



# Cycle Monitor — Real Estate Market Cycles

First Quarter 2009 Analysis  
May 2009

## Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.

The bottom of the real estate cycle can be predicted by two related events: when GDP begins to grow again and when the labor market begins to add jobs again. Most economists predict GDP growth should turn positive in 4Q09, and employment growth usually follows two quarters later. However, many economists expect that it may be 3Q10 before we see job growth, as a partial “jobless recovery” like the last two recessions may ensue due to weak employer confidence. Real estate recoveries are driven mainly by employment growth.

Office occupancies declined 0.7% in 1Q09 and rents declined by 2% in the first quarter, producing a 4.5% annual decline.

Industrial occupancies declined 0.6% in 1Q09 and rental growth fell 1.5% for the quarter and 4.5% annually.

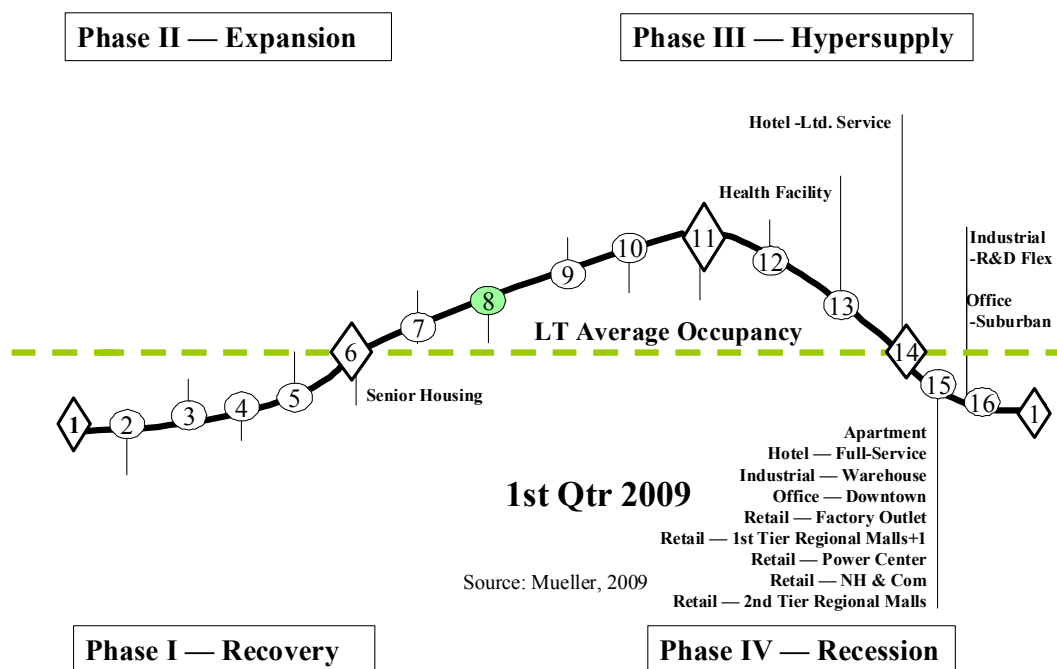
Apartment occupancy declined 0.5% in 1Q09 and rental growth declined 1% for the quarter, but only 1.5% annually.

Retail occupancy declined 1.6% in 1Q09 and rental growth fell 2% for the quarter and 5% annually.

Hotel occupancies declined 2% in 1Q09 and RevPAR fell 6.2% for the quarter and 19% annually.

The National Property Type Cycle graph shows positions of most sub-property types, major markets are reviewed inside.

## National Property Type Cycle Locations



Phase I — Recovery

Phase IV — Recession

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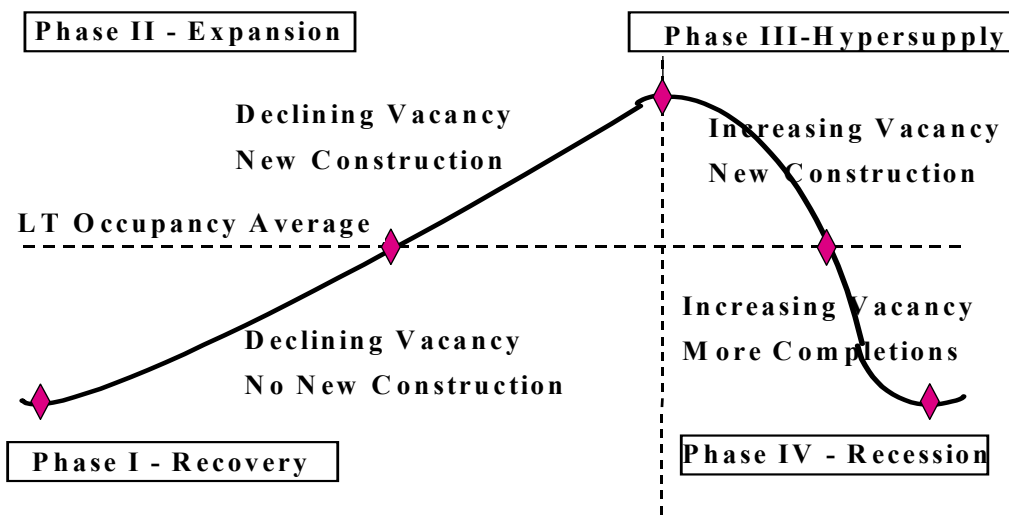
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All relevant disclosures and certifications appear on page 9 of this report.

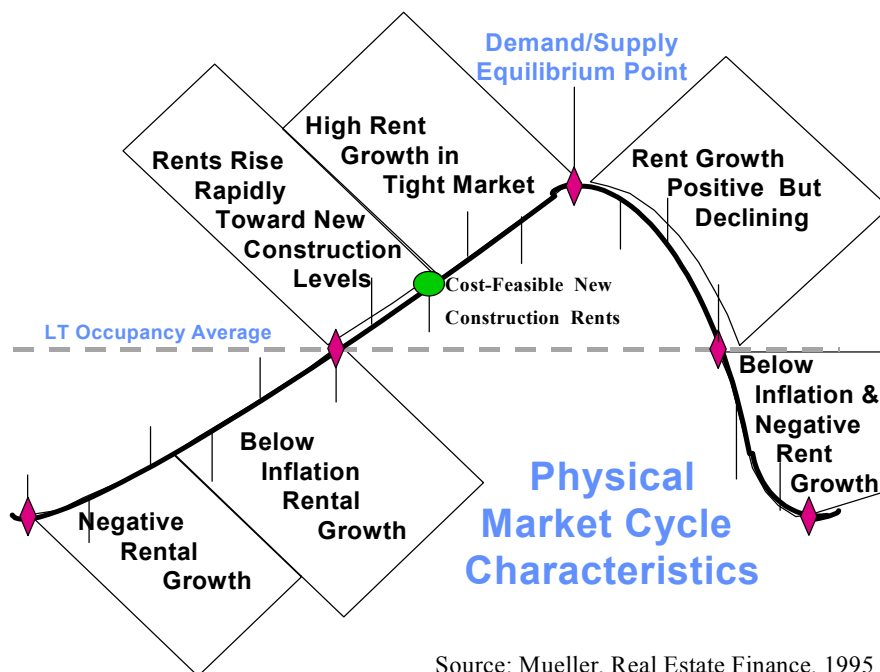
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that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

### Market Cycle Quadrants



Source: Mueller, Real Estate Finance, 1995

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

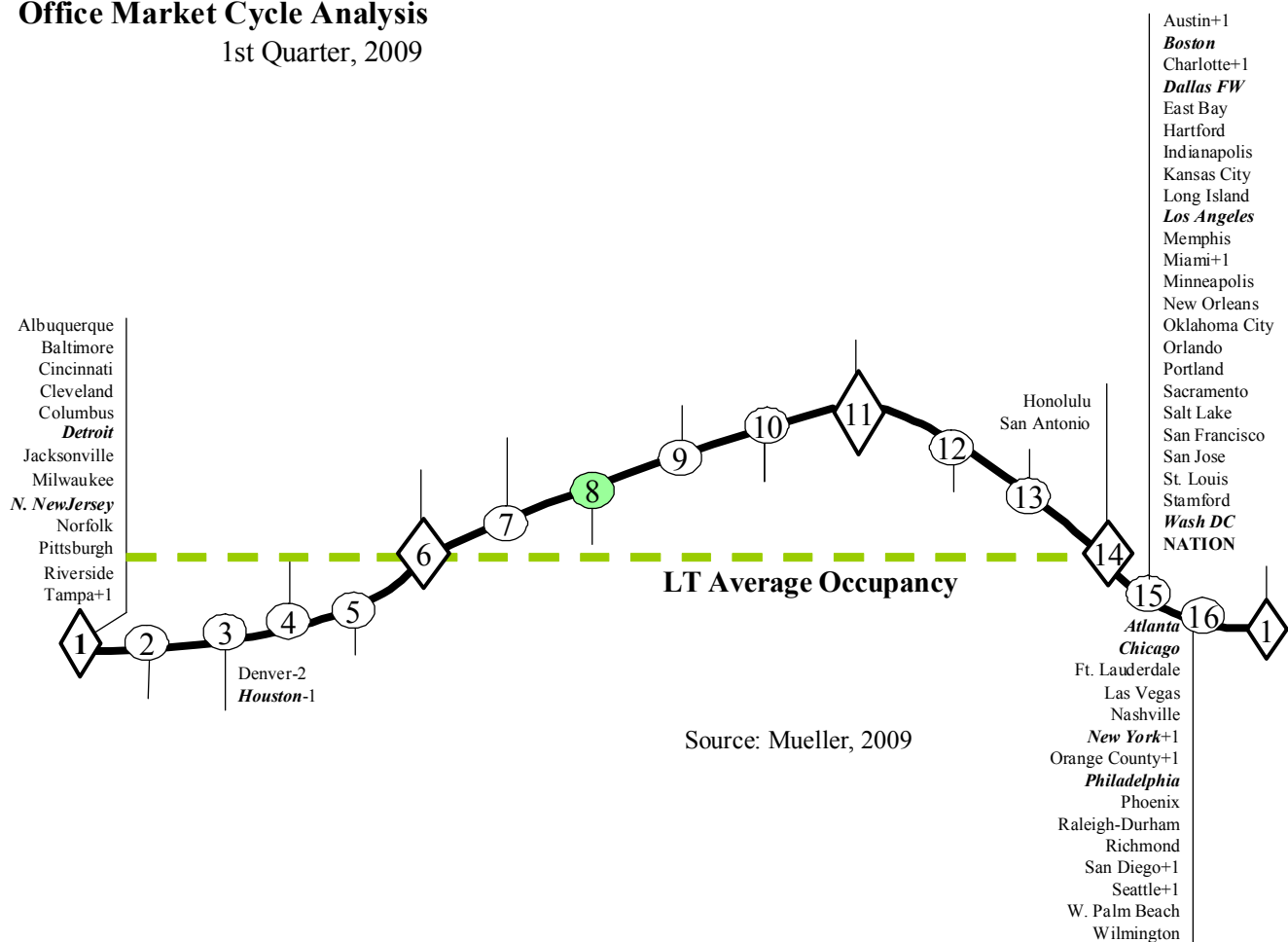


Source: Mueller, Real Estate Finance, 1995

## OFFICE

The national office market occupancy level declined 0.7% in 1Q09, which resulted in a 2.3% year-over-year decline. Eight markets now have vacancy rates above 20% with Phoenix being the worst at 25%. Job losses reached their peak in 1Q09 and finally slowed in April 2009. These job losses created negative absorption of 18.4 million square feet in 1Q09 — the highest since the dot com bust — and 2.8 million of the total were in New York City where financial firms let go of their excess space. Occupancy declines of more than 1% were seen in Charlotte, Detroit, Miami, Milwaukee, Riverside and Seattle. Low levels of construction are helping to keep this down-cycle at a slower pace than previous cycles and should help to produce a quicker recovery. Rents declined 2% in 1Q09 and were down 4.5% year-over-year. With employment losses on the decline, we now expect rent declines to slow to 4.5% in 2009.

### Office Market Cycle Analysis 1st Quarter, 2009



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

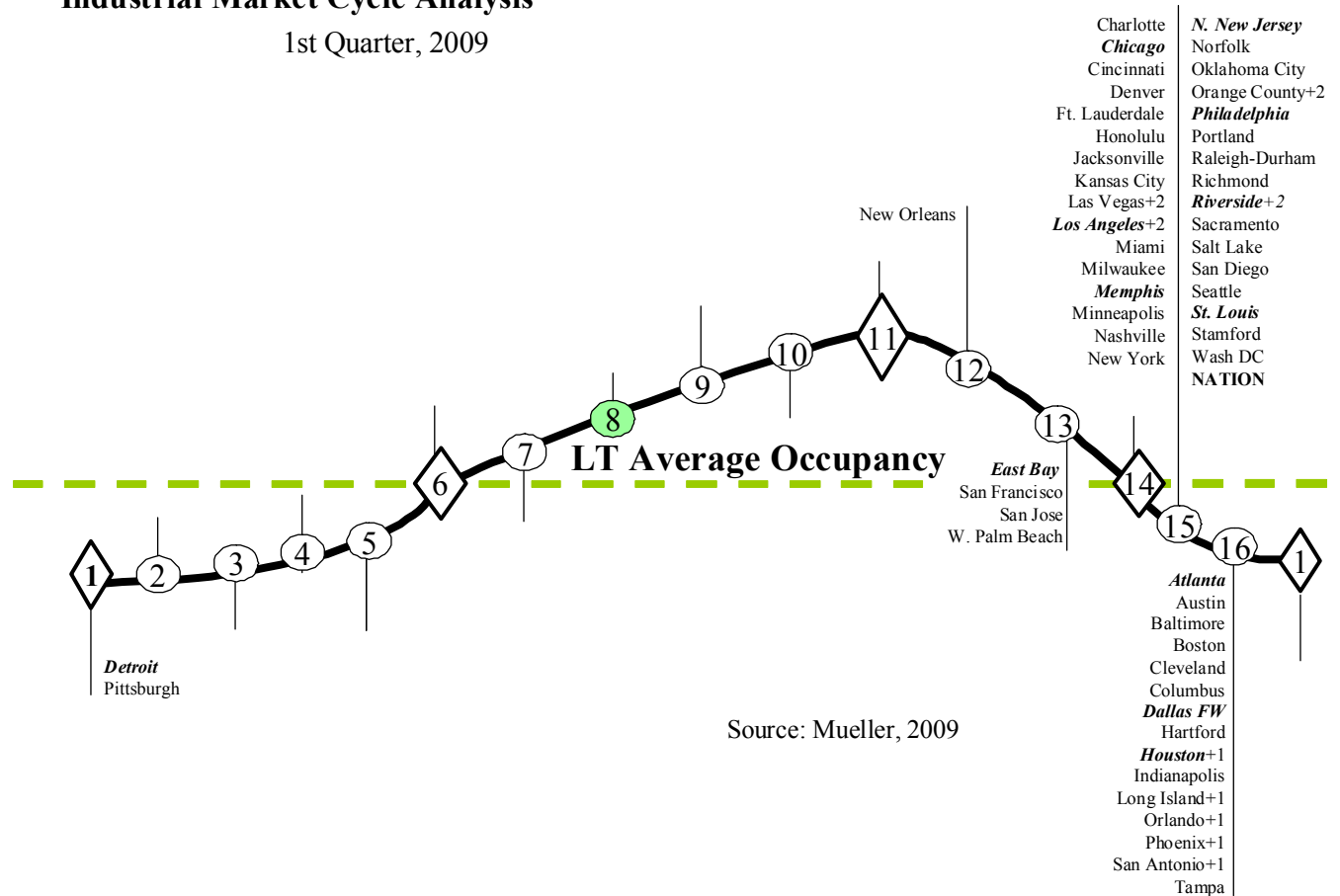
Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their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

## INDUSTRIAL

Industrial occupancies declined 0.6% in 1Q09, creating a full-year decline of 2.1% year-over-year. From a market peak in 3Q07 of 92.4% occupancy, 1Q09 was the worst quarter in this down-cycle with absorption being a net negative 40 million square feet, of which 8.3 million square feet were in northern and central New Jersey. Los Angeles remains the best market at a 97% occupancy level even though it had negative absorption. Eighty-five percent of new construction was in warehouse/distribution space and occupancy fell fastest there, which accounted for more than half of the negative industrial absorption. The five markets with largest occupancy declines in 2008 were also the worst housing markets, namely Las Vegas, Orlando, Reno, Riverside and Phoenix. The good news is that space under construction dropped to the lowest rate in 10 years. We expect 2009 will be a down-year for industrial space with no occupancy bottom reached nationally. Rents were down 1.5% for the quarter and 4.5% year-over-year. We estimate occupancies to decline an additional 2% in 2009, which should force rents down about 4% for the year.

### Industrial Market Cycle Analysis

1st Quarter, 2009



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

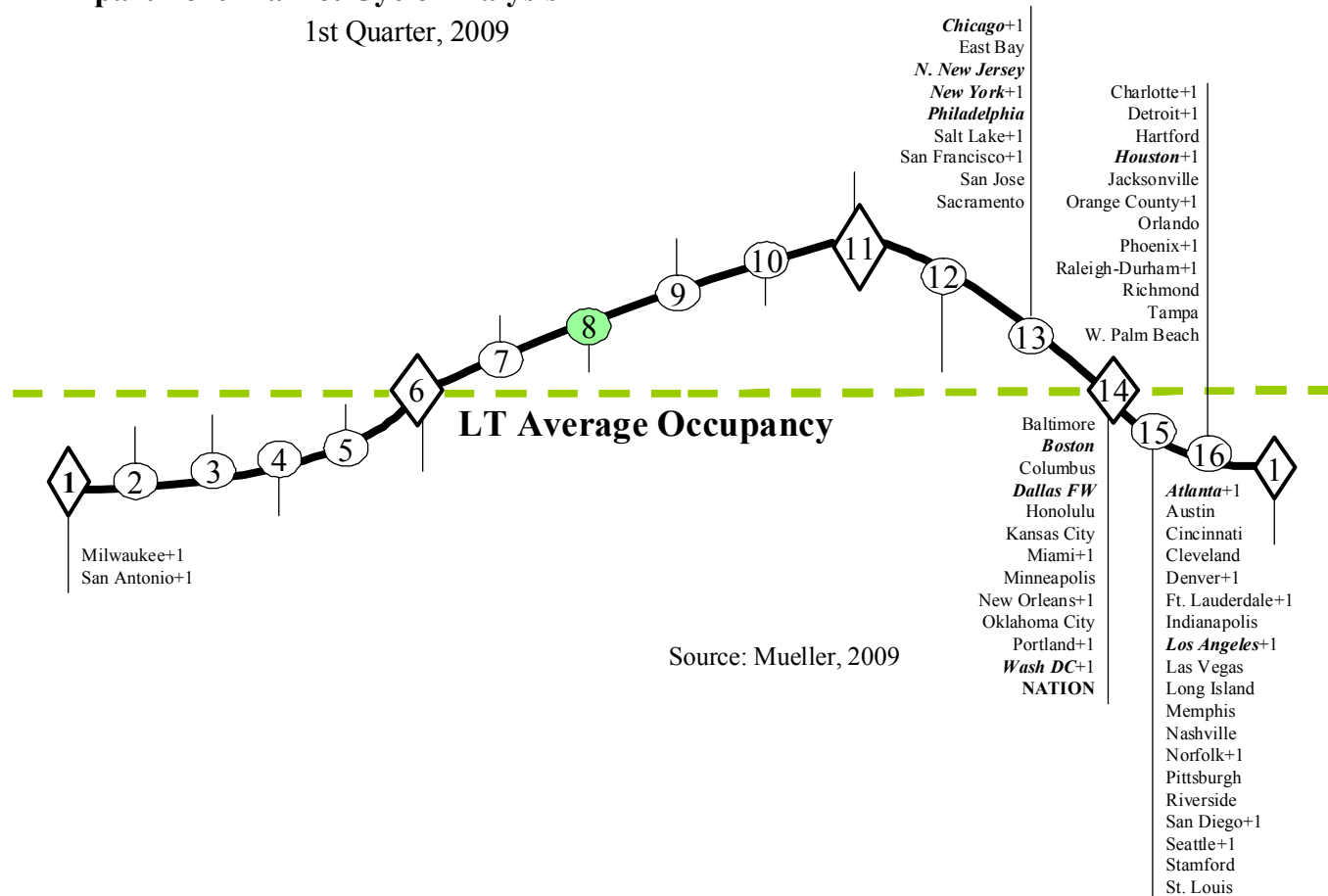
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their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

## APARTMENT

Apartment occupancy declined 0.5% in 1Q09, producing a 1.4% decline year-over-year. Continued job losses are causing many renters to double- or triple-up or move home with family. The lack of new jobs also causes high school and college graduates to postpone their first rental experience. With job creation not expected until 2010, we do not expect apartment occupancies to improve in 2009. Rents were down 1% in 1Q09, the largest decline in four years, but down only 1.6% year-over-year. We expect occupancies to decline another 1.6%, which should cause rents to decline about 3% in 2009.

### Apartment Market Cycle Analysis

1st Quarter, 2009



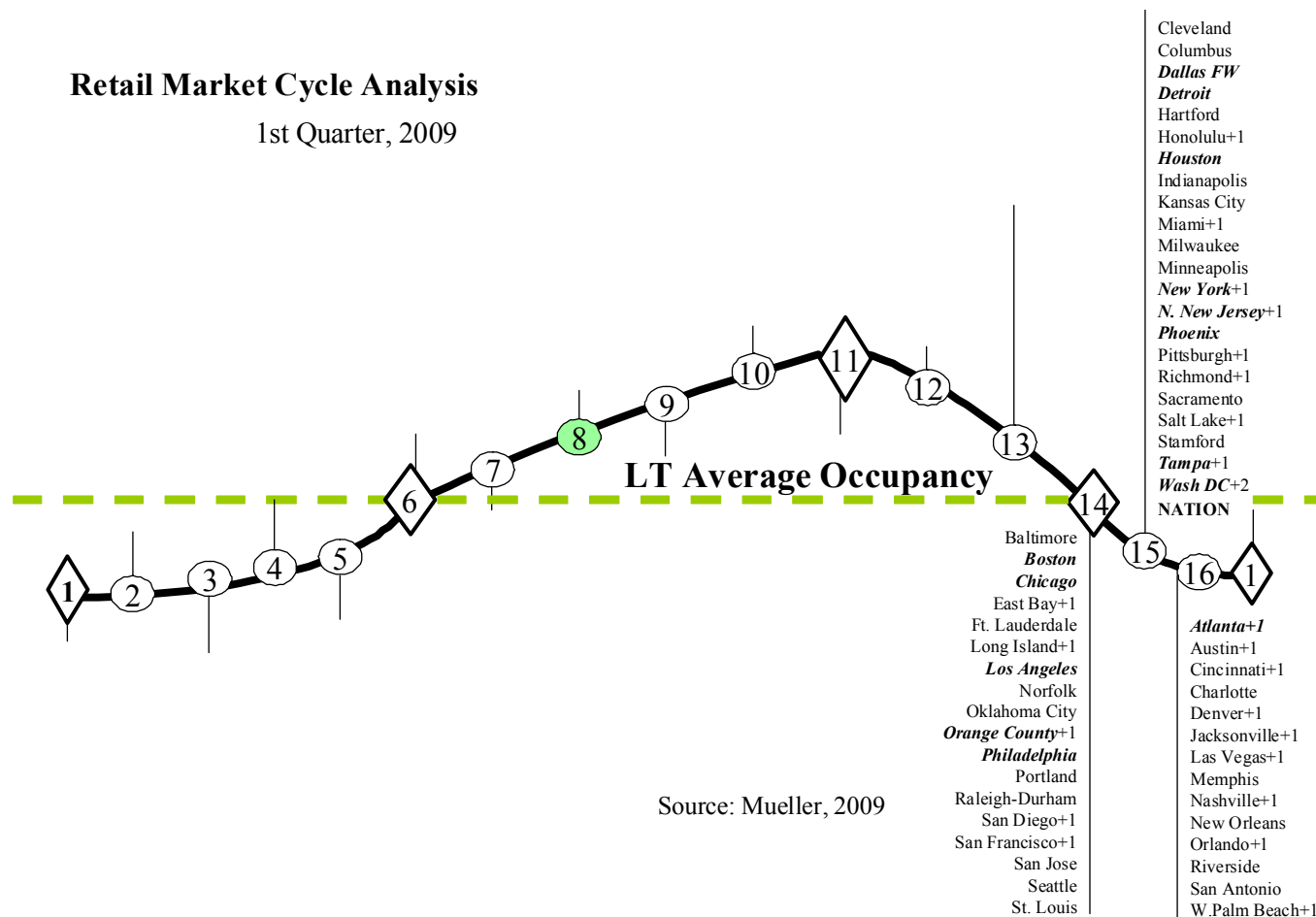
Source: Mueller, 2009

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

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

## RETAIL

Retail occupancies declined 1.6% in 1Q09, producing a 4.9% decline year-over-year. This decline came from negative net absorption of 24 million square feet in 1Q09. We estimate occupancies should decline another 3% in 2009 and hit bottom at the end of the year. This could produce rent declines as large as 7% in 2009. The average time to lease space has almost doubled to a full year. The most pain has been felt in centers where an anchor has closed. As an example, Circuit City closing has caused their centers' vacancy to rise by an average of 22% due to decreased traffic. Rents were down 2% in 1Q09 and 5% year-over-year. We expect occupancies to decline another 3.5%, which should cause rents to decline about 7% in 2009.



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

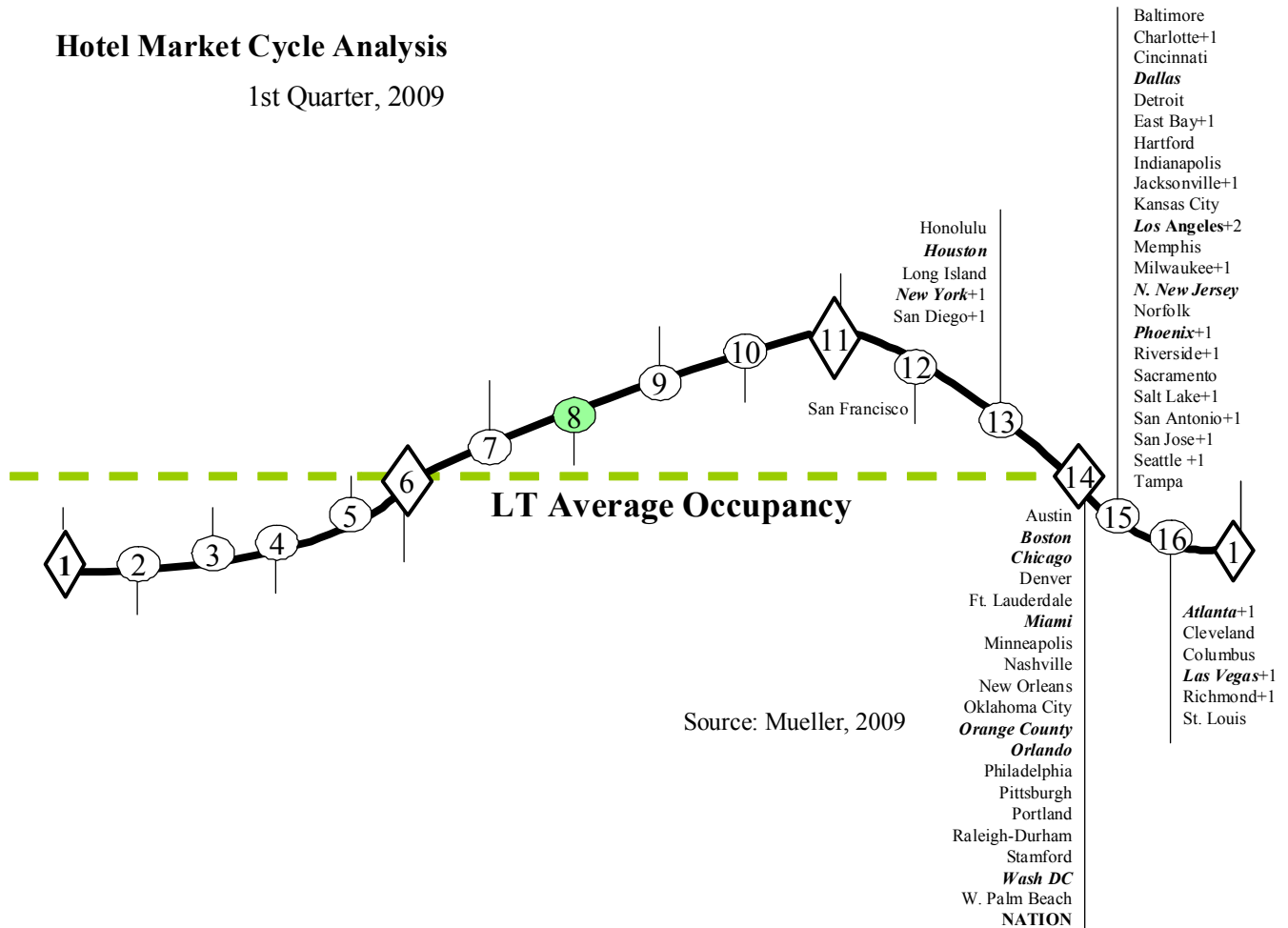
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their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

## HOTEL

Hotel occupancies declined 2% in 1Q09 and 5% year-over-year. Many business conventions were cancelled in the first quarter to save costs or to escape the scrutiny of the press who were trying to expose corporate luxury spending. While the national average occupancy level stands at 62%, which has been the break-even occupancy level in the hotel industry, occupancies are expected to drop below 60% during the remainder of 2009 as GDP continues to decline. RevPAR growth declined by 6.2% in 1Q09 and was down 19% year-over-year as hotels dropped room rates in an attempt to attract guests. We estimate occupancies could drop another 6% during the remainder of 2009, which could push RevPAR down as much as 11% in 2009.

### Hotel Market Cycle Analysis

1st Quarter, 2009



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

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

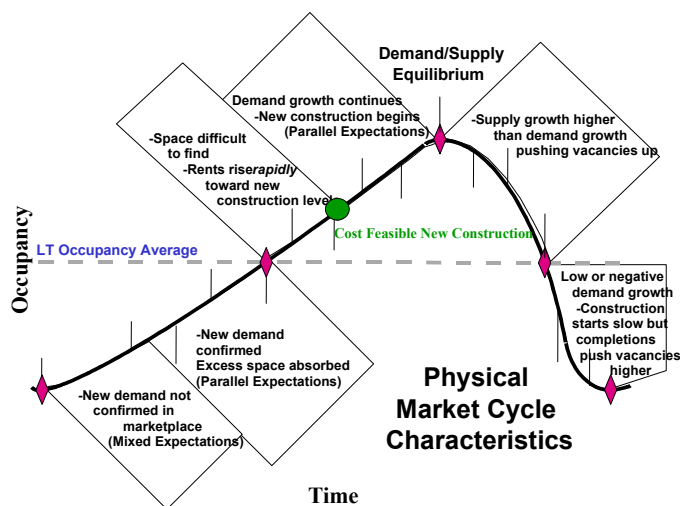
**MARKET CYCLE ANALYSIS — Explanation**

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

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

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

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



Source: Mueller, Real Estate Finance, 1995

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

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