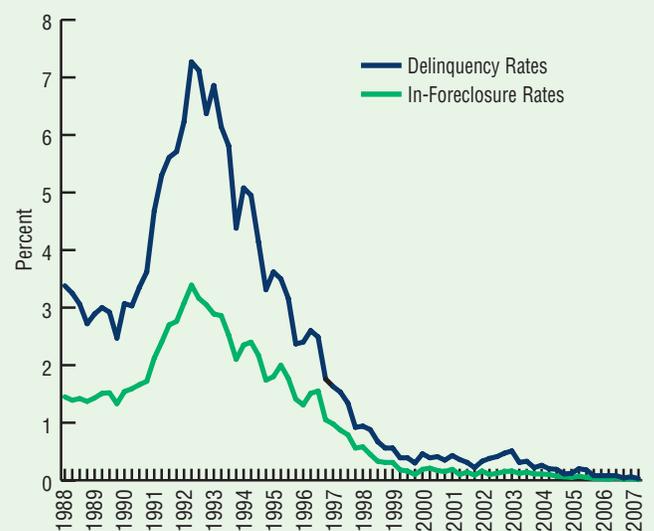
Rating agency backbones also stiffen. They hope to duck unwelcome allusions to “early-1990s appraisers” and “Enron accountants” who had provided cover for questionable client practices. “Now the bartender needs to be carded.” Tougher scrutiny and more stringent analysis of new CMBS offerings follow recent downgrades. Loans and structures that passed muster in January 2007 won’t in January 2008. “They missed it on housing—now they’re determined to be more careful in commercial.”

Greater Caution. What ultimately happens to once-huge fixed-income buyer appetites for CMBS and CDOs is uncharted territory. Distress in real estate securities mixes with widespread uncertainties in corporate bond markets—global capital also overleveraged and overspent on a host of initial public offering (IPO) financings and generous company refinancings. “Bond buyers will be much more cautious and discriminating across the board.” Undoubtedly, some undercapitalized CDO and hedge fund shops, which were big buyers of CMBS paper, may fold in the wake of margin calls on their markedly down portfolios. “All the financial engineering enabled pawning off risk to someone else. With so many tranches and different investors, you really don’t know who the losers are.” “Some New York office buildings have 22 levels of debt and no one understands the deals.” When underlying collateral in some securities inevitably goes bad, sorting out liabilities and protecting borrower stakes may be worthy of *Bleak House*. “No one really has any idea of what will happen when a CDO goes bad.” It’s all a prescription to keep spreads wider and make bond investors more disciplined, at least in the near term.

Extended Pain. Many lenders take higher reserves and write down loan inventories. Financial companies see stock prices hammered and some mortgage bankers close down. Layoffs escalate and even some big players may hit the wall. Over the next several years, refinancing risk at maturity will pose an ongoing test for the markets. Many recent borrowers will probably not be able to secure new loans at comparable rates or terms. “Covenant-light, covenant-loose, and covenantless” mortgages will not be available

either. Unless property cash flows and values increase enough to meet inflated underwriting expectations, borrowers may be up the creek and lenders or special servicers will be dealing with workouts, defaults, and foreclosures. The zenith of refinancing turmoil may be several years off depending on when loan terms reset, a nasty hangover of profligate underwriting.

Exhibit 2-5 U.S. Life Insurance Company Mortgage Delinquency and In-Foreclosure Rates



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

Government Oversight. Politicians and investors call for greater regulation and oversight in residential mortgage markets. Critics blame banking regulators for not clamping down on predatory lending practices that ensnared subprime borrowers. Expect scrutiny of commercial markets, too. CMBS lenders had claimed self-regulation worked through B-piece buyer analysis and rating agency reviews. But CDO sleight of hand encouraged B-piece buyers to take more risks and rating agencies just lost their way competing against each other to evaluate offerings. Regulated banks, meanwhile, pumped plenty of ill-considered loans into CMBS pools. Not coincidentally, federal, state, and local governments welcomed all the resulting transac-

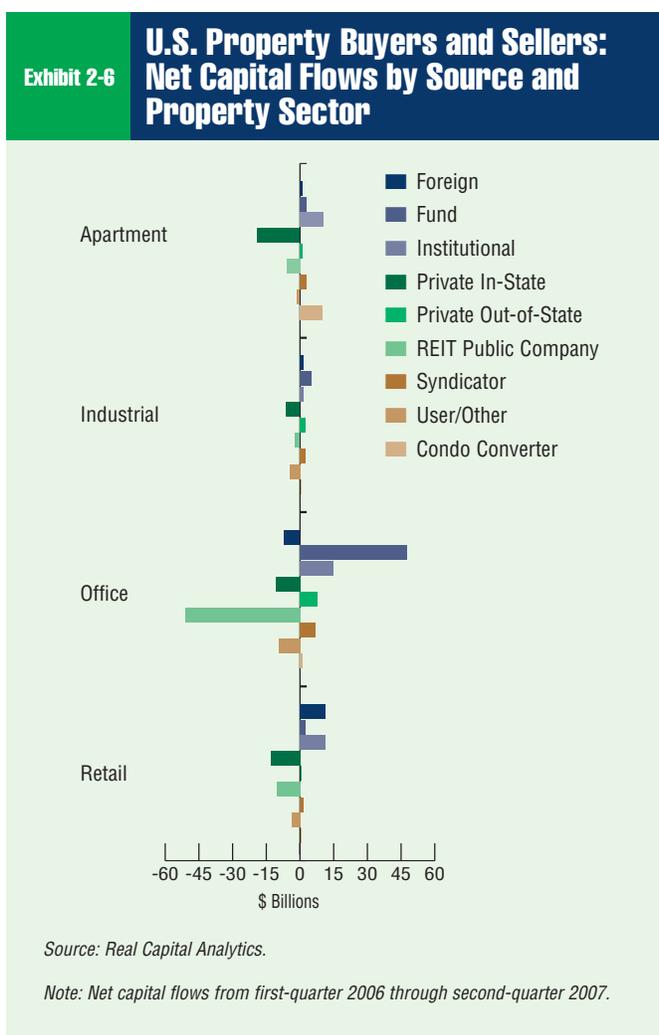
tions and higher property values, which fueled tax revenues. Likewise, homeownership has long been facilitated by government tax policy and funding backstops. Investment losses, squeezed profits, layoffs, and meager bonus pools may offer the best remedies for lax practices. That's how capitalism works, at least until institutional memories fade again.

Private Investors

Private Equity/Hedge Funds. These Wall Street-oriented momentum investors lived off financial structuring and leverage to supercharge returns, while earning handsome fees on committed capital, not to mention large “promotes.” Some hedge funds also were big buyers of CDOs and subprime securities as well as mezzanine debt. “They always tout high returns—going to do this, going to do that, and you’re going to give us big fees while we get to the going-tos.” Until now, most of these funds delivered on strategies and promise, while driving up prices and helping overheat markets. But unless they cashed out in a spasm of market-timing genius, “their model of high prices, high leverage, and high fees” may start backfiring. Some funds “must have fragile positions” now that the buy-and-sell flipping frenzy abates. They paid premiums for properties, face negative leverage, and confront prospects that rent growth cannot meet overly optimistic projections. Markets peaked, cap rates edge up, and exits close. Some hedge funds only recently migrated into real estate space, attracted by the easy money and quick trades—their executives have little experience managing properties and limited local market knowledge. “They put a ton of money into real estate and real estate debt without knowing what they were doing.” After getting burned, most hedge funds leave the scene and some New York landlords wonder about collecting on all those recently signed \$150-per-square-foot leases. Big investment banks may take some portfolio hits on existing properties, but they will buy time with clients based on past performance, and change to vulture-oriented strategies for new investments. “They aren’t returning the money they have and so what if returns are lower. It may be years before their investors notice.”

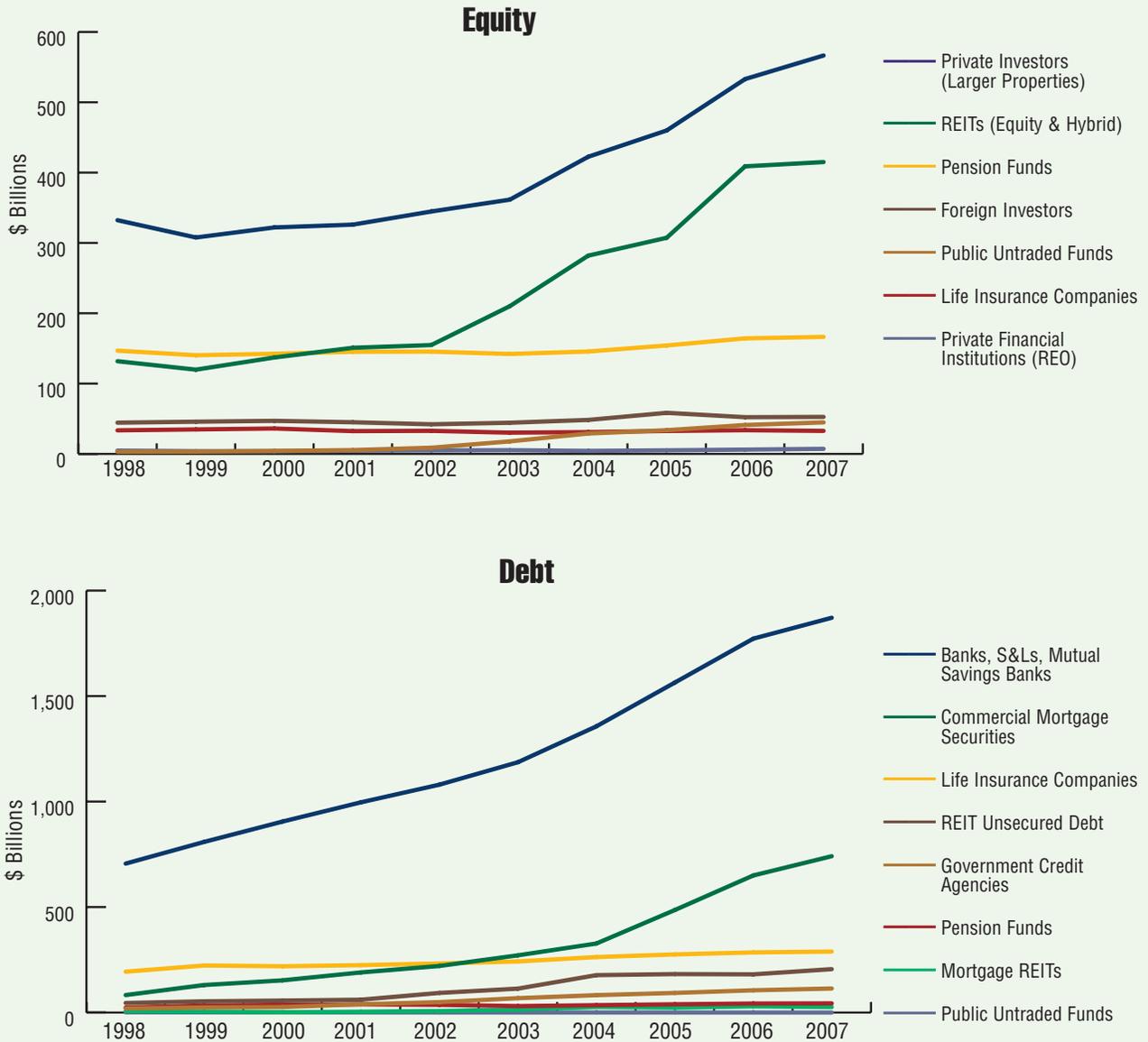
Syndicators, 1031 Investors, High-Net-Worth Investors. Private syndicators started backing off acquisitions when other leveraged investors crowded them out. “We made only one acquisition in 2006 and are quite happy about not

doing more,” says a funds manager. Many high-net-worth investors retreated from making one-off deals. Unable to compete against private equity investors for properties, family offices decided to invest in real estate via private equity funds. As noted, their results may be mixed. 1031 tenant-in-common investors—groups of high-income, less-rich-than-high-net-worth individuals—back off. Their high-leverage strategies don’t work anymore, and tax strategies have less appeal in flattening to declining markets.



U.S. Capital Sources

Exhibit 2-7 Real Estate Capital Sources: 1998–2007

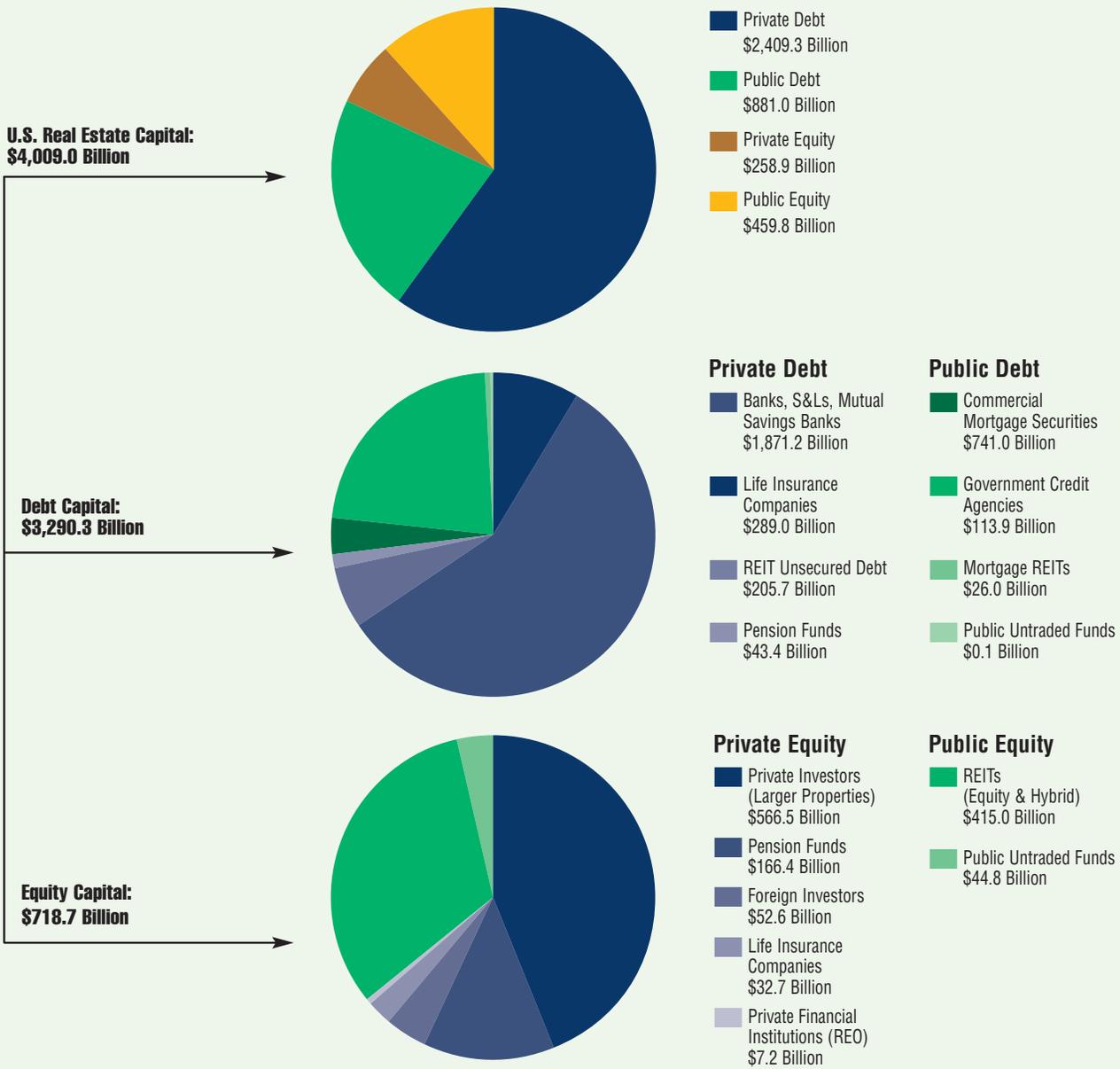


Sources: Roulac Global Places, from various sources including American Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserves, FannieMae.com, IREI, NAREIT, PricewaterhouseCoopers, and Real Capital Analytics.

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

*2007 figures are as of second quarter, or in some cases projected through the second quarter.

Exhibit 2-8 Real Estate Capital Sources: 2007



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.

*2007 figures are as of second quarter, or in some cases projected through the second quarter.

Pension Funds

Interviewees expect pension funds to invest through any market correction and take advantage of their liquidity to make deals at pricing that offers decent risk-adjusted performance. But nervous-Nellie plan sponsors need to get comfortable with more normalized single-digit core real estate returns. Their *raison d'être* for investing in real estate has been steady, predictable income to match growing liabilities for retiree pensions. During the last five years, typical core real estate portfolios have registered high-teen and 20 percent-plus returns. Wowed by performance, these institutional investors stepped up allocation targets and increased value-add and opportunistic investing, edging into overseas funds. “Clients want more value yield,” says an adviser. “They are really asset allocators, but they got used to the benefits of momentum investors’ push into the market.” To their credit, plan sponsors were active sellers in recent years, cashing out of marginal holdings as markets climbed to record price points.

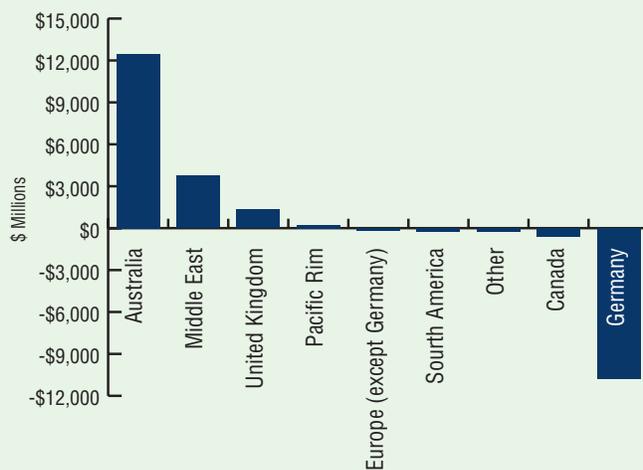
In 2008, plan sponsors should find themselves extremely well positioned in transaction markets. They have the cash to do deals and won’t face as much competition from private equity buyers, who had been outbidding them with leverage. Stepped-up pension fund real estate allocation targets—about 8 to 10 percent of total investment portfolios—may now take less time to attain; advisers have had trouble investing commitments in core funds. But high-octane performance will be more elusive in the market correction, and some recent higher-risk investments may sour in a downturn. Smaller and mid-sized plan sponsors, who had avoided property investing, finally enter the markets through pooled funds and REITs. “Their acceptance validates the maturity of the real estate asset class.” But their timing could have been better.

Foreign Investors

Interviewees anticipate that offshore investors will augment holdings in U.S. property markets now that the playing field is more open to them and less frothy. German and other European investors had pulled back, deterred by “overpriced” markets and private equity flipping. “They saw the REIT downturn as a warning signal.” Traditionally more conservative “buy-and-hold players,” they also sold into the acquisition frenzy. Any repricing should make them more comfortable and the weak dollar enhances their equity buying power. *Emerging Trends* surveys rank Middle Eastern and Asia Pacific/Australian investors as the leading foreign buyers in 2008, followed by the Germans (see Exhibit 2-10). Like most other investors, foreign players concentrate on familiar global pathway markets and prefer office investments. Many high-net-worth families and moguls have helped fuel New York condo prices, purchasing expansive *pièdes-à-terre*. “Asian investors take particular pride in ownership and consider long-term holds”—they don’t necessarily look at discounted cash flows. Despite the United States’ standing as the world’s number-one financial safe haven, offshore investors appear to direct a greater percentage of funds to Asia and Europe than in the past. They look for diversity and find greater yields in developing economies like China and India. “There are now plenty of other places to go.”

Exhibit 2-9

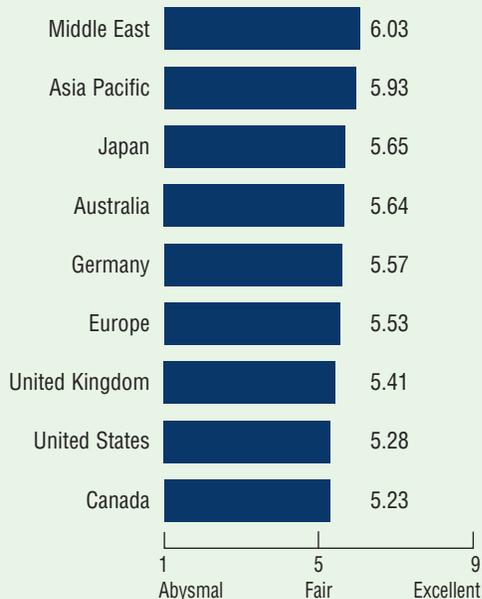
Foreign Net Real Estate Investments, 2006 to Second-Quarter 2007



Source: Real Capital Analytics.

Exhibit 2-10

Change in Availability of Equity Capital for Real Estate by Source Location in 2008



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

■ **Middle East** players quietly bank oil proceeds into U.S. properties, favoring New York and other familiar coastal cities. It's nice to have our gasoline money repatriated. "Besides preservation of capital, they also see strong investment opportunities." These low-key players use banal-sounding front companies and various institutional partnerships to make purchases under radar screens. "Behind the scenes, they have been very active."

■ **China** will come. "Government regulators have opened the way for real estate investment, loosening restrictions and seeking asset diversification." "They look for real estate investment talent to help them ramp up their understanding." "The investment in Blackstone was an early move." In a U.S. election year, friction over balance of trade and monetary policy could raise some hurdles.

■ **Japan** slowly and steadily reasserts a presence after bailing out of American markets in the early 1990s. "If they had only held on then, they would all look like heroes today." Instead of past practice, whereby Japanese institutional investors built their own U.S. staffs to manage investments, today they invest in commingled funds, REITs, as well as joint ventures. "They want core, not opportunistic, although they'll dabble in value-add."

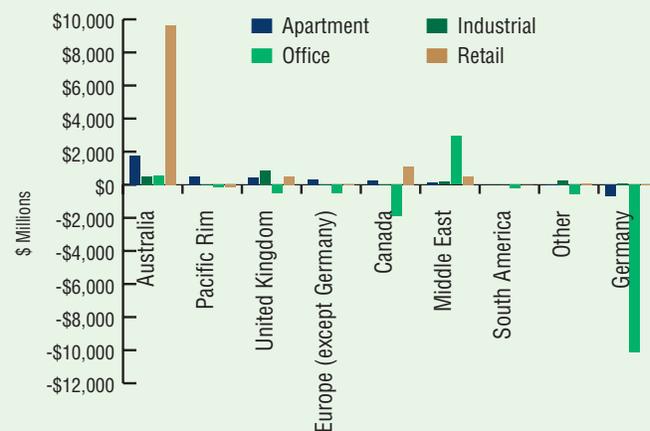
■ **Australian** superannuation funds continue to plunk money into the United States, having depleted investment opportunities back home in constrained markets. "They can't get enough." But they also step up investing in nearby Asia, where they have been getting more pop. Some interviewees say the Aussies overplayed recent U.S. buying, and may see some reversals.

■ **South Korea** "finally makes some inroads," but it's a little too early for **India**.

■ The **Germans** had retreated from acquisition markets—the price spiral and low cap rates made them uncomfortable. They will edge back as soon as markets resolve and they see the froth is gone.

Exhibit 2-11

Foreign Net Real Estate Investments in the United States by Property Type*



Source: Real Capital Analytics.

*Data from 2006 to second-quarter 2007.

“Without **leverage**, the public-to-private wave hits the skids.”

■ **Russian** investors have yet to deploy much capital, “but everyone is waiting.” Some moguls buy Manhattan apartments. Icy political relations may stall the process for now.

■ **U.K., Dutch, Irish, and Canadian** investors maintain an active presence.

REITs

Since a major correction in 1998, REIT stocks had been on a tear, outperforming the stock market and turning into analyst favorites. In 2007, the streak abruptly ended. “You might say they were the canary in the coal mine, a leading indicator of risk repricing.” Appropriately worried about housing contagion, mutual fund managers began a sector rotation out of domestic REITs and into global property stocks. Momentum players recoiled from public-to-private transactions, and individual investors started selling too as housing problems magnified. Who says the average investor discriminates between residential and commercial sectors?

Closely watched funds from operations now improve with declining stock prices, and the group “should be fairly valued after a 25 percent decline.” Companies will be buys if they are well managed and produce 6 percent dividends again. Some observers worry that softening market fundamentals could reduce net operating incomes and hit stock prices further. But most interviewees “don’t expect much more repricing.” “The outlook should be pretty stable,” says an analyst. “Leverage and credit lines are under control, and they have good development pipelines.” But don’t anticipate “spectacular performance” in the near term.

Staying Public. The “terrific run of performance” had a downside for some REIT managements. “Private equity firms were attracted by arbitrage values between public and private pricing, and saw opportunities in breaking up companies. Inexpensive financing greased public-to-private transactions, and buyers took opportunities to retrade properties for quick gains. “Without leverage, the public-to-private wave hits the skids.” “The raging concept that anyone can be taken private is now over.” “Pricing had been out of whack,” says an investment banker. “You probably won’t see any deals for a while.” Some REIT executives had viewed private equity buyouts as cashout opportunities with the added benefits of avoiding Sarbanes-Oxley regulations, analyst meetings, and quarterly reporting. If history is any guide, investment bankers will be taking private companies public in the next few years.

Probably a fitting exclamation point at the REIT performance pinnacle, the public-to-private transaction maelstrom discounted all the touted benefits of REIT models—greater management discipline, more transparency, and strong dividends. Once again, REITs had priced themselves into high-growth vehicles when they are really dividend stocks with upside potential. Dividends shrunk and the funds from operations could not keep up with the pricing levels. Some interviewees contend that the private takeouts were appropriate and good for the sector: “some companies were managed just for quarterly earnings,” “they’d become too institutional,” and “assets weren’t managed effectively.” “Did we really need 20-plus retail companies without much differentiation?” “The reality is some REITs are run by three guys and a dog,” says an analyst. “But most companies are incredibly well operated and professional.”

New Opportunities. Like pension funds, REITs had backed away from transaction markets, unable to compete against leveraged buyers. The revised landscape should offer them more accretive acquisition opportunities. “I have dry powder and am ready to move,” says a REIT executive. “Some companies may leave themselves susceptible to the slowing economy—they have active development pipelines and are doing more development than I have ever seen,” particularly in the retail sector.

Banks and Insurers

Wall Street's shutdown advantaged balance sheet lenders. "Suddenly, insurance companies can name their price." CMBS conduits had made insurers noncompetitive, but now they are popular again. Commercial banks, meanwhile, struggle in the wake of volume lending sprees, which had recorded huge profits on fees. "Insane" lenders were taking equity risk for debt returns and financing without interest reserves or covenants. "It was readily apparent what went wrong." Now interest-only loans are out, debt service coverage goes up, and loan-to-values head down. "They're being brought back into line" and "financing will not be so easy." "When banks have credit issues, they tend to pull in their horns across all lending." "Credit lines will be limited or curtailed."

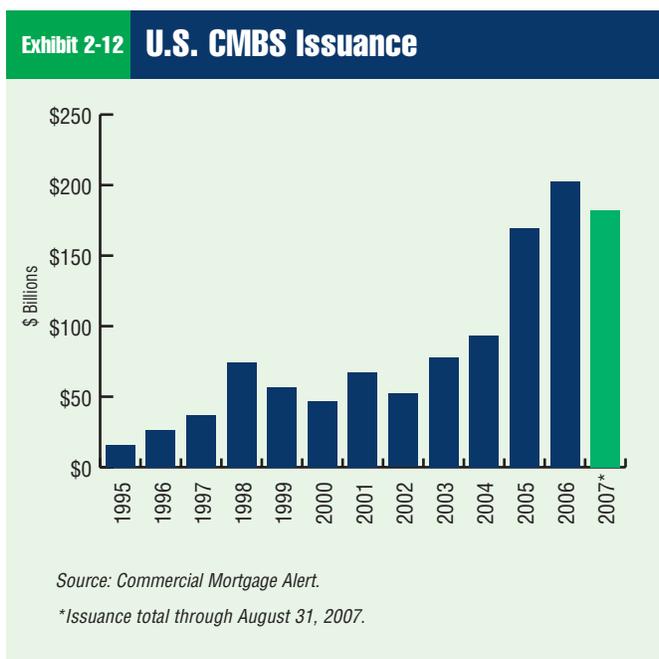
Regulators force banks to raise reserves. Worry increases over loan quality and problematic CMBS markets keep mortgages on bank balance sheets. Inventories marked to market inject red ink into financial company earnings statements. Some lenders really don't know what kind of trouble they may be in. "They've made loans where the borrower needs appreciation and a sell exit to pay loans off. Payback may be difficult now and many borrowers have so little equity in deals, it will be easy to walk away."

Some lenders thought they were doing themselves favors leaving the high-volume fixed-income business and lending more floating-rate debt. "If betting \$1 billion in capital, you better make more than \$10 million in fees." But more attractive fees on floating-rate originations may come back to haunt when already saddled borrowers cannot deal with rising rates. Most interviewees suggest that banks have been more cautious about construction lending, and "at least the pendulum has swung back from borrowers in favor of lenders."

More conservative life insurers gain respect for their restraint. "They did not lend on narrow spreads." At least the industry retains some institutional memory from the early 1990s, when several smaller companies failed and a handful of major players teetered close to insolvency, because of hemorrhaging real estate portfolios. Now their staple—long-term permanent loans at decent spreads—"will make a comeback."

CMBS AND CDOs

Some lenders moan about the lack of bond buyer differentiation between residential and commercial mortgage-backed securities. "We were hurt for the wrong reasons. Investors just assumed that all mortgages have the same problems." For support, they cite still-miniscule commercial delinquency and foreclosure rates, and reasonably solid supply/demand fundamentals. But just because residential markets faltered first, doesn't absolve commercial lenders and securitizers from originating and structuring "inherently risky investments" without appropriate risk premiums. "We've been over our skis, going down the black diamonds, and were bound to hit a bump," admitted a conduit lender. It may be just a matter of time before recent vintage commercial mortgage-backed securities (2004–2007) experience rising default rates in loan collateral and bondholders suffer principal losses in CMBS for the first time ever.



“Many intelligent people, the best and the brightest, do not know what will happen in the

Many interviewees gnash their teeth over CDOs—the three-letter acronym for collateralized debt obligations that morphed into a “four-letter word.” CDO structures took risk diversification to new levels, allowing owners of B-piece CMBS tranches and mezzanine lenders to sell off their debt investments into pools with tranches of subprime loans, and various other residential loans as well as CMBS swaps and who knows what else. CDO issuers then leveraged this soup of high-risk collateral by nine to one, offering bonds with high-yield returns. The CDO model seemed almost too good to be true. CDOs match liabilities to risk and lock in spreads, using hedging structures. The bonds have no floating-rate risk, and investors can only be hurt to the degree they have principal losses when loans mature. “It’s a good idea that can be corrupted by bad assets.” CDO issuers were geniuses at structure, but “forgot about asset analysis.” Alarm bells went off when subprime loans started defaulting. CDO investors—including hedge funds and offshore institutions—had been buying yield. “Now they stand on the window ledge—what they own is like a ball of yarn. It’ll take a long time

for them to understand the collateral and how they are doing.” In the meantime, the CDO market dries up—“bond buyers look like deer in the headlights”—and negative consequences ripple through other investments. “Mezz” lenders and B-piece buyers who stretched on questionable gambits get stuck with dicey plays. AAA-tranche owners are left exposed in deals where B pieces were sold off into CDOs. Lenders of all stripes try to come to grips with how to mark portfolios to market, and dramatically limit new lending until they get a handle on their inventories. “Many intelligent people, the best and the brightest, do not know what will happen in the case of defaults.” Investors mistook diversification in CDOs as an offset against systemic risk, but the bonds are only as good as the underlying real estate. “If there is a problem in the real estate industry, CDOs will bust.”

As CMBS markets settle down, chastened lenders and conduits will focus on “high-quality business”—loans on prime assets and borrowers with good credit. Loan volumes decline as B-piece buyers resume kicking out questionable mortgages in larger numbers and ratings agencies make stricter credit evalua-



tions on offerings. Owners with lower-quality properties in second- and third-tier markets will have more trouble refinancing just as markets may be softening. Facing more limited and expensive financing options, buyers will pull back from these markets. Cap rates will increase and values could sink in a flight to quality. CDO issuers go on a holiday.

Mezzanine Debt

The credit meltdown may take mezzanine lenders out of (some of) their misery. "Senior lenders had pushed down risk, evaporating mezz loans' risk-adjusted returns—they had only 1.0 debt service coverage." "No room was left for error," and mezz execution depended entirely on securitizers buying loans for CDOs. Repricing of risk will rationalize risk premiums across the capital stack, and give mezz lenders with liquidity the ability to make intelligent loans. Plenty of owners will be looking for lifelines. But mezz lenders, who made recent risky loans expecting to dump them into CDOs, "are holding the bag." And it doesn't smell good.



*“It’s a tale of two worlds—
New York
and everything else.”*

Markets to Watch

For years, *Emerging Trends* has extolled the handful of America’s 24-hour cities—multifaceted markets with desirable, walkable residential neighborhoods near commercial cores: New York; Washington, D.C.; San Francisco; Boston; and Chicago. These markets—together with southern California’s suburban agglomeration, and more recently Seattle—have gained further status as the preeminent U.S. global gateways, the nation’s commercial and cultural wellsprings in a rapidly integrating world economy. Not surprisingly, they have become magnets for corporate headquarters, business elites, the best and the brightest, as well as an outsized share of investors’ dollars. But now one real estate market definitively rises above all others, influencing investor psychology and setting the tone for the entire U.S. commercial real estate market.

Wall Street and Real Estate

The One and Only. A generation ago, New York City teetered on the edge of bankruptcy, engulfed in crime and mired in the consequences of urban poverty. Suburban metropolitan areas in the Sunbelt exploded in growth, and West Coast cities morphed into premier international destinations.

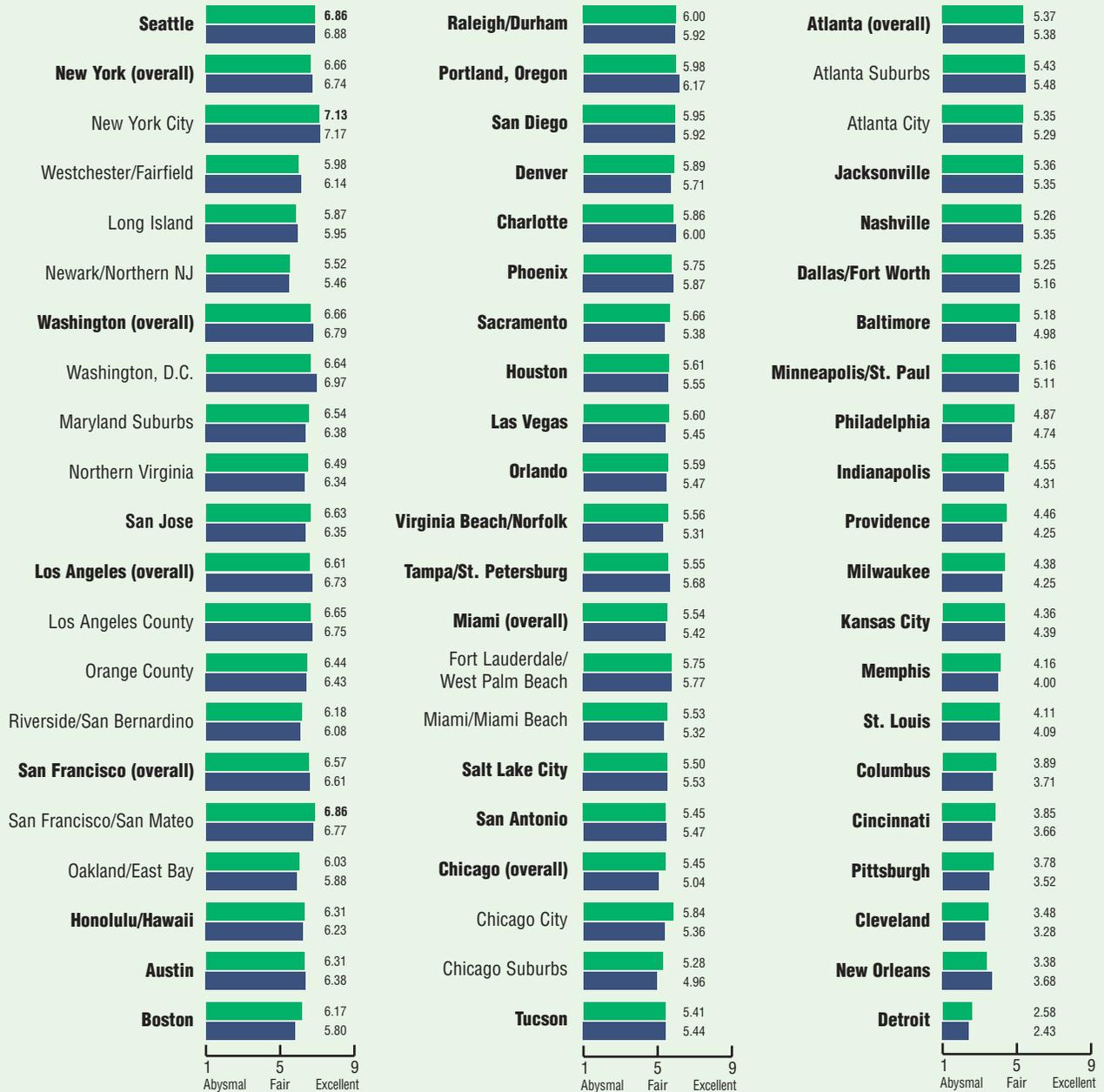
Washington grew into an urban power to match its political might. No matter, the Big Apple has always ranked at or near the top of the *Emerging Trends* surveys, recognized as a world finance capital—the country’s biggest, busiest, bossiest, and most exciting place. Now, the ultimate American 24-hour city rises to a new standing, joining London in a higher circle of predominant global real estate markets.

“It’s a tale of two worlds—New York and everything else,” says an interviewee from Chicago, where the same trophy-style skyscrapers lease for one-third the price of a Sixth Avenue tower. Vacancies are in the mid-single digits, rents have skyrocketed, fundamentals couldn’t be much better, and prices are off the charts. Foreigners park money and buy condos. Moguls concentrate like bees in a hive and Wall Street manages the world’s money. In the global economy, New York is America’s giant lodestone. “Other markets are okay, but not as good or as deep.” A Dallas developer says, “As long as New York stays strong, the feel-good ripples through everywhere. Any setbacks will precipitate dampening everywhere.”

Exhibit 3-1 U.S. Markets to Watch

Prospects for Commercial/Multifamily Investment and Development

■ Investment Prospects ■ Development Prospects



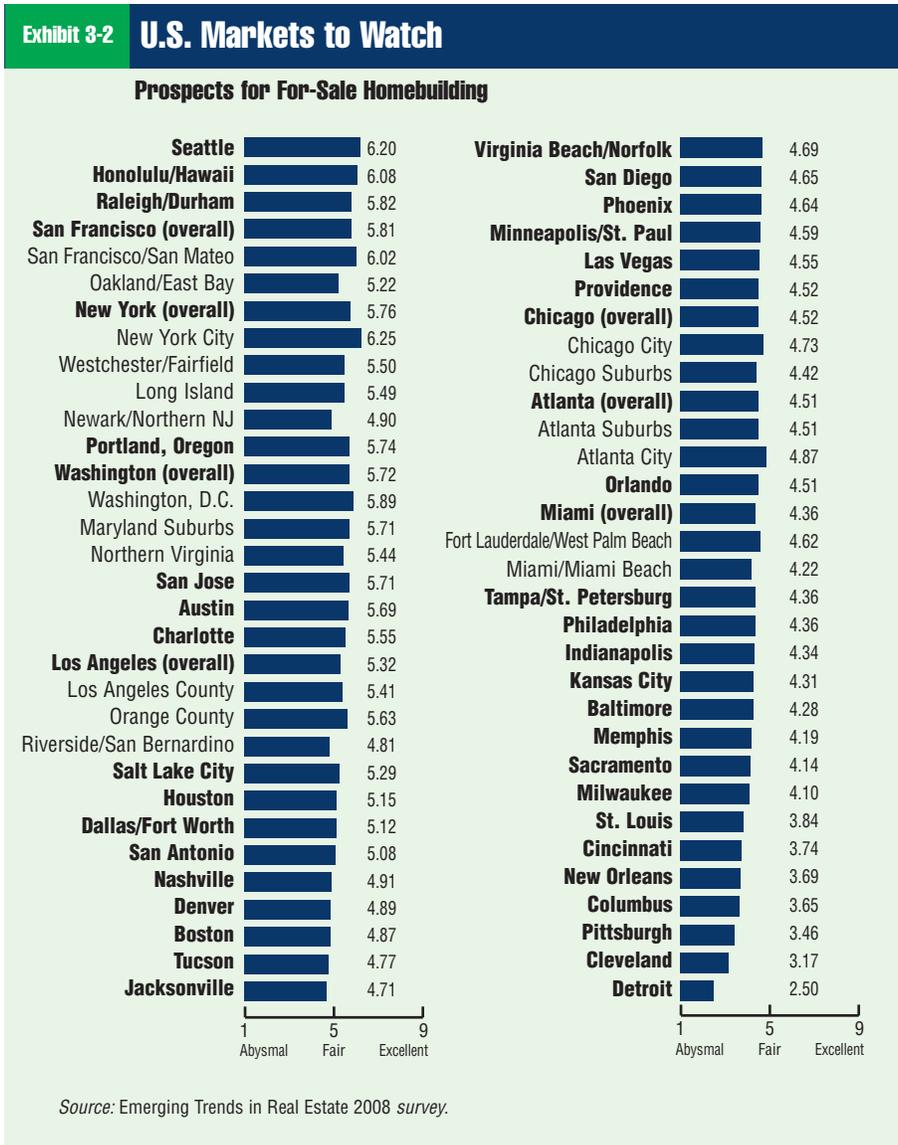
Source: Emerging Trends in Real Estate 2008 survey.

Note: Ranking is based on ratings of metro areas and their investment prospects. Some metro areas include ratings of separate markets within the metro area. If this list were ranked including all of these separate markets in the ranking, New York City would be ranked first and Seattle and San Francisco/San Mateo would be tied for second (see bolds on ratings for these cities).

Wall Street Again. Economic globalization and real estate's Wall Streetization launch New York's further ascendancy. All the capital fueling recent property market growth funnels through the Wall Street system, which creates the securitization structures and runs the trading machines. It's the money hub, the headquarters for private equity magnates, hedge funds, the big banks, and all the investment houses where investment decisions affecting everywhere else are made. Local and regional banks or insurance company field offices may no longer exist or don't have the clout. Real estate investment turns New York-centric.

Extravagant bonuses fuel Midas-class condo/coop/suburban home prices and enable Madison Avenue boutiques to pay kings' ransoms for rents. The cataracts of promotes and fees cascade into mind-blowing three-figure office leases. White-shoe attorneys even feel comfortable enough raising their billing rates to \$1,000 an hour so they can keep their cushy space with a view. The aura of New York prices, rents, and profits rubs off on other markets and "lifts all boats." Subliminal influences creep into the mind-sets of all the high-powered investment deciders who live or work there. Other investors can't pay the entry fee or find the properties too large to swallow, so they invest elsewhere, impelled by the precedents of billion-dollar Manhattan trades. New York, you're the top, reaching heights never reached before.

Demise of Local Owners. Still, the adage reminds everyone that "the higher you go, the harder you fall." That could apply to today's real estate markets, epitomized by New York. Any Wall Street tailspin would reach into all property sectors, particularly Manhattan office,

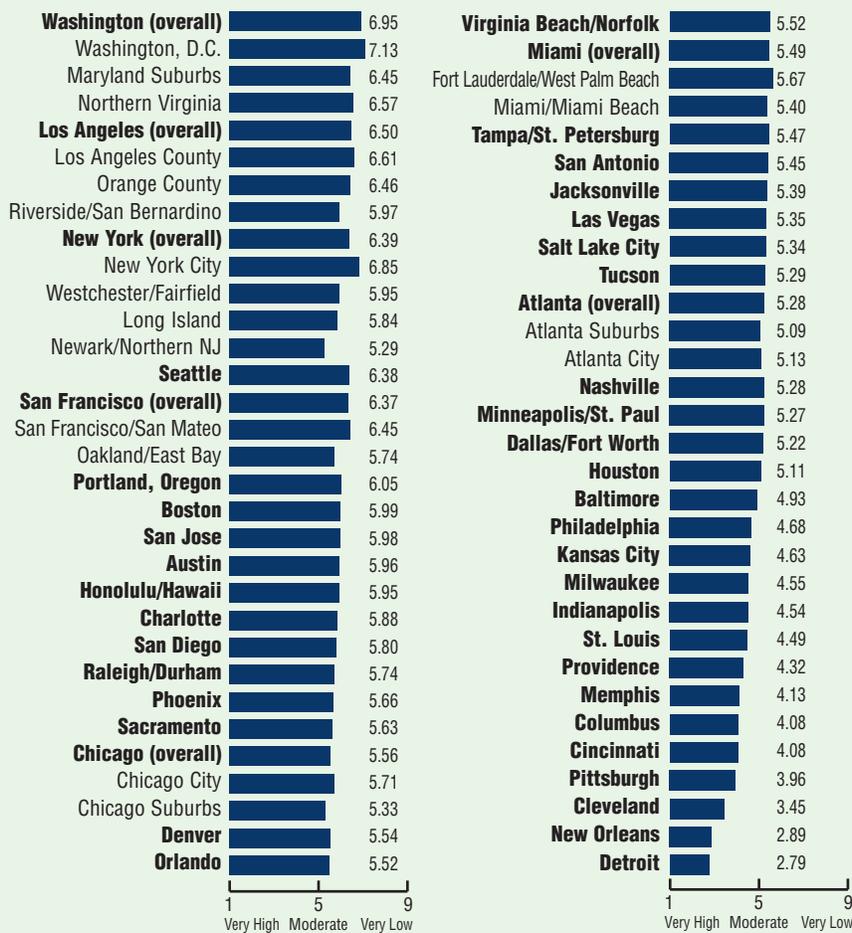


where financial companies constitute nearly 30 percent of midtown occupancies and more than 40 percent of downtown occupancies. But as long as Wall Street chooses to dominate real estate investing, New York should hold onto its industry preeminence, while the city's 24-hour dynamics buffer downturns. Those investment deciders will more likely want to protect their own backyard

too when local powers come calling. Unfortunately, many other commercial markets continue to lose locally based owners to far-flung institutions and/or landlords without local roots or long-term local interests. In the past when trouble struck, mayors or governors could appeal to the banker around the corner for forbearance on behalf of the

“You need to be on the **global** pathways.”

Exhibit 3-3 U.S. City Risk



Source: Emerging Trends in Real Estate 2008 survey.

regional shopping center company. Homegrown real estate families, who used to own most commercial properties, could be counted on to lead chamber of commerce initiatives. The powers that be would work together to sort out problems and boost local fortunes. What happens today when the malls and towers are mostly owned and financed by distant entities, which have limited

understanding of and lesser stakes in local matters? We may learn during the next recession when some governments see their tax coffers shrink or major properties face hard times.

Distance and Consequences. Long-distance ownership may also result in misjudging or not understanding local trends and issues that affect property performance. Technology and Wall Streetization combine to make real estate markets

increasingly transparent. A few mouse clicks on the laptop and anybody anywhere can access reams of cogent market-specific information: REIT analyst reports, broker vacancy information, leasing updates, mortgage delinquencies, and local news reports. But owning real estate isn't strictly comparable to owning stocks and bonds. When owners aren't on the ground and don't have local relationships, they can miss key market nuances or valuable backroom conversation. Big capital often tries to overcome distance issues by joining forces with operating partners, local sharpshooters who manage day-to-day operations and monitor the market pulse. History shows that joint ventures work well in upcycles, when profits grease partner comity. Conversely, downturns can stress these relationships, sometimes acrimoniously. Many institutions swore off operating partner ventures after early-1990s meltdowns involving bankruptcies, foreclosures, and costly litigation. At least back then, many of the big investment advisers had local offices with executives to deal with the headaches. Any breakdowns today could maroon many owners, who won't have dependable local resources. Here come the SWAT teams, living out of hotel rooms for weeks on end.

Smile Investing

Short List. Interviewees continue to recommend the familiar “smile investing” formula—focusing on coastal markets with some attention paid to interior Sunbelt leaders (Atlanta, Dallas) as well as Chicago. They like cities with “high immigration flows” and places where college grads and career climbers want to locate. “Twenty- and 30-year-olds focus on only a few places to settle and that’s

it.” The list of first choices includes San Francisco, Los Angeles, and Seattle on the West Coast and D.C., New York, and Boston on the East Coast. Lesser-rank regional favorites are Atlanta and Miami in the South, Denver in the Rocky Mountains, Dallas and Houston in the Southwest, and Chicago in the Midwest. All these cities have large international airports, major shipping ports, and/or export-import hubs. Access to global markets is critical—sitting on an important interstate intersection no longer makes a city relevant. “You need to be on the global pathways.”

Smile and Be Happy. The West Coast—from Seattle on down to San Diego—has “top-to-bottom strength.” “Trade with Asia is a mainstay” and “high tech is back.” Attractive Pacific harbors and mountain vistas offer special lifestyle draws, while water, mountains, and deserts provide geographic barriers to entry that help control growth and husband value. New York is ground zero for top finance, advertising, legal, and media jobs. Washington lures political movers and shakers and think-tank types. Boston mixes top money managers, academic elites, and high-tech gurus. Miami solidifies its status as a Latin American gateway and European pleasure destination.

Coping with Growth. High-growth development havens—Atlanta, Dallas, Houston, Denver, and Phoenix—see commercial vacancies drop and enjoy improved supply/demand fundamentals. “But these markets are not tightening as fast as they should” with new construction underway and storm clouds on the economic horizon. The warm-weather Sunbelt agglomerations still offer cost-

effective lifestyles and business-friendly operating environments (low taxes, cheaper labor and utilities, less expensive real estate). Traffic congestion, infrastructure problems, and severe car dependence increasingly spoil some suburban pleasures. Cities dependent on the Colorado River begin to worry about how population growth will affect future water supplies. All those people moving from high-cost California markets may go thirsty one day in Nevada, Arizona, Utah, and Colorado without new water sources or stepped-up conservation. Forget green lawns in these places. Florida girds for further population gains—an additional 12 million people over the next quarter century—and confronts water shortages, too. While older 24-hour cities struggle with aging infrastructure, newer Sunbelt metropolitan areas grapple with poorly planned road and sewer/water systems that can’t cope with in-migration trends. Dispersed commercial nodes and sprawl can’t be retrofitted easily with hub-and-spoke mass transit. Costs for road maintenance and infrastructure improvements, meanwhile, shift to states and cities from the federal government. Remember “no new taxes”? But local politicians and residents need to face up to harsh realities: higher local taxes and user fees, more restrictive zoning and planning, and toll roads. As they mature, these suburban agglomerations will become more urban and expensive.

Rustbelt Blues. People in the Northeast and Midwest industrial belt don’t want to hear it, but their market prospects fade. Interviewees characterize cities in these areas as “risky” and “overpriced,” leaving “no exit strategies.” Detroit ranks in the survey basement,

just behind Hurricane Katrina-ravaged New Orleans and Cleveland. “You kid yourself if you say you can cherry pick.” It’s the old story—backbone manufacturing jobs continue to shift to low-cost overseas markets or right-to-work states in warmer Sunbelt climes. Long, dreary winters without recreational attractions deter new growth industries from headquartering there. “There’s no global cachet or special quality of life to sustain them.” The agricultural breadbasket region doesn’t attract much attention either. Only Chicago and Minneapolis appear to have staying power with investors—they hold onto diversified corporate bases. But enthusiasm is muted. Everyone focuses on the coasts.

Crime, Growth, and Green Issues

Crime Watch. Urban crime rates increase in many cities across the country, a disturbing trend that could threaten the resurgence of city lifestyles. For now, the problems seem concentrated in cities like New Orleans, Detroit, Baltimore, Newark, and Oakland, which have not benefited from sizable move-back-in waves of empty nesters and echo boomer career makers. Poor neighborhoods still concentrate near their urban cores. Many violent crimes—robberies, aggravated assaults, and murders—are committed by gangs of minority juveniles and young adults, whose demographic cohort not so coincidentally expands after dipping to generational lows during the mid-1990s. Poverty

hasn't disappeared from flourishing 24-hour cities, but jobs are more plentiful and zooming property values have displaced some poor neighborhoods toward perimeter districts and into inner-ring suburbs. Big-city mayors and police chiefs rail against lax gun control laws over concerns that murder and mayhem may increase. Nothing will subvert 24-hour dynamics faster than fear of violent crime.

Changing Suburbs. Despite sporadic degeneration and nettlesome congestion, American suburbs “are alive and well.” Income, job status, and good schools continue to influence where people choose to live. For many families, suburban life still offers the most affordable and attractive option. “Apartment rent levels in [major 24-hour cities] are two times what they are in surrounding suburbs” and house prices in suburban areas are much better values than prime center-city condos and coops when you factor in better public schools and all the added space. “But successful suburbs will need to embrace diversity in housing—two-acre lots wall off diversity—and recognize the benefits of orienting mixed-use developments around mass transit.” Higher gasoline costs and lengthening commute times will steadily restrain people from locating in far-flung suburbs, and many will increasingly locate closer to commercial cores. Annual car expenses—loan payments, gas, regular maintenance service, repairs, insurance—can exceed debt service on a \$100,000 mortgage. People will start factoring the economics of using mass transit more and cars less. Time is

money, too. More empty nesters and most career-oriented singles will continue to flock closer to 24-hour centers. Many graying, upwardly mobile baby boomers shift lifestyles from parent-centered suburban activities that involve shuttling kids around, to “an intown apartment closer to work and a lake house.” Young adults crave convenience and the more active city social scene. “It’s hard to hook up with people in the burbs.”

Green Bandwagon.

Governors and mayors also promote sustainability programs to improve energy efficiency in big cities as well as reduce congestion, pollution, and heat island effects. Higher energy costs and chronic traffic snarls sap competitiveness—businesses cannot operate effectively or profitably if utilities sock it to them and employees or delivery trucks get stuck in jams. Global warming effects and health concerns galvanize public awareness. In the handful of 24-hour cities with good mass transit, costs for infrastructure repairs and improvements may derive increasingly from congestion pricing schemes like those successfully implemented in London and under consideration in New York. Development guidelines and incentives encourage green projects.



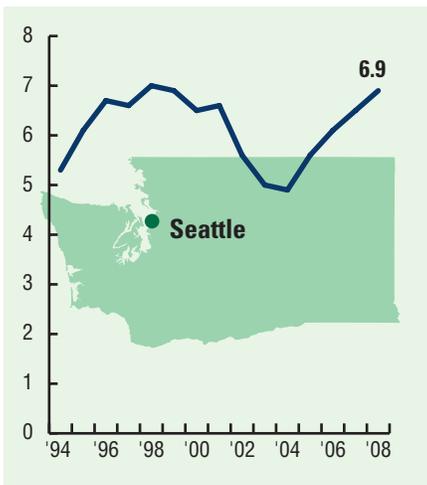
Major Market Review

Emerging Trends 2008 rankings of metropolitan area investment and development prospects again showcase respondents’ strong bicoastal preferences. Among major markets, New York City’s premier standing gets reinforced. Seattle and San Francisco also are top tier and improve dramatically. Los Angeles and Washington, D.C., maintain high ratings, while Boston rebounds into the top circle. Condo problems blemish San Diego, the number-one market

two years ago. Denver leads the Sunbelt agglomerations, while Phoenix drops back from overbuilding concerns. The city of Chicago improves, registering well ahead of Midwest laggards, but its suburbs show less strength. Atlanta and Dallas maintain perennial mediocre scores, just behind condo-plagued Miami. Philadelphia stays near the survey bottom. “A lot of second- and third-tier markets have not experienced the same rent gains of the top markets,” says a researcher. “Many are slightly up to flat, with some new supply. Any new office should do okay, but at the expense of second- and third-tier properties.”

Seattle

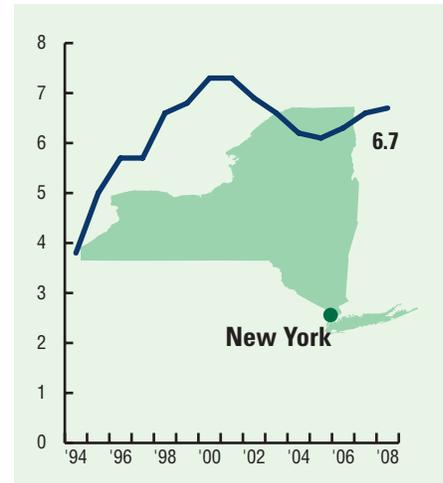
This Pacific Northwest center takes advantage of converging trends. Seattle is developing into an exciting 24-hour city smack-dab on key Asian shipping routes and its brainpower economy diversifies, led by corporate heavyweights Microsoft, Boeing, Washington Mutual, Amazon, and Costco. Even Google adds a presence. “The economy feels more stable than ever



before.” Not even gloomy autumns and dreary winters discourage in-migration. Growth controls and geographic barriers concentrate higher-density, mixed-use development, which draws residents into attractive new downtown neighborhoods, and the city becomes more expensive, “following the San Francisco model.” Multifamily and industrial sectors rate as the leading buy candidates in the entire survey. It’s also the nation’s best homebuilding market—house prices keep increasing, according to respondents. Retail energizes, too. Puget Sound ports attract their fair share of Pacific Rim import/exports, bolstering the solid warehouse market. Sub-10 percent office vacancies push companies to seek deals for big blocks of space. “Rents accelerate dramatically,” but “pricing can’t get much higher”—approaching “or exceeding replacement cost.” Landlords will need to “operate on all cylinders” to reach pro formas. “But you get better returns for less than in San Francisco or southern California. It’s still the best West Coast value.” Bellevue develops into a satellite office market. Abysmal traffic congestion strangles commuters “with no relief in sight.” No wonder people move into urban nodes.

New York

“Catapulted beyond mere U.S. markets,” New York City’s “monster” pricing deters many investors. “Everywhere else looks like a bargain.” Record office rents don’t keep up with price spirals, but still trail rates in other global kingpin markets like London and Tokyo. “The weak dollar makes the city look cheap next to top



European markets.” Tenants have been undeterred. Manhattan office vacancies approach record lows both in midtown and downtown. Everybody wants to be at the center of action. “Some companies consider the [cheaper] Jersey burbs another world,” and corporations don’t want to chance losing employees in tight labor markets over suburban relocations. “It’s worth paying higher rents to attract better talent.” Ad agencies and nonfinancial firms find midtown unaffordable, pushing up rents in submarkets. Downtown benefits, too. Any new construction has miniscule impact on overall existing inventory. A limited number of sites and high development costs lead to fewer new office buildings than in previous cycles. “Replacement cost hurdles give buyers some extra comfort.” The city features the tightest apartment rental market in the country, where “stratospheric rents” may not guarantee either high-rise views or white-glove addresses. Room rates go “off the charts” in an underroomed hotel

“Washington’s always been very good to us.”

market. Back up the armored car at check-in. New lodging projects should score. But Wall Street distress dampens outlooks. “They add people like crazy in good times, and get rid of them immediately in bad.” Financial firms led the market up and would lead any retreat. Layoffs and parsimonious bonuses would finally cool off white-hot coop sales. Almost-completed condo projects could be ill timed. And will some hedge funds stay alive to pay those \$150-per-square-foot office rents? Global pathway status and 24-hour dynamics cushion downside risk. But recent buyers and lender/bond-

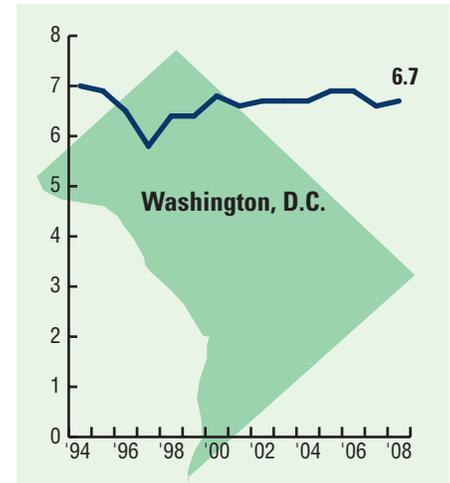
holders, who bankrolled some boggle-the-mind acquisitions, should be nervous. “Short New York?”

Also, New York’s suburbs are not nearly as strong as Manhattan—two different worlds.

Washington, D.C.

Past its peak, the nation’s capital turns into a hold market. “Washington’s always been very good to us,” says a large pension plan sponsor. Congress and the President pledge to cut waste, but the “government never stops” and neither do

the seemingly ballooning number of lobbyists who somehow make sure the budget doesn’t get cut for programs that favor their constituencies. Substantial new office supply gets absorbed, but demand slows. Pricing got well ahead of rental rates—recent buyers may get burned if they overleveraged and expect more spikes. Markets inside the beltway show “no weakness” and Maryland suburbs “hold up” (development restrictions make building there more difficult), but “historically more volatile” northern Virginia softens in light of overbuilding, especially in the western suburbs around Reston and Herndon. Apartment landlords can still push rents in this “premier multifamily market”



thanks to ultra-low home affordability. House prices had skyrocketed until abruptly hitting the wall in 2006. Late-in-the-game condo converters had to reverse course. Homeowners face more value erosion, and retailers start to feel the pinch. But the enduring government machine cushions against abrupt downturns—perfect for core owners.

Los Angeles

Southern California’s economy crests in the housing market slowdown. A familiar cyclical pattern reemerges as some businesses and locals relocate out of state to less expensive regions when prices escalate too fast. Then again, “How many people can afford \$650,000 homes?” Many people stretched to buy and the market had been fertile territory for sub-prime lenders. ARM resets could ignite a further downturn. The Orange County office market softens: mortgage bankers issue a ton of pink slips, and some companies belly up. But West L.A. office has “never been so good,” feeding off a mix of advertising, financial, and entertainment companies, which have been “on fire.” Media moguls and movie stars “meet by the pool” and pay whatever price at the slew of upscale and luxury





hotels. Pacific vistas fetch heady premiums. Downtown L.A. has momentum behind its condo/residential push. “Finally, a small residential core has been established.” L.A./Long Beach remains the country’s top port, but clogged transport routes reach capacity, compromising logistics for moving containers to Inland Empire distribution centers. The overall warehouse market remains “red hot.” Land prices “go through the roof.” “Crazy” multifamily markets see 3.5 cap rates. A lack of affordable housing and mortgage angst feed high apartment occupancies.

San Francisco

Back near the top, the City by the Bay shows big survey gains, propelled by resurgent high-tech businesses. This prototypical brainpower Mecca takes advantage of scenery, climate, and strategic location to draw top minds, many incubated at Stanford and the Berkeley and San Francisco campuses of the University of California. “People want to live there” despite the high cost. “Young techies gravitate to the 24-hour downtown over the burbs.” Good condo absorption may be offset by rapidly increasing high-end inventory. The office market tightens

appreciably—“stuck tenants” must pay up even for commodity, nonview space or move out of the city. Some “wonder if they need to stay.” View space breaks \$100 per square foot again. New projects creep off the drawing boards, and new supply won’t be a near-term drag. City hall’s push for affordable housing components in projects deters developers. The market ranks as the survey’s top hotel “buy.” Tourists flock to Alcatraz and Ghirardelli Square. Warehouse also rates a strong buy. Everyone bets Asian trade won’t let up (not a bad wager).

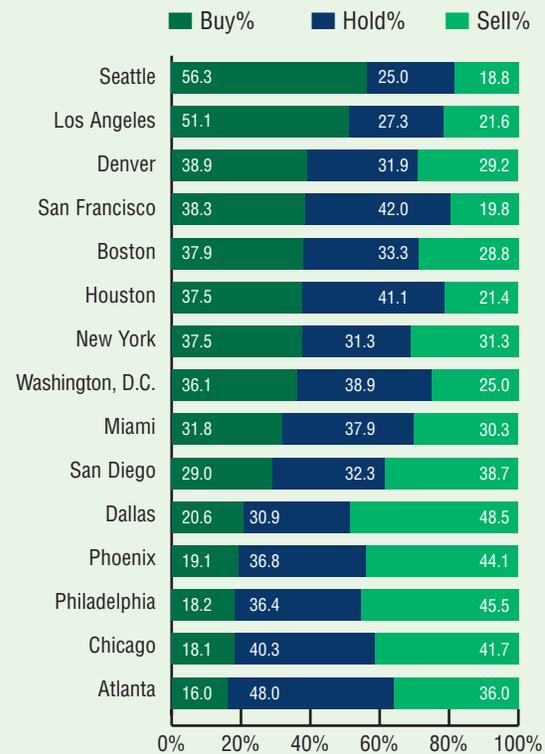
Boston

The resurgent office market enjoys recent rent spikes—money managers, insurers, and

professional firms take new space and high-tech/biotech companies expand. No major building activity leads to pent-up demand and the price per pound escalates in a landlord’s market—“all of a sudden, properties are worth some big bucks and tenants realize it’s time to make deals.” A wellspring of local colleges and universities supplies highly skilled talent and the cosmopolitan downtown provides attractions. Boston is more “hot and cold” than New York or D.C., and its tenant depth becomes increasingly suspect. Bank consolidations have hit hard. Once a major

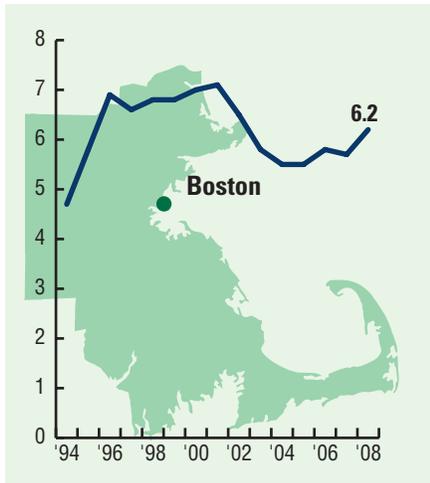
Exhibit 3-6

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

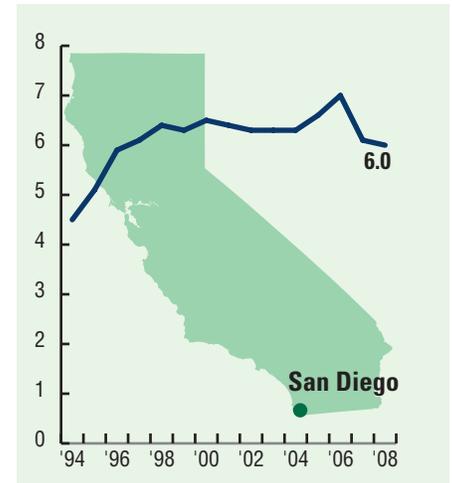


Source: Emerging Trends in Real Estate 2008 survey.

*“In Boston, if a financial company **hiccups**, the whole office market can suffer.”*



banking center, Boston no longer has any commercial bank headquarters and “Gillette is gone” too. Mega-employer Fidelity moves more back-office functions to nearby, lower-cost New Hampshire and Rhode Island bases. “If a financial company hiccups, the whole office market can suffer.” After major run-ups, housing values dip, with more declines anticipated. But low affordability spurs renter demand, and Boston apartments rate a strong buy signal even as the market digests new multifamily supply. “The pig has come through the python, but will take some time to absorb.”



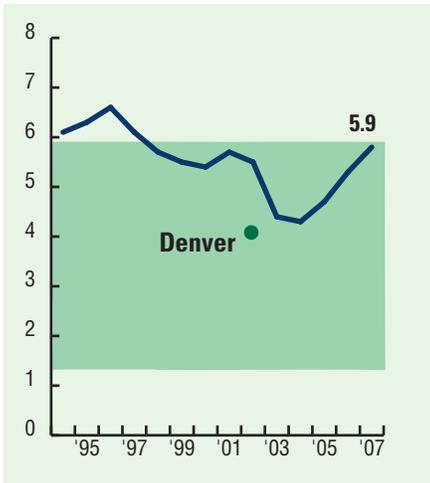
San Diego

This market could be “a leading indicator” for any correction. After flipping multiple office buildings multiple times, “exhaustion sets in.” “Prices got to the point where the last guy is in.” “Values may need to readjust.” An expensive business climate and a small airport deter corporate relocations. Rents downtown stagnate. Prime business centers continue to migrate north near desirable coastal enclaves. Del Mar is now ground zero, but Oceanside tempts the Chargers with a new stadium proposal, which includes surrounding office and mixed-use development. At some point, commercial office

nodes will link northward all the way to Orange County. Housing markets were among first to list nationally—prices got way ahead of themselves. Now, condos come back as rental units, dampening short-term multifamily prospects. Loathsome traffic congestion benefits infill grocery-anchored retail and strong convention activity buttresses hotels. Industrial “disappears” as developers shift “to higher and better uses.” “Some softness exists, but what a great unique place to live.”

Denver

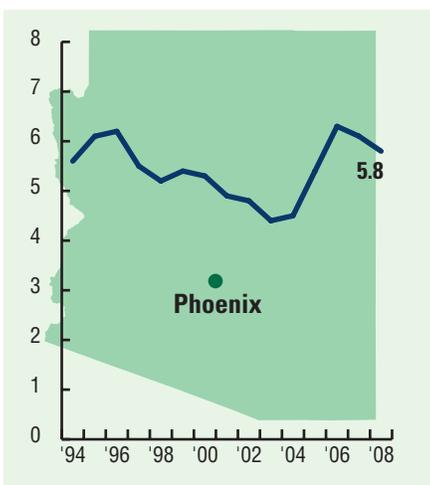
This metropolitan area retools its downtown, reviving a true urban core in the midst of a sprawling suburban agglomeration. Its “vibrant” LoDo entertainment district and light-rail transit hub work wonders. People and businesses move back in. Light rail—“built right into high-rent suburbs”—provides downtown with a major edge. Employees have access from all points and can avoid lengthening car commutes to spread out suburban office nodes. Fast-growing northern suburbs cluster around master-planned transit-oriented development, linking directly to downtown. “Downtown office has been



gangbusters—you've got to pinch yourself.” Housing slumps and apartments firm—a lot of wide-open space makes it easy to build. Turbo-charged population in-migration may slow temporarily.

Phoenix

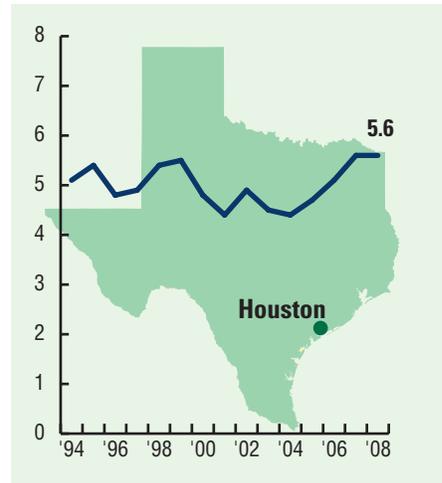
“You can smell the growth.” This metropolitan area “really operates like a big suburb of southern California.” People and businesses gravitate from lofty California cost structures to the more affordable desert oasis. The area captures back-office operations from L.A. and Orange County businesses and overflow



from busting-out Inland Empire distribution centers. But Phoenix is no headquarters town—Wal-Mart is the top private employer here. Subdivisions and strip centers spill further out into the *mesa*. Construction fuels the local economy, which gets a winter boost from snowbirds filling up local resorts and condos. Florida hurricane fears make the Arizona desert even more attractive as a retiree relocation destination, although in the future the issue facing area residents may be too little water, not too much. But the city is still one stop away from global pathways, and poorly planned sprawl development spells future trouble. The area needs revamped infrastructure to keep pace with all the growth, including more roads and improved sewage treatment and water systems. Light rail is coming, but locals question whether it can work since the city has no defined commercial core. Denver's success may be hard to repeat. Commercial developers keep building. Office and apartments show signs of softening as declining housing markets temporarily put the metropolitan area's growth engine into a lower gear.

Houston

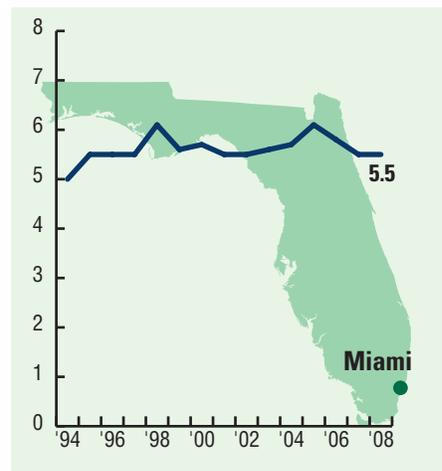
High gasoline and heating oil prices may tick off the rest of the country, but Houston benefits. “After 25 years in the hole,” the city's office markets finally strengthen thanks to surging energy company performance. “The city had tried to diversify away from dependence on oil and gas businesses after they tanked in the 1980s; now it's time to embrace them again.” A new container terminal boosts shipping capacity and warehouse prospects. The market is well positioned to attract more traffic directed away from West Coast ports through the Panama



Canal. But the easy-to-build environment lets developers get ahead of the market. Plenty of jobs and a low cost of living keep people coming in droves—nearly 200,000 in the latest census for the year ending 2006. Commodity, workforce housing sprouts in ever-spreading suburbs “with no zoning to get in the way.”

Miami

The condo mess “only now unfolds.” Projects, begun before the downturn, move toward completion. How many



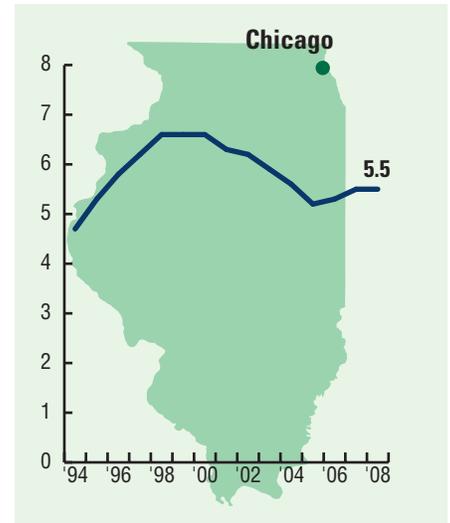


buyers will leave their downpayments on the table and walk away? “Lawyers are busy looking for contract exits.” Many units will be converted to rentals, potentially hurtling the Class A apartment market into oversupply. Other multifamily sectors “should hold their own” as local housing woes mount. Developers, caught up in condo mania, neglected other prop-

Chicago

The city sidesteps the “Midwest blahs,” “but you need to be careful.” New office projects lease up at the expense of existing buildings. In classic Chicago fashion, developers keep building unfazed by market softness. “Three big new projects, scheduled for 2009 delivery, will oversupply the market.” “Why should they worry? Existing owners can’t compete against the new green bells and whistles.” Tenants move into the new buildings

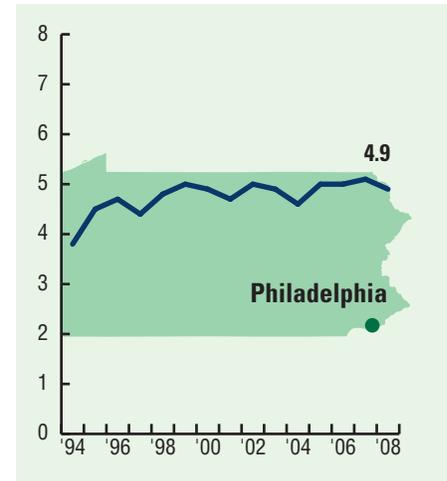
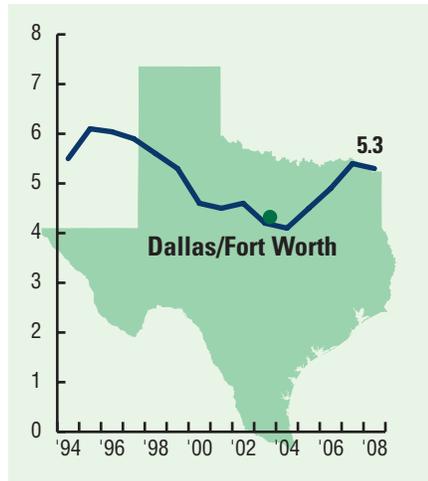
erty types. Office hangs in there and the warehouse market ranks as one of the nation’s best. Both sectors feed off of Latin American commerce and trade. The weak dollar draws European tourists to beachside hotels, which register record revenues. Pinched between the ocean and the Everglades, the south Florida region will build up since it can no longer build out. Like the rest of the state, the Miami area “faces fundamental issues”: choking growth, depleted water supplies, hurricane threats, expensive insurance rates, and higher taxes to support the population influx. “Water is like a third rail—no one wants to touch the issue.”



“and leave holes.” As a result, “rents haven’t moved much except for new space,” where rates approach \$40 per square foot. “Your best bet is to build and sell.” “Buyers of existing [space] pay close to replacement cost.” After rampant flipping, “prices can’t go any higher. The music is fading [on transactions].” Suburban markets whittle away at mid-to upper-teen vacancies in a shaky recovery. Usually solid industrial markets could show weakness in a development wave, retail remains firm, and hotels do well. Too many apartments may be in the pipeline given the slowing economy. The city stands well above the suburbs with investors.

Atlanta

Chronically overdeveloped, Atlanta can’t get relief from building fever since the local economy feeds off growth—“our engine and our enemy.” Every sector is soft. New “big-box industrial sits empty,”



“too much office is underway,” and “retail development is ahead of other markets.” “They like to build there.” Inevitably, the uptown Buckhead and Midtown markets will meld into an urban core, served by the MARTA subway. High-rise apartments and condos appear at every major intersection, drawing the move-back-in crowd who can’t stand the suburban commutes any longer. But downtown continues to languish without any meaningful residential development. A new aquarium and World of Coke attractions won’t do the trick. The huge Hartsfield-Jackson Atlanta International Airport positions the city as the Southeast’s transport hub and link to global markets. Charlotte, Raleigh, Birmingham, and Nashville can’t compete.

Dallas/Fort Worth

“So many developers, so much new supply.” Population and employment go like gangbusters, and building follows. Office vacancy never seems to get below 20 percent. But the warehouse market tightens with strong rent growth—“never thought that would happen.” “Pricing has been

less aggressive for commercial properties than in other national markets.” Investors have been wary of poor supply/demand fundamentals. “It looks like we may be late to a bad party rather than an early arrival.” Airport infrastructure puts the city on global pathways. The uptown market continues to transform into a high-density residential/upscale retail node with 24-hour elements. Mortgage woes could strike—heavy subprime borrowing occurred here.

Philadelphia

A lack of dynamic job growth hurts prospects, although Center City shows untapped potential, featuring a mixed-use core, 24-hour elements, and some new residential projects, encouraged by tax incentives. The CBD really can’t support new office construction, but the giant Comcast headquarters tower careers toward completion. The cable company had nowhere else to expand,



“but the rest of the market will soften and start hurting.” B and C apartments perform well in infill areas.

Smaller Market Prospects

Investors typically back away from second- and third-tier markets in any correction—capital turns more selective, concerned about market tenant depth and more limited exit strategies. In general, ardor for smaller markets levels off or declines modestly in *Emerging Trends* surveys. Interest has peaked. The possibility of a flight to quality and capital retreat from these metropolitan areas will depend on the level of potential economic retrenchment. “Second-tier markets are always more volatile.” The entire market can feel the pain when a single major employer downsizes. Places on the edge of investors’ radar screens can more easily fall off them when money pulls back or finds comparable deals in larger markets.

San Jose registers the only significant jump from the 2007 survey (6.6 from 6.1). Resurgent tech companies pave the way. This market traditionally seesaws with sometimes dramatic swings . . . “Everyone dreams about going to Hawaii, just not necessarily investors.” “For now, Asians park dollars in **Honolulu**. A recent uptick in tourism provides “growth pop.” Military bases add cushion, but any consumer belt-tightening on the mainland would be felt quickly. Developers ramp up in **Austin**, the Texas favorite. The state capital, the flagship campus of the University of Texas, and a sizable cluster of high-tech businesses combine to create a dynamic local economy and attract brainpower workers. Downtown multi-family gains favor in evolving 24-hour

neighborhoods. But like Dallas and Houston, the city can get overbuilt easily . . . **Raleigh-Durham** and **Charlotte** benefit from population moves into the Carolina corridor. A temperate climate and relative proximity to mountains, the seashore, D.C., and Atlanta are attractions. Research Triangle high-tech businesses and local banks provide economic muscle. Home prices keep increasing into the mortgage market headwinds . . . **Portland**’s market “looks like a miniature Seattle.” Growth controls have encouraged strong fundamentals, tamping down on overbuilding . . . **Sacramento**’s state capital remains its great asset. Worries intensify over condition of local levees . . . **Las Vegas** drowns in condos as concerns about water resources grow. Colossal new



hotel-casino projects propagate along the fabled Strip. Operators gamble that high rollers and conventioners can't get enough of all the action, shows, and unique scene **Orlando** and **Tampa** struggle with perceptions over Florida condo mania, insurance costs, and growing pains Staid **Salt Lake City** gets a high-tech boost and like the rest of Utah feeds off of California out-migration **Jacksonville** and **Nashville** enjoy growth in service businesses, but investors tiptoe around "lack of depth." **Minneapolis** rates "the best of the Midwest after Chicago." More blunt interviewees suggest: "It's the only place to invest in the Midwest other than Chicago." **New Orleans's** outlook fades. The French Quarter still makes for an enticing convention backdrop, but even before Hurricane Katrina hit, the ravaged city could not compete as a regional corporate base against Houston, Dallas, or Atlanta. Government lip service hasn't translated into a meaningful recovery plan.



Housing deservedly sinks further into the ratings basement, threatening to take the economy and other real estate sectors down.

Property Types in Perspective

For 2008, *Emerging Trends* interviewees peg all commercial and multifamily property sector investment prospects in the fair to modestly good range, assuming the economy prolongs a slow to moderate growth track. Not surprisingly, housing rates a “modestly poor” outlook. Notably, the surveys signal that all sectors, except distribution/warehouse, have passed their cyclical performance peaks after producing substantial high-teens annualized performance in recent years. Two core stalwarts—distribution/warehouse and moderate-income apartments—lead the survey in their customary spots. Hotels drop behind office after topping the rankings two years ago. Interviewees get more skittish about retail and more pessimistic about housing (see Exhibit 4-1).

■ Over the years, distribution/warehouse regularly battles apartments for ranking honors. Last year, apartments claimed first position; now the industrial sector reclaims the survey’s highest rating. Coveted big-box properties in coastal gateways are the favored cash cows for pension fund investors. These port/transport hub markets stand in relative equilibrium, benefiting from exploding global trade.

■ Apartment acquisitions may have been overpriced in recent deals, but the property category appears well positioned to take

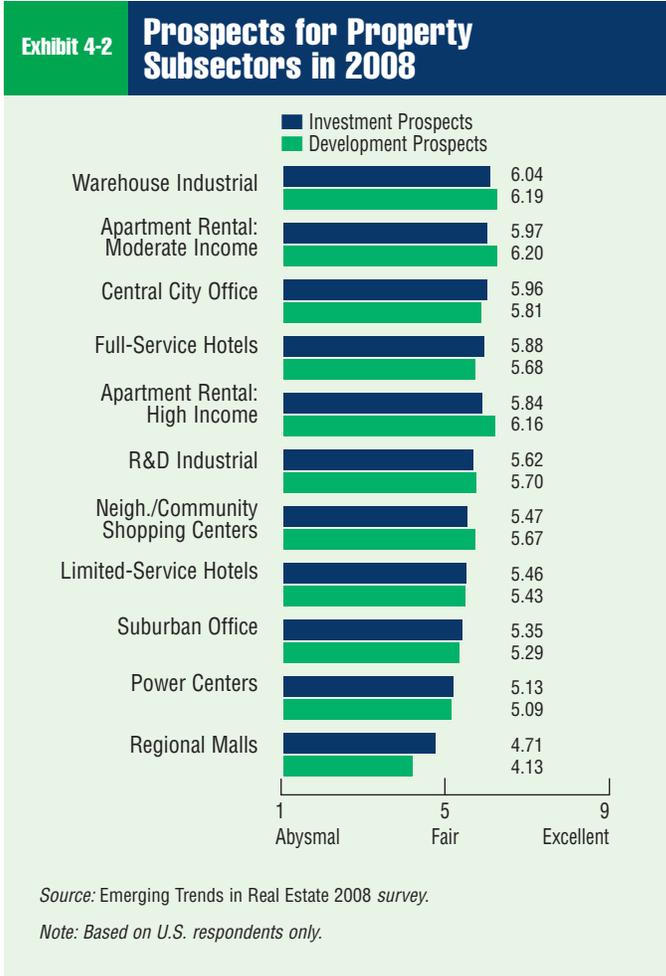
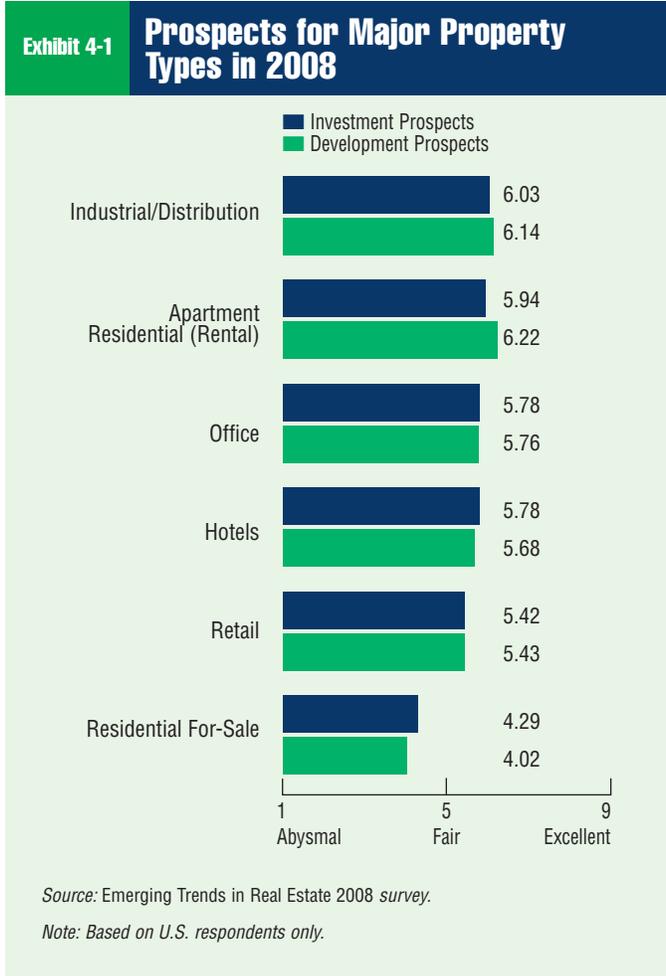
advantage of demographic trends and housing market distress.

■ Respondents like the supply/demand fundamentals in 24-hour, global pathway cities, and tick up the ratings for central city office to 5.99, versus 5.70 in last year’s survey. But forecasts for suburban office decline—investors worry about sluggish demand and stepped-up building in some markets.

■ Hotels track down as occupancies decline and new construction augments room supplies, especially in suburban markets and limited-service categories. Full-service hotels in 24-hour markets rate better than limited service.

■ Retail raises caution flags. Absorption declines and new supply increases, while performance lowers in the wake of waning consumer demand. Investors hope housing market reversals don’t lock consumer pocketbooks. Respondents’ gloom centers on B and C regional malls.

■ Housing deservedly sinks further into the ratings basement, threatening to take the economy and other real estate sectors down. Condominiums (4.27) rate lowest of all survey subcategories. Rising foreclosure rates, ARM resets, the subprime mess, and tougher financing markets foreshadow an extended slump.



Top Buys. For buy/sell/hold, retail categories and suburban office rate the lowest buy scores, while moderate-income apartments and industrial properties register the best buys. “The smart buys or holds are properties with cash flows,” says an interviewee. “Apartments, industrial, and well-leased CBD office will avoid trouble in a slowdown.” Land—specifically, lot tracts from reeling homebuilders—also records an overwhelming buy vote. Respondents recommend selling B and C regional malls, power centers, and limited-service hotels. These categories have crested past performance peaks. In a more uncertain, down-cycle investment environment, interviewees feel most comfortable holding properties. Their best selling opportunities were missed and a better buying season may lie ahead.

Cap Rate Hikes. In 2008, respondents expect that cap rates will rise modestly in a tight band from approximately 25 to 50 basis points. Rates will increase the least (27 basis points) for in-demand distribution/warehouse and the most for neighborhood/community centers (49 basis points). Unleveraged internal rates of return (IRR) are expected to range from 10.76 for limited-service hotels down to 8.59 for regional malls. Expected IRR numbers increase across all property sectors compared with last year’s survey results (see Exhibit 4-3).

Relative Development Discipline. Development outlooks also rate fair to modestly good ratings, although more conservative lending practices and tighter underwriting may leave some projects at the blueprint stage. Respondents note most development potential in industrial warehouse categories, moderate-income apartments, and lifestyle centers, the hottest concept among cooling retail sectors. Downtown office also gets a boost

Exhibit 4-3

Prospects for Capitalization Rates and Internal Rates of Return

	Cap Rate July 2007 (Percent)	Expected Cap Rate December 2008 (Percent)	Expected Cap Rate Shift (Basis Points)	Expected Unleveraged IRR*
Apartments: High Income	5.26	5.70	+44	9.67
Regional Malls	5.56	5.96	+40	8.59
Central City Office	5.60	6.07	+47	9.02
Apartments: Moderate Income	5.70	6.14	+44	9.68
Warehouse Industrial	6.28	6.55	+27	9.13
Neighborhood/Community Centers	6.35	6.84	+49	9.35
Power Centers	6.36	6.79	+43	9.22
Suburban Office	6.52	6.97	+45	9.55
Hotels: Full Service	6.67	7.12	+45	10.72
R&D Industrial	6.71	7.06	+35	9.48
Hotels: Limited Service	7.45	7.84	+39	10.76

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

*During holding period.

off last year's numbers—equilibrium in 24-hour cities supports new construction. “A big pipeline exists for retail and hotels—you need to pick your spots.” Of course, forget about homebuilding.

Prior to credit gridlock, investors had stepped up development activity, looking for bigger returns relative to acquisitions, but without getting traditional risk premiums. “Eight to 10 percent is not enough for the risk.” The more sober financing markets should reorient expectations, and preempt some moves by private equity and hedge funds into new construction—they want maximal leverage to boost returns and may not be able to make the numbers work. High material costs, labor and contractor shortages, and drawn-out entitlement processes also stymie new projects—higher development costs mean developers need to achieve higher rents. “It’s not a sure bet that rents will keep rising enough.” China, India, and other developing countries continue to compete for concrete, steel, and other building materials, bidding up material prices. Infrastructure and other public works projects draw away contractor teams from commercial development. Available land turns into a precious commodity in coastal, barrier-to-entry markets—it’s much harder to assemble sites and get entitlements and permits.” The tougher regulatory environment acts as a development governor and helps sustain equilibrium, but builders grit their teeth.

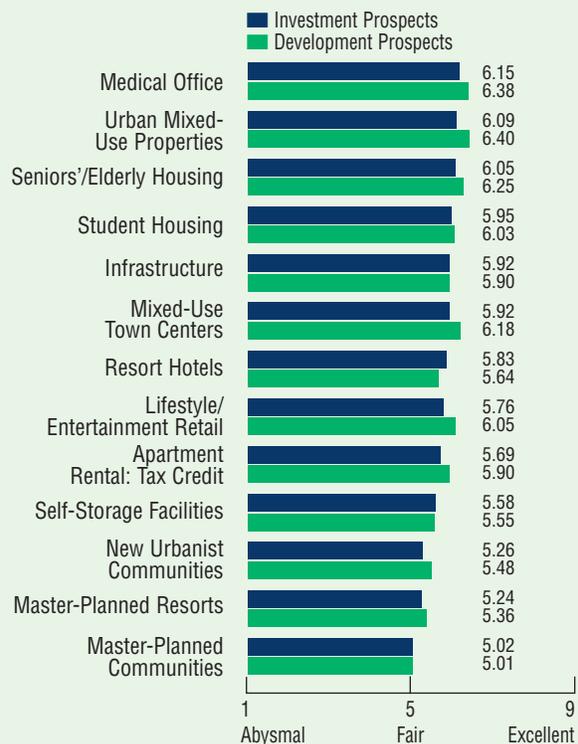
Veteran entrepreneurs note the lack of up-and-coming traditional “gunslinger” developers to replace the old guard. “The *Man in Full* is gone. It’s hard to BS people anymore with lines

like ‘When I build ’em, they come.’” Those good old days of development binging that led into the early 1990s’ industry depression show few signs of reappearing in the current cycle.

Niche Interest. Certain niche property categories maintain solid ratings—especially seniors’ housing and medical office, demographic plays on graying baby boomers and their parents, who are living longer and longer. Infill housing and urban mixed-use properties also get nods—people want more convenience and want to live closer to work. Any sector associated with homebuilding gains little traction. Prospects plunge for golf course communities, attached single-family homes, and timeshare properties. And condos bring up the rear.

Exhibit 4-4

Prospects for Niche and Multiuse Property Types in 2008



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

Industrial

Strengths

“Love it.” Core, institutional investors can’t get enough of these cash machines and keep upward pressure on prices. Tenant demand has come back with a vengeance. “They just chug along.” As consumer-driven global trade becomes more central to overall economic growth, investors focus almost entirely on the relative handful of global pathway markets along the coasts as well as Chicago, Atlanta, and Dallas, which boast the busiest international airports in the nation’s midsection. Historically, these properties never get overbuilt enough to upend relative equilibrium. “Steady as she goes” and just what pension funds adore. For value-add and opportunity investors, “performance doesn’t move the needle.” Well, excuse me, recent mid- to high-teens returns aren’t enough?

Exhibit 4-5		Prospects for Warehouse Industrial in 2008	
	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.04	1st
Development Prospects	Modestly Good	6.19	2nd
Expected Capitalization Rate, December 2008		6.6%	
Expected Unleveraged IRR During Holding Period		9.1%	
Buy		Hold	Sell
40.3%		39.4%	20.4%

Source: Emerging Trends in Real Estate 2008 survey.
Note: Based on U.S. respondents only.

Weaknesses

If the consumer goes into a cocoon, warehouse demand will cool. These properties would suffer recessionary chills quickly. For the long term, demand growth will continue to ebb and tenant needs will undergo further transformation as just-in-time distribution channels evolve further to speed deliveries and cut costs. In 2007, vacancies finally dropped under 10 percent for the first time since 2001, but supply/demand fundamentals usually tighten more at or near market peaks. “Rent growth

Exhibit 4-6		Prospects for R&D Industrial in 2008	
	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.62	6th
Development Prospects	Modestly Good	5.70	5th
Expected Capitalization Rate, December 2008		7.1%	
Expected Unleveraged IRR During Holding Period		9.5%	
Buy		Hold	Sell
28.2%		44.4%	27.3%

Source: Emerging Trends in Real Estate 2008 survey.
Note: Based on U.S. respondents only.

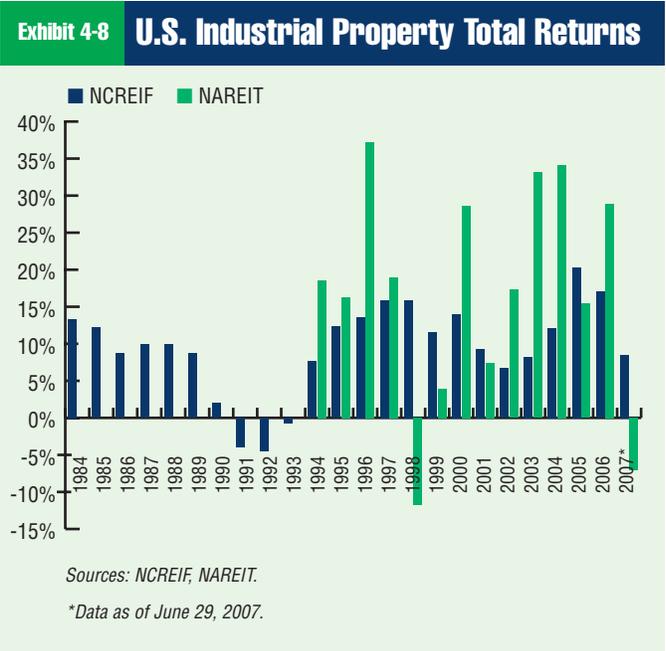
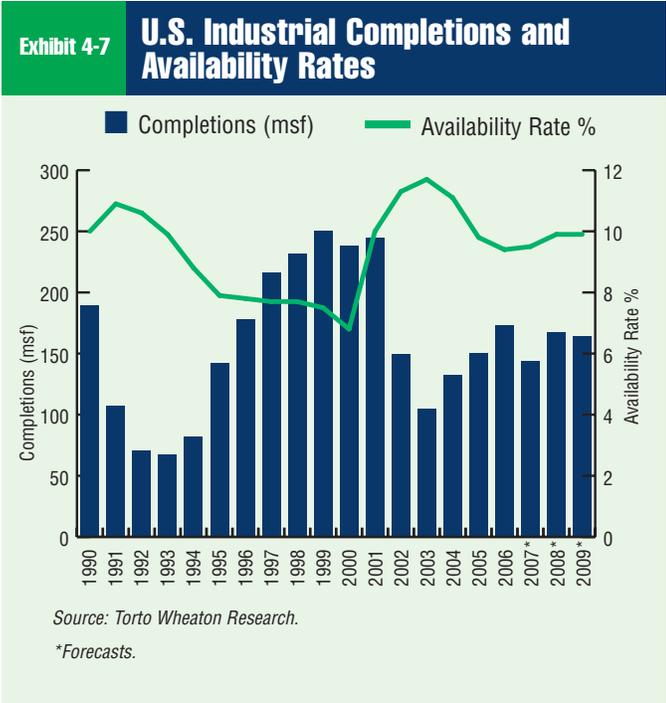
really has not been as good as in the past.” Markets off global pathways rate third-tier status. Logistics mavens continue to remove links from transport chains, eliminating intermediary warehouse locations wherever possible and focusing more on distribution than storage. “At overseas departure points, they attempt to stock containers for delivery to individual stores.” Buyers, meanwhile, always struggle to acquire bargains and build meaningful diversified portfolios.

Best Bets

Global pathway markets locked into import/export traffic cannot miss over time. “Pacific ports [L.A./Long Beach, San Francisco, Seattle] are near full capacity and it’s hard to build.” Asian shippers look to Suez Canal and Panama Canal options, boosting prospects for already attractive East Coast and Gulf Coast destinations where northern New Jersey/New York dominates and Miami ranks as a top survey “buy.” Houston gains with its new container terminal. Interviewees talk up long-term prospects for Charleston and Savannah, too. Jacksonville and even Mobile could benefit.

Avoid

Steer clear of properties with older, low-ceilinged storage space in global pathway markets unless it can be redeveloped into big-box. Midwest markets in the manufacturing belt suffer from auto industry misery. Shippers now bypass once-strategic inland, interstate intersections without direct global connections. Be careful in hot growth markets like Atlanta and Dallas, where new construction always keeps markets soft. Some ports



may not be able to accommodate larger “superbarges,” which become popular for ocean shippers. “They will be losers.”

Development

New construction trails late-1990s levels. Big-box gets overbuilt in some inland hub markets (Chicago, Atlanta), but long-term trends should support construction of distribution structures over obsolescent storage space. Clogged West Coast ports force more challenging logistics options—including rail and truck links to new, less congested inland distribution centers like Phoenix and Kansas City. More offloading occurs in Mexico for rail and truck transport to distribution centers north of the border. On the East Coast, places like Harrisburg, Pennsylvania, and Columbus draw attention—they have rail heads with proximity to large population concentrations. “Follow the logistics industry to figure out your development and investment strategy.”

Outlook

Investment bifurcation will continue. High-ceilinged, high-tech space in primary port markets attracts premium pricing. Except for new inland distribution center locations and interior markets with superior international airports, other industrial markets slowly wither. Local manufacturers and retailers will still lease traditional storage space, but new technologies turn many of

these properties into dinosaurs. Expect investment performance to head south quickly from uncharacteristically lofty levels—the recent appreciation binge is over—to typical high-single-digit returns. Pension fund appetites should cushion against pricing erosion. The economy plays the wildcard. Worst-case scenario: prime industrial properties stumble, but not too badly.

Research & Development

While the distribution/warehouse sector produces superior, “steady-eddy” performance over time, R&D properties run hot and cold. Their fortunes are tied closely to volatile high-tech and biotech businesses. The current upswing in high-tech company activity now accelerates R&D real estate performance, after severe declines in the wake of the 2001 tech wreck. Typically an opportunistic timing play, R&D rates a “hold” or “sell” today. The best buying opportunities were in the 2002–2005 period, when some properties couldn’t find tenants. Investors always need to be wary of tenant credit quality and quirky special needs. If these companies flame out when their design concept or drug research implodes, specially designed interiors may be costly to retrofit for new users. As long as tech markets hold up in places like Silicon Valley, Austin, Seattle, La Jolla, and Raleigh, these properties will score. But R&D is one real estate sector where it doesn’t pay to buy and hold for too long.

“The percentage of people moving into homes is down, benefiting **multifamily.**”

Apartments

Strengths

All investors want apartments—“capital demand is quite healthy.” Value-add and opportunity players like to upgrade B and C properties to sell to core investors who covet steady income streams. The supply side is under control relative to absorption, except for some overbuilt condo markets where units will revert to rentals. Tenant demand should increase over time, led by swells of young adult echo boomers, immigrants, and mortgage market-compromised homeowners and would-be homebuyers. “The percentage of people moving into homes is down, benefiting multifamily.” If you are a long-term investor, “there’s a lot of room to run after recent terrific performance.” “Don’t be too greedy—you’ll get high-single-digit returns.”

Exhibit 4-9

Prospects for Moderate-Income Apartments in 2008

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.97	2nd
Development Prospects	Modestly Good	6.20	1st
Expected Capitalization Rate, December 2008		6.1%	
Expected Unleveraged IRR During Holding Period		9.7%	

Buy	Hold	Sell
44.7%	35.4%	19.9%

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

Exhibit 4-10

Prospects for High-Income Apartments in 2008

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.84	5th
Development Prospects	Modestly Good	6.16	3rd
Expected Capitalization Rate, December 2008		5.7%	
Expected Unleveraged IRR During Holding Period		9.7%	

Buy	Hold	Sell
28.3%	42.1%	29.6%

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

Exhibit 4-11

U.S. Multifamily Completions and Vacancy Rates



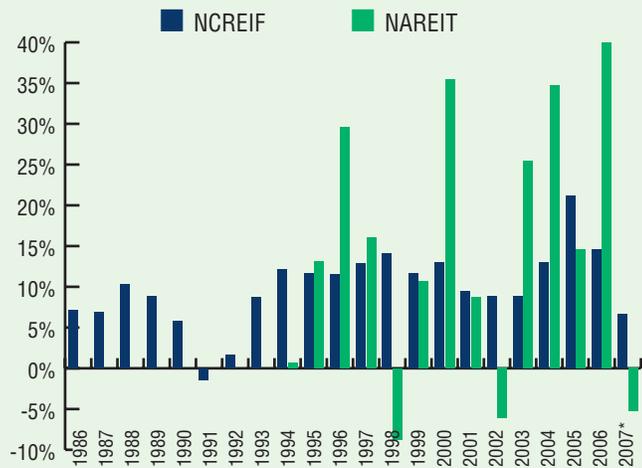
Source: Torto Wheaton Research, M/PF (sum of top markets).

*Forecasts.

Weaknesses

Slowing job growth may hurt short-term demand. Sub-5 percent vacancy nationwide will tick up if the economy dampens, discouraging some renters who will double up or shack up with parents. “It will be harder to push rents; the fundamentals are less robust.” South Florida condo mania markets and Las Vegas

Exhibit 4-12 U.S. Apartment Property Total Returns



Sources: NCREIF, NAREIT.

*Data as of June 29, 2007.

start to weaken as sponsors turn into landlords. Speculative buyers also rent out units to stem their losses or keep up with debt service. San Diego and Washington, D.C., have also been affected by condo-to-rental conversions, but those markets can rebound quickly. Recent construction is up considerably and the delivery pipeline is ample and growing in certain markets. Chicago may soften in a building wave that outstrips short-term demand.

Best Bets

The familiar barrier-to-entry markets with low housing affordability remain top buy choices: San Francisco, Seattle, and anywhere along the D.C.-to-Boston corridor in the Northeast. Southern California always ranks high, too. B and C properties should be well positioned for increased demand spurred by the subprime/ARM fallout. “You can always get a B-plus price point with cost-effective renovations.” Watch for opportunities.

Highly leveraged private owners who recently bought at ridiculously low cap rates (“3.5, are you kidding me?”) could find themselves whipsawed in the credit crunch. Also, some broken condo deals could make for ripe steals.

Avoid

A-quality apartments in condo-depressed markets will suffer as for-sale units convert to rentals and inventories increase. Oversupply tends to “snuff out results” in development havens. “Job growth doesn’t necessarily drive residential, it’s the ratio of supply to demand.” Be careful in Phoenix, Dallas, Atlanta, Houston, or anywhere else where it’s easy to build competitive units.

Older properties can work in barrier-to-entry markets, but not in hot growth cities where new projects draw away tenants.

Development

Developers confront “difficult economics” and entitlement hurdles. Condos and office can be more profitable. Local governments increasingly tack on affordable and workforce housing requirements to secure approvals for higher-use/rent projects. Developments near mass transit gain renter preference for their convenience. “The trend is to involve residential in mixed use with retail components.” Prime infill locations in agglomeration markets—downtown L.A., Buckhead/Midtown in Atlanta, LoDo in Denver, uptown Dallas—have particular appeal to the move-back-in crowd.

Outlook

Investors may be “hard pressed to go wrong.” Demand trends will strengthen over the next decade, development should remain controlled, and historic returns have always been solid. Even housing declines generate some pluses to offset other potential economic weakness. “Condo reversions are a short-term blip.” “Apartments outperform!”

“It doesn’t make sense to build a **brown** office building.”

Office

Strengths

The New York aura—record rents, record rent increases, and sub-5 percent vacancies—lifts investor perceptions nationally. San Francisco, West Los Angeles, and Seattle also tighten dramatically and register notable rent spikes, while Boston and Denver record heady rent and occupancy gains. “But many other markets are just okay.” Prices and values race ahead of cash flow metrics. Sellers hit grand slams—buyers and lenders lost perspective in an escalating orgy of spending cheap money, betting on the come. Luckily, dizzying construction costs restrained developers and lenders for a while. In a nick of time, the credit logjam may derail new projects just as private equity and hedge funds, antsy for alpha, readied bulldozers and cranes. If the economy steadies and steams ahead “rents have room to grow,” especially in favored barrier-to-entry cities with high development hurdles.

Exhibit 4-13		Prospects for Central City Office in 2008		
	Prospects	Rating	Ranking	
Investment Prospects	Modestly Good	5.96	3rd	
Development Prospects	Modestly Good	5.81	4th	
Expected Capitalization Rate, December 2008		6.1%		
Expected Unleveraged IRR During Holding Period		9.0%		
Buy	Hold	Sell		
30.8%	38.5%	30.8%		

Source: Emerging Trends in Real Estate 2008 survey.
Note: Based on U.S. respondents only.

Weaknesses

Offshoring, technology advances, and related productivity gains hurt growth in office demand. Despite near-full employment in the United States and restrained construction relative to past cycles, vacancies begin to increase before many markets reach equilibrium, especially in the suburbs. Absorption slows dramatically off 2005–2006 peaks. “What does that tell you?” Recent employment growth—concentrated in health care, education, construction, and retail—has not translated into a surge in office jobs outside global pathway centers and high-tech

Exhibit 4-14		Prospects for Suburban Office in 2008		
	Prospects	Rating	Ranking	
Investment Prospects	Fair	5.35	9th	
Development Prospects	Fair	5.29	9th	
Expected Capitalization Rate, December 2008		7.0%		
Expected Unleveraged IRR During Holding Period		9.6%		
Buy	Hold	Sell		
18.9%	38.3%	42.8%		

Source: Emerging Trends in Real Estate 2008 survey.
Note: Based on U.S. respondents only.

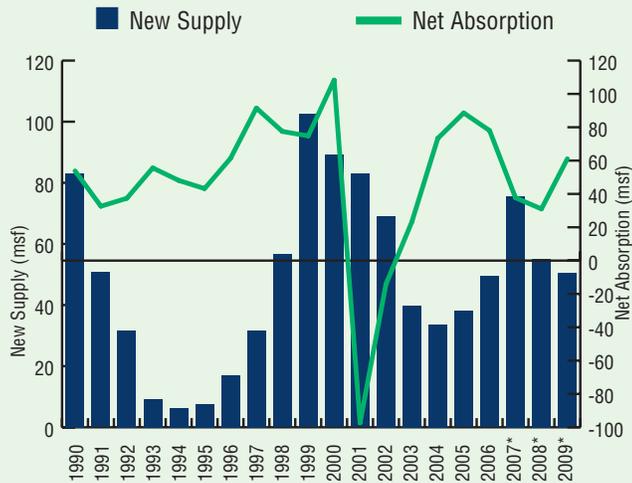
markets. Even some suburban submarkets near 24-hour cores experience “dormant demand.” Certain northern New Jersey and northern Virginia markets languish. Chicago suburbs stay soft. Companies encourage hoteling and keep space-per-capita ratios as low as possible (under 200 square feet). Office workers spend more time at home or on the road, using their laptop, cell phone, and BlackBerry. Forty percent of IBM employees have no dedicated offices. “You really can work from anywhere.” Certain analyst and research jobs have been successfully farmed overseas—thanks to Internet technology. These long-term paradigm shifts could be amplified by near-term economic distress. Mortgage bankers lead a small layoff wave. Will more financial companies follow suit? Corporate belt-tightening would short-circuit demand drivers from augmenting rents. Prices obviously overshot—crystal balls don’t see significant enough rent increases to justify “optimistic” underwriting projections unless the economy takes off again.

Best Bets

Think green. Big tenants will embrace new green building technology—under-floor air conditioning, cubicle-by-cubicle cooling, triple-pane glass—which delivers greater comfort for employees, better light quality, lower utility costs, and increased layout flexibility to reduce space per capita. Also, “companies want environments with high-tech options to attract young talent in a highly competitive, low-unemployment environment.” Hold well-leased buildings in 24-hour markets where enduring supply/demand fundamentals should sustain future rent growth.

Exhibit 4-15

U.S. Office New Supply and Net Absorption



Source: Torto Wheaton Research.

*Torto Wheaton Forecasts.

Exhibit 4-16

U.S. Office Vacancy Rates



Source: Torto Wheaton Research.

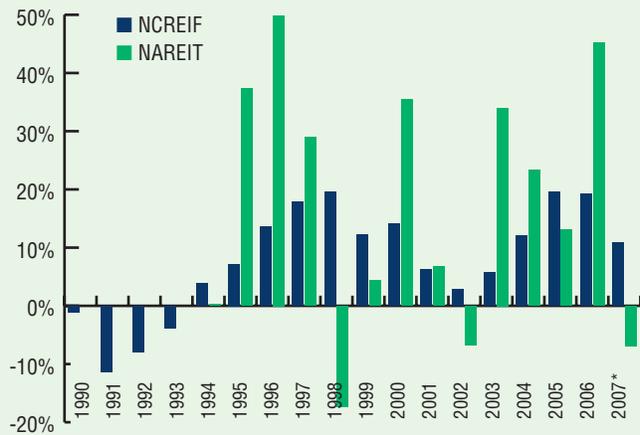
*Torto Wheaton Forecasts.

Avoid

(Well, at least be careful.) Over time, older space will lose tenants to new green projects, if in direct price competition. “Brown buildings will not command the same rents,” and they cannot easily be retrofitted to obtain LEED efficiencies without “major surgery and prohibitive expense.” Investors may get caught short if they fail to calculate the impacts of pending obsolescence, especially in easy-to-build markets.

Exhibit 4-17

U.S. Office Property Total Returns



Sources: NCREIF, NAREIT.

*Data as of June 29, 2007.

Development

Focus on urban infill and densifying suburban nodes, catering to businesses and employees “moving back in for greater convenience.” “It doesn’t make sense to build a brown office building.” Spend the modest extra cost on green technologies and reap the competitive benefits. Need for new space in most markets is limited. Tempered capital should be less aggressive and mute development urges. Any new buildings will successfully draw tenants, using green enticements. Existing inventory suffers, if developers can get financing.

Outlook

Buyers beware—office pricing needs to adjust and markets appear more vulnerable to demand slowdowns. Investors should go to the sidelines, while long-term holders take satisfaction in robust gains. New owners swallow hard and hope the economy supports their wagers on future rent growth. The odds against them get longer. Developers need to retreat and the economy must escape further damage from housing-related declines. Any flight to quality will reinforce leading 24-hour markets and buffet weaker locations. High-occupancy buildings should ride out brief dislocation thanks to long lease terms and markets at or close to equilibrium. But don’t expect a resumption of anything-goes pricing or eye-popping rent increases. That’s over. Tenants get some breathing space.

Hotels

Strengths

Industry room rates break records and profits soar. Business travel has remained strong, while foreigners flock to the States, enjoying buying power made possible by the weak dollar. Full-service hotels in coastal cities sit in the sweet spot of demand, maximizing the benefits derived from synergies in 24-hour corporate centers and global pathway destinations. Corporate elites, the private equity crowd, and plenty of other high-income earners flock to upscale resorts to enjoy their windfalls. “Operations couldn’t be better.” New York is as good as it gets—condo conversions reduced supply as demand ignited. A good economy would let markets plateau as development activity intensifies.

Exhibit 4-18		Prospects for Full-Service Hotels in 2008		
	Prospects	Rating	Ranking	
Investment Prospects	Modestly Good	5.88	4th	
Development Prospects	Modestly Good	5.68	6th	
Expected Capitalization Rate, December 2008		7.1%		
Expected Unleveraged IRR During Holding Period		10.7%		
Buy	Hold	Sell		
23.8%	43.9%	32.2%		

Source: Emerging Trends in Real Estate 2008 survey.
Note: Based on U.S. respondents only.

Exhibit 4-19		Prospects for Limited-Service Hotels in 2008		
	Prospects	Rating	Ranking	
Investment Prospects	Fair	5.46	8th	
Development Prospects	Fair	5.43	8th	
Expected Capitalization Rate, December 2008		7.8%		
Expected Unleveraged IRR During Holding Period		10.8%		
Buy	Hold	Sell		
21.6%	35.2%	43.2%		

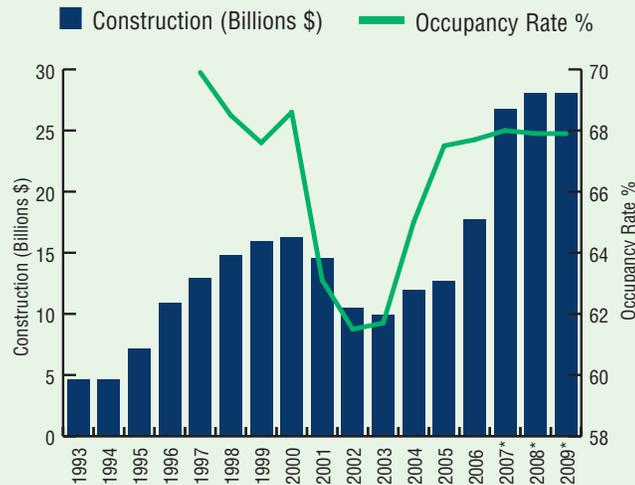
Source: Emerging Trends in Real Estate 2008 survey.
Note: Based on U.S. respondents only.

Weaknesses

“It’s the late innings.” “Higher room rates and occupancies always promote new construction.” “Significant new supply is on the horizon.” Uneasy owners and operators know all too well the familiar scenario—new construction and heightened economic risk usually precipitate hotel downturns. Occupancies plateau, and even sanguine interviewees predict decreasing room revenue growth. Economic shifts can register almost immediately—consumers, feeling the mortgage squeeze, have cut down on their leisure travel and CFOs will downsize travel and entertainment budgets at the first sign of lowered profit margins. As usual, development concentrates in easy-to-build suburbs—proliferating all-suites brands and intersection hotels are most exposed to new competition. Recent record pricing levels will make it difficult for new owners to achieve operations targets unless the economy expands. In many markets, especially major urban locations and resorts, hotels depend on immigrant labor. Any border restrictions and government crackdowns on employers could reduce employee pools and hamstringing operations.

Exhibit 4-20

U.S. Hotel Construction and Occupancy Rates

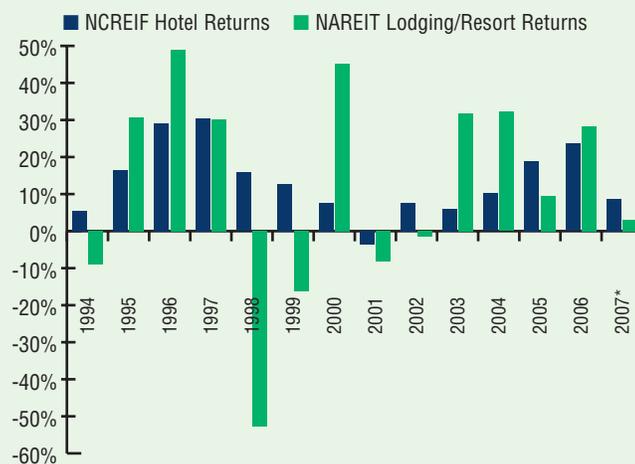


Sources: U.S. Bureau of the Census, Moody's Economy.com, Torto Wheaton Research.

*Forecasts.

Exhibit 4-21

U.S. Hotel/Lodging Property Total Returns



Sources: NCREIF, NAREIT.

*Data as of June 29, 2007.

Best Bets

Luxury and upscale segments will be more insulated from new supply by daunting development costs. New York, San Francisco, and other major business centers are underserved. Sit on your wallets and wait for the inevitable correction before investing again. Bargains will eventually appear.

Avoid

Watch out in suburban locations where many development projects may be ill timed. Hotel-condo projects also “have been overdone.” Sales stall out in the overall housing crisis. It’s time to curtail lending on new projects.

Development

Cost of construction makes it hard to build luxury four- and five-star hotels, insulating them against oversupply. But roadside sticks-and-bricks projects mushroom again. New rooms slated for delivery through 2009 exceed levels from the pre-2002 boom that exacerbated the last downturn, following 9/11.

Outlook

After reaching new performance pinnacles, hotels top out in pricing and performance. Always extremely volatile, the lodging sector needs a solid economy to keep from getting swamped in its latest development wave. History has shown that this industry typically busts after booms. If consumers regain their footing and keep spending, despite housing woes, then slackening growth rates in occupancies and revenues should be measured. But a recession means more empty rooms and falling rates. Coming out of the last downturn, many owners deleveraged, making them less vulnerable to cash flow problems in future corrections. Any recent buyers who borrowed heavily may wish they had learned that lesson.

“Retail is primed for a wallop in any recession.”

Retail

Strengths

“Fantastic” luxury-end shopping centers “have been hitting the ball out of the park” and lifestyle centers near upscale neighborhoods “look quite secure.” Affluent consumers keep spending—they haven’t felt the pinch yet. Infill grocery-anchored retail also “prosperes off necessity buying.” Fortress malls still look impregnable. These regional and super regional centers, owned mostly by a handful of REITs, “have become an insider’s game.” The companies have cornered the best suburban retail locations and leverage national tenant relationships to best advantage across their portfolios. Bigger and better-capitalized retailers can withstand market pressures better—“they quickly morph new products if something fails.”

Exhibit 4-22 Prospects for Neighborhood/Community Centers in 2008

	Prospects	Rating	Ranking
Investment Prospects	Fair	5.47	7th
Development Prospects	Modestly Good	5.67	7th
Expected Capitalization Rate, December 2008		6.8%	
Expected Unleveraged IRR During Holding Period		9.4%	
Buy	Hold	Sell	
30.7%	35.9%	33.3%	

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

Weaknesses

Everybody wonders when consumers will back off. If higher gasoline and energy prices were not enough, “housing could be the straw that finally breaks the camel’s back.” Discounters already suffer as middle-class and lower-end consumers get more stressed. Discretionary spending depends on what’s left

Exhibit 4-23 Prospects for Power Centers in 2008

	Prospects	Rating	Ranking
Investment Prospects	Fair	5.13	10th
Development Prospects	Fair	5.09	10th
Expected Capitalization Rate, December 2008		6.8%	
Expected Unleveraged IRR During Holding Period		9.2%	
Buy	Hold	Sell	
10.4%	40.1%	49.5%	

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

Exhibit 4-24 Prospects for Regional Malls in 2008

	Prospects	Rating	Ranking
Investment Prospects	Fair	4.71	11th
Development Prospects	Modestly Poor	4.13	11th
Expected Capitalization Rate, December 2008		6.0%	
Expected Unleveraged IRR During Holding Period		8.6%	
Buy	Hold	Sell	
10.1%	43.1%	46.8%	

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

over in paychecks, now that home equity lines get more expensive or are tapped out. Developers keep building ahead of absorption rates—and vacancies track upward. “Consumers almost have too many choices, which overlap. Every direction you turn there is new retail. How can they all make decent returns?” Internet buying steadily increases, including for mall staples like clothing. Inexorably, Web purchases eat into demand growth for bricks-and-mortar retailers. Commodity, lower-quality locations ultimately suffer. Video and record stores look like goners. Mom-and-pops “have an even rougher time” competing against national brands and digital sellers.

Exhibit 4-25

U.S. Retail Completions and Vacancy Rates: Top 50 Markets

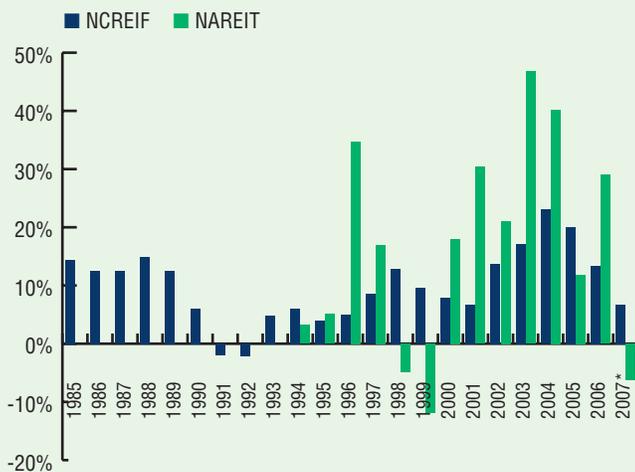


Source: Torto Wheaton Research (sum of top markets).

*Forecasts.

Exhibit 4-26

U.S. Retail Property Total Returns



Sources: NCREIF, NAREIT.

*Data as of June 29, 2007.

Best Bets

Hold grocer-anchored centers near premier infill neighborhoods where populations have high disposable incomes and above-average wage increases. Lifestyle centers gain at the expense of lesser B and C malls because consumers like the drive-up convenience. “They are easier to get around.” Fringe locations won’t do well. “The real concern focuses on places serving low- and middle-income strata.”

Avoid

Stay away from older B and C malls with obsolescent features and substandard tenant lineups. Ghost mall syndrome may return. Owners got a reprieve during the recent consumer binge, which kept retailers profitable and expanding. The deluge of recent development and consumer fatigue combines to endanger their prospects. Vacancies will increase and revenues could short-circuit. These properties are prime candidates for demolition and new uses. Newly developed strip centers near suburban-perimeter subdivision projects “take it on the chin” as peripheral damage to housing declines.

Development

Developers get ahead of themselves, even though land and construction costs have “forced down yields.” Ghost malls will provide opportunity for new mixed-use projects. Many municipalities try to rework mall sites into town centers with large retail components as well as residential, office, and recreational facilities.

Be cautious with regard to lifestyle center locations—this concept has been played to the hilt.

Outlook

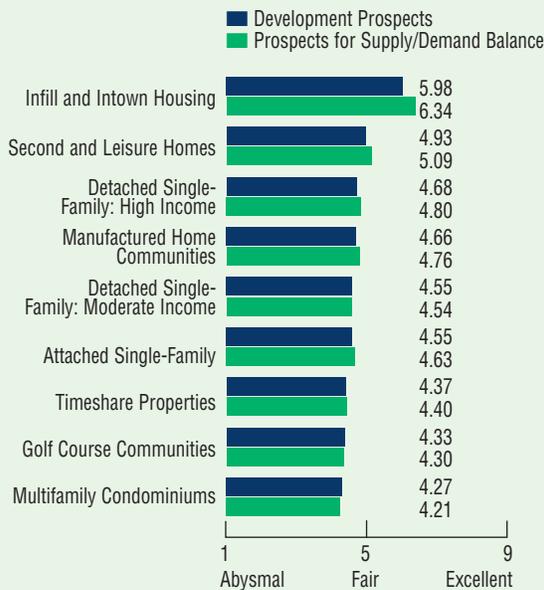
Worst-case scenario: “Retail is primed for a wallop in any recession.” Most interviewees agree: “It’s time to chill” and wait out the economy. Wage gains and low unemployment need to offset the deflationary housing scene. In any case, risk increases, and returns further decline off record highs.

Housing

Strengths

People will always need housing—“that’s a built-in cushion.” Everybody agrees that housing markets required an overdue correction. Condo/coop prices in global pathway markets, particularly New York, have held their own, offsetting declines elsewhere. Low-leveraged owners or borrowers who locked in fixed rates at record lows ride out the storm. Long-term owners sit pretty, despite recent paper losses.

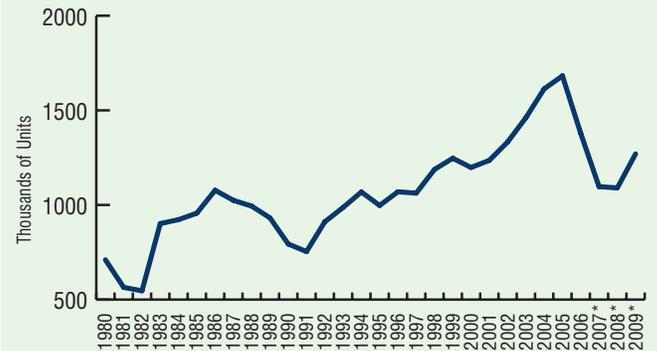
Exhibit 4-27 Prospects for For-Sale Housing in 2008



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on U.S. respondents only.

Exhibit 4-28 U.S. Single-Family Building Permits



Sources: U.S. Census Bureau, Moody's Economy.com.

*Forecasts.

Weaknesses

“This is the only real estate sector where fundamentals are totally in the trash can.” Unfortunately, housing markets are the nation’s biggest property category, with an outsized influence on the U.S. economy. “I don’t know where some of these statistics are coming from saying home prices are down 2 or 3 percent. It’s more like 15 to 25 percent in many markets.” ARM resets and higher refinancing hurdles could prolong the agony set in motion by the subprime lending crisis. “The government and a bunch of crooks tried to turn some lower- and moderate-income households into homeowners when they didn’t have the means.” But many good-credit homeowners, entranced by low borrowing rates, also cashed out home equity “drinking the Kool-Aid” that house values can only increase. Well-heeled buyers took out jumbo mortgages to acquire dream castles. Many people may have stretched too far. For-sale signs pop up everywhere and inventories balloon. Stricter mortgage standards and higher mortgage rates deplete buyer demand even for discounted product.

Best Bets

Buy distressed homebuilder inventories at markdowns. Busted condo deals offer prime targets, too. Vultures circle for opportunities. Wait and buy houses after further market declines. Foreclosure auctions are coming and motivated sellers will make deals. Cash buyers can score big time. Homebuilder and mortgage stocks will bottom out. Surviving companies will make good buys. Regulators will tighten lending standards. Take that wager to the bank.

Avoid

That's the best advice for these markets.

Development

“The development community got fat, dumb, and happy in the 2003–2005 period and way out of whack on inventory and pricing.” Now homebuilders face a painful dilemma: They must burn off bloated inventories while they keep building, hoping they can sell without discounting too much. “Homebuilders have too many costs sunk in land to stop construction.” But many buyers may balk at deliveries in the more difficult borrowing environment. Some homebuilders decide to cut bait, taking excess inventories off their books in sales, “causing big declines in land values.” Ouch.

Outlook

Prices and values have room to drop further as foreclosures increase. When recovery begins, probably not until late 2008 or sometime in 2009, progress “will be very staccato.” “This is not a normal cyclical downturn; recovery will take longer.” Low interest rates and lender incentives pulled many first-time homebuyers into the market before they normally would have bought. As a result, little pent-up demand exists. Higher mortgage rates will make buying less attractive. “This will take time to clean up.” Expect most borrowers “to suck up higher mortgage costs when ARMs reset. Only time will tell how bad it gets.” The entire economy may depend on what happens. Other real estate players hold their breath.

Niche Sectors

In recent years, some institutional investors and advisers became enamored with niche investment categories. Needing a place to park allocations, they sought relative value opportunities after prices for major property sectors had been bid up to uncomfortably high levels. This intensified interest directed a spillover of funds into previously thinly invested sectors like self-storage, student housing, seniors' housing, manufactured homes, and medical office. Adjusted for risk, these niche sectors turned expensive too, and early investors benefited. Distracted by the changing mood in capital markets, investors may back off niche categories. But demographic and lifestyle trends should continue to make the following types of properties viable investments:

Mixed Use. Whether urban infill or suburban town centers, mixed-use projects with residential underpinnings should attract increasing demand from people looking to escape the congestion hassles and increasing costs associated with car dependence. Pedestrian-friendly developments near transit stops receive the most attention. More people want to be able to walk to the grocery store or access playgrounds without packing into the minivan. If they can leave the car behind and use light rail or trains to get to work, even better. “Developers will be willing to pay more for land and deal with more constraints, involving TOD [transit-oriented development], because they believe it is more valuable. Road networks aren't getting any better.” But mixed use has its place—“don't try it in a cornfield.” New urbanist visions have “bifurcated into cute suburban subdivision alternatives caught in the midst of sprawl and new downtown neighborhoods like LoDo in Denver; Carlyle in Alexandria, Virginia; Kendall in Miami; and Atlantic Station in Atlanta. These urban-oriented developments ultimately attract singles, childless couples, and empty nesters who want to be closer to the action, pre-

ferring convenience to greater suburban privacy and more spacious homes. Investors, lenders, and developers continue to wrestle with the ultimate mixed-use challenge: “coalescing financing and sector expertise, while timing construction of the different uses to avoid missing the market.” “It’s hard to build the components simultaneously.”

Seniors’ Housing. Tenant demand will only grow, but the big demand push won’t occur for another decade when the heart of the baby boomer cohort approaches age 65. Adult communities ranging from no-kids subdivisions and apartment buildings to assisted care proliferate. Builders need to remember to limit stairs and include ramps. If 50-somethings don’t pop more Lipitor and beta-blockers, they suffer wear and tear in knees and hips from overdoing running regimens and too many triathlons.

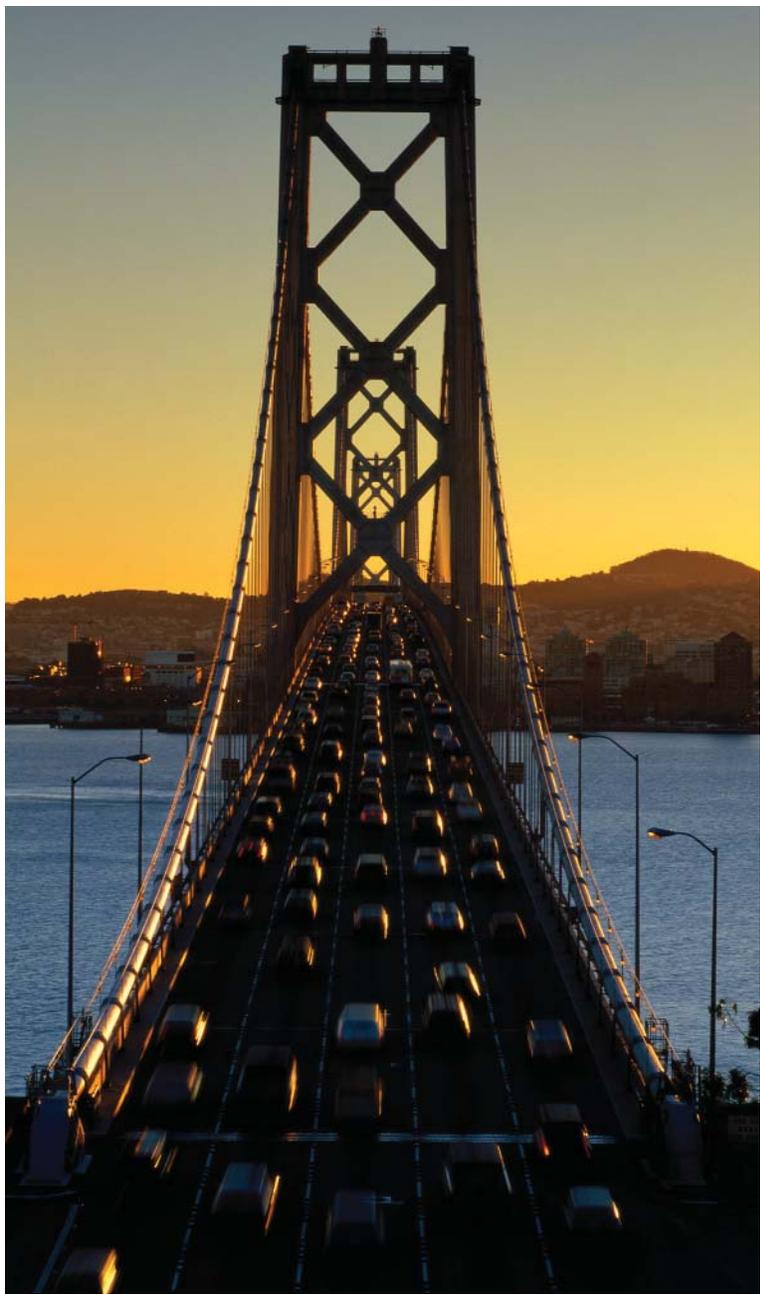
Medical Office. The older the average person gets, the more time he or she spends at doctors’ offices. The health care world keeps expanding. Hospitals turn into major campuses, surrounded by buildings for physician offices and facilities for tests and therapies. Demand for medical-related offices can only grow. But will there be enough doctors? Investment bank reversals might encourage more student brains to forsake MBAs for MDs. But first they’ve got to pass organic chemistry and be interested in more than just making money.

Student Housing. A bulge of echo boomers swamps campuses. If you think it’s too competitive getting into top schools, just try finding a decent dorm room with a tolerable roommate. Indulgent parents have been buying off-campus digs as investment gambits. That play may be over, but universities still outsource dorm development and management. Overflowing demand won’t be the problem for investors. Overflowing beer kegs may be.

Self-Storage. McMansion mania hits the wall in the housing meltdown. All those extra rooms don’t provide as much comfort after the monthly mortgage and utility bills arrive. When people trade down or move back to apartments, all those overstuffed ottomans and extra china sets end up somewhere else for a while. Self-storage will be cheaper than funding that ARM reset.

Manufactured Homes. Investors make the ultimate land play. Owners provide minimal infrastructure (curbs and streetlights), generate rental income, and profitably wait for the next best use. Expect tenant demand to pick up. When housing markets head south, manufactured homes become very popular.

Infrastructure. If Katrina weren’t enough, the Minneapolis bridge collapse alerts Americans to a growing crisis: the country’s infrastructure is failing and taxpayers will need to find a way to pay for trillions of dollars in repairs and new systems or face more tragedies and gridlock. Investors approach states and cities about long-term leases to take over operations of toll roads and high-trafficked bridges and tunnels with plenty of revenue potential. Politicians start to realize that private investment doesn’t address broader land use and integrated mass transit solutions, which will be necessary to make the nation’s infrastructure more competitive and safe.





“We always get caught up in U.S. trends, but they don’t affect us to the same magnitude. Our markets are less volatile.”

Emerging Trends in Canada

Canadian interviewees appear more positive about prospects for 2008 than their U.S. counterparts. “2008 won’t be spectacular, but still above average.” “We’ve been on fire for the past five years and the credit markets will cause a slight pullback.” U.S. housing woes haven’t extended to Canada, where regulators and laws clamp down on excessive mortgage lending practices. Property markets, including housing, track at or near equilibrium with high occupancies and controlled development, and the national economy benefits from unquenchable worldwide thirst for energy resources. Vacancies are lower than in U.S. markets and rents increase with healthy demand. “We always get caught up in U.S. trends, but they don’t affect us to the same magnitude. Our markets are less volatile.” Cap rate compression has escalated values and prices—“some correction may be in order. It will start outside of Canada and then come here.” “But the real estate markets here should be better positioned to withstand any storm.”

Any downswing in the U.S. economy will affect Canadian manufacturers—85 percent of the country’s exports go south of the border. In September 2007, the Canadian dollar hit par

Exhibit 5-1 Emerging Trends Barometer 2008

Buy/sell/hold rating prospects on a 1-to-9 (abysmal-to-excellent) scale.



5 = fair, 6 = modestly good, 7 = good, 8 = very good.

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

“In Canada, capital flows can be **sustained** where in the United States they may decline.”

Exhibit 5-2 Firm Profitability Forecast

Prospects for Profitability in 2007 by Percentage of Respondents



Prospects for Profitability in 2008 by Percentage of Respondents



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

with the U.S. greenback for the first time in more than 30 years, “and the exchange rate no longer offers a cushion” for exporters. Buttressing Canada’s economy is oil, gas, and coal production in the nation’s western provinces. Rising global energy demand and increasing prices boost overall economic gains. The country’s relatively small population (32 million, or about one-tenth of the total population the United States) depends on immigration to expand. Toronto, Montreal, and Vancouver—the nation’s primary gateways—benefit from inexpensive labor pools filled with new arrivals. Canadian respondents, as in U.S. surveys, express the most concern about interest rates, job growth, and wages. They expect mortgage rates, interest rates, and inflation rates to increase modestly over the next five years, also tracking closely U.S. interviewees’ outlooks.

Canada struggles with sprawl in suburbs surrounding the country’s handful of “vibrant” 24-hour cities, led by Toronto. So far, the nation has escaped the phenomenon of multinodal suburban agglomerations prevalent in the U.S. Sunbelt. Businesses cluster in downtowns, which offer traditional multifaceted, pedestrian-friendly environments and neighborhoods based on more traditional European cities. Most people commute from suburban rings on roads that increasingly experience traffic bot-

Exhibit 5-3 Real Estate Business Activity Prospects in 2008



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

tlenecks. “We have the same infrastructure issues as the United States. Roads and bridges are taken for granted and the government hasn’t set aside the money to keep them up.” Government struggles with integrating land use, increasing urban population density, and financing infrastructure needs. Interviewees com-

plain about a lack of insight and good planning, not to mention “high taxes.”

A strong economy, relative investor restraint, and various government logjams help Canada escape “real estate bubble syndrome,” “but we may experience adjustments,” especially in the event of a spillover of U.S. distress.

Real Estate Capital Flows

Compared with the United States, “capital has remained disciplined” in Canada. Players “have upper mind” hard lessons they learned from the property recession in the early 1990s, which sent investors reeling and put some “high-profile” developers out of business. Trading activity is limited—“the environment is not conducive to Wall Street styles.” A handful of large institutions and development companies dominate the country’s five primary real estate markets: Toronto, Montreal, Vancouver, Calgary, and Edmonton. “The big institutions control the CBDs” and the market for large regional shopping centers. These “conservative,” “sophisticated” owners hold long term, limiting the amount of available product in transaction mar-

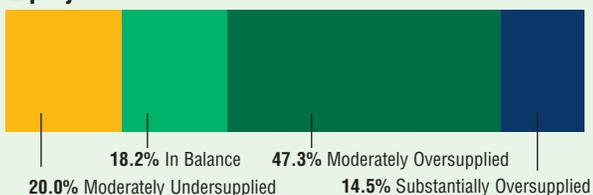
kets. “Barriers to entry keep prices high.” It’s hard for less well-capitalized investors or offshore buyers to break in, unless they concentrate on smaller properties—strip shopping centers and apartments—in the suburbs, which have become “the province of entrepreneurs and smaller players.” Investors wanting opportunistic returns “should head for Halifax and Winnipeg.”

Cap rates in major markets had been compressing, but interviews forecast that trends will reverse with very modest upticks, ranging from 16 basis points for warehouse/industrial to 38 basis points for central office. Expected unleveraged IRRs extend from a low of 7.98 percent for regional malls to a high of 10.23 percent for limited-service hotels (see Exhibit 5-5). “Cap rate compression is over; owners now will need to focus more on fundamentals than rely on capital growth.”

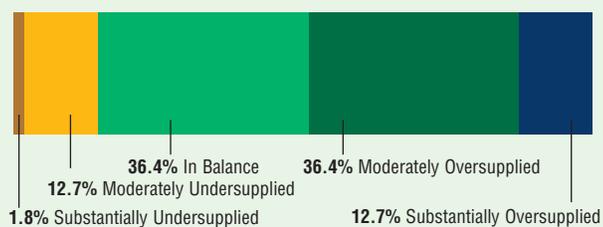
For 2008, survey respondents anticipate steady capital volumes, with pension fund investors still eager to increase portfolio holdings. “Capital flows can be sustained where in the United States they may decline.” Institutional investors outgrow Canadian markets and look to increase investments in the United States, Europe, and Asia. Foreign investors attempt to

Exhibit 5-4 Real Estate Capital Market Balance Forecast for 2008

Equity



Debt



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

Exhibit 5-5

Prospects for Capitalization Rates and Internal Rates of Return

	Cap Rate July 2007 (Percent)	Expected Cap Rate December 2008 (Percent)	Expected Cap Rate Shift (Basis Points)	Expected Unleveraged IRR*
Regional Malls	6.03	6.29	+26	7.98
Apartments: High Income	6.07	6.35	+28	8.70
Central City Office	6.29	6.67	+38	8.37
Power Centers	6.43	6.74	+31	8.38
Apartments: Moderate Income	6.66	6.88	+22	9.04
Warehouse Industrial	6.77	6.93	+16	8.40
Neighborhood/Community Centers	6.89	7.17	+28	8.55
R&D Industrial	6.98	7.19	+21	9.00
Suburban Office	7.03	7.33	+30	8.70
Hotels: Full Service	8.15	8.46	+31	9.68
Hotels: Limited Service	8.31	8.42	+11	10.23

Source: Emerging Trends in Real Estate 2008 survey.

*During holding period.

Exhibit 5-8

Prospects for Major Property Types in 2008



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

ing labor rates also gang up to compress development returns. Replacement cost hurdles loom large. Except in rapidly expanding population centers in the country's western provinces, new projects have been restrained, helping keep most markets tight.

A lack of land supply around major cities and increasing suburban congestion prompt developers and investors to undertake more infill and mixed-use projects. High housing costs and higher-density planning will favor multifamily projects over single-family development, especially in Toronto. "There's more profit in high-rise than low-rise or single-family [development]." Planners gauge how to redevelop older, underperforming center-city properties and integrate them with mixed-use concepts. Green development strategies make inroads. Tenants begin to demand green facilities and developers notice. "It's a market differentiator." Large inventories of old building stock make upgrades difficult. For new projects, "developers need to go green or go home."

Industrial outpaces retail in favored property categories, but all sectors show strength, including housing (see Exhibit 5-8). The national industrial vacancy rate is half the U.S. rate.

Toronto and Calgary rank as top distribution/warehouse markets. Core investors love the solid returns—a limited amount of land around airport/auto route hubs creates high barriers to entry and preserves values.

Exhibit 5-9

Prospects for Industrial/Distribution in 2008

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.31	1st
Development Prospects	Good	6.76	1st
Expected Capitalization Rate, December 2008		6.8%	
Expected Unleveraged IRR During Holding Period		8.3%	

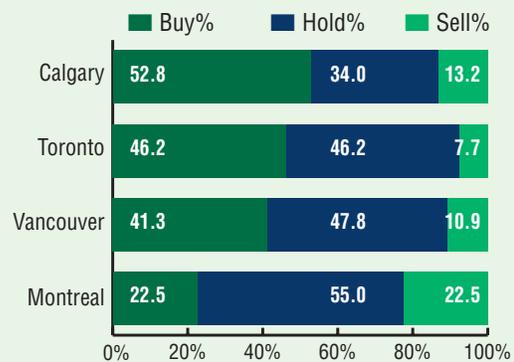


Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

Exhibit 5-10

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



Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

“Homebuilders cannot keep up the pace.”

Exhibit 5-11 Prospects for Retail in 2008

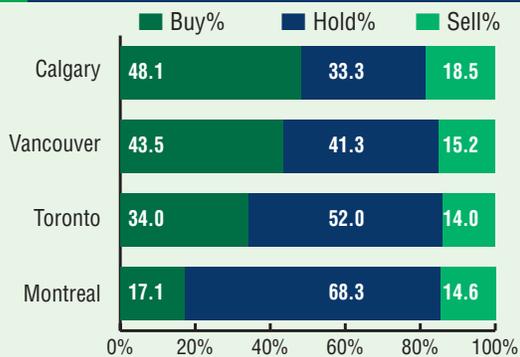
	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.21	2nd
Development Prospects	Modestly Good	6.18	3rd
Expected Capitalization Rate, December 2008		6.4%	
Expected Unleveraged IRR During Holding Period		8.3%	

Buy	Hold	Sell
24.1%	58.6%	17.2%

Source: Emerging Trends in Real Estate 2008 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 2008 survey.

Note: Based on Canadian respondents only.

Retail “has been on a roll,” thanks to the booming economy. Although Canadian consumers tend to be more frugal than Americans, unemployment declines to a 30-year low and people open their wallets. Interviewees recommend focusing on existing centers at infill locations in and around cities. “Development opportunities are limited and owners are insulated from competition.”

Exhibit 5-13 Canada: Retail

Year	New Supply	Net Absorption	Vacancy	Average Rent
2001	2,863,756	3,178,256	5.5%	\$21.80
2002	2,921,873	2,188,498	5.8%	\$21.72
2003	2,037,283	3,043,408	5.5%	\$21.85
2004	2,877,225	3,705,094	5.2%	\$22.78
2005	2,644,699	4,569,468	4.1%	\$23.84
2006	7,245,000	7,720,884	4.0%	\$24.49
2Q07	3,645,000	1,877,879	4.6%	\$25.78

Source: CB Richard Ellis and Rogers Media (Canadian Directory of Shopping Centres).

Exhibit 5-14 Prospects for Residential For-Sale in 2008

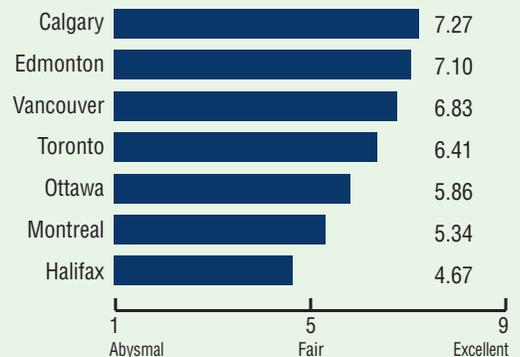
	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.20	3rd
Development Prospects	Good	6.72	2nd

Source: Emerging Trends in Real Estate 2008 survey.

Note: Based on Canadian respondents only.

Exhibit 5-15 Canadian Markets to Watch

Prospects for For-Sale Homebuilding



Source: Emerging Trends in Real Estate 2008 survey.

Housing may need to take a breather, even though the for-sale market seems to hold up. “Homebuilders cannot keep up the pace”—development will slow (except in high-growth western provinces). Single-family housing looks overpriced (sound famil-

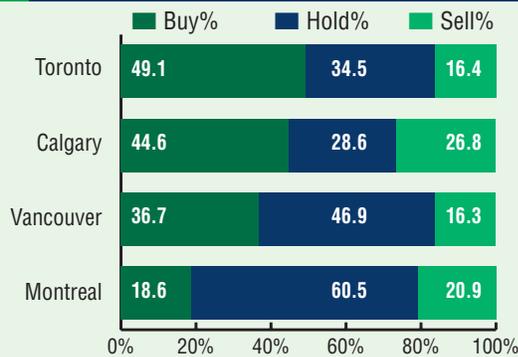
Exhibit 5-16 Prospects for Office in 2008

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	6.19	4th
Development Prospects	Modestly Good	5.72	5th
Expected Capitalization Rate, December 2008		7.0%	
Expected Unleveraged IRR During Holding Period		8.4%	



Source: Emerging Trends in Real Estate 2008 survey.
 Note: Based on Canadian respondents only.

Exhibit 5-17 Canadian Office Property Buy/Hold/Sell Recommendations by Metropolitan Area

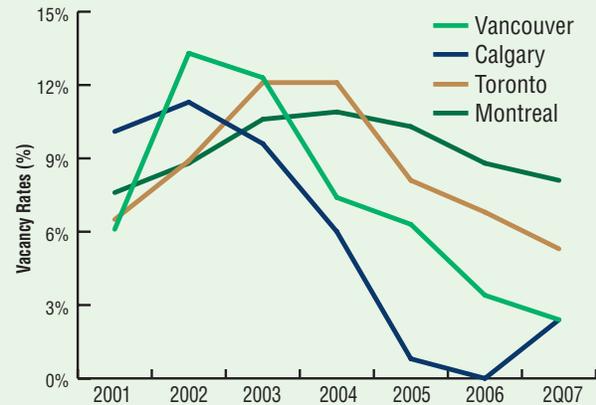


Source: Emerging Trends in Real Estate 2008 survey.

iar?), but more stringent lending standards have tempered pricing excess and high employment spurs homebuyers. First-time homebuyers look priced out—"the housing affordability index is too high." "Valuations may be reaching a breaking point," but interviewees see a market crest rather than a slump unless interest rates head north. "We have no subprime lending problem here."

Office stock concentrates in the 24-hour CBDs, where limited inventories and dated product fill up with tenants. Except for Montreal, where office vacancies approach 9 percent, Canadian metropolitan areas boast sub-5 percent vacancies, and rents have room to push higher. Tenants favor downtown

Exhibit 5-18 Canada: Downtown Office Vacancy—Class A Properties



Source: CB Richard Ellis.

Exhibit 5-19 Prospects for Hotels in 2008

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.96	5th
Development Prospects	Modestly Good	6.00	4th
Expected Capitalization Rate, December 2008		8.0%	
Expected Unleveraged IRR During Holding Period		9.4%	



Source: Emerging Trends in Real Estate 2008 survey.
 Note: Based on Canadian respondents only.

over fringe locations—stay away from small outlying commercial centers. Costs and land scarcity limit new development.

Hotels prosper with the strong economy. Investment and development prospects are modestly good, and most respondents rate the sector either a buy or a hold. Calgary and Vancouver are especially attractive buy markets.

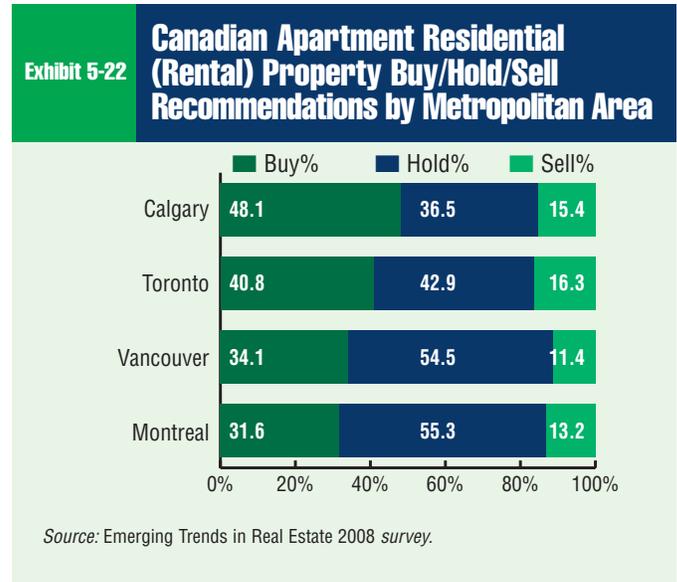


Exhibit 5-21 Prospects for Apartment Residential (Rental) in 2008

	Prospects	Rating	Ranking
Investment Prospects	Modestly Good	5.92	6th
Development Prospects	Fair	5.18	6th
Expected Capitalization Rate, December 2008		6.5%	
Expected Unleveraged IRR During Holding Period		9.5%	

Buy	Hold	Sell
4.2%	66.7%	29.2%

Source: Emerging Trends in Real Estate 2008 survey.
Note: Based on Canadian respondents only.

Rental apartments do well in major cities with high immigration flows. Primary western cities—Vancouver, Calgary, and Edmonton—veer toward housing shortages as workers, attracted by a plethora of well-paying jobs, pour into the energy zone. Apartment occupancies soar. Development in other regions remains difficult because of costs and land scarcity. Existing owners can push rents. “It gets more difficult to provide affordable housing in urban cores.”

Markets to Watch

Canadians like to live and work in central cities, “as long as you can afford it.” If housing is too pricey in 24-hour neighborhoods, people move to inner-ring suburbs or beyond and commute back into the cores. Investors, especially the institutions, concentrate on downtowns, too. Planners and developers focus on infill and more vertical projects, which reinforce the urban cores.

The hot-growth energy cities out west—Calgary and Edmonton—score the highest ratings for investment prospects, development, and for-sale housing. Toronto, Canada’s premier global pathway city, and Vancouver also register strong scores. Ottawa and Montreal follow, and Halifax in the Eastern Maritime provinces lags.

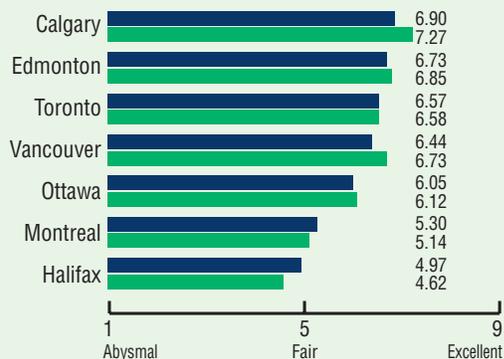
Calgary is the Canada’s “resource” capital and North America’s number-one boomtown. People move there in droves, although recent reports suggest this may be slowing. Available jobs still exceed the number of available workers—“Tim Hortons has trouble hiring to keep open on more than one shift.” Developers build out to the horizon—“sprawl reaches the nether reaches.” The country’s most business-friendly city, Calgary boasts no sales taxes. “People have more dollars than you can imagine.” Survey respondents shout out strong buys for all sectors.

Edmonton experiences same Calgary-style growth wave. “Calgary may be the energy headquarters, but Edmonton is where the work gets done.” As long as demand for energy resources stays strong, this market has legs. When the bust

Exhibit 5-23

Canadian Markets to Watch

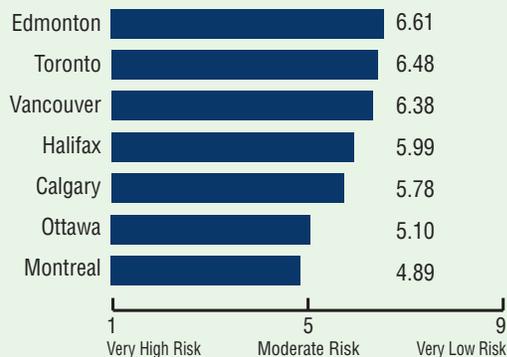
Prospects for Commercial/Multifamily Investment and Development



Source: Emerging Trends in Real Estate 2008 survey.

Exhibit 5-24

Canadian City Risk



Source: Emerging Trends in Real Estate 2008 survey.

comes—maybe no time soon, given global energy hunger—think Houston circa 1985.

Vancouver, one of the continent's most beautiful cities, operates on all cylinders. Water and mountains create classic geographic barriers to entry as well as dramatic natural backdrops. The diversified economy roars—besides “back from the dead mining [copper, zinc, gold, coal],” the city provides “a big-deal port” and is high-tech center. Microsoft opens a campus and companies like Electronic Arts base there. Outrageous real estate prices frustrate homebuyers and commercial investors. “The market is extremely hard to crack.” Bite-sized buildings—a typical office is 500,000 square feet—make it hard to satisfy

appetites. Owners don't sell anyway. The market stymies foreigners. “They want it and can't get it.” Holding the 2010 Winter Olympic Games is “icing on the cake.”

Toronto, Canada's “always steady” headquarters town, ranks as a major global pathway destination, 24-hour city, and manufacturing hub. “Never bet against it.” Compared with other national financial centers, “the city is cheap.” The rising loonie hurts manufacturing industries, and clouds over the U.S. economy “threaten to stall out momentum.” Three new office towers are under construction, adding 3 million new square feet of office space. High taxes and budget deficits “make it hard to do business.” Politicians face a tough choice—raise taxes to uncomfortable levels or cut services. Office, industrial, and apartments still rate solid buys.

Quebec's separatist movement appears to have gone into hibernation, but **Montreal** still faces concerns about market stability and overall growth prospects. Bilingual fissures raise business costs and turn off big corporations, which all moved to Toronto many years ago. The recent acquisition of Alcan means the market lost another corporate mainstay. But plenty of government offices fill space. Not particularly dynamic, the local market is “tough to break into.” Lining the banks of the powerful St. Lawrence River and shadowed by Mount Royal, the city's distinctive skyline has hardly changed in years—“there's been no spec building.” Out of habit, investors steer clear.

The Canadian federal government is one of the largest employers in **Ottawa**, which makes this city susceptible to changes in government public service employment levels. Any move to downsizing spells trouble.

Investment in the **Maritimes** should generally be approached cautiously. There may be some opportunistic returns for speculative investors who are knowledgeable about the specific centers in this area. But overall, the country's economic engine moves west.

Best Bets

- Focus on the high-growth energy markets—all property categories.
- Hold coupon-clipper central business district office.
- Develop infill condos near subway stops in Toronto.
- Buy infill sites wherever you can.
- Invest overseas—domestic opportunities are too limited at current prices.

Interviewees

Ackman-Ziff Real Estate Group, LLC

Larry Ackman
Gerald Cohen
Ari Hirt
Jason Krane
Simon Ziff

Advanced Realty Group

Gregory N. Senkevich

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Michael J. Acton
Marc L. Davidson
Robert J. Plumb

AMB Property Corporation

David C. Twist

AM Connell Associates, LLC

Alice M. Connell

Archon Group, LP

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Roger Beless
Richard R. Frapart
Larry J. Goodwin
Steve Lipscomb
James L. Lozier, Jr.
Tabb Neblett
Barry Olson

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Column Financial, Inc.

Kieran Quinn

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Dorothy Cunningham

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Hal Ferris

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Mitchell Hersh

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Ron Sher

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Frank Creamer

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Jerome L. Rappaport, Jr.

New Tower Trust Company

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Alyce DeJong

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PSP Investments

André Collins

Quadrant Real Estate Advisors

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Retirement Residences REIT

Michael Miceli

Rosen Consulting

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Charles B. Leitner

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Luis A. Belmonte

The Shidler Group

Danny L. Swancey

Sonnenblick-Eichner Company

David Sonnenblick

Sorbara Group

Edward Sorbara

Joseph Sorbara

Spring Creek Development

Frederick R. Unger

State Teachers Retirement System of Ohio

Stanton West

The St. Joe Company

Peter Rummell

TIAA-CREF

Chris Burk

Thomas C. Garbutt

Phillip J. McAndrews, Jr.

Martha S. Peyton

Rick Rogovin

TIG

John M. Walsh III

Timbercreek Asset Management

Blair Tamblym

The Townsend Group

Frank Blaschka

Trammell Crow Residential

Kevin E. Andrade

Bruce H. Hart

Transwestern Investment Company

Stephen R. Quazzo

TriLyn LLC

Mark Antonicic

Thomas Kennedy

Trinity Real Estate, Inc.

Richard Leider

UBS Realty Investors LLC

Lijian Chen

Matthew H. Lynch

University of California at Berkeley

Kenneth Rosen

Vestar Development Company

Ryan Desmond

Vornado Realty Trust

Micheal D. Fascitelli

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Watson Land Company

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Ron Rozga

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the \mathbb{R}^n -valued function \mathbf{f} is a solution of the system (1) if and only if \mathbf{f} is a solution of the system (2).

Let us assume that \mathbf{f} is a solution of the system (2). Then, for any $t \in \mathbb{R}$, we have

$$\mathbf{f}(t) = \mathbf{f}(0) + \int_0^t \mathbf{f}'(s) ds = \mathbf{f}(0) + \int_0^t \mathbf{A}(s) \mathbf{f}(s) ds.$$

Since \mathbf{f} is a solution of the system (2), we have $\mathbf{f}(0) = \mathbf{0}$. Therefore, we have

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