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Mid-Year 2012 Commercial Real Estate Outlook

The outlook for solid returns in property shares is favorable, considering the limited new supply, modest demand and active capital markets, despite an uncertain macroeconomic environment. New supply is the lowest it has been since the 1970's. Demand is modest but outpacing supply. Valuations are discounted relative to bonds historically, and despite the capital markets having pangs of panic, the Fed is insuring both ample liquidity and low interest rates for the foreseeable future.

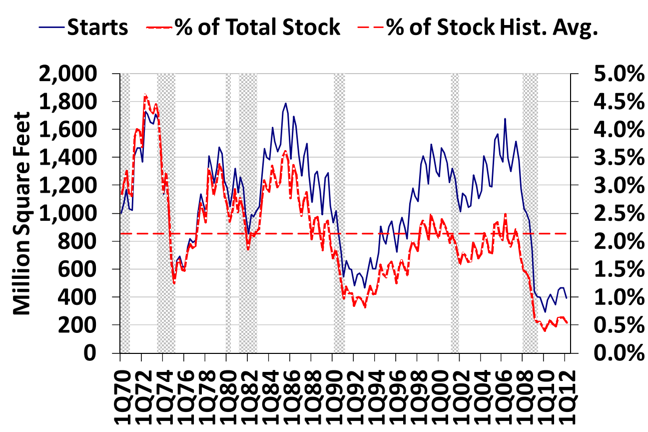
The same concerns about a recession or a liquidity crisis that plagued equity markets the last two summers are not going away in 2012 and will create continued volatility. However, analyzing the underlying drivers of specific companies suggest these scenarios should have little outcome on the profitability and valuation of certain property companies as we saw in the recession of the early 00's, while other companies will suffer. It is also apparent that the CMBS market is less relevant as an early warning sign of the health of the real estate market than it has been historically given the excessive involvement of the Fed.

The Real Estate Industry Is Healthy Overall

The key factors impacting real estate overall are healthy. Interest rates are low, there is little new supply, and strong demand should result in rents and net operating income rising and valuations continuing to improve generating attractive total returns.

- **New supply remains anemic in most markets and property types**. New supply growth of housing, office, retail, warehouse, lodging, and cellular towers are all well below historical levels, as shown in the aggregate construction chart in Figure 1 and by property type in Figures 5-11 in the Appendix.
- **Demand is outstripping supply and is stable with clear pockets of strength and weakness.** In the aggregate, demand is growing 1% as US population, household formation and jobs are all growing 1%.

Figure 1. Aggregate Construction Starts At Historical Lows



Source: LANDandBUILDINGS, Citi

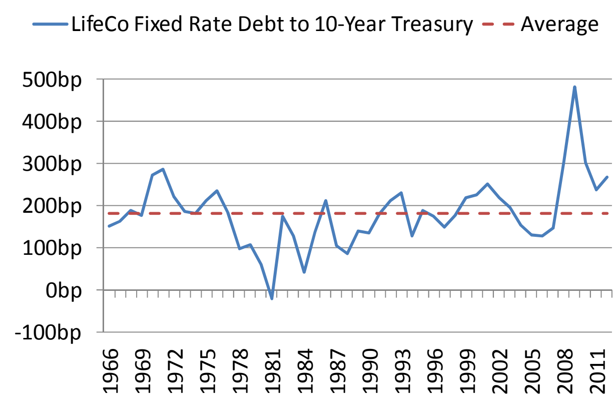
- **Capital markets are open to real estate, and real estate is cheap relative to the cost of debt.** The long arm of the Federal Reserve has insured that short liquidity squeezes are met with more accommodation.

Liquidity Pangs Create Buying Opportunities

The Federal Reserve, together with central banks around the world, has responded to sporadic liquidity squeezes and will likely continue to do so. Specifically, the near zero interest rate policy has created a search for yield by investors and mortgages with modest loan to value on commercial real estate are highly sought after.

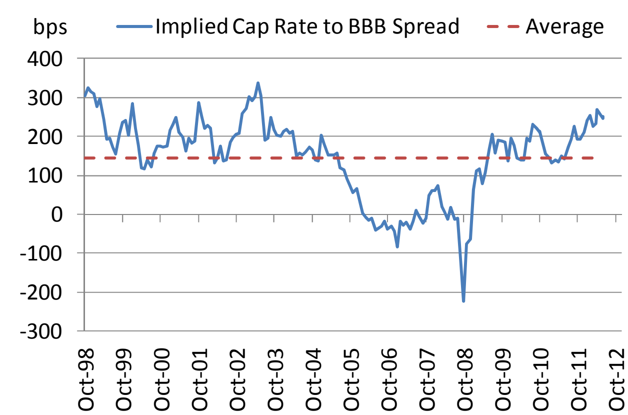
Interest rates for commercial real estate loans by life insurance companies remain wide relative to Treasury yields and should compress further (Figure 2). The attractive relative yields on commercial real estate have created strong investor demand for income producing properties and debt investors (Figure 3). As a result, loan maturities in the real estate industry are met with a strong investor appetite and in periods of liquidity squeezes, lenders continue rework loans as opposed to foreclosure.

Figure 2. Life Company Commercial Real Estate Loans Spread to Treasuries Above Historical Average



Source: LANDandBUILDINGS, ISI Group, ACLI

Figure 3. Implied Cap Rate to BBB 110 bps Above Historical Average



Source: LANDandBUILDINGS, Citi

Most Compelling Investments Opportunities

The property stocks with the most compelling return opportunities in our view are those sectors with strong secular growth opportunities including apartments, cell towers, data centers and high-end retail. Any price weakness due to macro factors could present attractive opportunities to add to positions.

Pockets of Weakness

The property stocks that are likely to struggle are those where demand has been weakening or is starting to weaken. The junk rally of early 2012 has left many of these stocks with limited valuation upside and their inferior earnings growth should result in share price declines. Evidence of slowing demand started to reveal itself at the end of the first quarter and into the second quarter in certain markets and property types. Specifically:

- Industry participants and our contacts with local brokers tell us New York City office demand remains sluggish with leasing activity through May approximately 20% below the 5 year trailing average, causing vacancy in Midtown to rise 40 bps as financial service tenants reduce or hold steady headcount. Hiring at financial services firms should remain subdued given the challenging revenue outlook, which will weigh on associated industries and keep demand in check.

- A meeting with one of the largest leasing agents in Washington D.C. indicated D.C. office leasing has ground to a halt as tenants await the outcome of the government's looming sequester, other budget cuts and the fall Presidential election.
- Lower-end retailers have seen same store sales deteriorate to 2.2% in the second quarter from 3.6% in the first quarter, which should translate into weaker tenant demand and less pricing power for centers catering to these retailers.

Sector Review & Outlook

- **Apartment companies should continue to drive rents and occupancies higher**. The sector will likely have strong cash flow growth of 10-15% annually over the next two years driven by pent-up household formation, a difficult single family mortgage financing environment and an increasingly wealthy renter pool as higher earning households that have historically owned their home choose to rent. Apartment rents as a percent of income remain below historical average, at 20% on a national basis and are even more favorable relative to historical levels in coastal markets.
- **Retail performance will likely be divided.** High-end retail segment is expected to remain on solid ground, while non-mall REITs will likely continue to struggle with leasing up small shop space.
  - For the high-end segment, strong tenant sales combined with active development and redevelopment programs should support above-average earnings growth. Public valuations in the 5.0-5.5% range, a discount to private market values, suggest mid-teen returns are likely over the next 12 months.
  - Lower sales productivity shopping centers are trading roughly in line with private market values. Shares could come under pressure as these assets continue to struggle with leasing up vacant small shop space and a difficult small business financing environment.
- **Cellular towers represent one of the strongest secular growth stories.** Secular demand for tower space is translating into double-digit organic EBITDA growth. In the first quarter one company experienced a 25% increase in leasing activity year-over-year as carriers build out their networks to support 4G rollouts and growing data demand from smartphones. Conversations with management and other industry players indicate that these long-term trends have remained robust thus far in 2012, with demand coming from a more diverse customer base (e.g. Sprint with its rollout of Network Vision plan).
- **Gaming's recent pricing pressure represents an opportunity.** During the quarter, gaming stocks came under pressure—down 30%-plus from their peak. The Macau market is a secular growth story as infrastructure improves and consumer wealth increases, allowing for more of China's population to drive gaming revenue. People's Bank of China recent aggressive steps to address slowing growth in China will likely add to the potential gaming revenue growth. During June, gaming revenues perked up after a weaker May coming in at 12% year-over-year growth. July and August are tougher comps year-over-year, however,

growth should remain at least in the mid-single digits, comparisons will get easier later in the year and China easing policies will provide a tailwind.

- **Office likely to remain sluggish with a few bright spots.** As mentioned earlier, office demand is relatively tepid as businesses mostly remain in space-shrinking mode or are seeking to maximize productivity in existing space rather than increasing office space needs. Office rents in suburban markets are mostly flat and above market rents in place will likely result in net operating income declines as rents roll down unless landlords are successful at gaining market share. The one bright market in the office segment is Northern California which is benefitting from strength in the technology corridor.

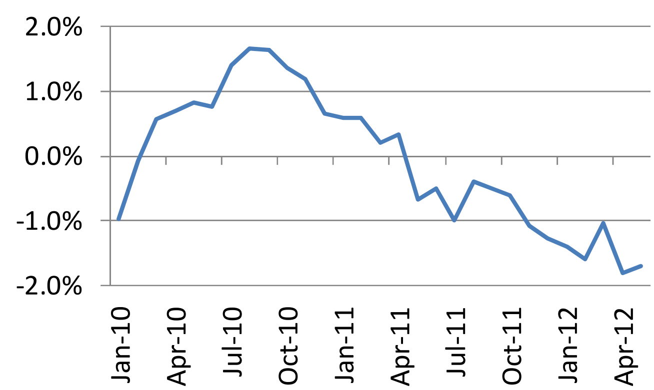
International Real Estate

While much focus of late has been on the global economic environment and a potential slowdown, favorable fundamentals exist in certain markets and segments.

- **Brazil.** In June, we visited with the management teams and toured assets of the key public companies in Brazil. Brazil represents a market with a great potential for meaningful appreciation of its real estate as interest rates fall and underlying demand continues to build. Specifically, the mall companies are enjoying robust high single digit sales growth, low double digit growth in rents and nearly full occupancy. Retail per capita is fraction of the developed markets and the middle class is robustly growing.

- **Europe**. Retail sales in Europe continue to erode. Retail sales continue to fall year-over-year, down 1.7% on a 3 month moving average through May, with the most significant declines in the peripheral countries (Figure 4). Internal growth for many European Mall companies should not be meaningful as the ability to drive rent increases is waning. Valuations are likely to be under pressure as financing becomes more difficult and assets for sale overwhelm demand, particularly for less prime offerings.

Figure 4. Eurozone Retail Sales Continue to Deteriorate



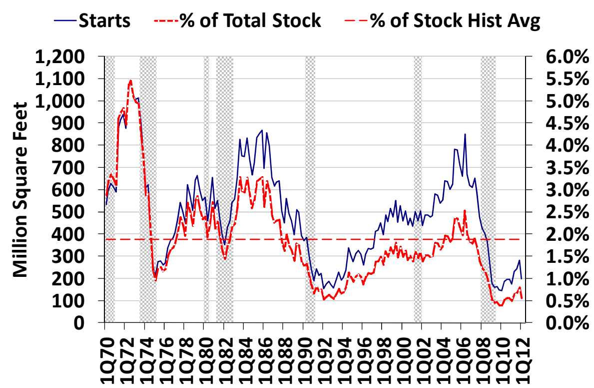
Source: LANDandBUILDINGS, Bloomberg
Note: Data is on an inflation adjusted basis on a 3 month moving average.

If you have any questions or would like to discuss, please do not hesitate to call.

Warm regards,

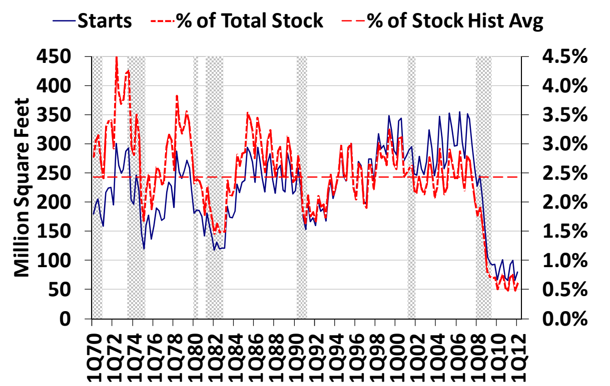
Appendix

Figure 5. Multifamily Starts at 0.7% of Stock



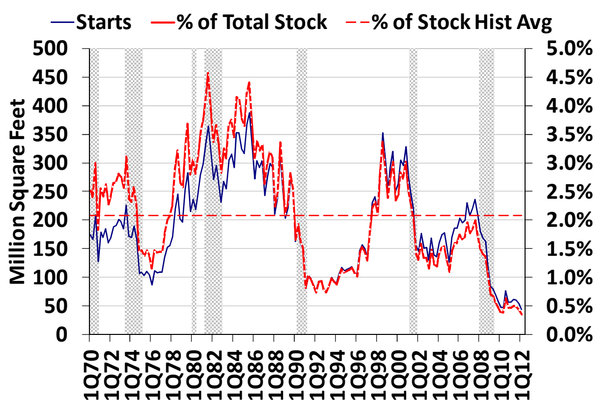
Source: LANDandBUILDINGS, Citi

Figure 6. Retail Construction Starts at 0.6% of Stock



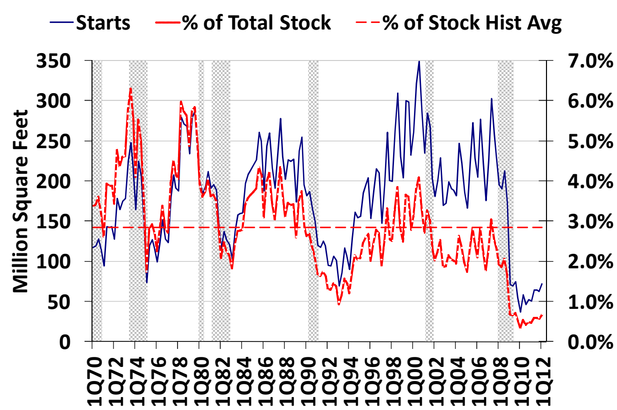
Source: LANDandBUILDINGS, Citi

Figure 7. Office Construction Starts at 0.5% of Stock



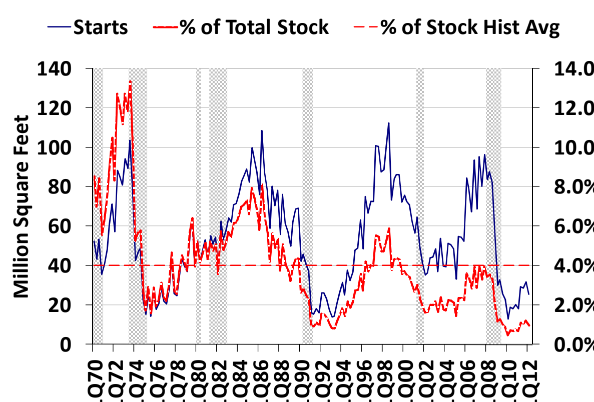
Source: LANDandBUILDINGS, Citi

Figure 8. Industrial Construction Starts at 0.9% of Stock



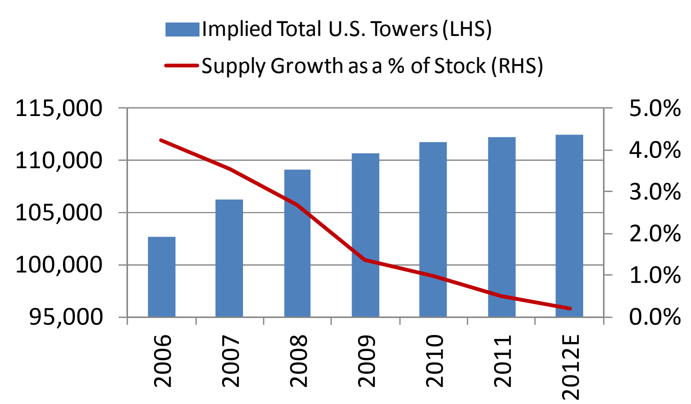
Source: LANDandBUILDINGS, Citi

Figure 9. Lodging Construction Starts at 1.3% of Stock



Source: LANDandBUILDINGS, Citi

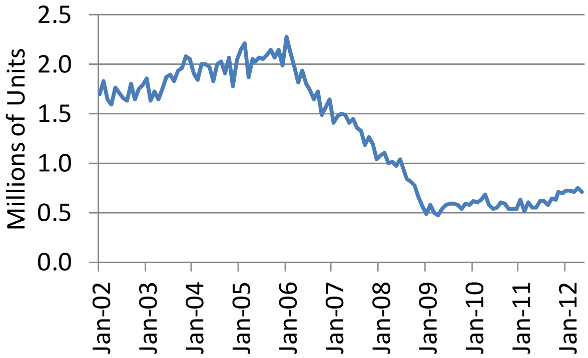
Figure 10. Tower Construction Activity Below 1% of Stock



Source: LANDandBUILDINGS, BAS-ML Estimates

Appendix:

Figure 11. Total Housing Starts Well Below Trend
Demand in Excess of 1 Million Household Formations



Source: LANDandBUILDINGS, Bloomberg (Seasonally Adjusted Annual Rates)

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