DIVIDEND CAPITAL
RESEARCH

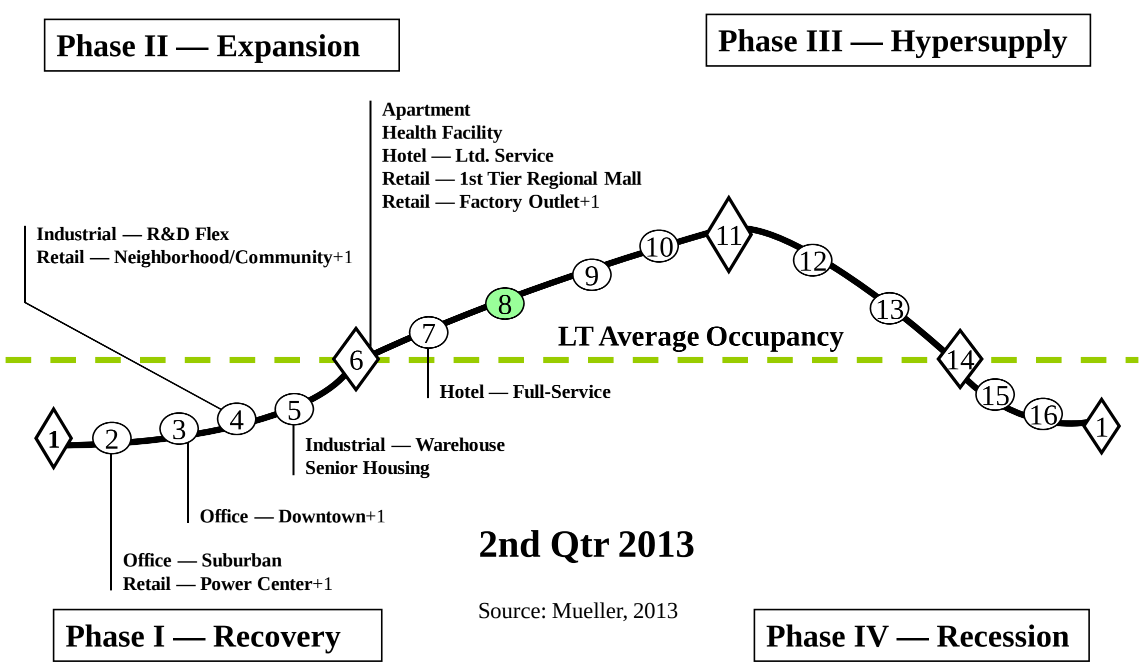
Cycle Monitor — Real Estate Market Cycles

Second Quarter 2013 Analysis
August 2013

Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.
Economic and job growth continue at a moderate pace. This growth continues to fuel a slow recovery in all the real estate property types. The economic base industry of each city is a major driver of how quickly each city is growing, and there is more bifurcation of city growth than previous cycles. The “have growth” cities are fairing much better than the “have not” cities. Many employers continue to wait and see how the new tax laws and medical system will affect them before moving ahead with large expansion plans. We think that moderate growth may continue for the foreseeable future.

Office occupancies **improved** 0.2% in 2Q13, and rents grew 1.0% for the quarter and 2.0% annually.
Industrial occupancies **improved** 0.2% in 2Q13, and rents grew 1.0% for the quarter and 3.6% annually.
Apartment occupancies were **flat** in 2Q13, and rents grew 0.8% for the quarter and 2.7% annually.
Retail occupancy **improved** 0.1% in 2Q13, and rents grew 0.2% for the quarter and 0.2% annually.
Hotel occupancies **improved** 0.6% in 2Q13, and RevPAR grew 1.5% for the quarter and 7.4% annually.

National Property Type Cycle Locations



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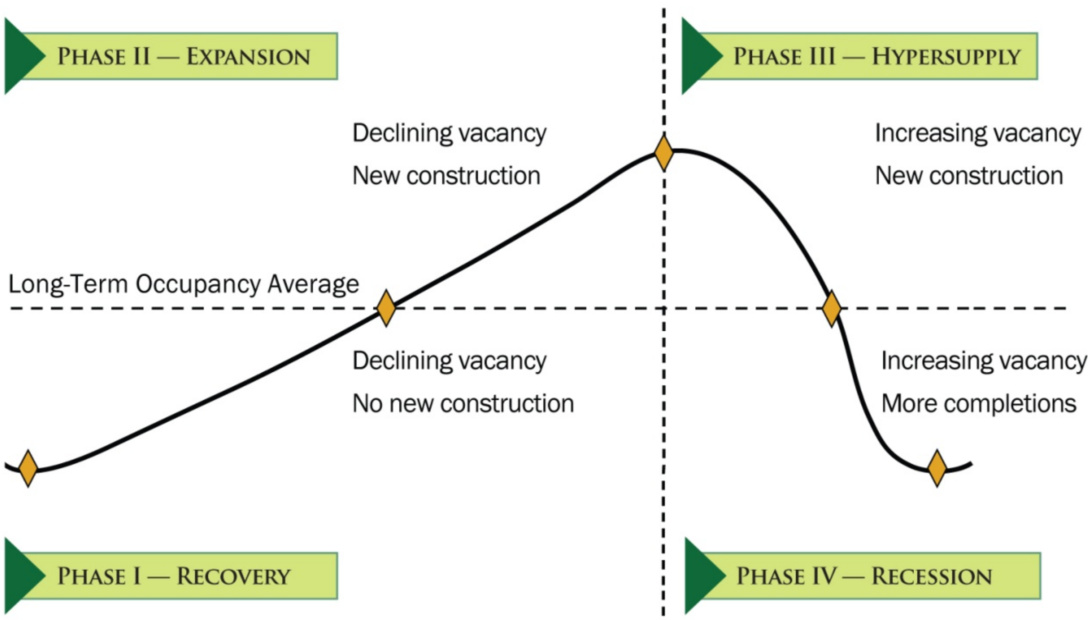
All relevant disclosures and certifications appear on page 9 of this report.

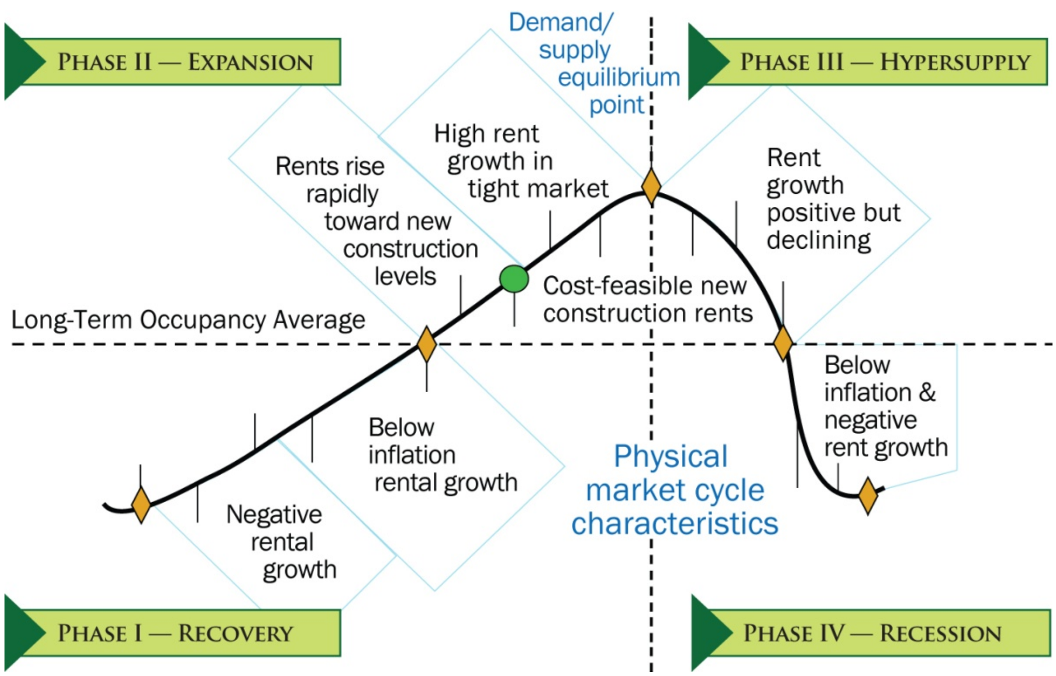
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that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

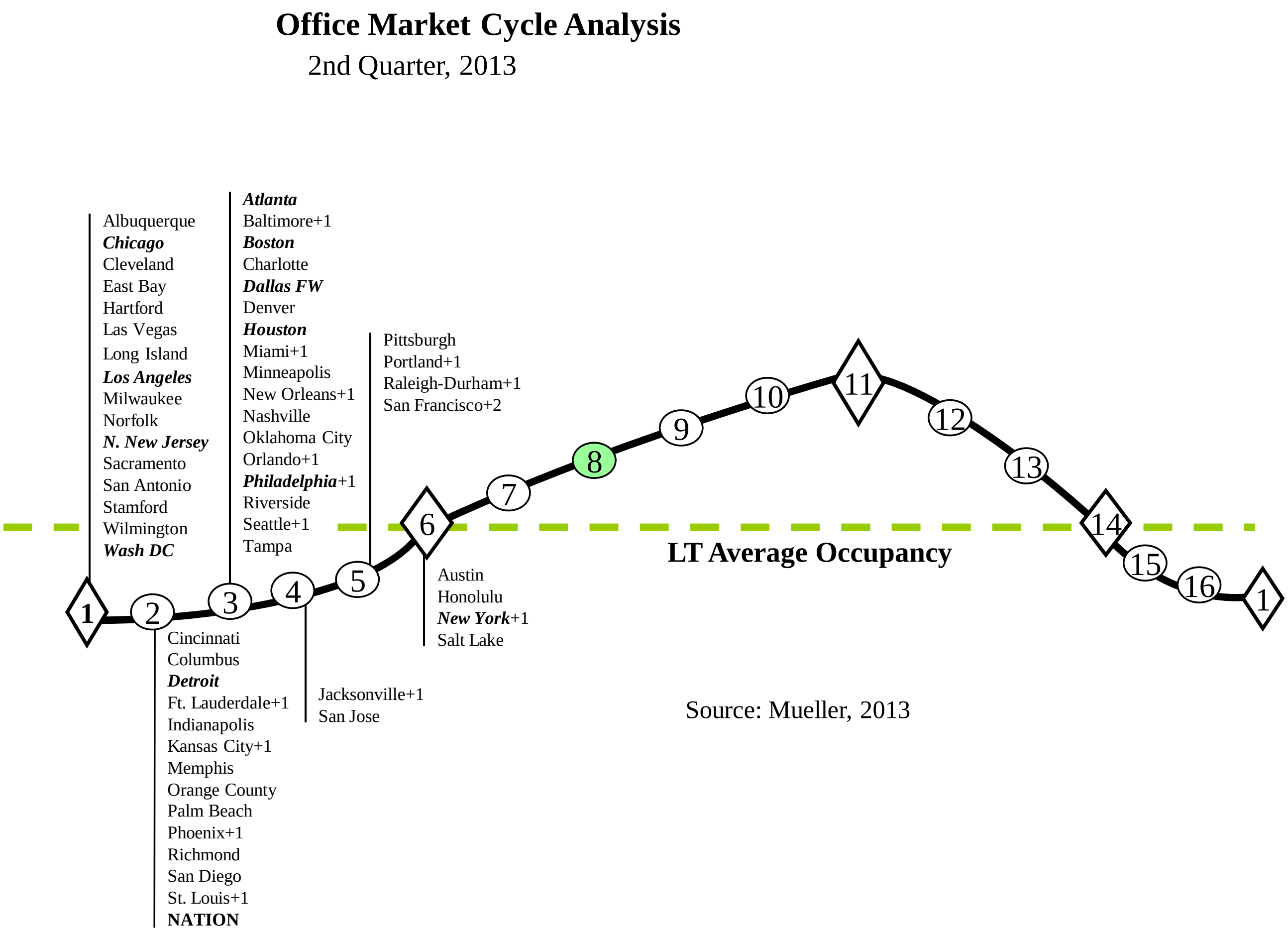
Rental growth rates can be characterized in different parts of the market cycle, as shown below.



Source: Mueller, Real Estate Finance, 1995.

OFFICE

The national office market occupancy level improved 0.2% for 2Q13 and was up 0.6% year-over-year. Office demand continued its slow growth pace, but new supply jumped to more than seven million square feet in 2Q13 after a very slow sub-two million supply growth in 1Q13. Strongest net absorption was in the California and Texas markets, evidencing the technology and energy industries as having the strongest job growth to fuel office demand. We expect to see supply continue at a very slow pace for at least the next year, with most new construction in downtowns, as suburban office vacancies are too high to support rent growth. New office space is winning most lease contests, as tenants prefer newer spaces when rental rates are still low. Average national rents were up 1.0% in 2Q13 and were up 2.0% year-over-year.



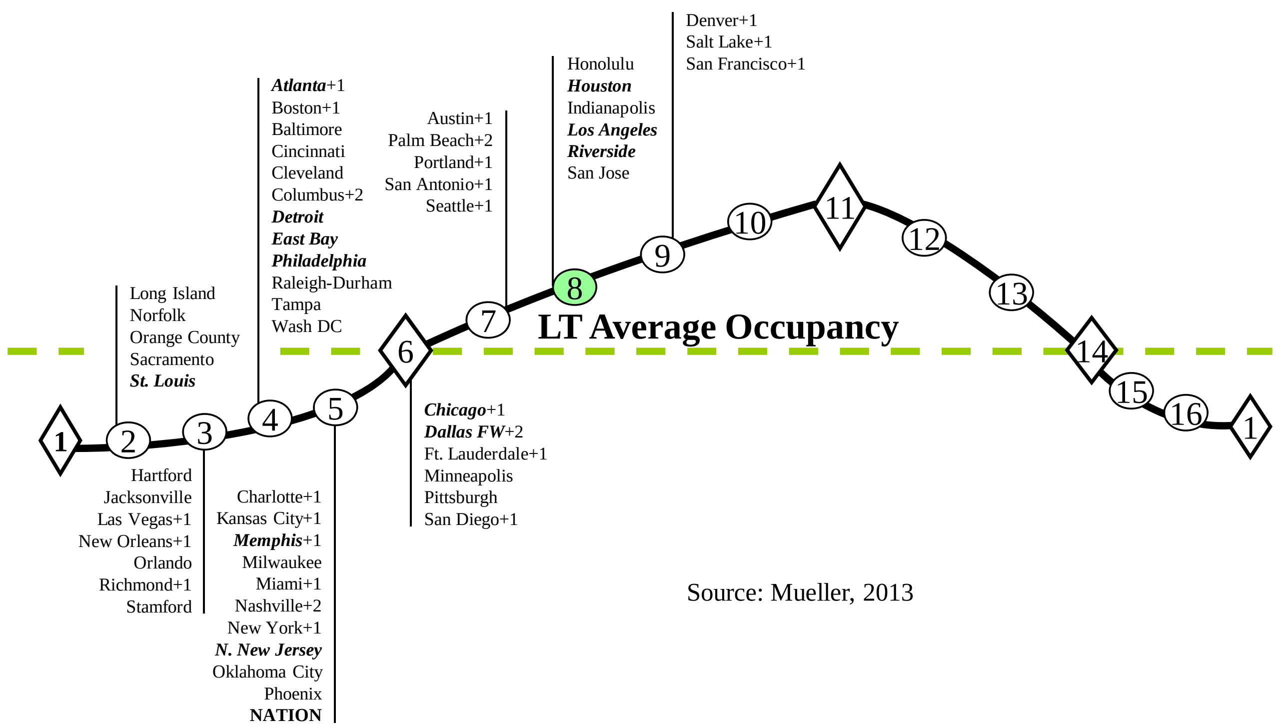
Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor. Thus, the 11-largest office markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

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 improved 0.2% in 2Q13 and were up 0.9% year-over-year. Almost half of all industrial markets had occupancy improvement to move forward at least one cycle position. With retail sales improving dramatically in 2013, demand for industrial to store finished goods, as well as goods in process has been strong. The ISM manufacturing index continues to average above 50 in most months which indicates expansion in U.S. manufacturing. New supply continues at a moderate pace creating continued positive net absorption with the higher demand levels. The industrial national average rent index increased 1.0% in 2Q13 and was up 3.6% year-over-year.

Industrial Market Cycle Analysis
2nd Quarter, 2013



Source: Mueller, 2013

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.

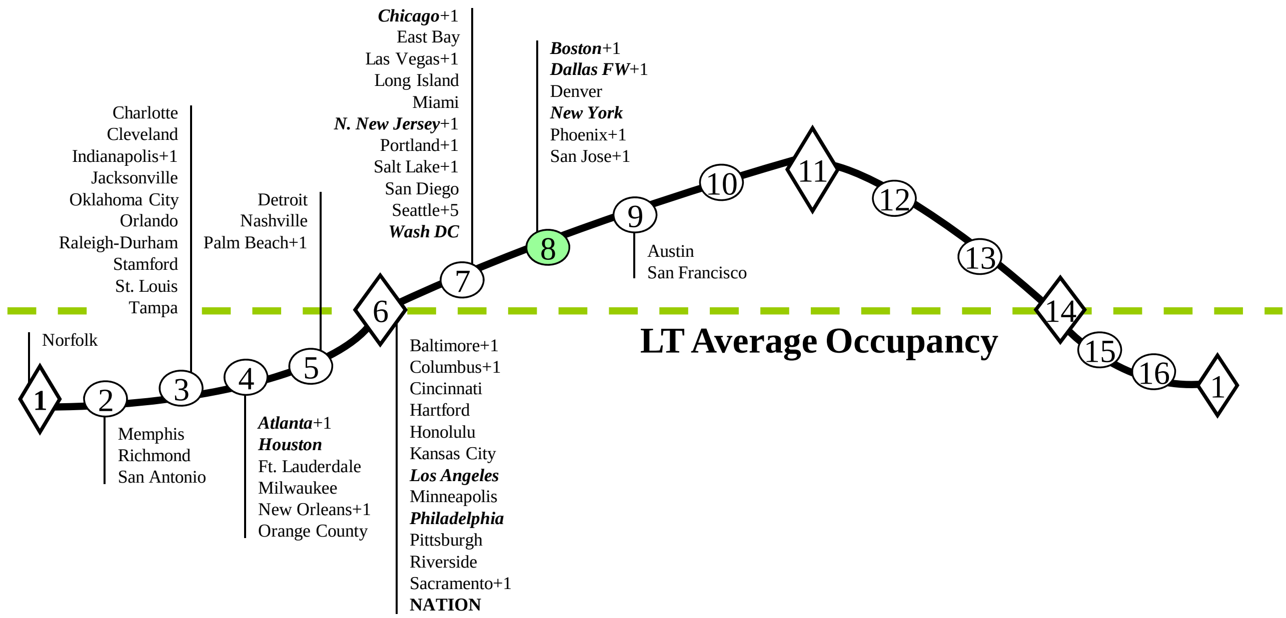
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their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

The national apartment occupancy average was unchanged in 2Q13 and was up only 0.3% year-over-year. Demand continues to be strong, but the second quarter new supply growth was almost double 1Q13, as we have been predicting. Most expect over 100,000 new apartment units in 2013 which is creating lower net absorption in most markets. Net absorption dropped from almost 40,000 units in 1Q13 to about 30,000 units in 2Q13. When foreclosed homes being put on the rental market are added, we expect net absorption to be fairly flat for the rest of the year. Average national apartment rents improved 0.8% in 2Q13 and were up 2.7% year-over-year.

Apartment Market Cycle Analysis

2nd Quarter, 2013



Source: Mueller, 2013

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.

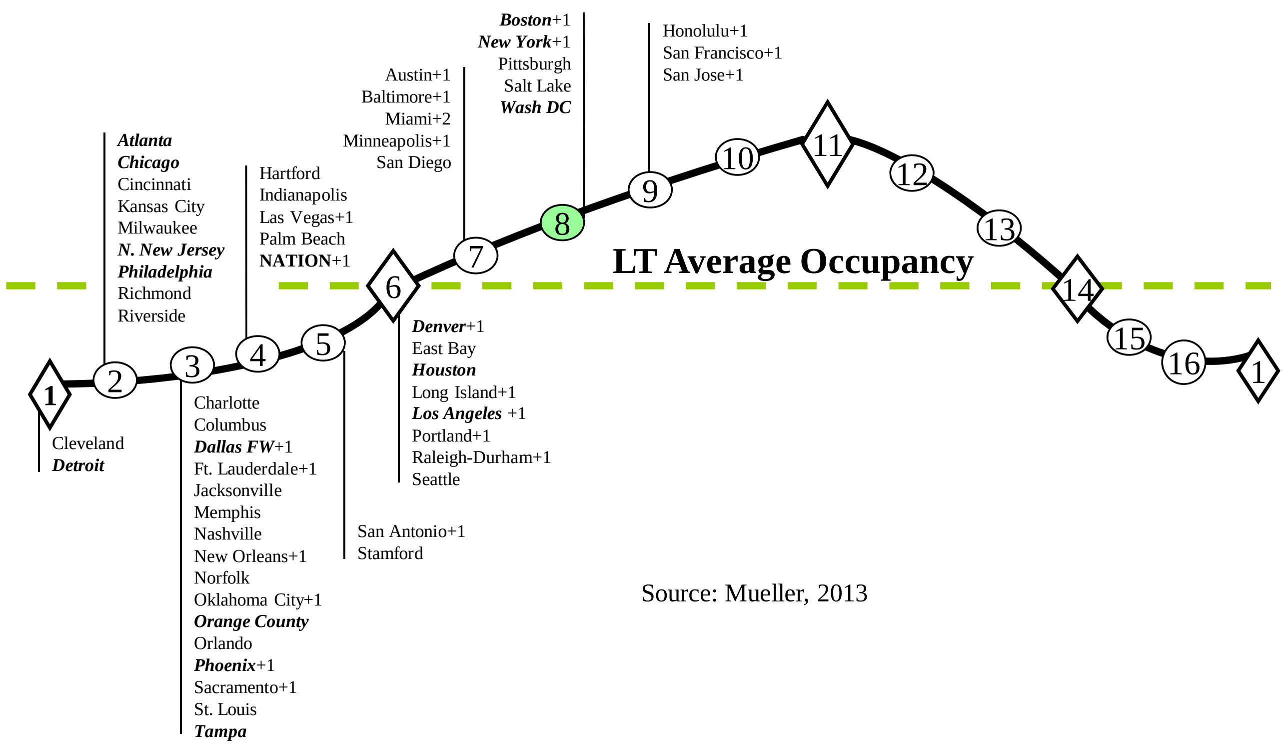
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 improved 0.1% in 2Q13 and were up 0.4% year-over-year. More than twenty markets improved their cycle positions and the national average moved forward to point #4 on the cycle graph. Retail sales have been strong and are up more than 20% since the bottom of the recession and are now above the pre-recession peak. Local, regional and national retailers are expanding again, creating moderate demand for the existing space available. Retail has finally reached the point of having rents increase with average rents increasing 0.2% in 2Q13 and 0.2% year-over-year.

Retail Market Cycle Analysis

2nd Quarter, 2013



Source: Mueller, 2013

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.

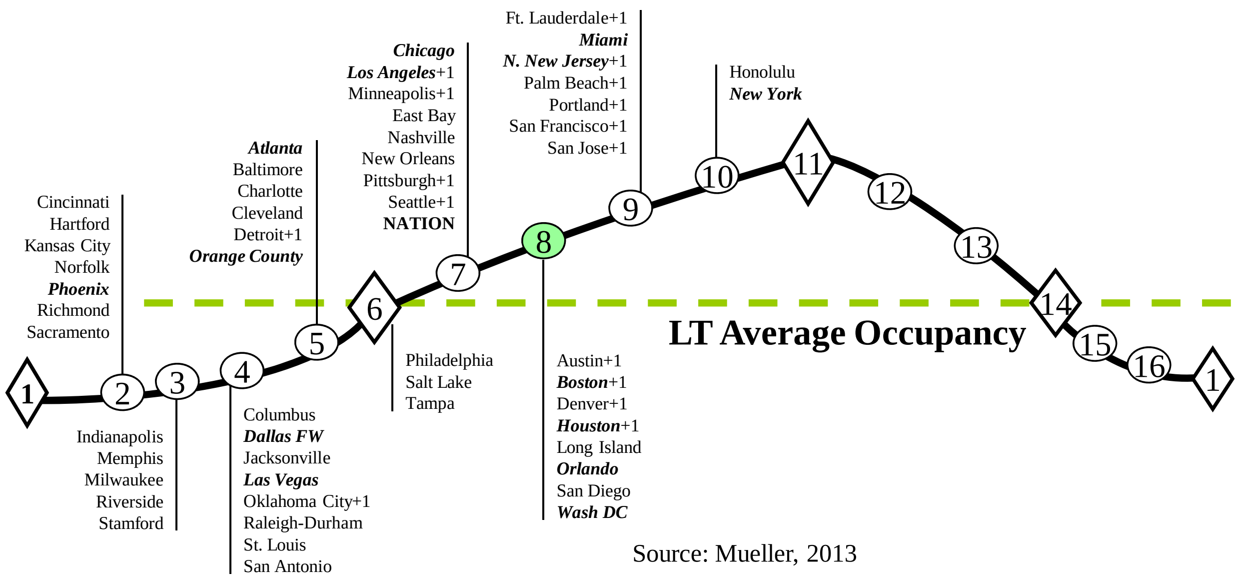
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 improved an average of 0.6% in 2Q13 and were up 1.7% year-over-year. Most occupancy increases were in markets that are already in the growth phase of the cycle (point #6 and above) and there was little movement in the markets in the recovery phase of the cycle. We expect to see more new hotel construction in the year ahead. National average Hotel RevPAR improved 1.5% in 2Q13 and was up 7.4% year-over-year.

Hotel Market Cycle Analysis

2nd Quarter, 2013



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 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.

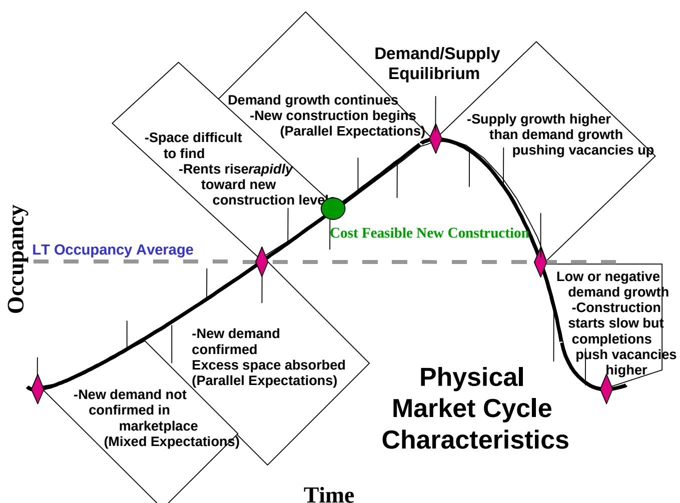
MARKET CYCLE ANALYSIS — Explanation

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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