Jonathan Litt
Managing Principal

2nd Quarter Commercial Real Estate Outlook:

Risks To The Rally

Crosscurrents surrounding the sustainability of the rally abound. Consider a recent issue of the Wall Street Journal that ran two side-by-side columns, one titled "IMF Sees Growth Slowing in '11" and the other "Economists: Growth to Quicken." Global stock markets have shrugged off conflicts in the Middle East and the earthquake in Japan, and while events are quieting down, the hangover is about to begin. Earnings season is upon us and the impact of higher oil prices and shortages of components from Japan will impact industries differently. Legacy issues including the pending end of QE2, government debt and deficits and healthcare are flaring up again. Many consider higher interest rates and a weaker stock market synonymous with the ending of QE2 given the precedent in 2010 with the ending of QE1 despite the starkly different outlook for the global economy. The concerns are adding up, some with good rationale and others less so.

The key drivers for real estate: an attractive financing environment, a growing economy and little new supply, will likely continue despite the macro concerns.

Lenders Lining Up to Real Estate

Despite the recent machinations in the Middle East and Japan, lenders continue to shed their tight underwriting and property owners are enjoying tighter spreads, higher loan to values and attractive interest rates. The CMBS market, which was largely written off just a year ago, will likely see over $45 billion of new securitizations in 2011. Fortunately, development financing remains scarce.

Private Real Estate Investors Putting Money to Work

Private institutional real estate investors have gone from queuing *to exit* core private real estate funds to queuing *to get into* core private real estate funds, to the tune of $7 billion waiting to be put to work. Opportunity funds are awash in capital and the public markets are open for attractive opportunities in real estate.

Inflation and Interest Rates May Stay in Check

After nearly 30 years of a bull market in bonds, conventional wisdom holds that a bear market is next. Conventional wisdom may well be right. However, a range bound bond market appears more likely in the near term given slack in the labor force. Inflation has been tame for over 30 years and fewer and fewer investors lived through the extraordinary inflation of the 1970's to recall the impact. Many argue that real estate is a good store of wealth in an inflationary environment and that inflation is upon us. Deleterious inflation is unlikely upon us.

Real estate can be a good store of wealth in an inflationary environment. However, it depends on the circumstances. Little new supply and a growing economy, both in terms of population, employment and households, will be an attractive environment to own real estate. In high barrier to entry markets, investors should enjoy returns well ahead of inflation, and in low barrier markets, returns that keep pace with inflation.

Economic Growth Supports Stronger Real Estate Demand

Excess supply or a stagnating economy coupled with inflation will be the kiss of death for real estate values. Fortunately, today the global economy is enjoying a period of little new supply and a growing economy both in financial terms and population, jobs and household growth.

The consensus among economists is the global economy and the US will grow 3.3%[i] and 3.0%, respectively. While these estimates are down due to higher oil prices, the outlook for 2011 is positive. Growing economies typically enjoy more jobs, population and households. People occupy real estate and/or drive demand for real estate. With more people working, real estate demand should increase. The

US will likely experience a shortage of well located housing, office, retail, hotels, warehouses, etc. in dense markets that offer attractive job opportunities and life style.

What Supply?

The current pace of new construction of office, apartments, hotels, warehouses and shopping centers has not been this low (300 million square feet) since our time series began in 1994, with the average level of new construction around 1 billion square feet a year. Unlike the stock market, which hit bottom and has been rising ever since, new construction ground to a halt beginning in the summer of 2007 and remains at generational low levels.

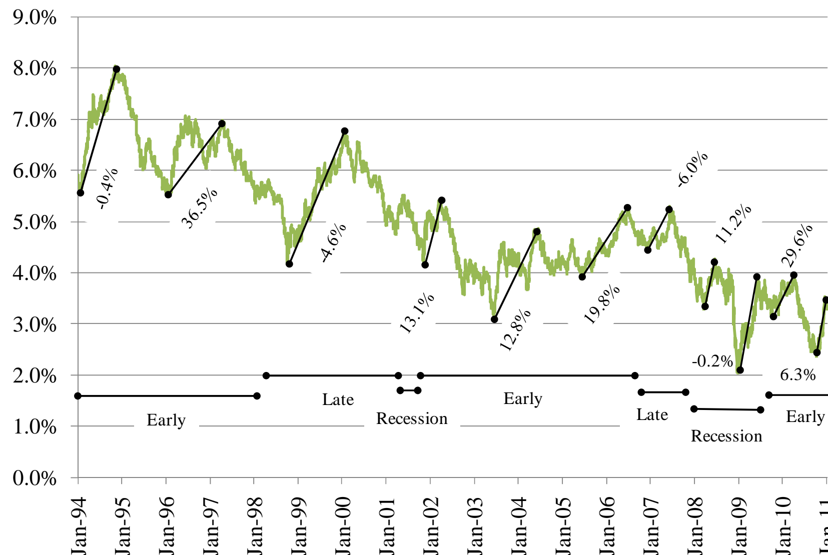
Debt and equity capital remains scarce for new construction, which when coupled with a modestly growing economy, has led to little new construction. Few signs are emerging that an avalanche of new construction is upon us.

Dr. Evil's Demand – A 6% Mortgage

Imagine Dr. Evil in the movie "Austin Powers" waking up in 2011 after being cryogenically frozen since the 1970's and demanding, not money, but a 6% mortgage, so he could arbitrage the double digit mortgage rates when he was frozen. The members of the "United Nations Secret Meeting Room" would have been laughing even harder than at his demand for $1 million in the movie. Six percent mortgage rates by historical standards are a bargain. The current spread to 10-year treasuries is wider than average due to expectations of a rise in government bond yields. A back up of 50-100 basis points in the 10-year would likely result in a smaller increase in mortgage interest rates as spreads narrow and would be a bargain by historical standards.

In the core of an economic recovery, rising interest rates have proven to be an environment for strong returns for commercial real estate, while later in the economic expansion, rising interest rates have proven to be a money making environment to short real estate (Figure 1).

Figure 1: Public Property Should Outperform in an Early Recovery Period



Source: Bloomberg

Likely Sowing the Seeds of the Next Real Estate Bubble

Neither today's interest rates nor commercial real estate valuations are screaming bubble. However, we are likely sowing the seeds of the next bubble by virtue of the excessive amount of capital the Federal Reserve has created. Capitalists will seize the opportunity and bid up hard assets to squeeze out the spread between real estate cap rates and borrowing costs to the point where the only way a deal pencils is if rents heat up to unprecedented levels. Lenders will chase these opportunities with aplomb, perversely incentivizing borrowers to bid values to unsustainable levels at which point the bubble will likely burst and short opportunities will abound.

Emerging Markets Should Benefit from Tightening

In the Fall of 2010, we discussed that the tightening policies of some emerging market economies was likely going to be a headwind to an otherwise robust fundamental opportunity. As the tightening cycle appears to be working, with inflation moderating, these markets are again poised to enjoy attractive investment returns.

<u>US Portfolio Strategy – Select Value Opportunities Have Most Upside Potential, Along With Select Blue Chips</u>

Blue chips and select value companies should outperform over the next year. Blue chip companies should enjoy the best operating fundamentals and internal growth prospects, combined with an additional growth engine coming from acquisition and development opportunities, leveraging their cost of capital advantage.

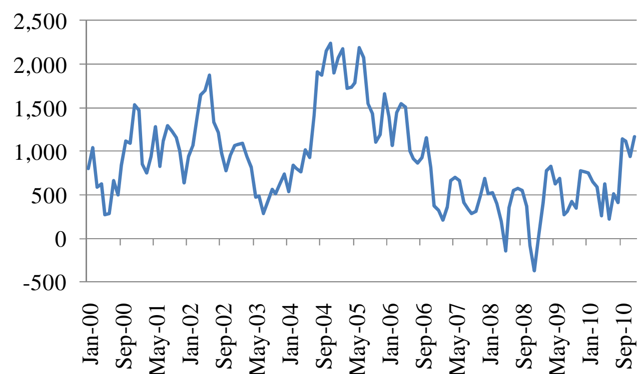
Select value companies have the greatest upside potential for asset value appreciation from both improving fundamentals as well as the re-opening of the CMBS market, which should help provide more debt capital for B/C assets outside of the top tier markets. The implied cap rate spread between prime and non-prime assets is currently 200 bps, with prime companies trading at implied cap rates of 5.5% and non-prime companies trading at 7.5%. Same store NOI for non-prime companies are improving, but at a more modest pace than the prime companies. Both prime and non-prime fundamentals should continue improving.

Highlights of What We Like

Apartments – Accelerating Household Growth Driving Strong Pricing Power

The apartment sector has the strongest fundamental backdrop with accelerating demand and virtually no new construction. There is likely upside to earnings estimates and asset values as operating results are likely to surprise to the upside as the year unfolds. Household formations were suppressed during the recession and improved to 1.2 million in 2010 (Figure 2). Further improvement is likely, as was experienced coming out of the last recession. Strong pricing power is evident with 5% or greater rent increases on lease renewals, which should help drive same store NOI growth in the mid to upper single digits this year and next. Implied cap rates for the group average 5.3%, but some names trade at cap rates closer to 7%, which are particularly attractive given that the same store NOI growth prospects are similar to the richer names.

Figure 2: Pace of Household Formations Accelerating Year Over Year

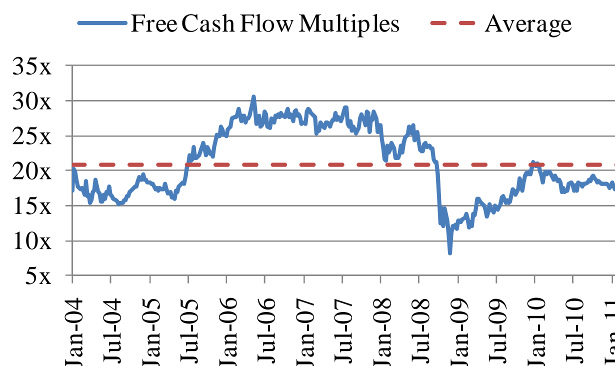


Source: JP Morgan, US Census Bureau

Cell Towers – Pullback on AT&T/T-Mobile Merger Concerns Overdone

The planned merger of AT&T and T-Mobile will likely reduce revenue growth by roughly 1% annually over the next few years as duplicate antenna locations are eliminated. In-place leases with AT&T and T-Mobile will cause the impact to be muted and take time to occur. The industry faced similar issues in the past with the AT&T and Cingular merger in which the bark turned out to be greater than the bite as fewer locations were ultimately reduced. In the midst of the AT&T and Cingular merger, tower valuations expanded and the revenue loss for the tower operators was only 2%. The stocks are currently trading at 16x 2011 EBITDA and cash flow multiples of 17x, which is attractive given the strong EBITDA growth in the low double digits likely over the next few years (Figure 3).

Figure 3: Tower Cash Flow Multiples at a Discount to Historical Levels



Source: BofA-ML

AT&T and T-Mobile will need to upgrade to 4G technology, creating additional revenue for the towers. The merger will also likely lead to greater clarity from other potential drivers of tower demand; two emerging 4G carriers are looking to build out networks, Clearwire and LightSquared, and Sprint is more likely to team up with one or both of these emerging carriers. If these carriers are able to obtain financing to build out their networks, this would be incremental revenue for the tower companies.

Central Business District Office – Midtown Manhattan Recovery Picking Up

Improving demand for CBD office space from job growth and improved optimism from tenants to expand their businesses is helping drive a recovery in the leasing markets, with Midtown Manhattan leading the way. Midtown Manhattan landlords are beginning to regain pricing power with several raising asking rents. Manhattan leasing activity during the first quarter of this year was the highest first quarter level of activity since 2004, with 7.6 million square feet of leases signed in the quarter. Financial services firms will likely see improved profitability in 2011 and be an incremental source of demand. A sign that activity is picking up is a likely re-start of Boston Properties' development at 55th Street, which was halted during the recession. Given the limited availability of large blocks of vacant space in the market, demand for Boston Properties' new building should materialize. Implied cap rates of 5%-6% appear fair based on recent private market transactions and given the potential for strong rent growth over the next few years.

Datacenters – Demand Growth Should Trump New Supply

Owners of datacenters will likely continue to generate strong internal and external growth despite pockets of new supply in some markets. Data center shares are attractively valued trading at a discounted FFO multiple of 14x, a 10% discount to REITs, and should generate strong FFO growth in the mid teens over the next two years. Development and redevelopment will likely drive strong growth and capital appreciation should occur as the industry matures and cap rate compress on existing assets, making the current portfolios that the companies own more valuable.

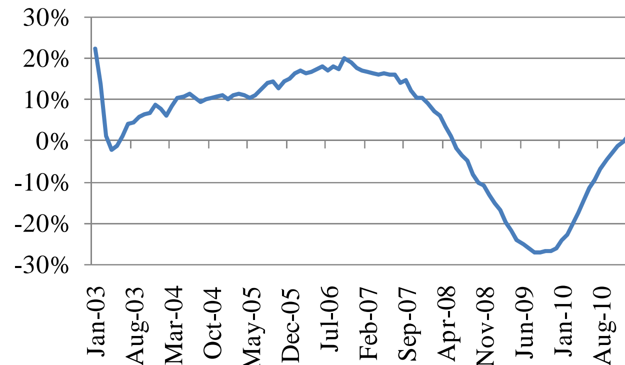
Gaming – Macau Strong, Singapore Emerging as a Success and Las Vegas Should Begin to Turn

The US-based gaming operators are an opportunity to invest in strong demand growth in Asia, specifically in Macau and Singapore, as well as a rebound in Las Vegas. Macau gaming revenues were up over 40% year-over-year during the first quarter, with the high-end VIP gaming customer driving much of the increase. Singapore is also establishing itself as a powerful gaming market in less than a year since the

opening of two large projects, and while some kinks are still being worked out, profitability has exceeded initial expectations.

Las Vegas suffered tremendously during the recession from the combination of new room supply as well as a significant shutdown in convention activity. RevPAR is still 35% below early 2007 peak levels, but on a year-over-year basis has been showing improving trends (Figure 4). The rebound will take some time, but similar to the lodging markets around the country, the turn can be powerful and the mix shift away from leisure customers to higher paying business customers as convention business returns can drive a strong rebound in RevPAR. The stocks are trading at EBITDA multiples of 13-14x, with both EBITDA growth and cash flow per share growth of 15%+ over the next few years from a combination of internal and external growth drivers.

Figure 4: Las Vegas Hotel RevPAR Trends Improving



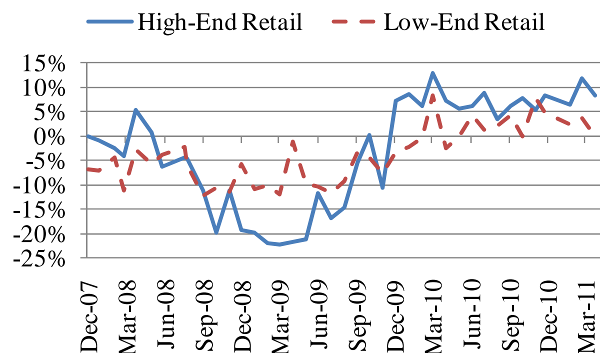
Source: BofA-ML, LVCVA

Note: Data reflects year-over-year change in 12 month moving average hotel RevPAR.

High-End Retail – High-End Retailers Leading the Same Store Sales Recovery

High-end retail landlords are in the catbird seat and are likely to gain negotiating power with retailers on existing stores during the lease renewal process. They will be the location of choice for retailers looking to expand given the landlords of the high-end centers own the centers with the strongest sales productivity. The strong recovery in sales and cost controls are driving improved profitability of the retailers. During the first quarter of this year, the high-end stores generated same store sales of 8.8%, well ahead of the 2.0% increase for the traditional/low-end stores (Figure 5). The high-end retail companies are trading cap rates of 6% - 6.5%, attractive relative to blue chip companies in other property sectors.

Figure 5: High-End Retail Same Store Sales Growing at a Faster Pace



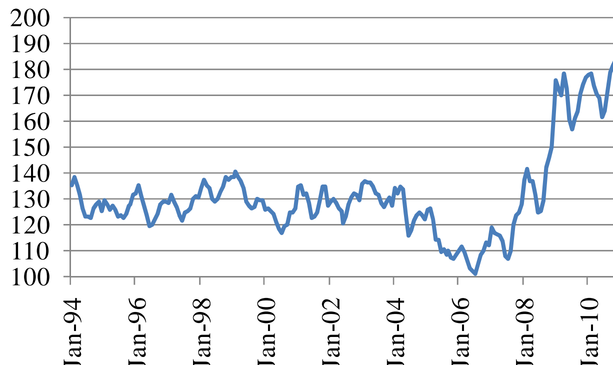
Source: Company reports, BofA-ML

Homebuilders – Housing Bouncing Along Bottom, Public Companies Well Positioned

The public homebuilders are well positioned for an eventual recovery in the housing market given: 1) the dearth of new construction today, at an annualized pace of less than 500,000 new homes built in the most recent month, 2) public builders likely to gain market share from private builders that still have limited access to capital, 3) home affordability is at record highs, likely to entice better credit households to buy a home (Figure 6) 4) the public builders' ability to generate strong gross margins of 15-20% based on current home prices in most communities and 5) a shortage of new homes in sub-markets that customers want to live in as much of the foreclosed inventory is in less desirable, more distant submarkets to employment centers. A strong recovery will likely take time given the overhang of foreclosures and difficulty in obtaining mortgages, but a stable environment should allow for profitable operations at a

modestly higher sales pace than today. Current valuations near book value makes select builders look attractive.

Figure 6: Housing Affordability Near Record High Levels



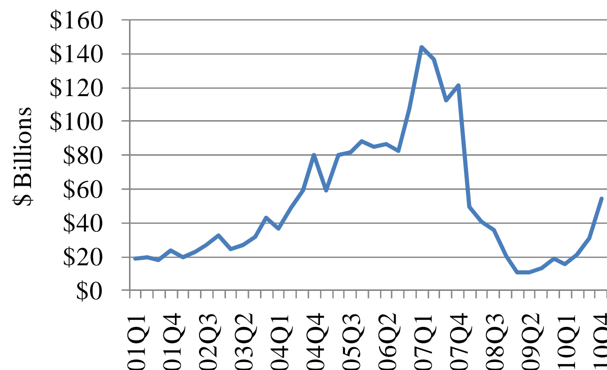
Source: National Association of Realtors

Note: Data through 2/28/2011

Lodging – Weather-Related Weakness and Higher Oil Muddy Outlook, but Valuations Attractive

The underperformance of the lodging companies so far this year is creating a buying opportunity in the sector as three key concerns are likely overblown: 1) the pockets of weakness in RevPAR during January and February are largely attributable to poor weather, 2) Marriott's pre-announcement that RevPAR was expected to be 7% worldwide for its portfolio during the first quarter, short of its initial expectations of 7% to 9% appears mostly company specific and peers have not seen similar weakness and 3) oil prices at current levels are a headwind, but are unlikely to disrupt a multi-year lodging up cycle. RevPAR growth in the high single digits to low double digits this year and next are likely, which should translate into EBITDA growth near 20%. The risk-reward at current valuations of 13-16x 2011 EBITDA seems compelling given the growth outlook and the stocks are trading at the lowest forward multiples since the end of 2009.

Figure 7: Transaction Volumes Starting to Pick Up



Source: Real Capital Analytics

Real Estate Service Companies - Benefiting From Improving Transaction and Leasing Volumes

Commercial real estate transaction and leasing brokers are beneficiaries of the recovery in commercial real estate transaction and leasing volumes. Transaction volumes are on a strong upward trajectory as capital markets continue to open up (Figure 7). Leasing activity is also accelerating, and despite rents remaining well below peak levels in many markets, one public company office execute recently stated that 2011 leasing volumes for his company will could be at record levels, a good sign for the companies that will be brokering these transactions. Margin expansion will also be a key driver of growth over the next few years as the companies leverage their global platforms. The stocks are trading at 11x-13x 2011 EBITDA with strong EBITDA growth of at least 15%-20% likely over the next few years.

Highlights of What We Do Not Like

There are select opportunities throughout the universe that we have identified as likely to underperform, but property sector calls are increasingly challenging as the recovery in fundamentals is becoming more widespread and going-concern questions have been taken off the table. Companies with inferior business models as well as those with weak balance sheets putting them in a difficult position to grow are likely to be challenged ahead. Two sectors that are likely to underperform are healthcare and triple nets.

Healthcare – Growing Off a Larger Base More Challenging

The healthcare companies have been active acquirers over the past year, which is making the external growth story more muted as now even more transactions will be necessary to generate the same level of growth. While many of the transactions have improved the quality of the portfolios, the internal growth prospects remain inferior to other property types during the economic expansion. Current valuations are not pricing this in, with the larger cap healthcare companies trading at 6% implied cap rates and 20%+ premiums to private market valuations.

Triple Nets – Inferior Growth Prospects Not Reflected in Valuation

The triple net lease sector has the least leverage to the economic recovery and offers limited inflation protection given the lease structure with a typical annual rent increase of 1%-2%. Despite this, the stocks trade at rich valuations of 6%-7% implied cap rates, likely a 40%+ premium to underlying asset value. Acquisition activity will likely continue to be relatively modest given the fragmented nature of ownership in the industry, suppressing FFO growth to average in the mid single digits over this year and next.

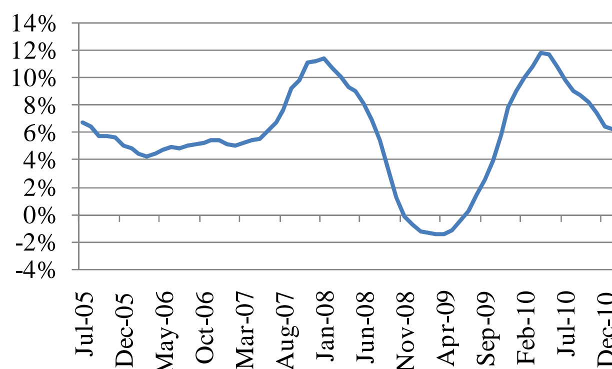
International Portfolio Strategy – Emerging Markets Staged to Outperform Developed Markets

The emerging markets, having already undergone tightening measures, are well positioned to generate strong returns and outperform developed markets outside the US as economic growth is superior and inflation appears to be leveling off. Owners of income producing real estate as well as homebuilders in markets where government policies should allow for increased transaction volumes and moderate price growth appear well positioned.

China Homebuilders - Focus on Developers With Exposure to Tier 2 and 3 Cities

Contracted sales in first quarter were up 64% year-over-year for the top 25 developers despite a third round of policy tightening initiatives. Still, household property restrictions seem to be working with volumes down in the more restricted tier 1 cities and aggregate average selling prices moderating to up 5.9% year-over-year through February (Figure 8). Developers that have greater exposure to tier 2 and 3 cities should see strong growth as these cities have had relatively less speculative activity and could benefit from less restrictive policy measures. Though further rounds of policy measures could act as a headwind, the latest round of tightening has had its intended effect and the listed developers' discounted valuations, strong growth profiles and market share gain potential provide a strong tailwind. The developers trade 8x-10x 2011 EPS, compared to a 17x multiple historically, and will likely grow earnings by 25% to 30% in 2011.

Figure 8: China Year-over-year Property Price Increases are Moderating



Source: ISI Group, CEIC

Brazil - Fundamental Growth Story Remains Intact

The Brazilian economy should continue to benefit from its young and growing population, increasing domestic demand and developing credit markets. GDP is expected to grow 4% to 5% over the next two years despite fears of increased inflation and interest rate increases.

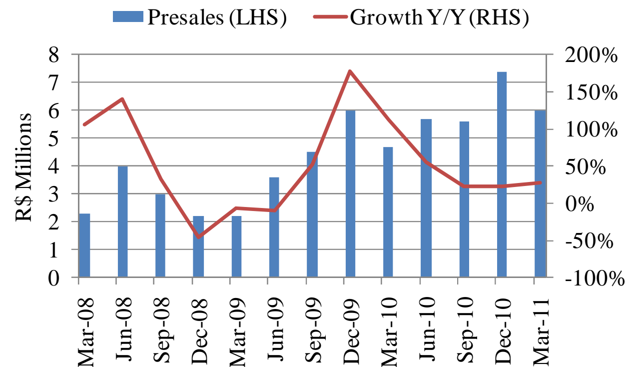
- **Brazilian Homebuilders** - Pre-sales continue to be strong with one of the larger homebuilders recently reporting 26% contracted sales growth in the first quarter (Figure 9). The Brazilian homebuilders have an attractive long term growth profile with the growing prosperity of the

- population that should lead to growing demand for housing across the price spectrum. The government's housing program is providing a boost to the lower end of the market by providing mortgages to low-income families to address the housing deficit. The homebuilders should be able to generate high double-digit annual growth in launches given the strong demand for low-income housing. The group currently trades at 8x-9x 2011 EPS, compared to 15x historically, and will likely have 30%+ earnings growth over the next two years.
- **Brazilian Malls** - Retail sales continue to be strong with 8% year-over-year growth and is supported by stronger retailer fundamentals (Figure 10). Earnings should grow as public companies consolidate the highly fragmented mall business and as developments begin to fill the dearth of organized retail. Today, the group trades at 13x-14x 2011 EBITDA with EBITDA growth in excess of 25% driven by internal and external growth.

Europe Retail – Fiscal Austerity Measures a Drag on Economic Activity

The sovereign debt issues in Europe over the past year and austerity plans to right size government budgets are weighing on economic growth, with a likely slowdown in Eurozone GDP growth to 1.7% in 2011, down from the 1.8% growth in 2010 and at the low end of major markets around the globe. Retail sales in Europe were up only 0.1% year-over-year in February, a marked slowdown from the year-over-year gains of approximately 1.5% during the middle of last year (Figure 11). Annual rent increases on in-place leases will be reduced as a result and constrain retailers' new store opening plans. Shopping centers trading at 6% implied cap rates does not reflect the challenges ahead for the portfolios given the weaker economic backdrop and are trading at 10%-20% premiums to underlying asset value.

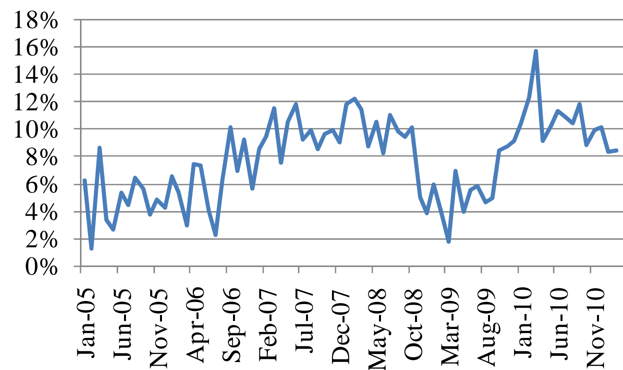
Figure 9: Brazil Contracted Sales Growth is Expected to be Up 20% to 25% This Year



Source: JP Morgan

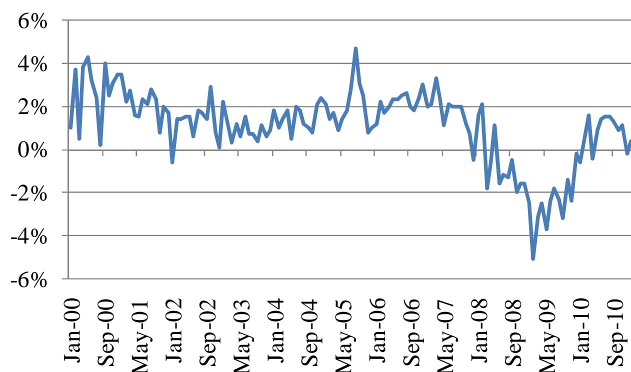
Note; March 2011 is estimated. Represents Brazil Homebuilder group contracted sales growth

Figure 10: Brazil Retail Sales Are Up 8% Year-to-Date



Source: Bloomberg

Figure 11: Eurozone Retail Sales Have Weakened



Source: Eurostat

Note: Data reflects year-over-year retail sales excluding motor vehicles.

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Note: All figures are as of April 12, 2011.

LANDandBUILDINGS Background:

Jonathan Litt is the Founder and CEO of LANDandBUILDINGS, a long/short investment firm that actively invests in securities of global real estate and real estate related companies. Prior to LANDandBUILDINGS, Jonathan Litt was Managing Director and Senior Global Real Estate Strategist at Citigroup where he was responsible for Global Property Investment Strategy from 2000 to March 2008. Jonathan Litt led the #1 Institutional Investor All American Real Estate Research Team for 8 years and was top ranked for 13 years while at Citigroup, PaineWebber and Salomon Brothers. Craig Melcher, Co-Founder and Principal at LANDandBUILDINGS, was a key member of the Citigroup team. LANDandBUILDINGS was seeded by funds advised by Citi Alternative Investments in the summer of 2008, now SkyBridge Capital. Land & Buildings Investment Management is a Registered Investment Adviser with the SEC.

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[i] Represents JP Morgan data