DIVIDEND CAPITAL
RESEARCH

CYCLE FORECAST — Real Estate Market Cycles

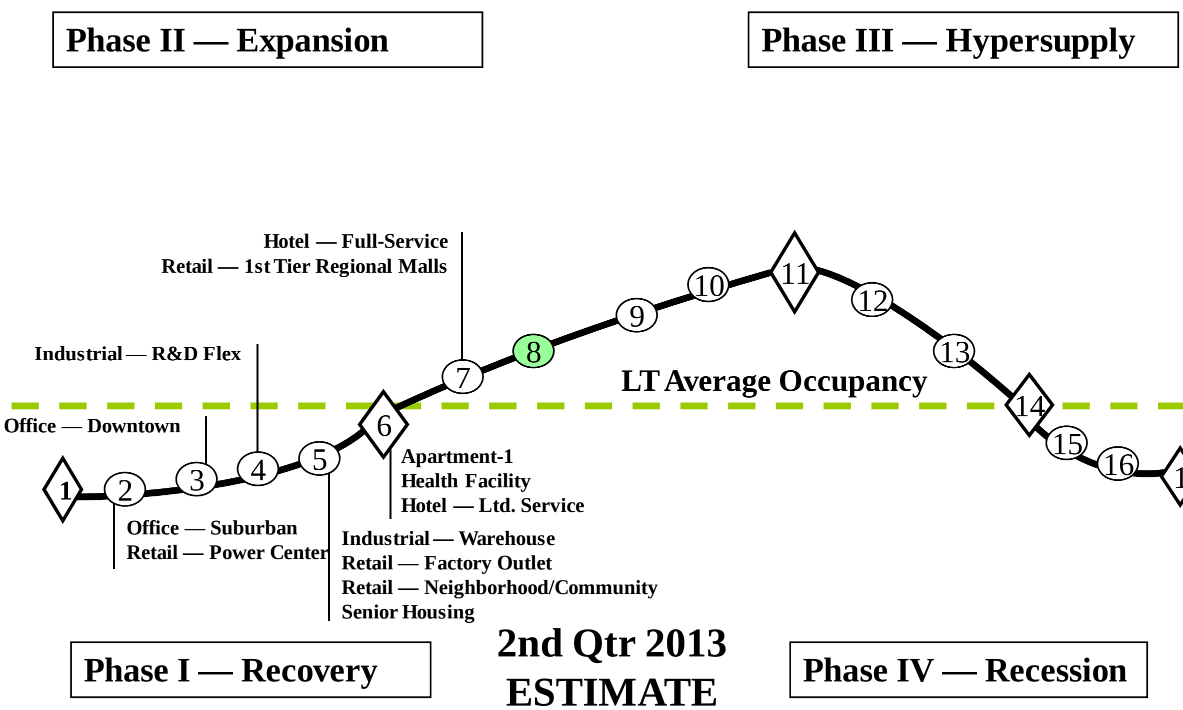
Second Quarter 2013 Estimates
August 2012

The economic outlook for the first half of 2013 continues to be moderate. The key factors from economists seem to be a resolution of the European debt crisis in the first half of 2013, a continued sluggish economy if democrats win or republicans take over, but need time to implement their policies, a 2012 overvalued stock market moving sideways and muted consumer and business confidence. All this points to positive but moderate demand for commercial real estate and continued low supply.

Office occupancies are forecast to improve 0.2% in 2Q13, with rents improving 0.7% quarter-over-quarter.
Industrial occupancies are forecast to improve 0.2% in 2Q13, with rents improving 0.1% quarter-over-quarter.
Apartment occupancies are forecast to be flat in 2Q13, with rents improving 0.6% quarter-over-quarter.
Retail occupancies are forecast to improve 0.2% in 2Q13, with rents improving 0.1% quarter-over-quarter.
Hotel occupancies are forecast to improve 0.1% in 2Q13, with quarterly RevPAR improving 7.0% quarter-over-quarter.

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

National Property Type Cycle Forecast



Source: Mueller, 2012

Glenn R. Mueller, Ph.D. 303.953.3872 gmueller@dividendcapital.com
Dividend Capital Research, 518 17th Street, 17th Floor, Denver, CO 80202
www.dividendcapital.com 866.324.7348

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

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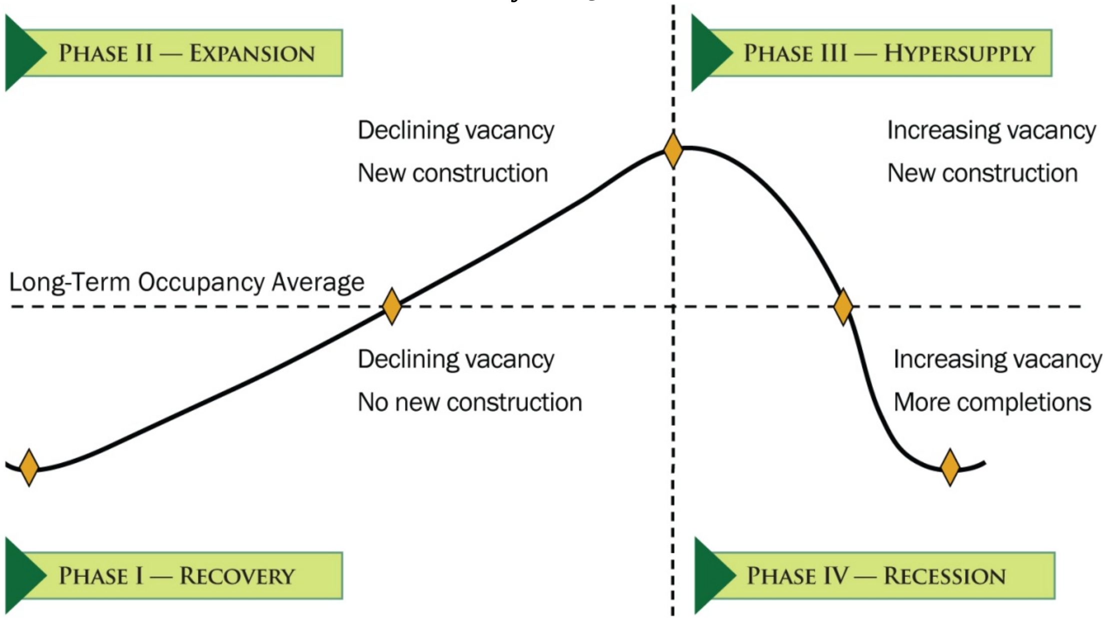
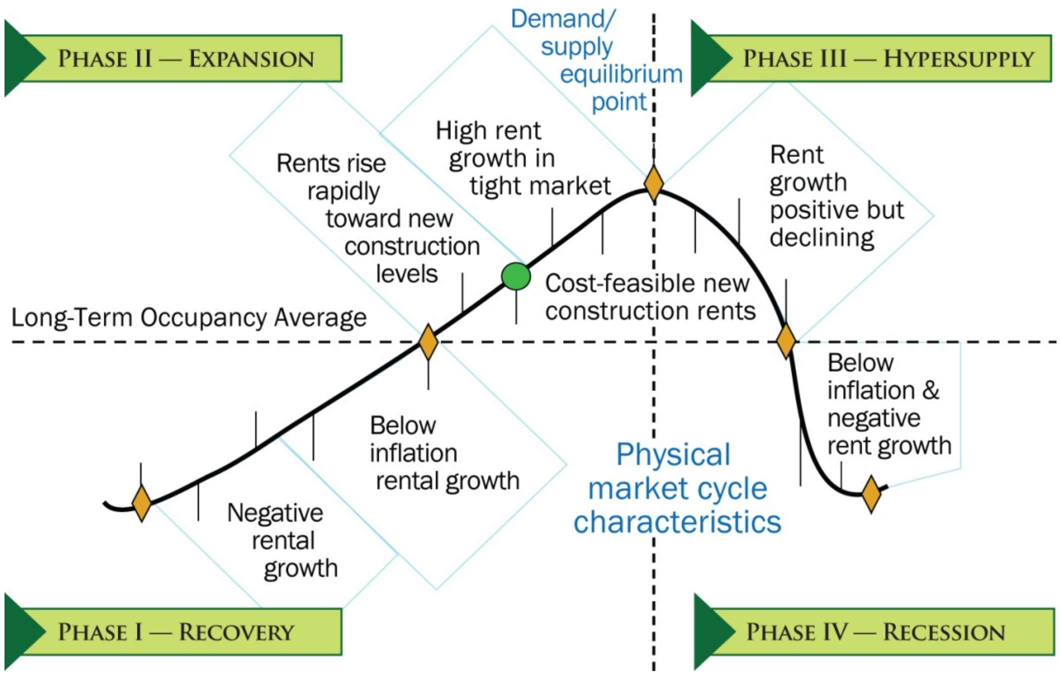
The cycle forecast analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). The market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models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

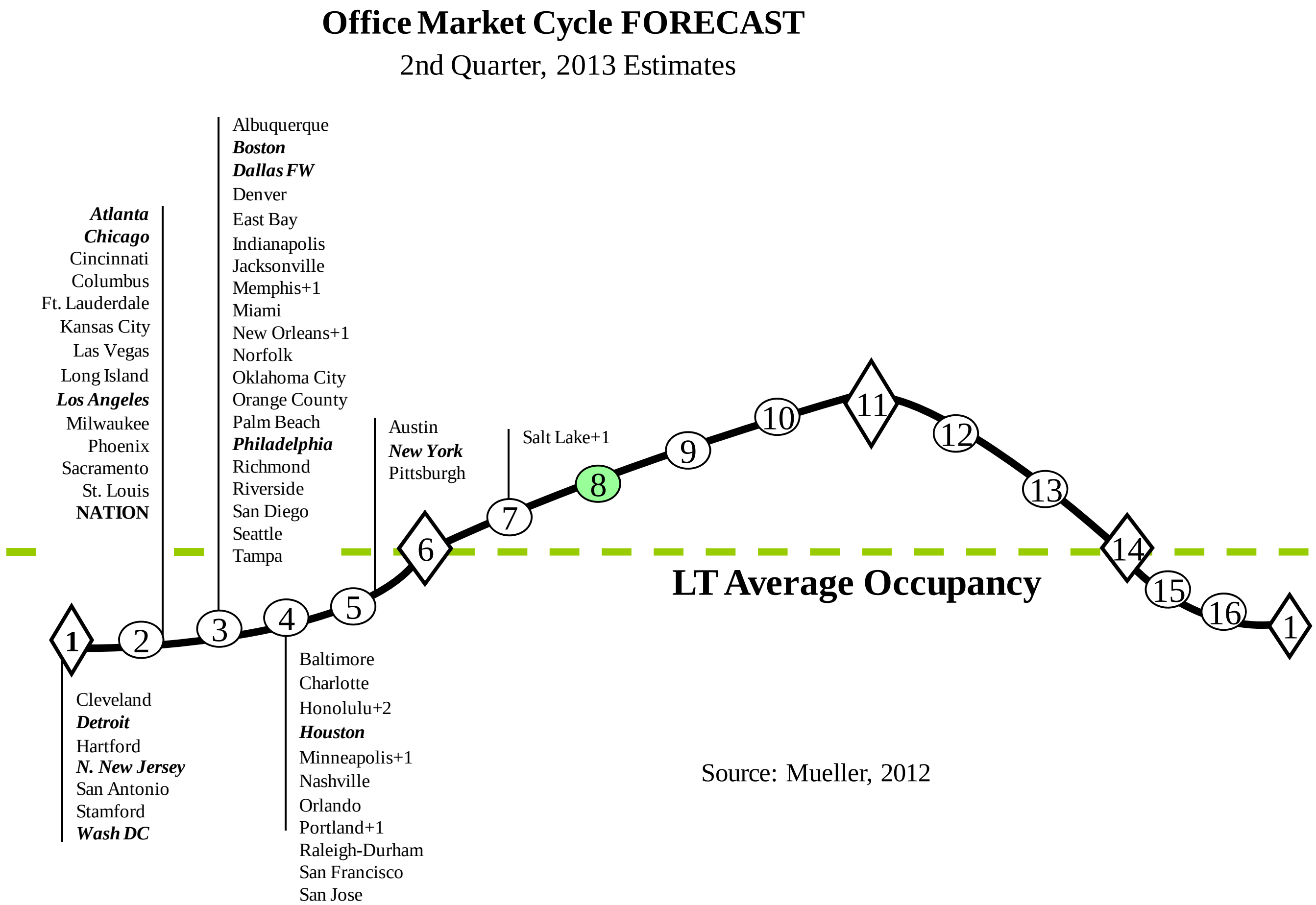
Rental growth rates can be characterized in different parts of the market cycle, as shown below.



Source: Mueller, Real Estate Finance, 1995.

OFFICE FORECAST

Office occupancies are forecast to improve 0.2% in 2Q13, producing a 0.6% increase year-over-year. Moderate consumer and business confidence are producing a slow economic growth forecast. The forecast of slow economic growth along with flat Wall Street employment growth provides only moderate office demand growth. Office construction is expected to stay low as well. We estimate national average office rents to improve 0.7% in 2Q13 and thus, produce rental growth of 2.5% year-over-year.

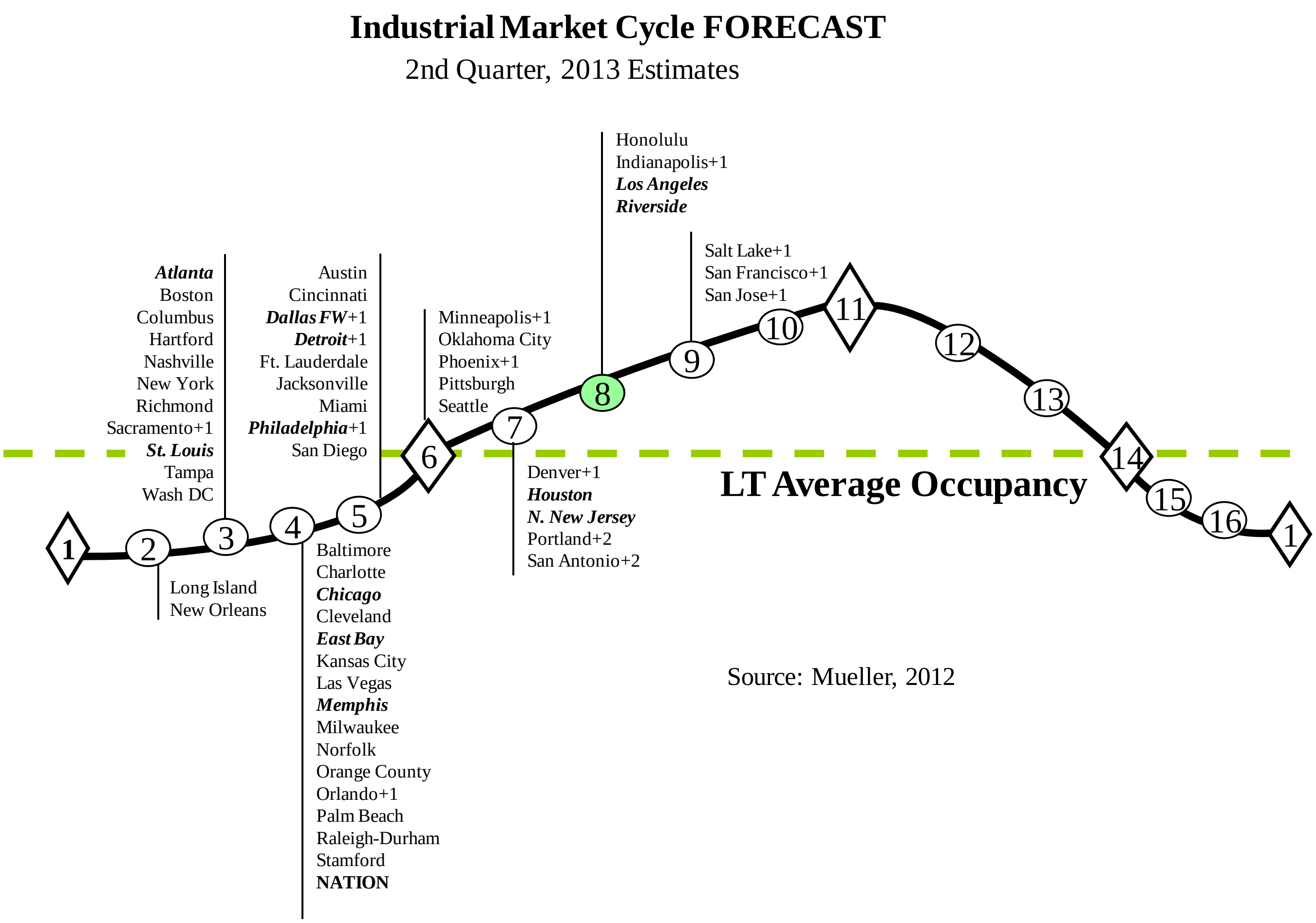


Note: The 11-largest office markets make up 50% of the total square footage of office space that we monitor. Thus, the 11-largest office markets are in ***bold italics*** to help distinguish how the weighted national average is affected.

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 0.2% improvement in industrial occupancies in 2Q13 and a 0.9% improvement year-over-year. The manufacturing-led recovery of 2010 & 2011 has slowed in 2012 and this slower growth level is expected to continue into 2013. Moderating economies in previously high-growth China and India are expected to be part of the lower demand for U.S. goods. However, low levels of new construction supply should keep industrial fundamentals improving. Fourteen markets advanced their forecast cycle positions and 17 markets are now in the growth phase of the cycle, most of them are major port and trucking markets that are on the "***Path of Goods Movement.***" We expect rents to increase 0.2% in 2Q13 and be up 0.5% 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.

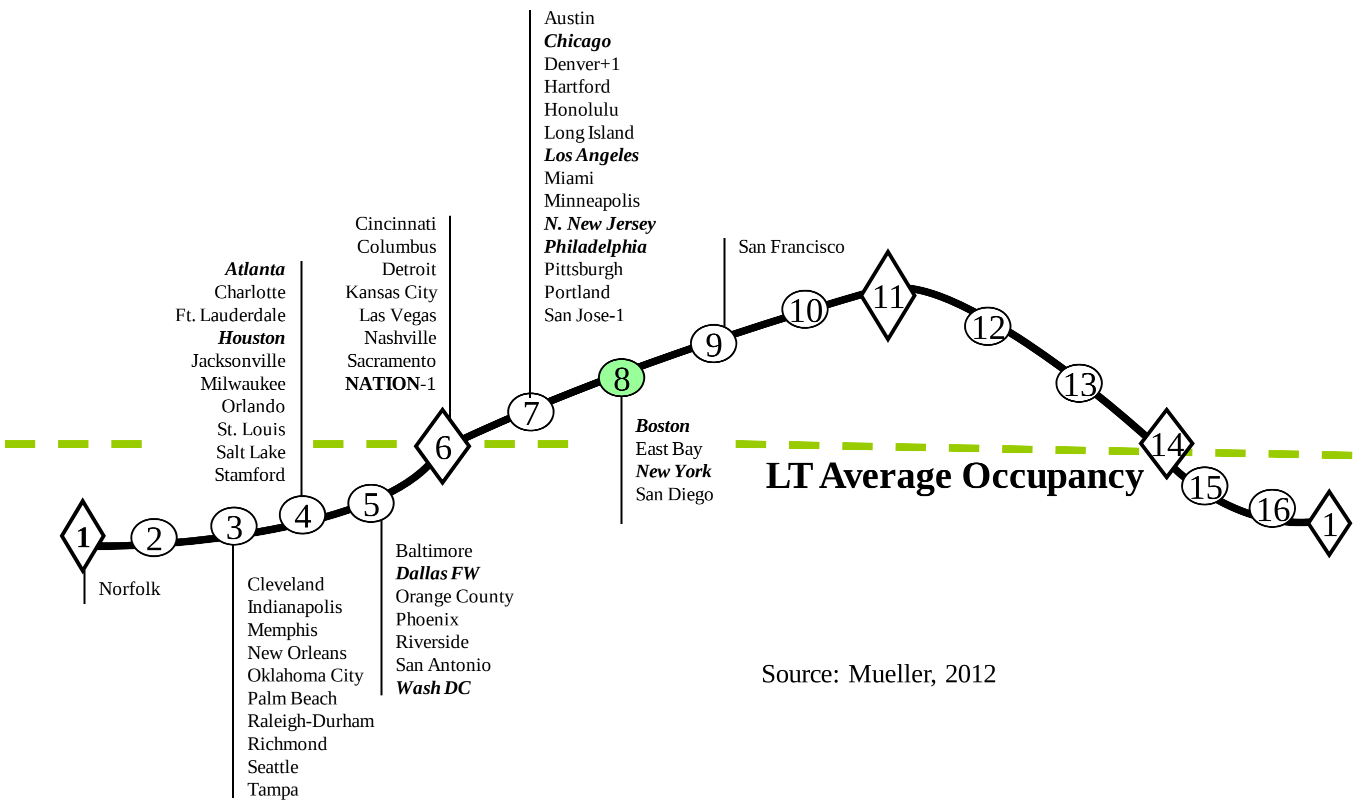
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their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

We estimate no occupancy increase in 2Q13, but a 0.6% increase year-over-year due to earlier quarter increases. Our opinion is that current strong new construction in 2012 and foreclosed homes being bought by investors and put on the rental market may absorb any new demand that might increase occupancy rates. We have therefore moved the national average occupancy level BACKWARDS to position six on the cycle graph which implies that rental growth may slow — due to all the new supply in the market. Twenty-six markets (one short of half of all the markets we cover) are in the growth phase of the cycle forecast, but could move backwards if too much supply is produced. This oversupply concern was previously forecast to happen in 2014, but now that institutional investors like BlackRock are getting into the foreclosed home rental market, the oversupply could happen much sooner in 2013. We estimate the national apartment rental rate to increase 0.6% in 2Q13 and estimate a year-over-year rental increase of 2.7%.

Apartment Market Cycle FORECAST

2nd Quarter, 2013 Estimates



Source: Mueller, 2012

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.

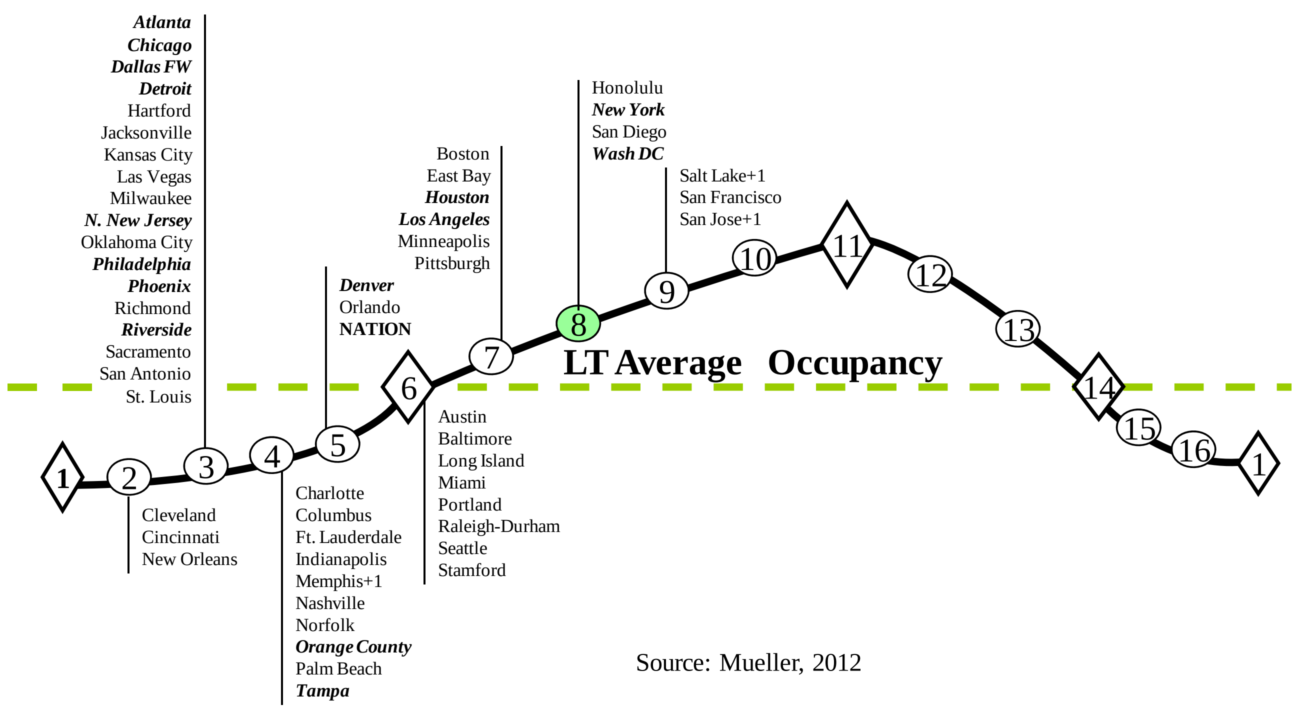
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 2Q13 and be up 0.6% year-over-year. The slow economic forecast is expected to keep retailer expansion at moderate levels. But this moderate demand forecast coupled with slow supply growth should produce minor improvements in occupancy levels in 2013. Only three markets had enough improvement in their occupancy forecasts to move forward in the cycle graph, the lowest movement of markets in many years. We expect retail rental rates to increase 0.1% in 2Q13 and only 0.2% year-over-year.

Retail Market Cycle FORECAST

2nd Quarter, 2013 Estimates



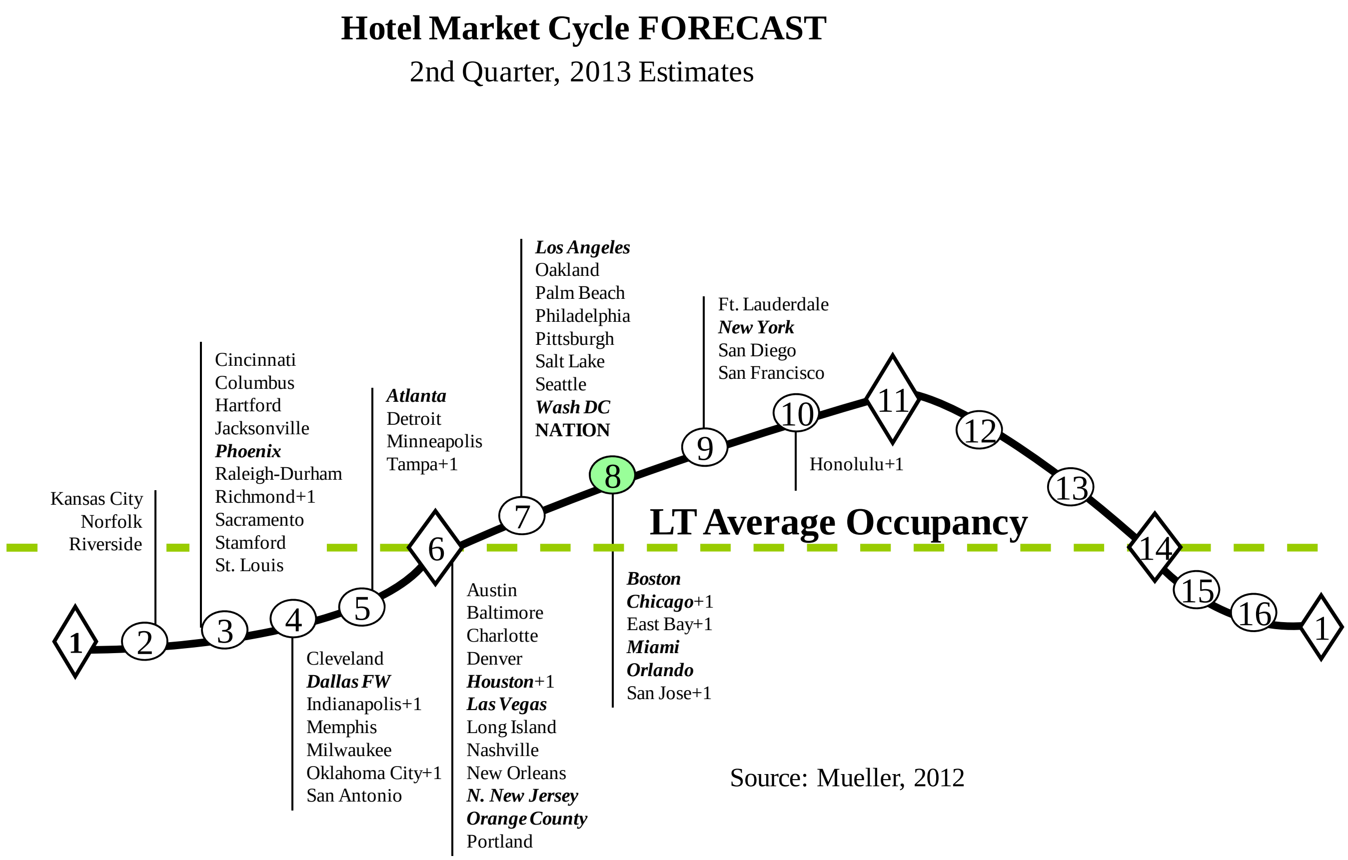
Source: Mueller, 2012

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 2Q13 and improve 0.8% year-over-year. Continued business and leisure travel growth is expected for 2013. Only nine markets improved their forecast cycle position versus 18 in 1Q12. However, 32 out of 54 markets (more than half) are now forecast to be in the growth phase of the cycle by 2Q13. We estimate RevPAR could increase 7.0% in 2Q13 and annual RevPar should improve 4.0% year-over-year.



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.

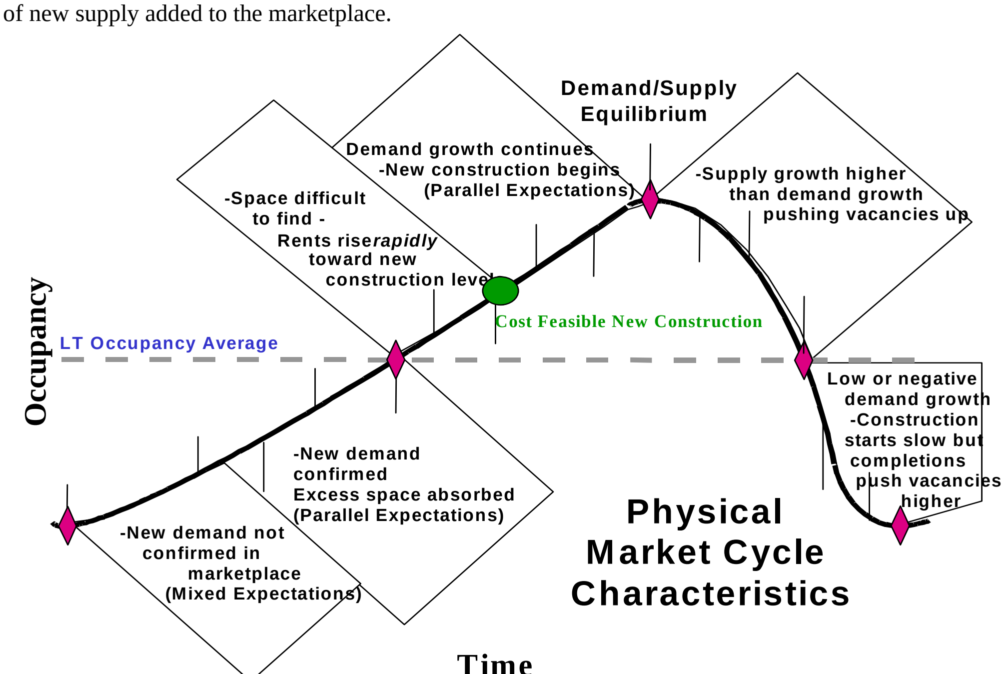
MARKET CYCLE ANALYSIS — Explanation

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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