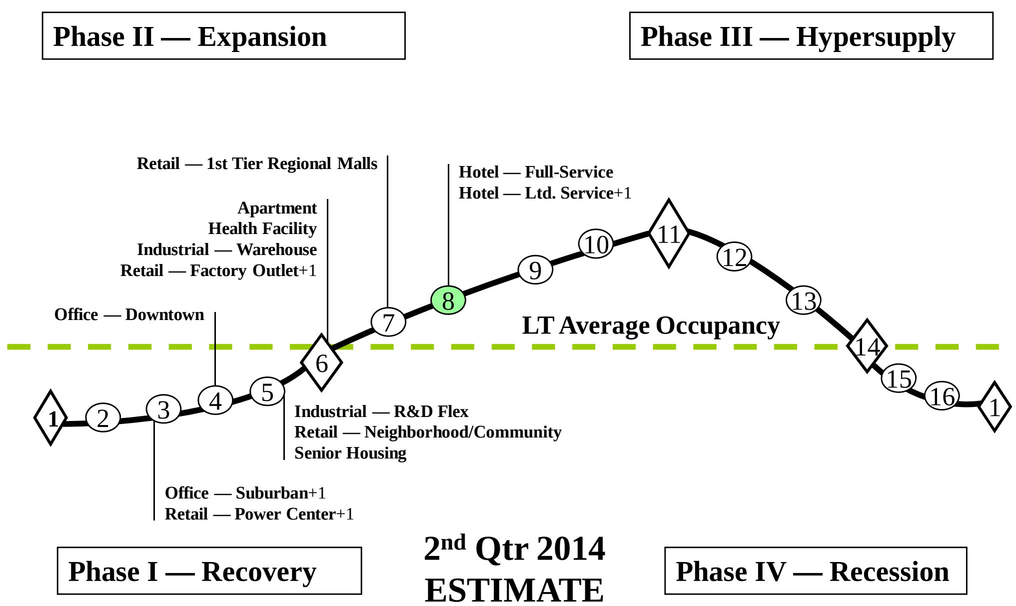
CYCLE FORECAST — Real Estate Market Cycles

Second Quarter 2014 Estimates
August 2013

The summer stock market pullback seems to point to a continued slow economic recovery/expansion period in 2014. Many employers do not want to expand to the point where they will be required to comply with the new affordable healthcare act, which could keep employment growth at the lower 150,000 per month level versus the 250,000 level seen in previous recoveries. We continue to expect moderate new supply in all property types except apartment. Thus, we expect continued occupancy and rent growth in most markets.

Office occupancies are forecast to **improve** 0.2% in 2Q14, with rents improving 0.7% quarter-over-quarter.
Industrial occupancies are forecast to **improve** 0.1% in 2Q14, with rents improving 0.6% quarter-over-quarter.
Apartment occupancies are forecast to **decline** 0.4% in 2Q14, with rents improving 0.6% quarter-over-quarter.
Retail occupancies are forecast to **improve** 0.2% in 2Q14, with rents improving 1.0% quarter-over-quarter.
Hotel occupancies are forecast to **improve** 0.1% in 2Q14, with quarterly RevPAR improving 1.5% quarter-over-quarter.

National Property Type Cycle Forecast



Source: Mueller, 2013

National Property Type Cycle Graph shows relative positions of sub-property types — major markets are reviewed inside.

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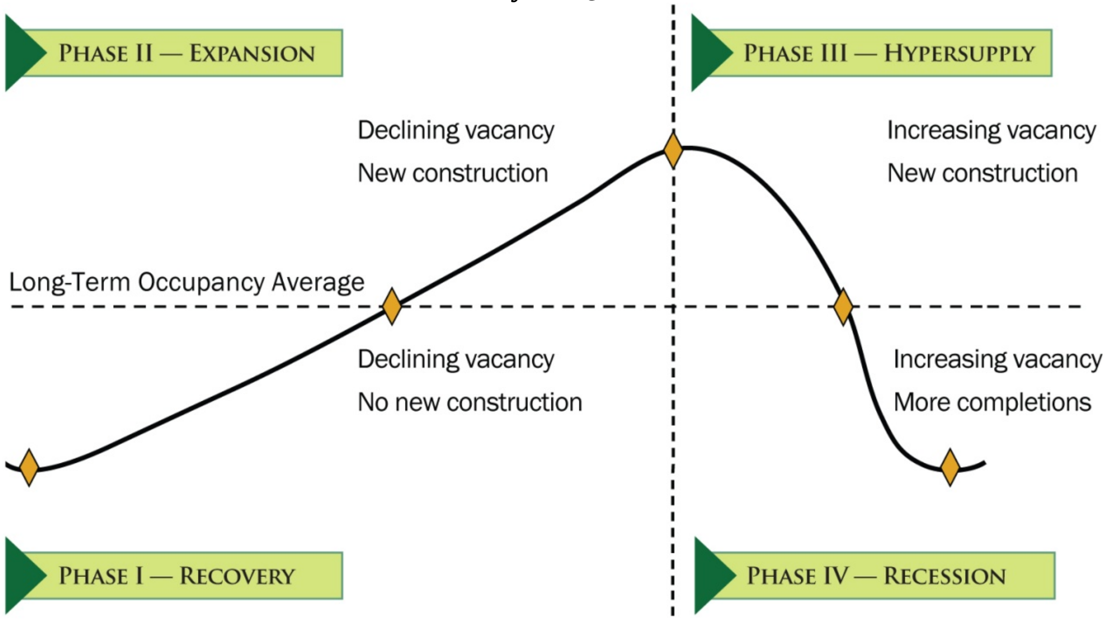
All relevant disclosures and certifications appear on page 9 of this report.

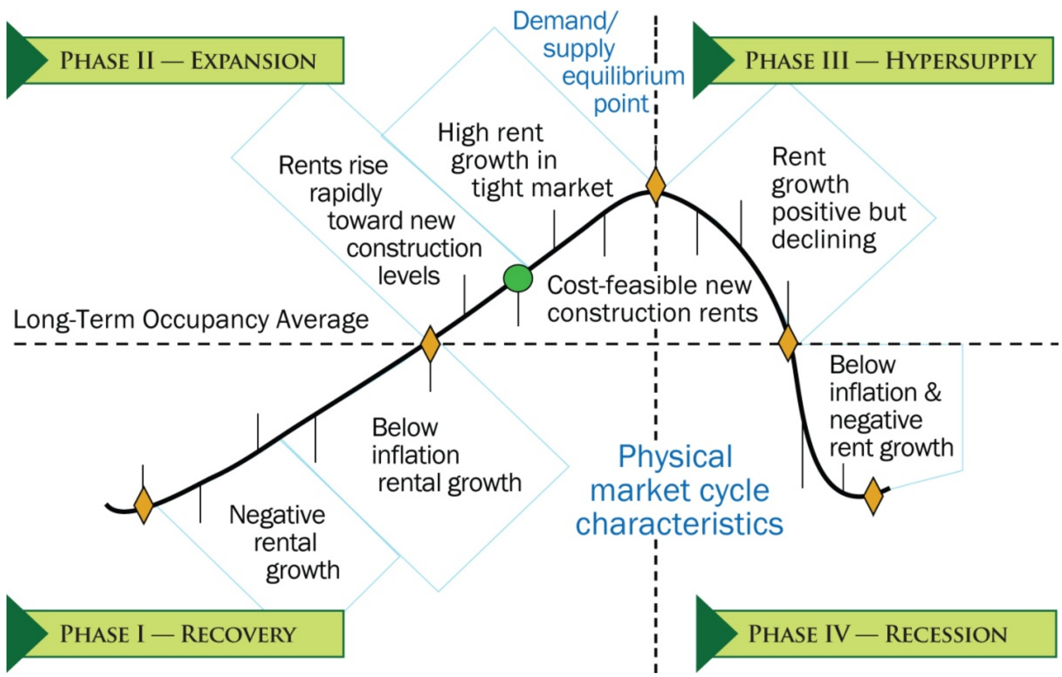
The cycle forecast analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). The market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models 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 supply and demand 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.



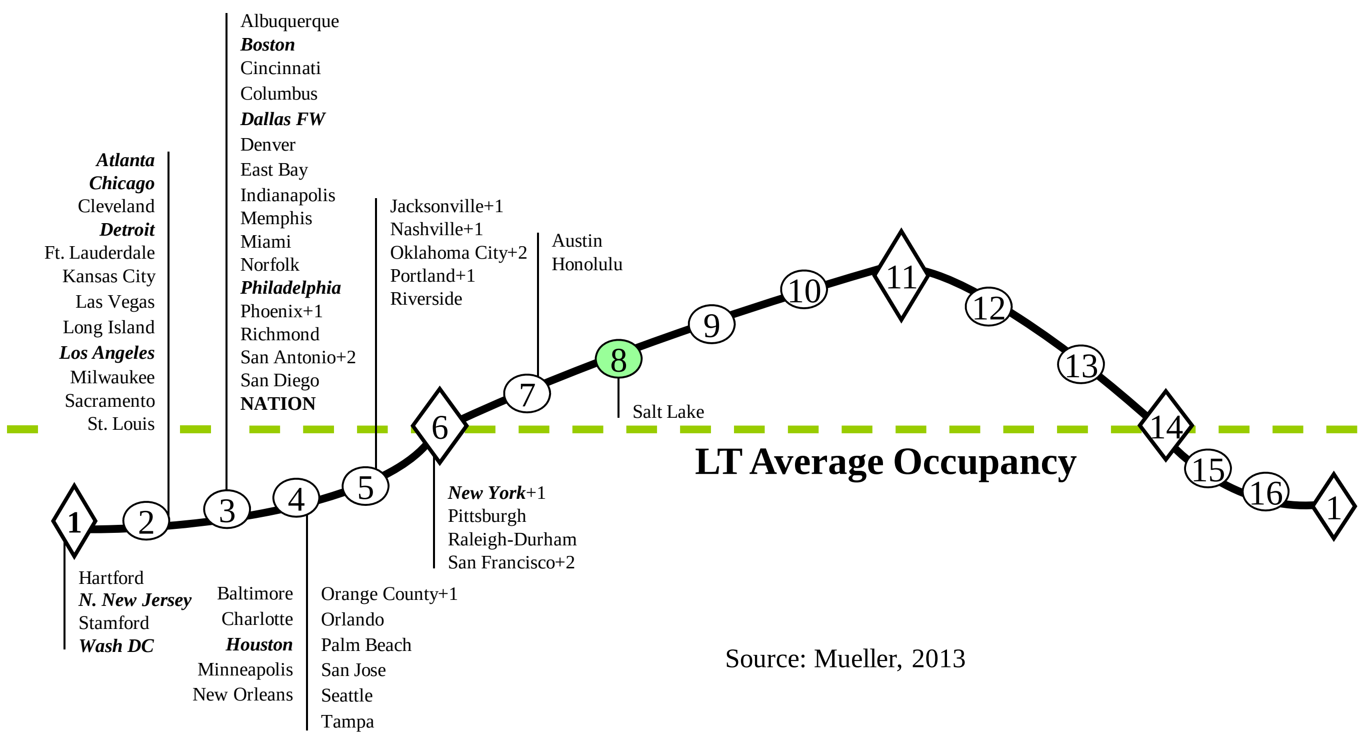
Source: Mueller, Real Estate Finance, 1995.

OFFICE FORECAST

Office occupancies are forecast to improve 0.2% in 2Q14, producing a 0.5% increase year-over-year. Only nine markets improved their cycle position in this forecast because the employment growth forecast for 2014 continues to have a muted 150,000 per month number with some new supply coming online that would keep net absorption at a very moderate rate. Financial services, technology and energy are expected to be the leaders in new job growth and the cities with these concentrations are forecast to move forward. We expect rents to increase 0.7% in 2Q14 and be up 2.9% year-over-year.

Office Market Cycle FORECAST

2nd Quarter, 2014 Estimates



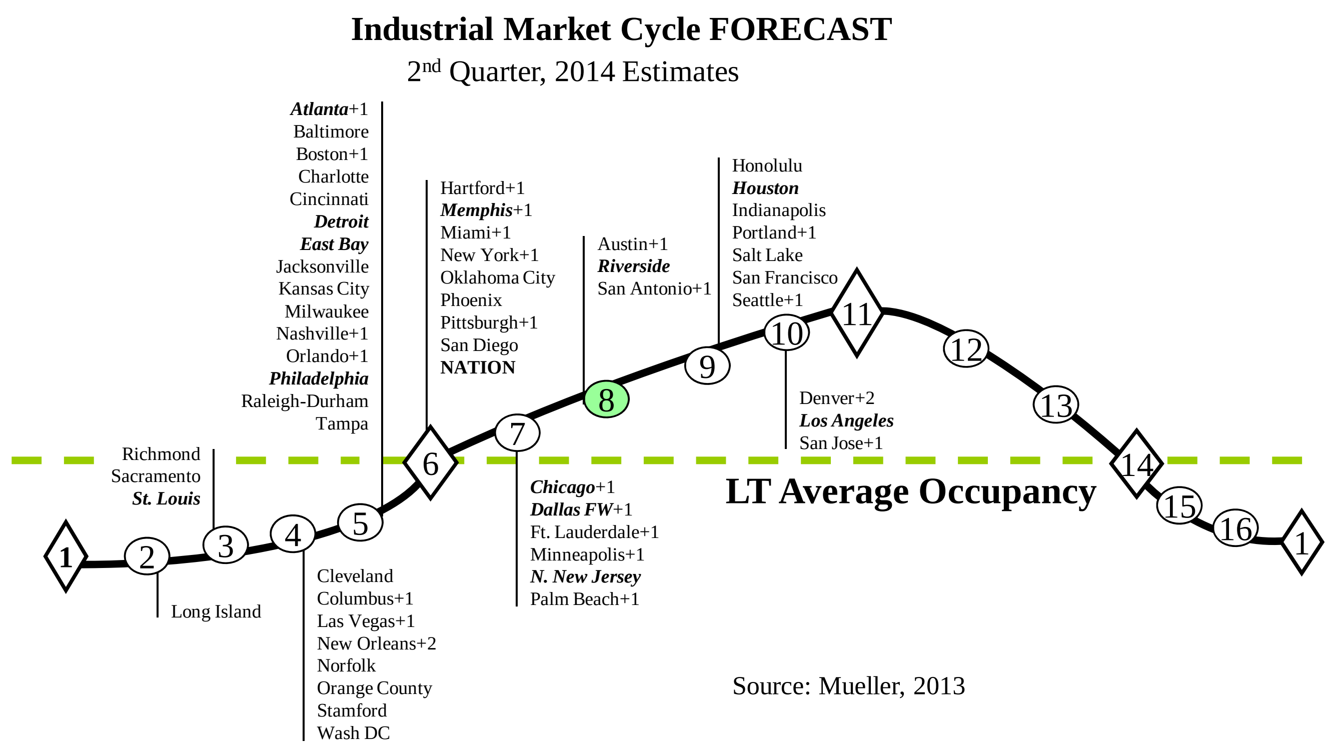
Source: Mueller, 2013

Note: The 11-largest office markets make up 50% of the total square footage of office space that we monitor. Thus, the 11-largest office markets are in ***bold 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.

INDUSTRIAL FORECAST

We forecast another 0.1% improvement in industrial occupancies in 2Q14 and a 0.6% improvement year-over-year. Almost half of the markets are expected to improve their cycle position during the second quarter of 2014. Increased demand from the growing U.S. manufacturing industry is expected to continue. Economists predict that low natural gas prices should continue and make the U.S. manufacturers even more competitive worldwide. Consumer spending is expected to accelerate as well, creating more retail demand for warehouse space. The low amount of new space being built should also allow landlords to increase rents. We expect rents to increase 0.6% in 2Q14 and be up 2.7% year-over-year.

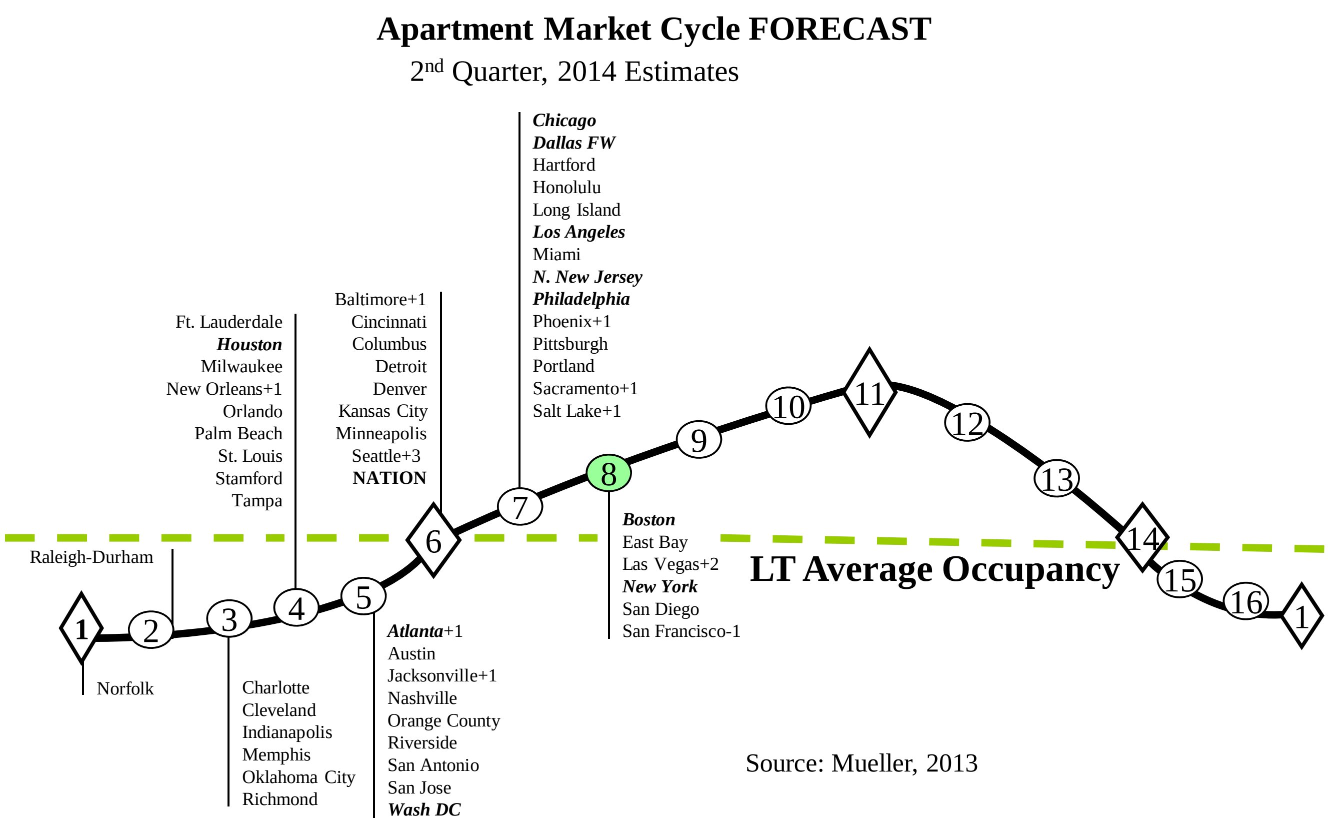


Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space that we monitor. Thus, the 12-largest industrial markets are in ***bold italics*** to help distinguish how the weighted national average is affected.

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.

APARTMENT FORECAST

Apartment occupancies are forecast to decline 0.4% in 2Q14, but be up 0.2% year-over-year. The continuation of strong new supply is expected to produce a minor amount of negative net absorption. Following the example of the Black Rock institutional investment fund that started buying foreclosed homes a year ago, some foreign institutional investors are now also buying foreclosed single family homes to place on the rental market, which should contribute to the oversupply of rental units in 2014. We now estimate that a number of markets will be at lower cycle positions in 2Q14 than they were in 2Q13 due to the strong new supply. We estimate the national apartment rental rate to increase 0.6% in 2Q14 and estimate a year-over-year rental increase of 2.6%.

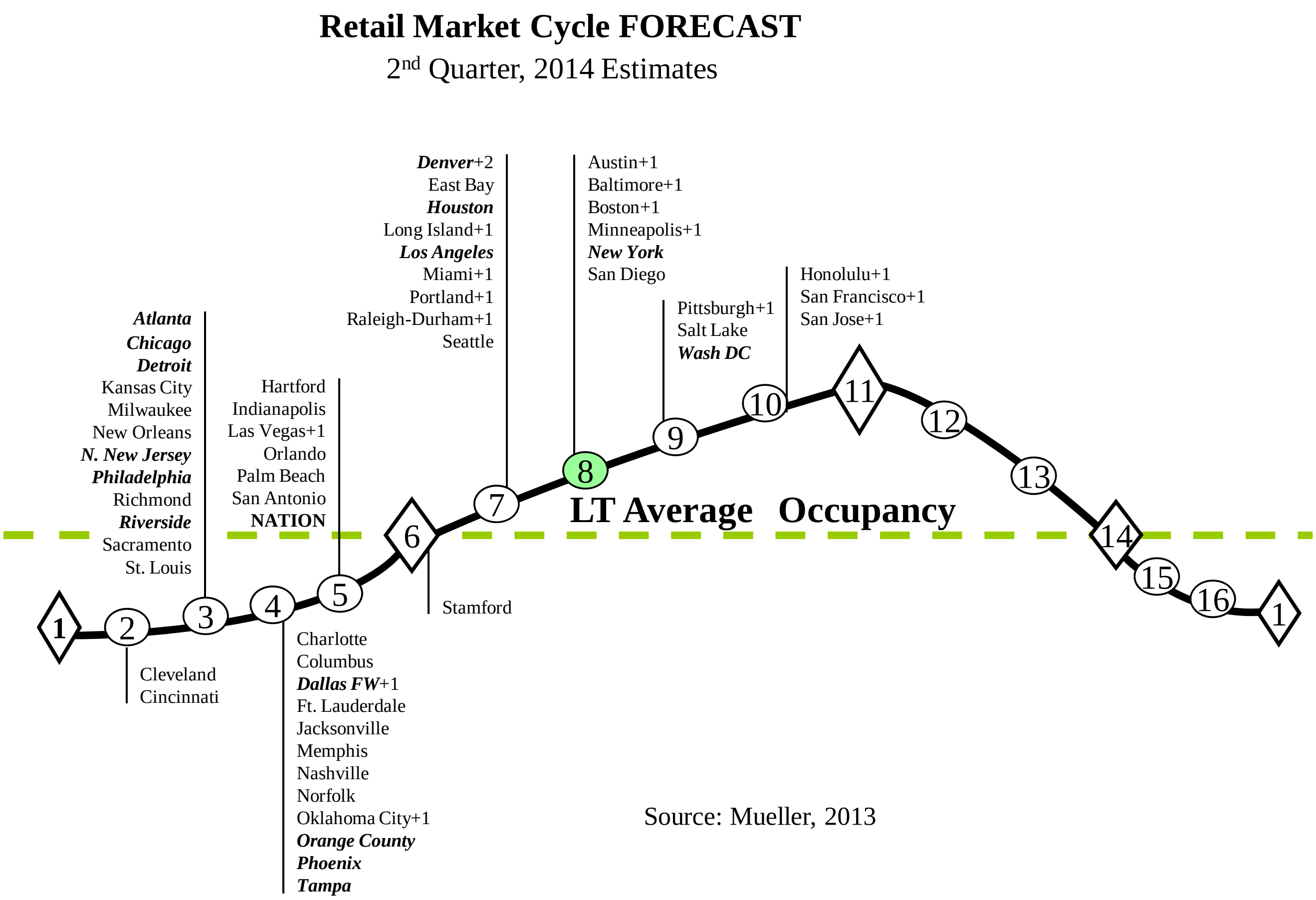


Note: The 10-largest apartment markets make up 50% of the total square footage of apartment space that we monitor. Thus, the 10-largest apartment markets are in ***bold italics*** to help distinguish how the weighted national average is affected.

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.

RETAIL FORECAST

Retail occupancy is forecast to improve 0.2% in 2Q14 and be up 0.5% year-over-year. Consumer debt levels have continued to decline while 2Q13 retail sales have been strong and this should give retailers the confidence to continue to expand locations. Continued low interest rates over the next year should also allow retail spending to grow. High quality regional malls are expected to continue their top occupancy position as consumers enjoy the expanded experience and entertainment options. Neighborhood and community center demand should also improve, driven by continued household formation and improved housing starts. We expect retail rental rates to increase 1.0% in 2Q14 and 3.0% year-over-year.



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

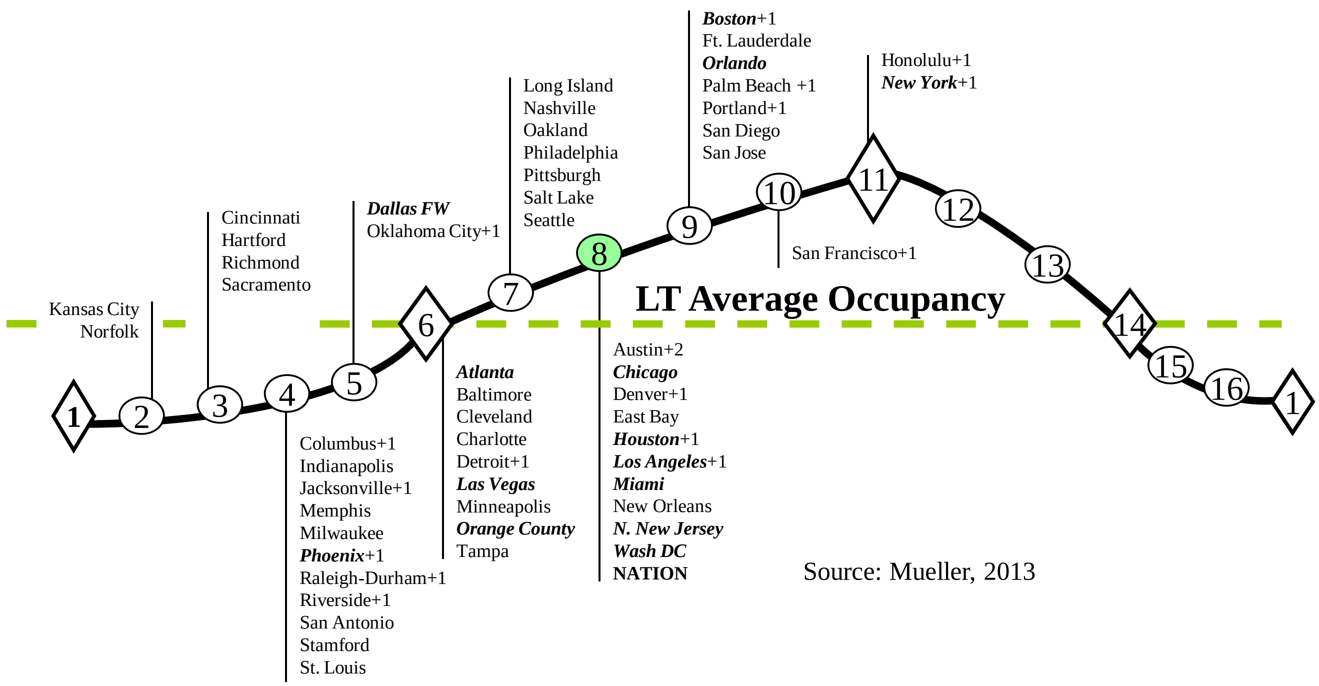
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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.

HOTEL FORECAST

Hotel occupancy is forecast to increase 0.1% in 2Q14 and improve 0.5% year-over-year. We estimate six markets to improve in the recovery phase of the cycle and ten markets to improve that are in the expansion phase of the cycle. Note that both New York City and Honolulu are expected to reach their previous cyclical peak occupancy levels (point #11) at the end of 2Q14. We have not seen as much new hotel construction as previous cycles and the number of announcements for expansions are less than expected, therefore we expect to see hotel occupancies continue to improve strongly. We estimate RevPAR could improve 1.5% in 2Q14, while annual RevPar may improve 2.9% year-over-year.

Hotel Market Cycle FORECAST

2nd Quarter, 2014 Estimates



Source: Mueller, 2013

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 ***bold 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.

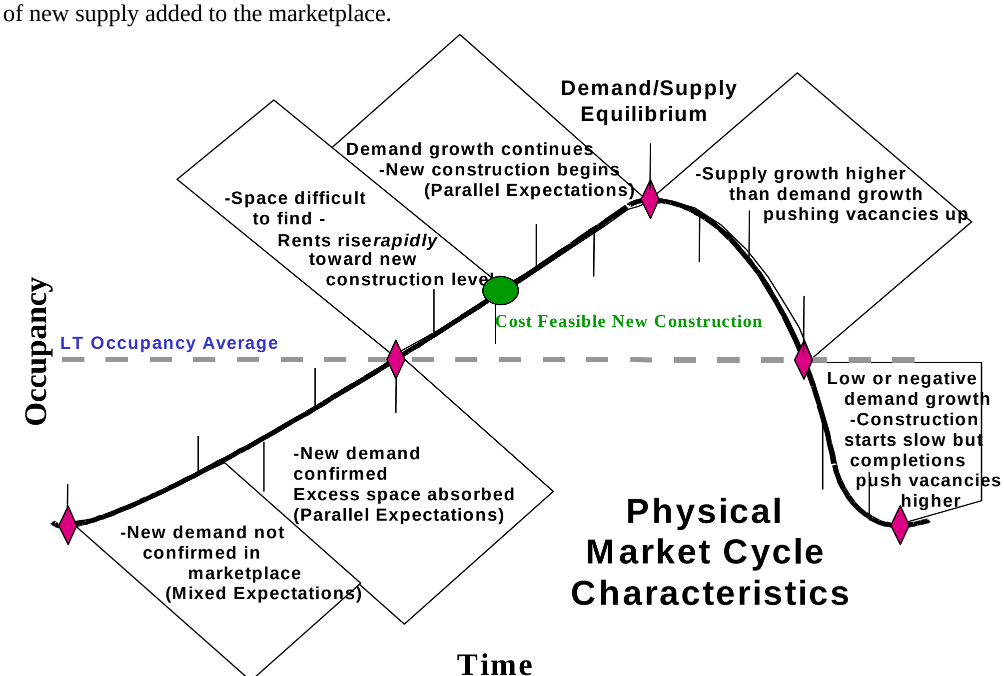
MARKET CYCLE ANALYSIS — Explanation

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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