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U.S. COMMERCIAL REAL ESTATE UPDATE: BEARING UP WELL UNDER PRESSURE

The investment performance of U.S. commercial real estate is holding up solidly despite the pressures exerted by the weak economy and financial market stresses. For the most recent four-quarter period, ending in 1Q2008, total return was 13.6% for the NCREIF-NPI index which serves as the gauge of sector investment performance. This return comprises a 5.41% income component and a 7.86% capital appreciation component. All four major property types shared in the strong performance; office led the way with a 17.5% total return, followed by industrial at 13%, retail at 11.6%, and apartment at 9.6%.

SOLID NET OPERATING INCOME GROWTH

Solid growth in net operating income was largely responsible for substantial total returns, with office leading at 7.7% growth in NOI, industrial lagging with -0.8% and retail and apartment coming in between. The strength in NOI growth for office and retail is not surprising because expiring leases are turning over at significantly higher rents compared to five or so years ago, when they were last negotiated. The difference in rents is significant enough to withstand quite a bit of economic pressure before any negative effect on NOI.



While the negative NOI growth for industrial space is one indication of the impact of the weak macro-economy, there are other indicators of stress as well. It is most visible to date in the weakening in NCREIF-NPI total returns since the 20.19% cycle peak posted for the four-quarter period ending in 1Q2006. Two primary factors are associated with the change. First, pricing of commercial real estate, as reflected in cap rates, is increasingly more conservative, following the shift in financial market sentiment last summer in reaction to the sub-prime residential mortgage crisis. Prior to the shift, cap rates had become more and more aggressive between 2003 and mid-2007 as abundant capital chased investment opportunities across all asset types. Second, commercial real estate market fundamentals are showing more divergence across geographic markets. Only 21 of the 85 major metro areas that we track outperformed the NPI index for the four quarters ending 1Q2008. The strong performing areas were led by Boston and Houston with performance north of 20%. At the peak of the cycle two years ago, 28 markets outperformed the index.

RIISING BUT STILL MODERATE VACANCY RATES

The divergence in fundamentals is apparent also in updated vacancy rate data. While average vacancy rates across all markets remain near long-term averages for all four major property types, they are higher than a year ago. Apartment vacancies are at 5.5% in 1Q2008 versus 4.7% in 1Q2007; industrial vacancies are at 9.8%, up from 9.4%; office vacancies are at 12.9%, up from 12.7%; and retail vacancies are at 9.5%, up from 8.4%. In addition, the increases in vacancy rates are occurring in a growing number of metro area markets versus a year ago. Delivery of new construction is a driver of rising vacancy rates in some metro areas, but in general the more important driver is deterioration in demand. The construction pipeline is historically modest on average for all property types and becoming more modest month-by-month as planned projects are canceled or postponed.

SLOW TRANSACTION ACTIVITY

Current economic and financial troubles have affected commercial real estate most vividly through their contributions to investor uncertainty and through the credit crunch. Investor uncertainty is demonstrated in the steep

drop-off in transactions since mid-year 2007. Real Capital Analytics reports that roughly \$35 billion in U.S. commercial real estate changed hands during 1Q2008, excluding transactions involving REITs. This is less than half the amount that transacted during the same quarter last year.

The decline in sales activity is due in part to tighter credit conditions. In particular, the credit generated through Commercial Mortgage-Backed Securities (CMBS) issuance has withered to only \$10.9 billion issued over the first four months of 2008 compared with \$96.8 billion for the same period last year, according to Commercial Mortgage Alert. Traditional portfolio lenders are providing commercial mortgages but not enough to replace CMBS; mortgage underwriting terms have become more stringent as well. The slow pace of sales is, in turn, contributing to further uncertainty in the marketplace by constraining the price discovery process.

SMALL DECLINE IN VALUE THROUGH MARCH FROM PEAK

But, on a brighter note, there has been very little distressed selling. The absence of anxious distressed sellers is limiting downward pressure on commercial real estate values. This is shown in the Moody's/REAL Commercial Property Price Index, which reported transaction prices 0.9% above year-ago levels for March 2008 and only 2.6% below the October 2007 peak in the index. In analyzing the index, Moody's notes the small number of transactions in recent months and the skewing of transactions toward lower-priced properties. This reinforces the view that sellers without a pressing need to liquidate are holding back as the market gropes for a new pricing paradigm.

The slow pace of transactions also reflects ongoing solid credit performance for commercial mortgage, which is in sharp contrast to the mushrooming foreclosures in the residential mortgage market. Both CMBS and life company commercial mortgages continue to enjoy delinquency rates below the 1% mark. There is a general consensus that such rates are at cycle lows with little expectation of significant decay in the near term. If a steep deterioration in commercial mortgage credit quality is indeed avoided in the quarters ahead, distressed sales should remain contained.

NATURE OF INSTITUTIONAL COMMERCIAL REAL ESTATE CUSHIONS VALUE VOLATILITY

The downdraft noted in commercial real estate transactions prices along with the weakening in macro-economic prospects and financial market uncertainty will eventually catch up to NCREIF-NPI investment performance measurements but it will take some time. The lag reflects, in part, the time it takes for all properties in the index to be appraised using today's more sober assumptions. The appraisal process is by no means perfect but it does shield commercial real estate from the wild and sometimes irrational gyrations in sentiment that periodically roil the public markets by channeling that sentiment slowly through professional appraisers. In addition, some very real

characteristics of institutional grade commercial real estate cushion values against sharp swings; these include high occupancy, creditworthy tenants, and long-duration leases with rent step-ups built in. The cushioning power was evident in the last recession when the NPI's weakest four-quarter performance was the 5.5% total return for the four quarters ending June 2002. This return comprises an 8.6% income component and a -3% capital component. A repeat of this past performance is by no means guaranteed, but history is a good gauge of how the asset class responds to stress. With solid market fundamentals, still-good credit quality, and sellers empowered with the luxurious option of doing nothing, U.S. commercial real estate has weathered recent stresses quite well.

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