U.S. Real Estate Chart Book: Pricing Questions

DECEMBER 2014

   

ROBERT CHARLES LESSER & CO.

Austin | Los Angeles | Orlando | Washington, D.C.

Contents

RCLCO

RCLCO is an SEC-registered, independent consulting firm that exclusively provides real estate consulting services. With more than 50 staff members in four U.S. locations, RCLCO provides consulting services in the areas of Institutional Advisory Services, Urban Development, Community and Resort Development, Public Strategies, and Strategic Planning and Litigation Support.

RCLCO's Institutional Advisory Services group provides services to commercial real estate owners in the areas of:

- Portfolio analysis, investment policies, and pacing plans
- Fund analysis and manager selection
- Investment and hold/sell analyses
- Asset management
- Market analysis, target markets, and independent research

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RCLCO 2015 Outlook

2014 turned out to be another great year for real estate. Total returns for the private real estate market were 11.2% as of the third quarter and the REIT market was up 21.9% by the end of November as compared to 14.5% for the broader stock market (S&P 500 index). Rents were generally up across all property types, as were occupancy rates, although we began to see occupancy flattening in a few markets (mostly residential) where the construction pipeline had been in full swing for quite some time. Banks continued to ease lending practices, and due to the Fed's continued push to keep interest rates low, mortgage rates were at the widest spread to cap rates since 2003. Pricing reached new highs in property types such as CBD office, mall retail, and mid/high rise apartments.

As we reflect on the past year and ponder the year ahead, investment opportunities are becoming more limited, not because of changes in the capital markets (which we have been concerned about for some time), but because of construction pipelines that are increasing in every property type. While new supply trends vary significantly by market and property type, it is surprising to see the speed at which supply is returning, even in some markets that still have above-average vacancy rates and rents that are below the previous peak. While rents continue to rise in almost all markets, we are seeing an increasing number of markets in which occupancy is beginning to flatten as new supply meets or exceeds demand. Although most of these markets are residential and have high occupancy rates, the construction pipeline is still strong. We take a closer look at new supply in this issue of the RCLCO Quarterly Chartbook.

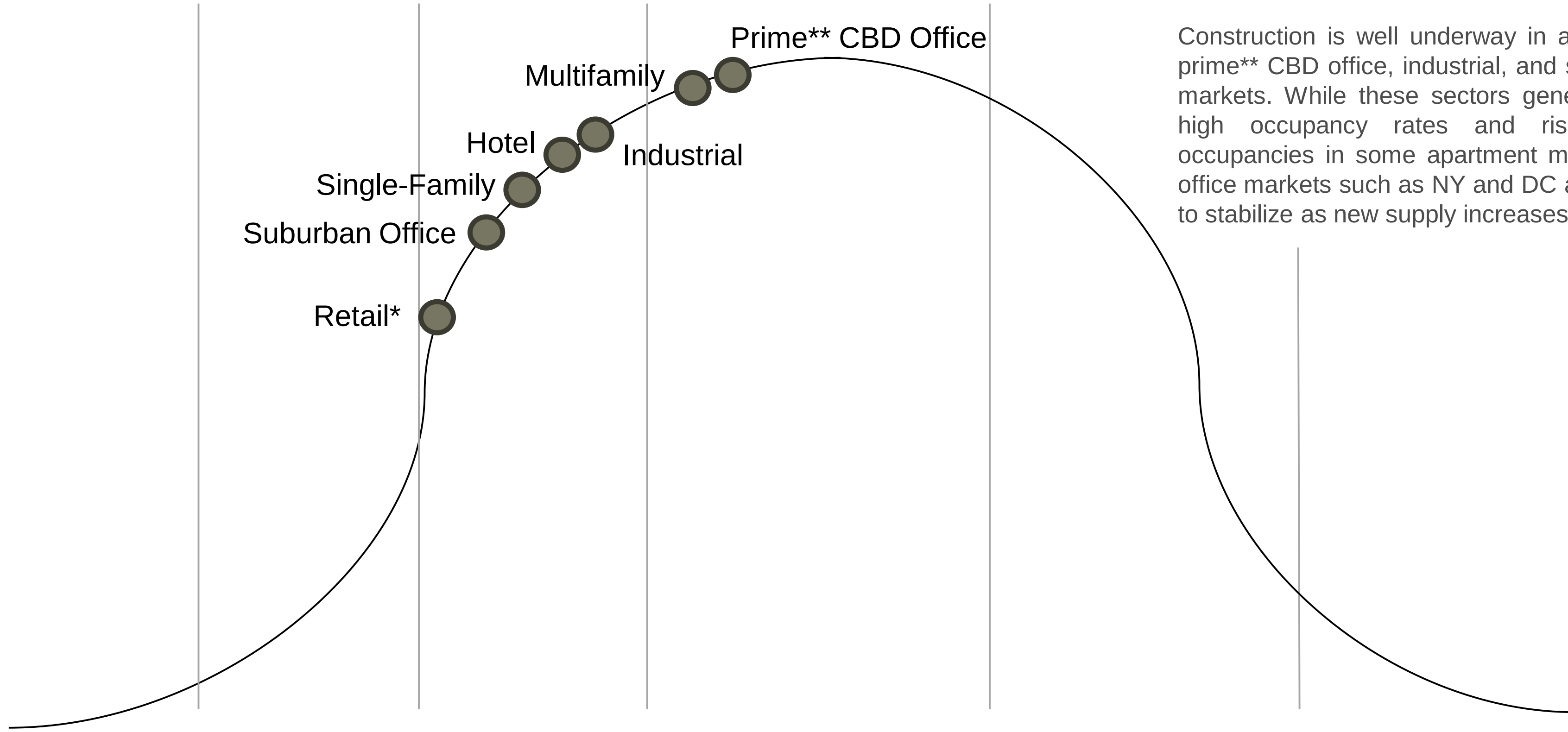
This brings to mind concerns about long-term obsolescence issues, particularly in the office and retail sectors where property usage is changing. In the office sector, denser usage requires open floor plates and higher parking requirements. In the retail sector, we watch for properties that can buck or at least complement e-commerce. In urban areas, we see changes in property usage, e.g., from out-dated office space to higher-value residential. Rent forecasts may also need to incorporate higher long-term vacancy trends.

As markets begin reaching peak occupancy rates, we encourage clients to review the risk profile of their portfolios. Are there properties that can be sold now while pricing is high that could have liquidity issues in a down market? Do mortgage terms match holding periods and what is the cost to lock in low interest rates? How will the property hold up to new supply pressures?

Overall, we maintain a positive outlook for 2015. Although supply is rising, we expect occupancy and rental rates to continue increasing with expectations of moderate economic growth for the year ahead. Multifamily occupancy rates are an exception as they have started to flatten in several markets, although occupancy remains high and job growth remains positive which is driving positive rent growth, as well as opportunities in select submarkets. While we expect interest rates to rise in the medium term, global market imbalances could again influence the U.S. to keep rates low in the near-term. As risk tolerance is generally high in this part of the cycle, we are seeing more creative ways to invest at various parts of the capital stack, although we encourage investors not to chase yields into unnecessarily risky investments.

Construction Pipelines Rising Across Most Property Types

Occupancy Low	Occupancy Rising	Occupancy Rising	Occupancy High	Occ. Above Average	Occupancy Low
Demand Improving	Demand Improving	Demand Improving	Occupancy Flattening	Occupancy Falling	Occ. Flat to Down
Rents Flat to Down	Rents Rising	Rents Rising	Rents Flattening	Rents Falling	Rents Flat to Down
No Construction	Limited Construction	Construction	Construction	Construction	No Construction



Construction is well underway in apartments, prime** CBD office, industrial, and some hotel markets. While these sectors generally have high occupancy rates and rising rents, occupancies in some apartment markets and office markets such as NY and DC are starting to stabilize as new supply increases.

Increase Vintage
New Development
Redevelopment & Lease-Up
Short-Term Leases

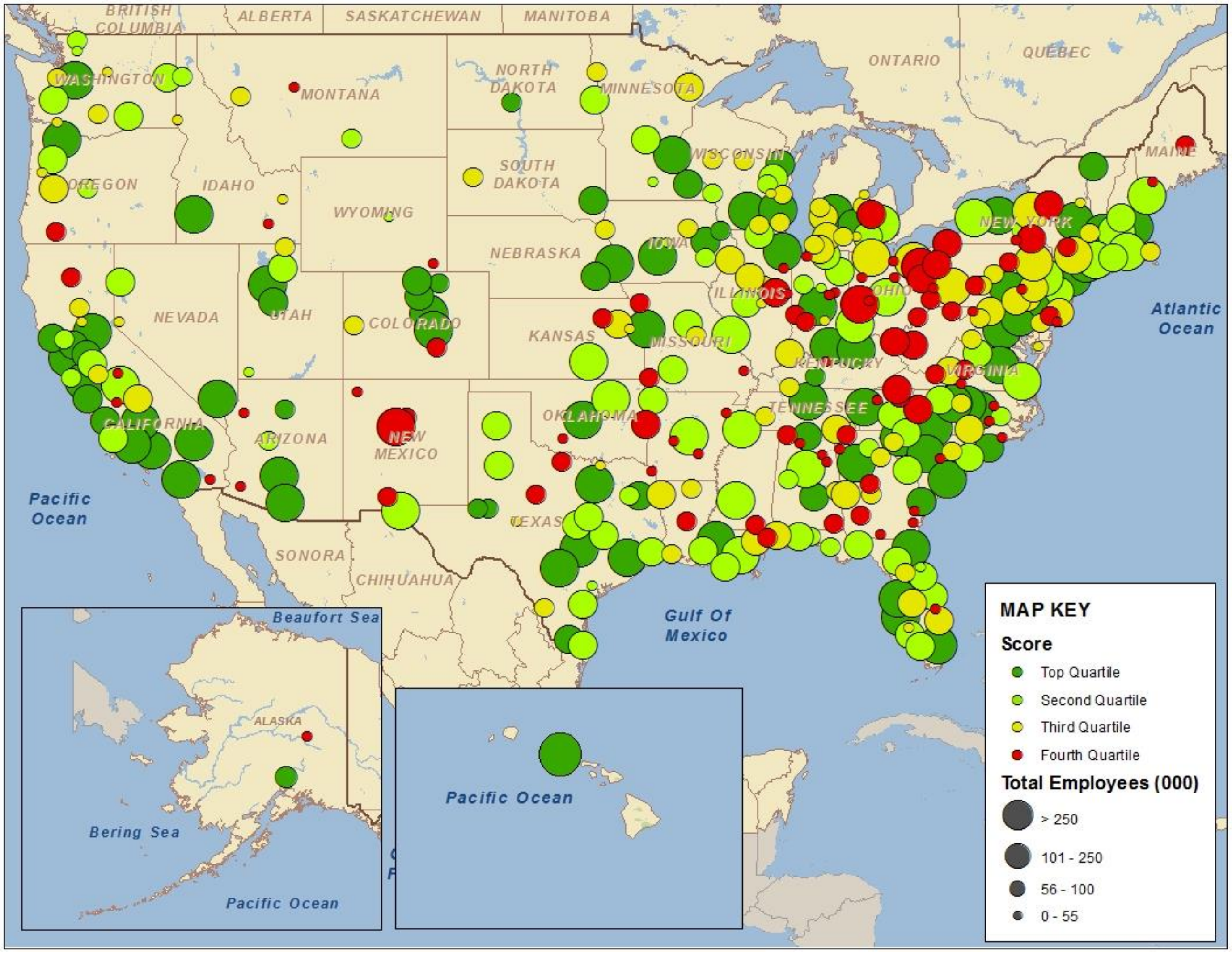
Reduce Vintage
Reduce Opportunistic
Reduce Risk: B / Non-Core, Leverage
Long-Term Leases

**neighborhood & community centers*
***includes New York, Washington, D.C., San Francisco, Seattle, Los Angeles, and Boston*

Source: RCLCO

Widespread Economic Growth

Our economic Hot Spot map measures short-term historic and forecast economic and job growth as well as structural factors such as income and the proportion and growth of the working population. **Economic growth is currently widespread, with particularly high growth in technology and energy markets**. Parts of the Midwest and Northeast are still struggling, although markets such as Minneapolis, Indianapolis, and Nashville rank highly.

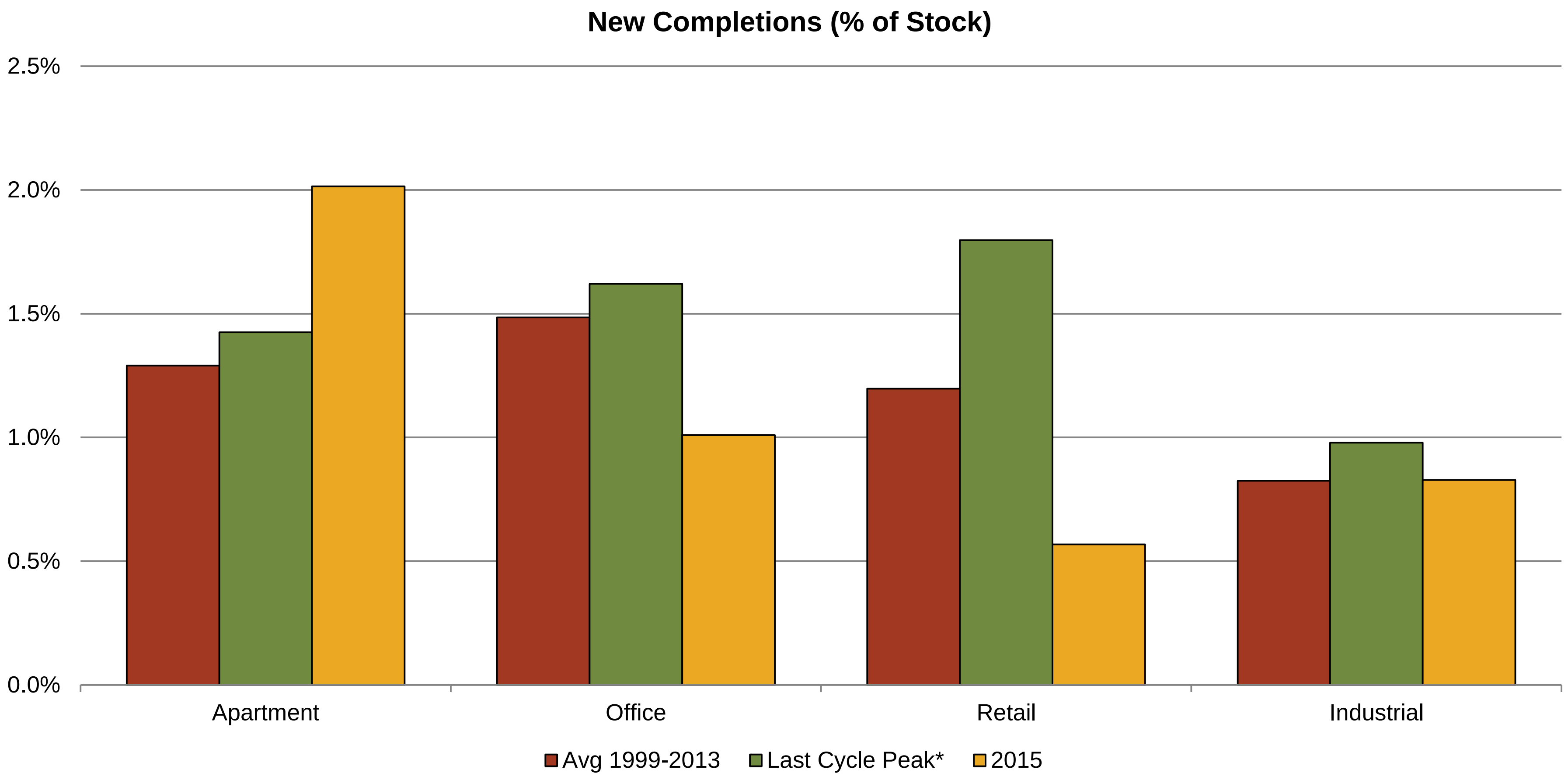


Source: BLS; RCLCO

U.S. Real Estate: Construction Cycles

Apartment Completions at Risky Levels

The supply cycle is also heating up, particularly in the apartment sector. 2014 apartment completions will reach nearly 2% of existing inventory nationwide, which is well above historical averages and even above levels experienced during the peak of the last real estate cycle. **Despite the pricing and supply growth in some property types, parts of the market are positioned for continued growth.** The office, industrial, and retail sectors are experiencing positive demand in excess of new deliveries, although variances exist by market (see the Appendix).

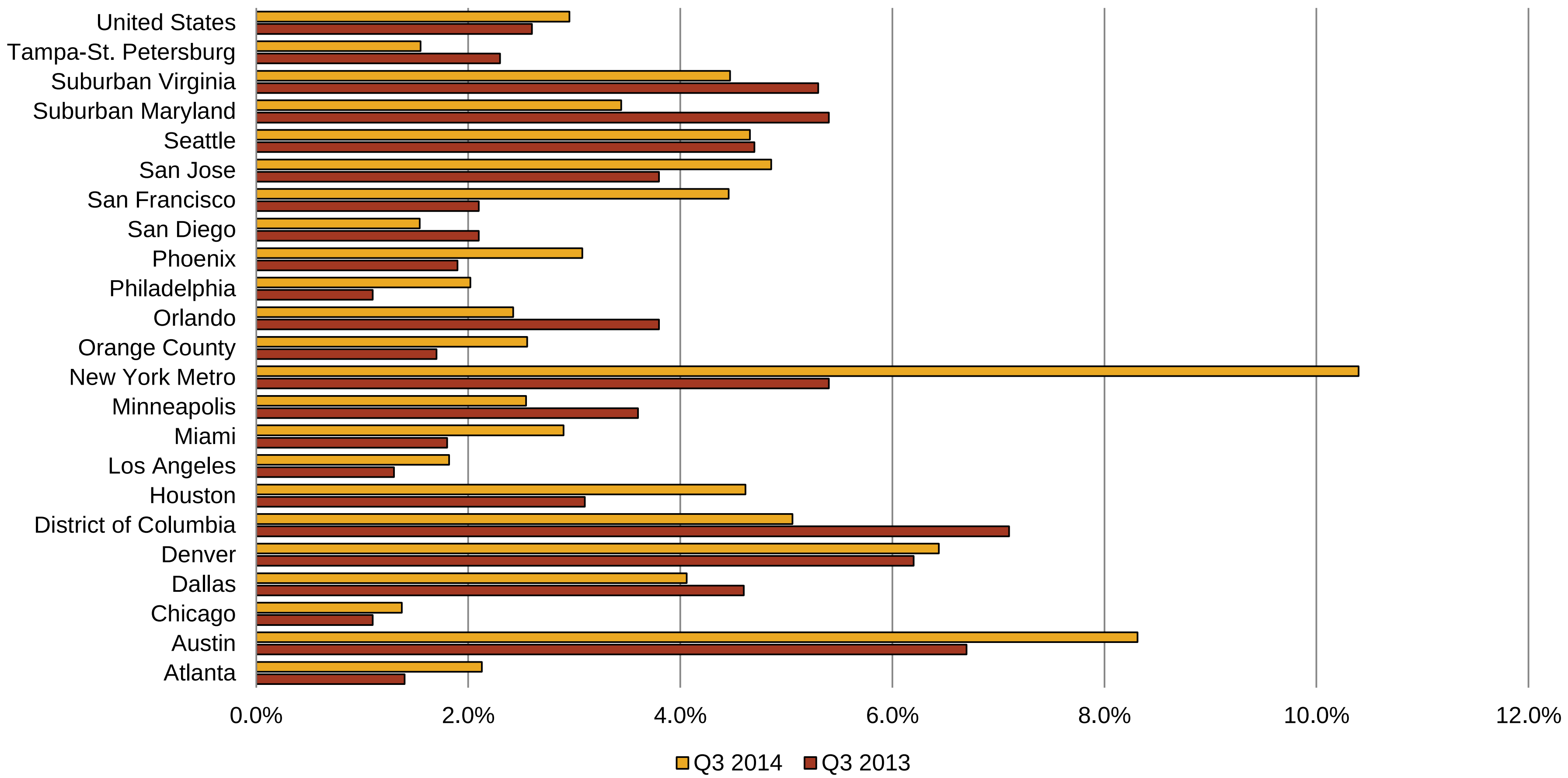


** Last Cycle Peak occurred in 2009 for apartments, in 2008 for office, in 2006 for retail, and in 2006 for industrial.*
Source: Reis, Inc.

Annual Change in Apartment Construction Is Market Dependent

While most apartment markets have more construction now than a year ago, construction in markets further along in the cycle is beginning to slow. And though markets like New York and Austin have very robust pipelines now compared to a year ago, some markets, including Washington D.C. and Tampa-St. Petersburg, have far less construction now than they had in Q3 2013. The apartment market is experiencing much more construction this year than any other asset class.

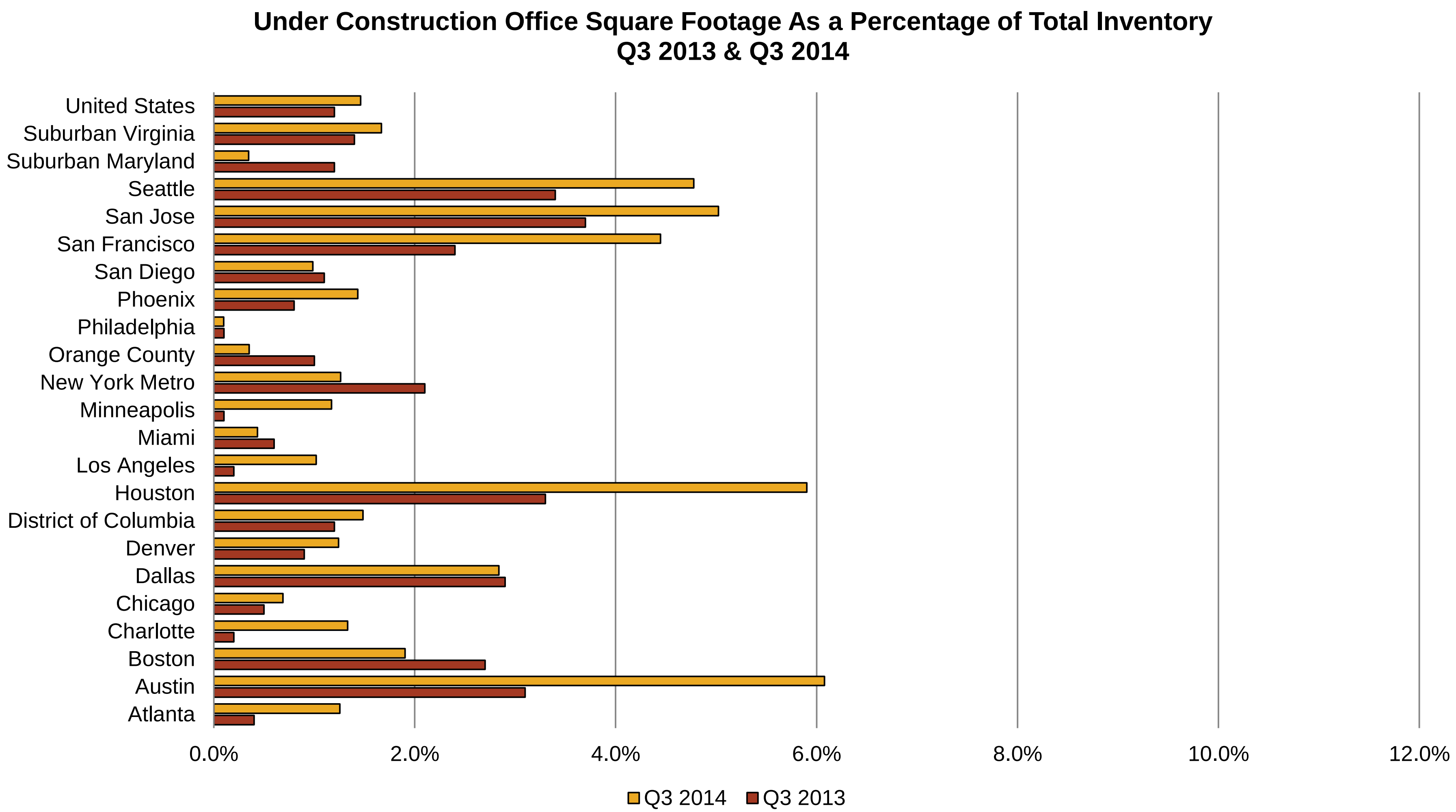
Under Construction Apartment Units As a Percentage of Total Inventory
Q3 2013 & Q3 2014



Source: Reis, Inc.

Office Supply Heating Up in Several Markets

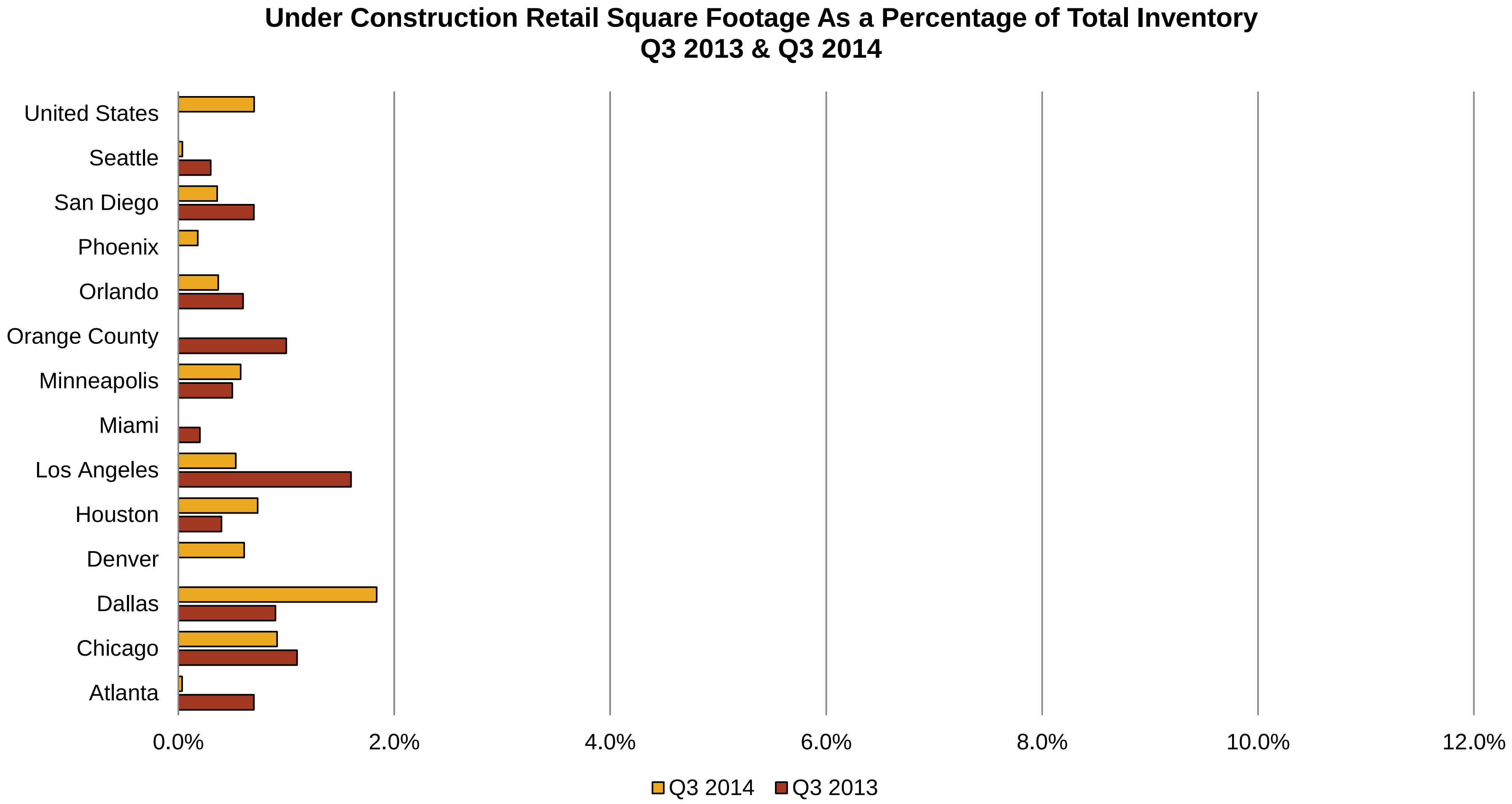
Although some prime office markets have less stock under construction now than a year ago, many markets have a substantially more robust pipeline now than in Q3 2013. Austin, Houston, Seattle, San Jose, and San Francisco all have far more robust pipelines than they did a year ago, and under-construction square footage is now over 4% of inventory in each market.



Source: Reis, Inc.

Very Little Retail Construction

Most retail markets (for neighborhood and community centers) have not yet begun to add significant supply. Not one retail market has under-construction square footage equal to even 2% of total inventory. We expect retail construction activity to pick up in 2015.

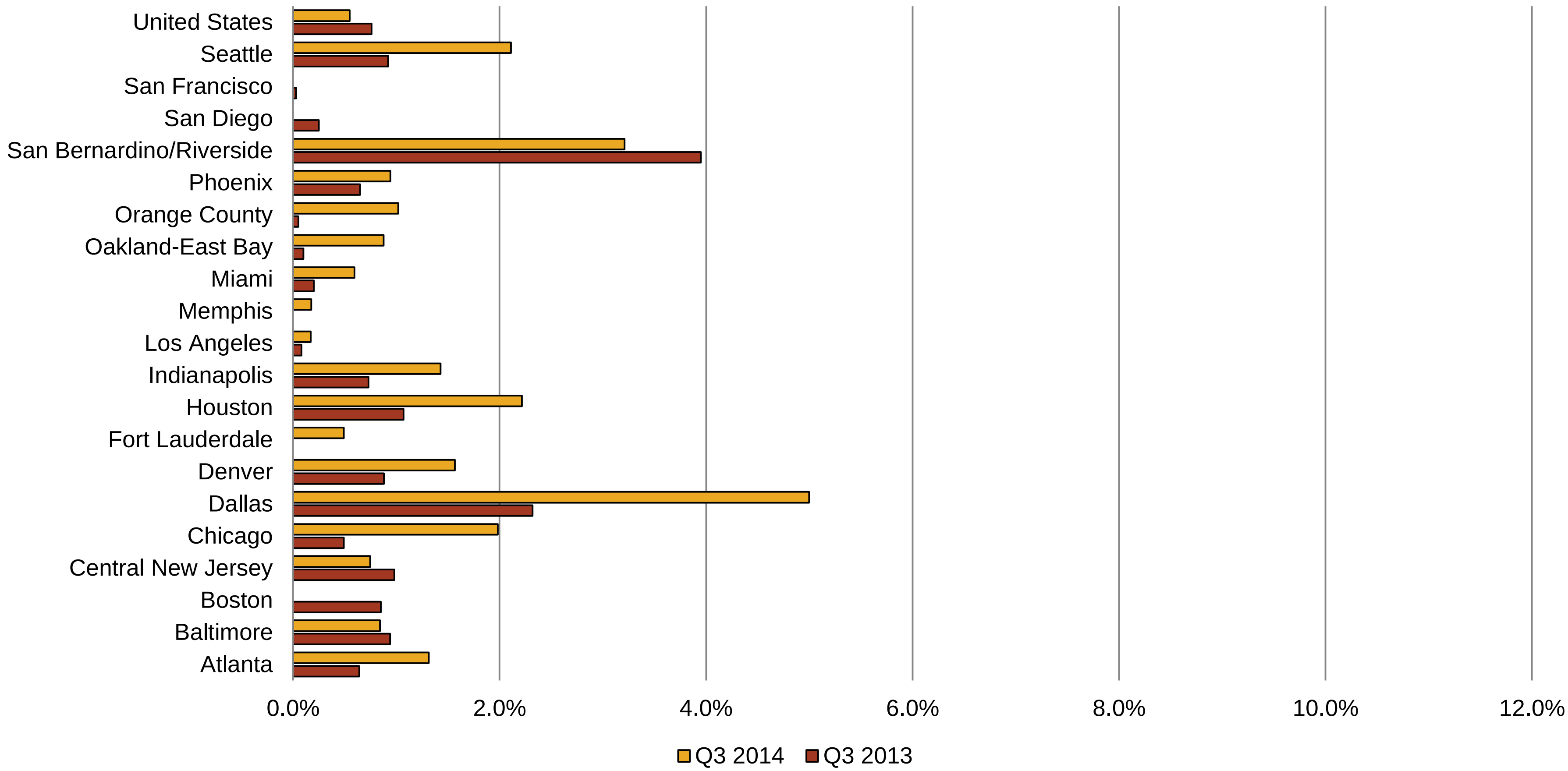


Source: Reis, Inc.

Industrial Pipelines Picking Up in Most Markets

Most U.S. markets' industrial construction pipelines have expanded in the past year. As businesses continue to improve following the Recession and e-commerce businesses continue to require large warehouses in areas outside of the "Big 5" industrial markets, the industrial market in most metropolitan areas should continue to add more industrial space.

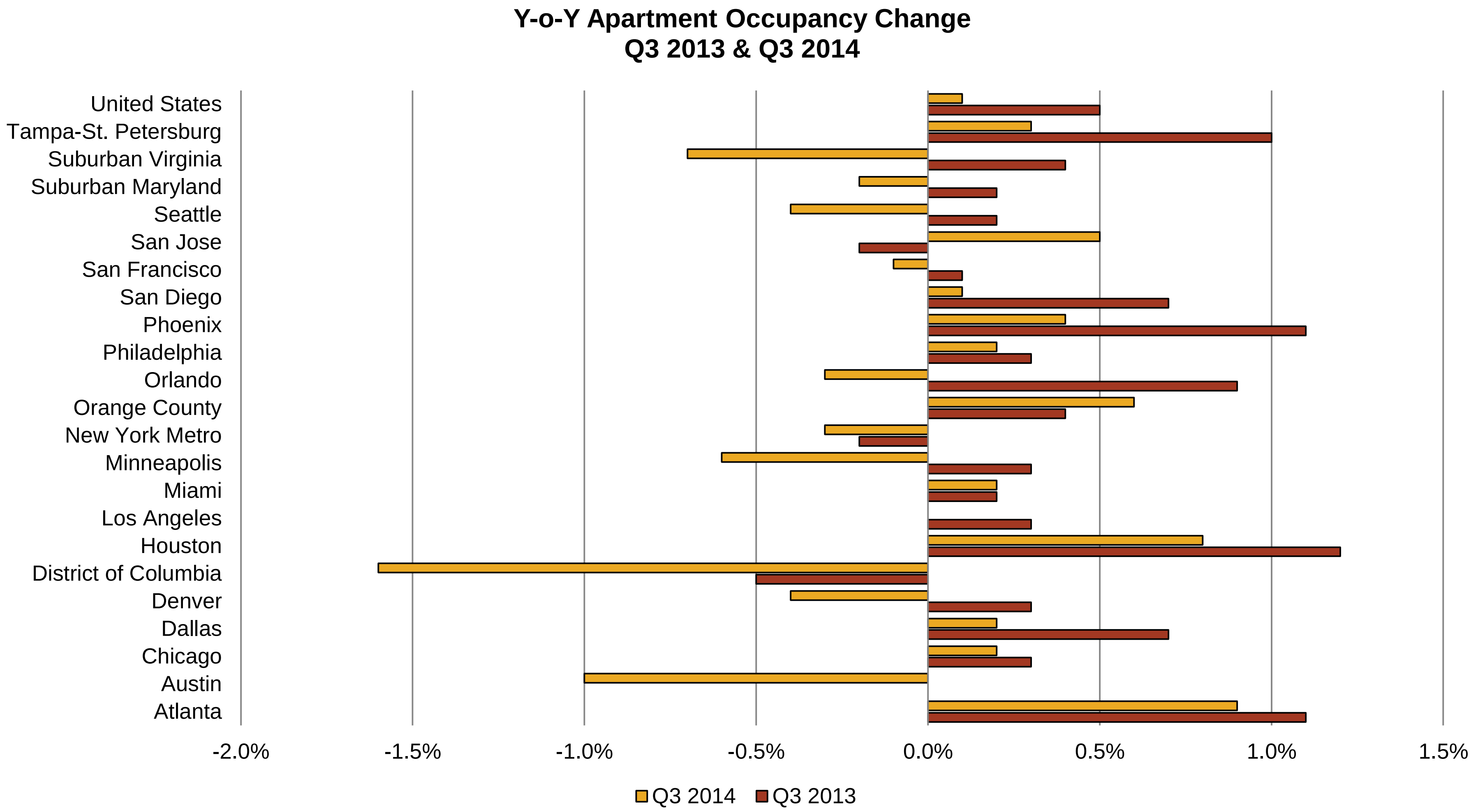
Under Construction Industrial Square Footage As a Percentage of Total Inventory
Q3 2013 & Q3 2014



Source: Reis, Inc.

Apartment Occupancy Growth Largely Decreasing

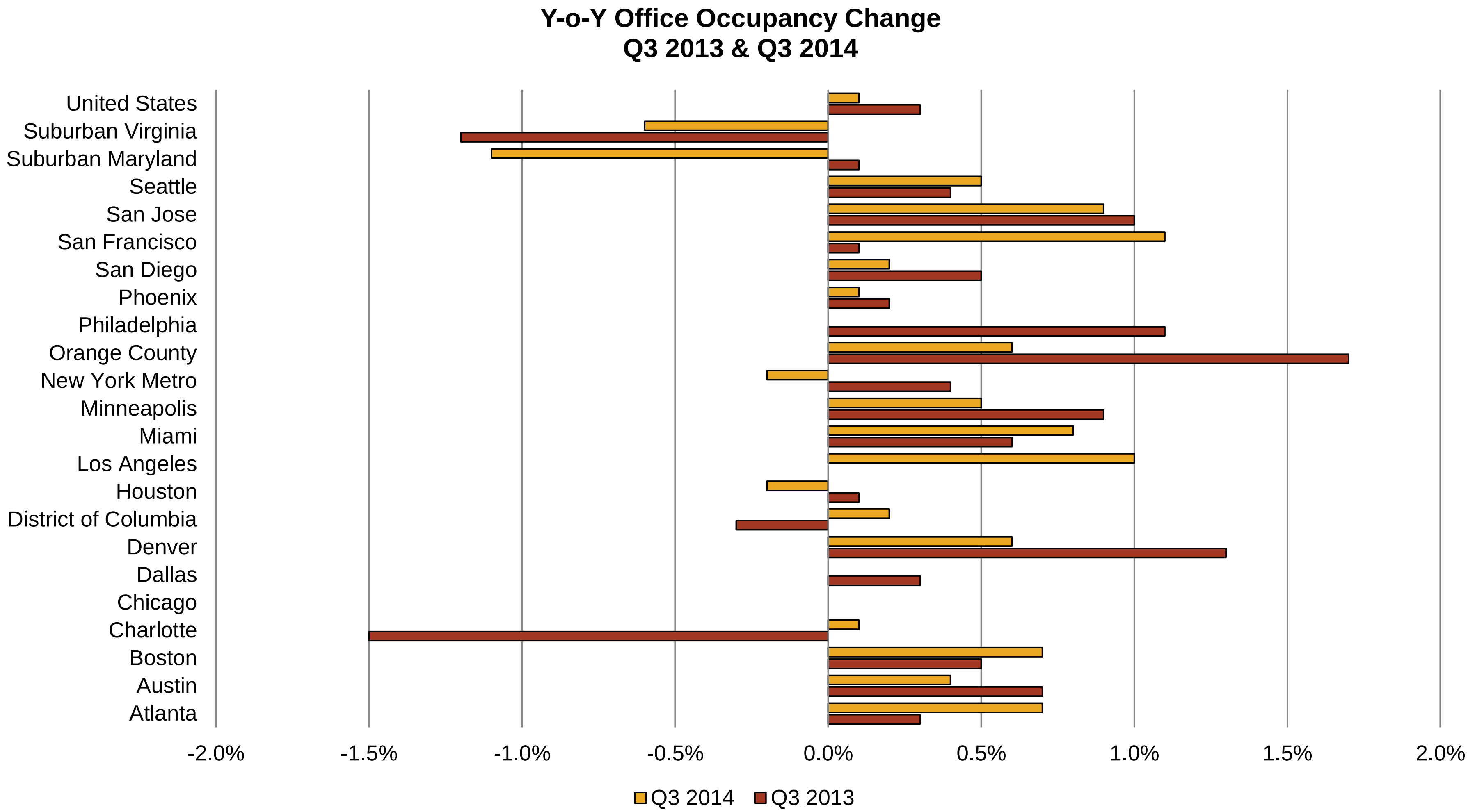
Most U.S. apartment markets' had lower y-o-y occupancy growth in Q3 2014 than they had in Q3 2013. The severity of the decrease seems to have largely depended on that market's point in the construction cycle; markets further along in the cycle, like Washington D.C., largely experienced negative occupancy growth over the last year.



Source: Reis, Inc.

Office Occupancy Growth Decreased in Most Markets Last Year

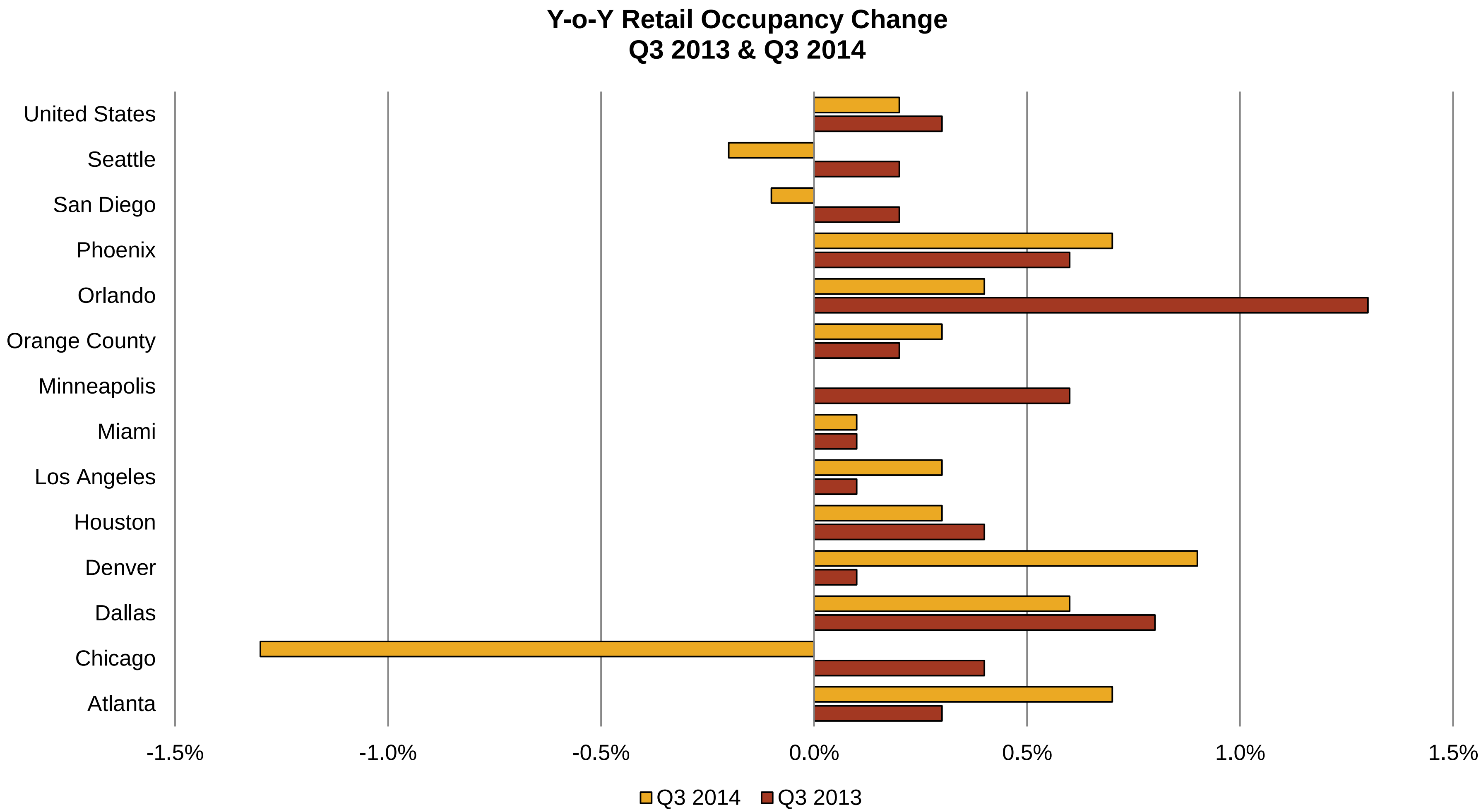
With few exceptions, U.S. office markets experienced less y-o-y occupancy growth in Q3 2014 than they did in Q3 2013. Despite this, most U.S. markets still had positive occupancy growth over the last year, suggesting that the U.S. office market is not quite as far along in the cycle as the apartment market.



.Source: Reis, Inc.

Retail Occupancy Largely Increasing

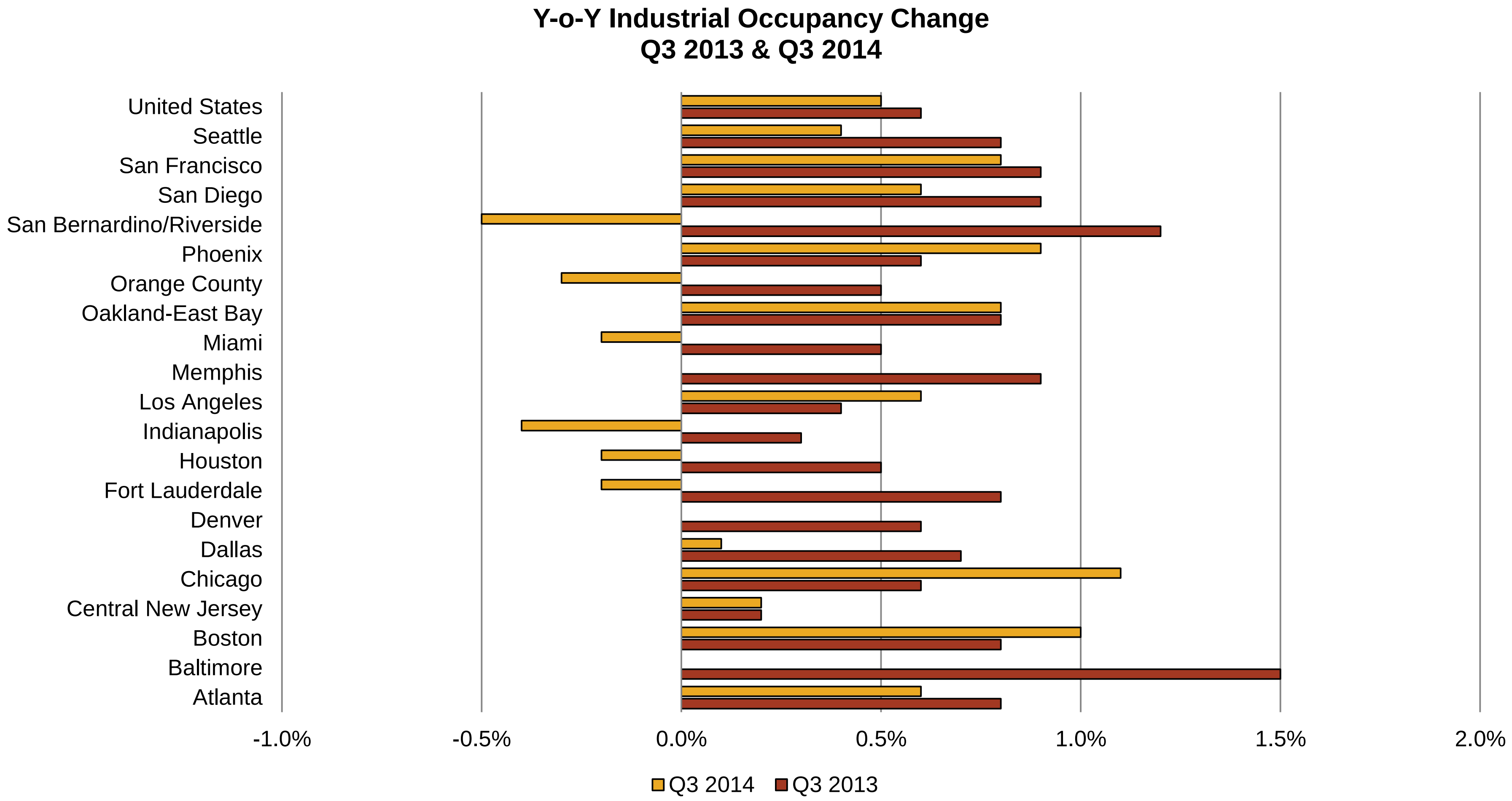
As the limited retail construction pipeline suggests, the retail market is the furthest back in the cycle of any of the four major asset types. For this reason, and due to the overall strengthening of the economy, the large majority of retail markets experienced occupancy increases over the past year.



Source: Reis, Inc.

Industrial Occupancy Growth Is Decreasing

As the supply cycle in the U.S. industrial market continues to heat up, occupancy growth in most industrial markets is decreasing. Given the industrial market's current position in the real estate cycle, we expect industrial markets to enjoy positive occupancy growth, although at a decreasing rate, for the next year or two.



Source: Reis, Inc.

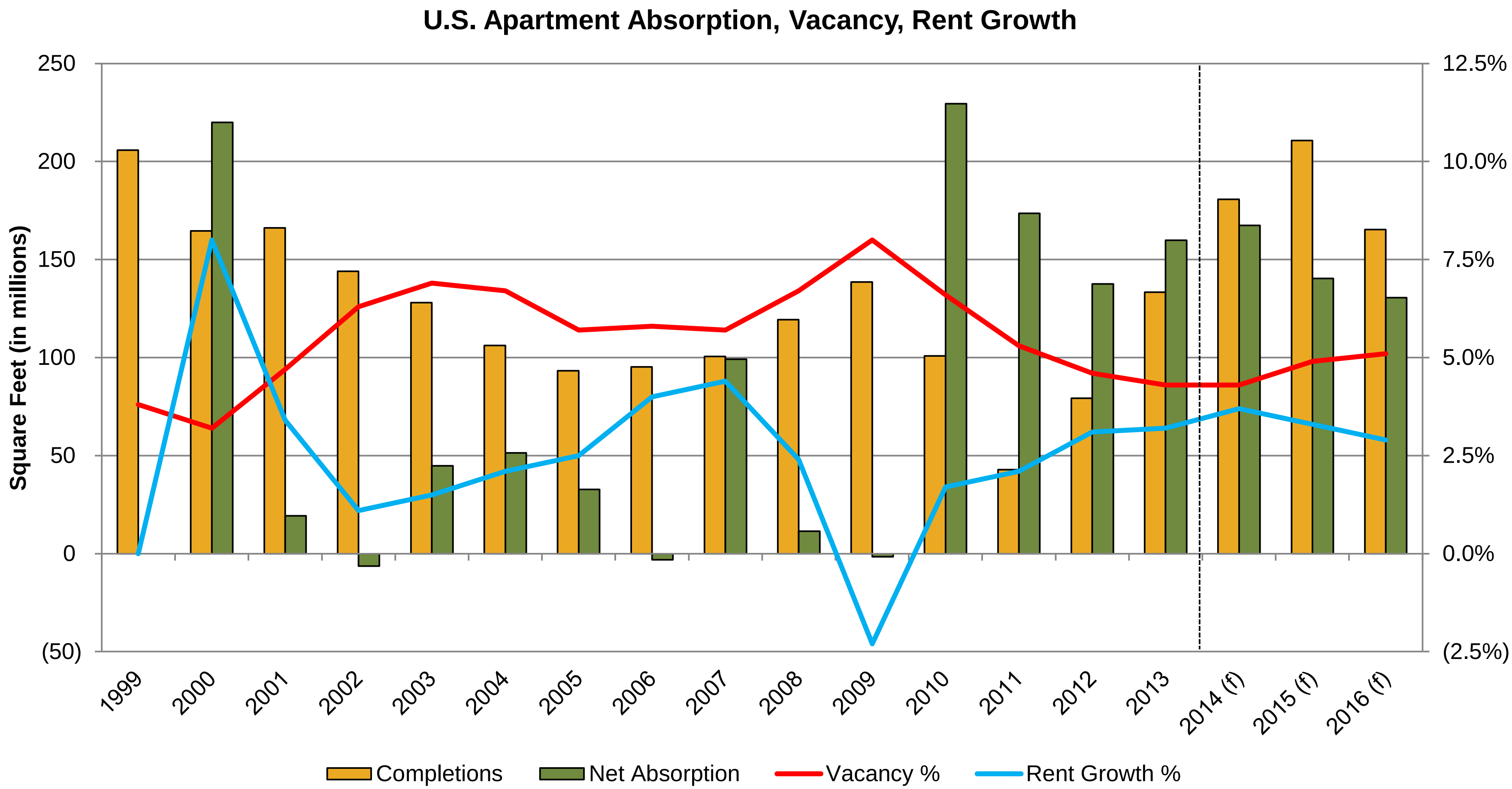
Appendix: U.S. Real Estate Market Trends

Residential Fundamentals

U.S. Apartment Absorption Projected to Be Outpaced by Completions in the Future

Q3 2014 U.S. apartment vacancy was up 10 bps quarter-over-quarter but was down 10 bps year-over-year to 4.2%. Owners have pricing power as they leverage low vacancies into rent growth for the 18th straight quarter.

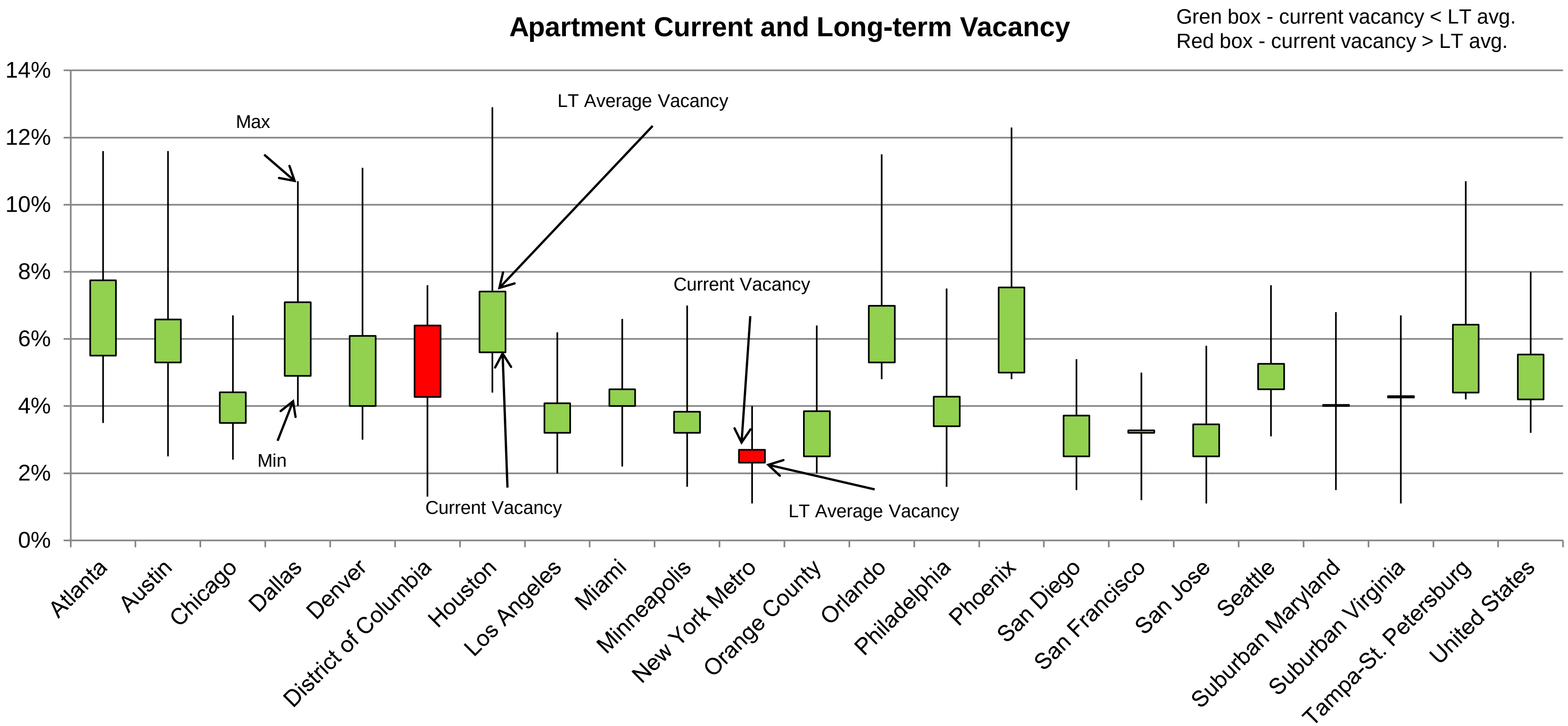
Vacancies have most likely reached their cycle lows in the first half of 2014. With projects under construction equivalent to over 3.0% of stock nationally, vacancy may begin to creep up. The rent growth forecast below could face some downward pressure if new construction occurs faster than expected.



Source: Reis, Inc.; RCLCO

Apartment Vacancy Historically Low

Apartment vacancies remain low as most major U.S. apartment markets are experiencing lower current vacancy compared to long-term (1990-present) averages. The only three markets with above-average vacancy are Washington, D.C., New York, and Suburban Virginia, although vacancies in these markets remain low at 6.7%, 2.7%, and 4.3%, respectively.



Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets
Note: "LT Average" = Long-term average, which is defined as 1990 until the present
Source: Reis, Inc.; RCLCO

U.S. Apartment: Market Risk Indicator

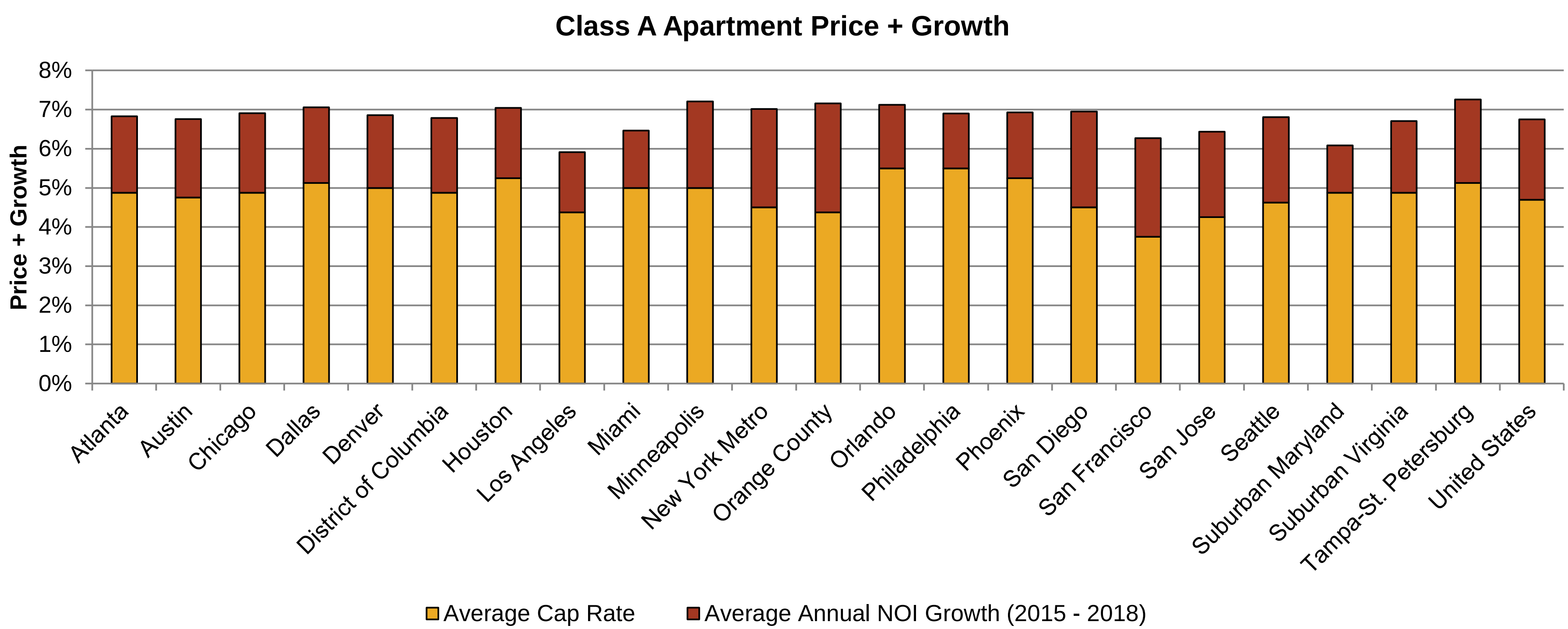
Rents continue to rise in *all* major apartment markets, with tech hubs San Francisco, San Jose, and Seattle and the resurgent Miami and Denver achieving the highest q-o-q and y-o-y growth. Due to historically high occupancy and rent levels, construction continues to be in full swing, with some **markets such as Austin, Denver, NYC, and Washington D.C. adding *over 5% of inventory* in the very near future**.

	Net Absorption % of Stock Current* Quarter	Completions % of Stock Current* Quarter**	Under Constr % of Stock Current* Quarter***	Occupancy****	Q-o-Q Occupancy Change	Y-o-Y Occupancy Change	Q-o-Q Rent Growth	Y-o-Y Rent Growth
Atlanta	0.2%	0.1%	2.1%	94.5%	0.2%	0.9%	0.8%	3.7%
Austin	0.9%	1.3%	8.3%	94.7%	(0.4%)	(1.0%)	1.9%	4.5%
Chicago	0.2%	0.2%	1.4%	96.5%	0.0%	0.2%	1.0%	3.6%
Dallas	0.8%	1.0%	4.1%	95.1%	(0.1%)	0.2%	1.7%	4.7%
Denver	0.7%	0.8%	6.4%	96.0%	(0.1%)	(0.4%)	2.4%	7.6%
District of Columbia	1.4%	2.2%	5.1%	93.6%	(0.7%)	(1.6%)	0.7%	1.3%
Houston	0.5%	0.8%	4.6%	94.4%	(0.2%)	0.8%	1.6%	4.7%
Los Angeles	0.2%	0.3%	1.8%	96.8%	(0.1%)	0.0%	0.9%	2.8%
Miami	0.2%	0.0%	2.9%	96.0%	0.1%	0.2%	2.5%	7.4%
Minneapolis	0.4%	0.8%	2.5%	96.8%	(0.3%)	(0.6%)	1.4%	4.3%
New York Metro	0.5%	0.2%	10.4%	97.3%	0.2%	(0.3%)	1.4%	5.2%
Orange County	0.1%	0.0%	2.6%	97.5%	0.1%	0.6%	1.2%	2.9%
Orlando	0.5%	0.7%	2.4%	94.7%	(0.2%)	(0.3%)	1.5%	4.0%
Philadelphia	0.2%	0.3%	2.0%	96.6%	(0.1%)	0.2%	0.8%	3.6%
Phoenix	0.4%	0.6%	3.1%	95.0%	(0.2%)	0.4%	0.9%	3.7%
San Diego	0.3%	0.1%	1.5%	97.5%	0.1%	0.1%	0.6%	3.2%
San Francisco	0.4%	0.6%	4.5%	96.8%	(0.2%)	(0.1%)	2.6%	9.0%
San Jose	0.5%	0.6%	4.9%	97.5%	(0.1%)	0.5%	2.0%	9.6%
Seattle	0.5%	0.8%	4.7%	95.5%	(0.3%)	(0.4%)	1.3%	6.4%
Suburban Maryland	0.4%	0.7%	3.4%	96.0%	(0.3%)	(0.2%)	0.8%	2.0%
Suburban Virginia	0.5%	0.6%	4.5%	95.7%	0.0%	(0.7%)	1.5%	2.9%
Tampa-St. Petersburg	0.3%	0.2%	1.5%	95.6%	0.1%	0.3%	0.8%	3.1%
United States	0.4%	0.5%	3.0%	95.8%	(0.1%)	0.1%	1.2%	3.9%

*Current quarter defined as Q3 2014
**Completions highlighted in Red if above 0.25% of Stock
***Under Construction highlighted in Red if above 1% of Stock
****Green if above city's historical average since 1990
Note: Above data includes only market rate rentable apartment space
Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; RCLCO

Apartment Pricing and Growth Expectations

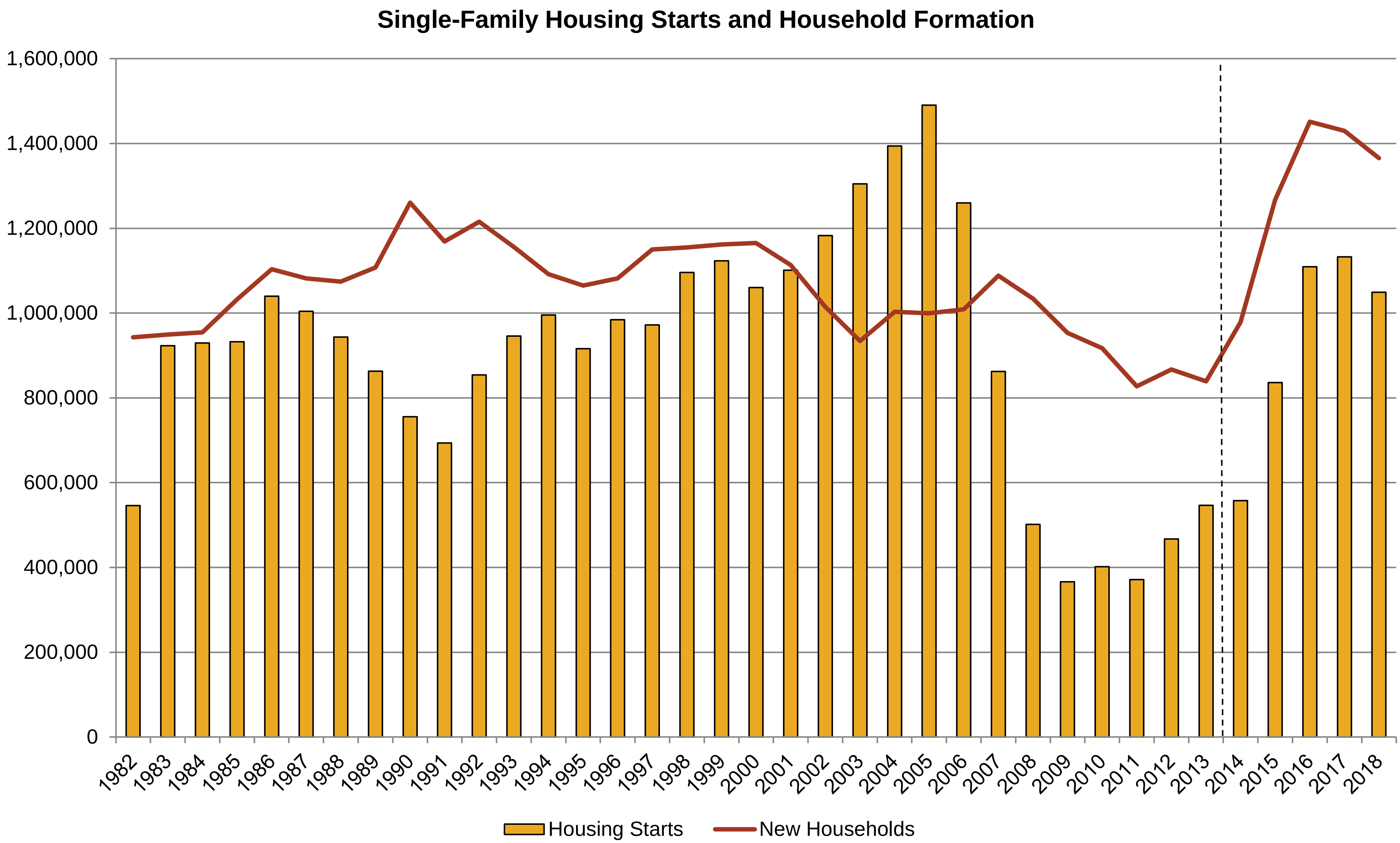
Investors continue to favor the low vacancy rates of the apartment sector, with average Class A cap rates hovering around 5% or lower, and some markets close to or below 4%. The graph below shows average Class A cap rates and average expected NOI growth for the next five years (which includes expected changes in occupancies and rents). While NOI growth going forward is expected to be positive, new supply is putting downward pressure on expected income growth and the combination of low cap rates and moderate rent growth results in the lowest forward return expectations of all major property types.



Initial yield and cash flow growth over the hold period are significant contributors to unlevered total return expectations. Low cap rates should thus be accompanied by higher growth expectations. While the above graph is an incomplete view, it does provide some indications of markets that should be particularly reviewed for further insights. For example, markets with low bars in the graph above may have less growth than needed to offset lower yields, or the growth may be more back-ended in a 10-year hold. Conversely, markets with high bars may be positioned to experience significant growth as compared to current pricing, or may be markets that are considered to be more risky and thus justify higher expected returns.

Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; CBRE; RCLCO

Household Formation Is Outpacing Single-Family Starts

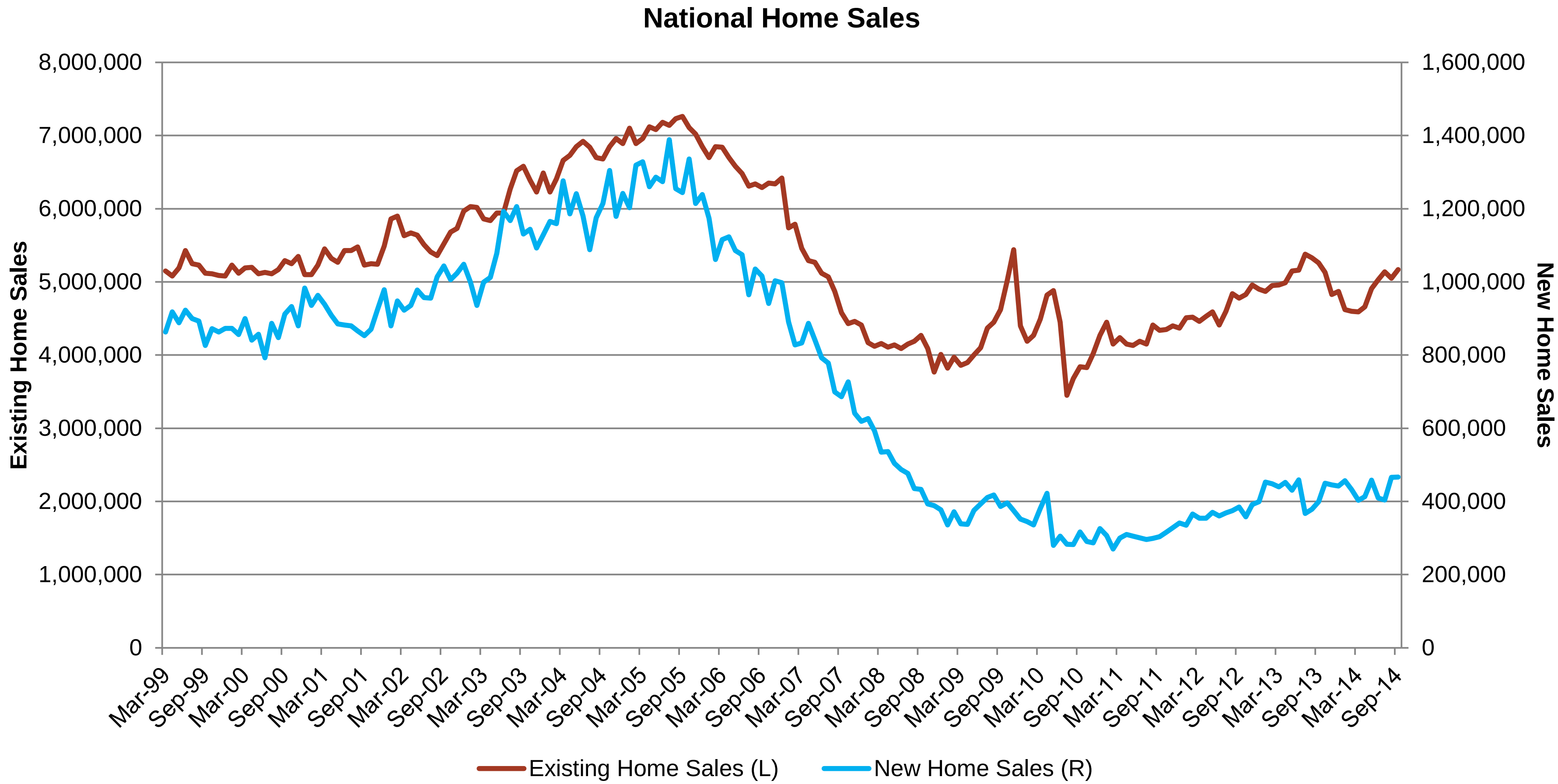


Note: Housing starts include single-family detached, townhomes, condominiums, and cooperative homes.
Source: Moody's Analytics; RCLCO

Existing Home Sales Pick Up

New home sales increased slightly in the 3rd quarter of 2014 as compared to Q1 and Q2 (on a seasonally-adjusted basis). However, housing start numbers over the last year - higher than at any point since the Recession - indicate that activity is finally picking up in the market.

Existing home sales continued to increase in Q3, although not quite at the Q2 pace. Nonetheless, the continued rebound of sales levels that approach summer-fall 2013 numbers indicates that the particularly harsh 2013-2014 winter may have been only a slight hiccup on an otherwise upward trajectory.



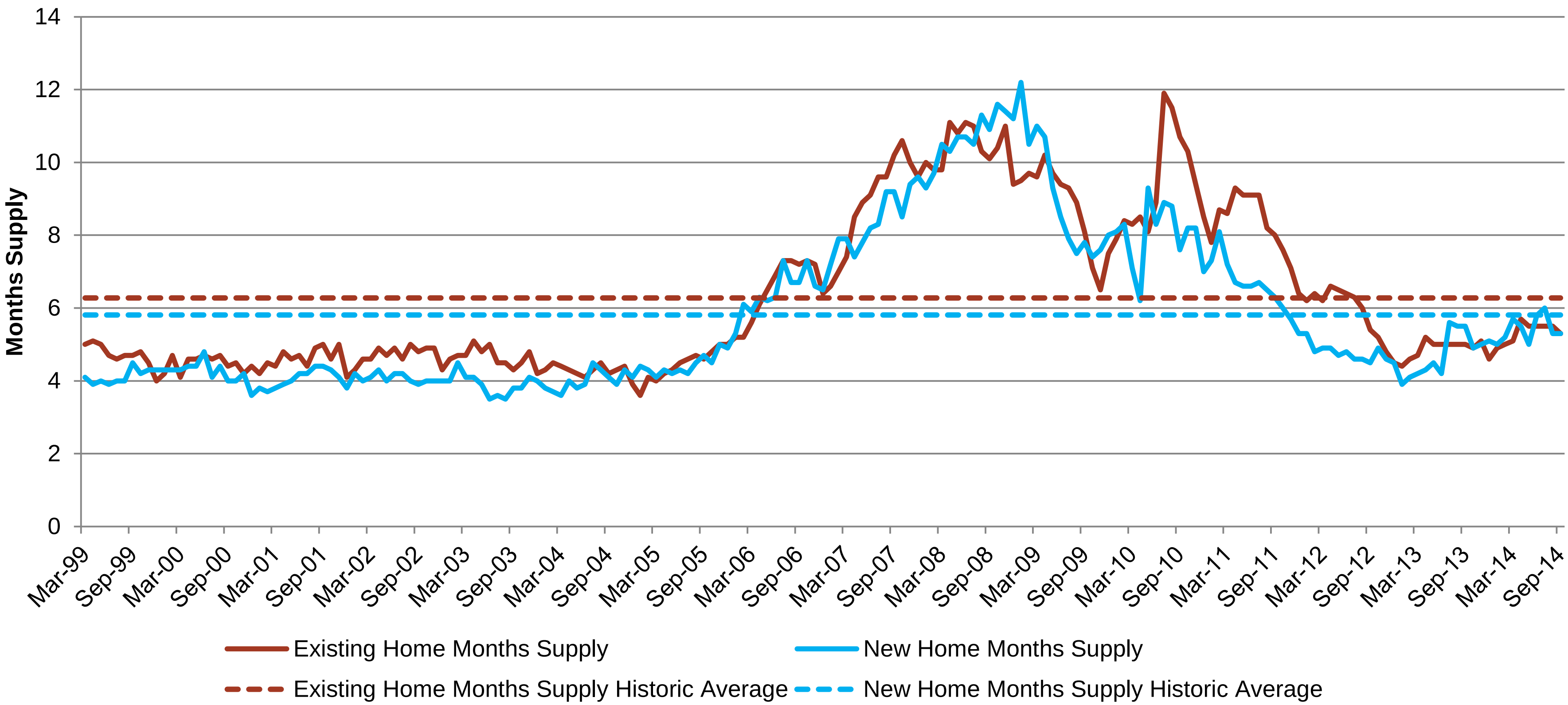
Note: Monthly data are seasonally adjusted annual rates
Source: U.S. Census Bureau; National Association of Realtors

Housing Supply Is Near Stabilized Levels

The inventory of homes available for sale has recovered since the downturn as a result of both fewer homes being put on the market and a higher volume of home sales. Inventory to sales ratios continue to stay near long-term stabilized levels, which should help to generate demand for new homes as well as support moderate increases in home prices.

In 2014, the supply of both existing and new homes has increased. Existing home months' supply increased from 4.6 at the end of 2013 to 5.5 by July 2014. New home months' supply increased from 5.1 at the end of 2013 to 6.0 by July2014.

New and Existing Home Months Supply of Housing
(1999 - September 2014)



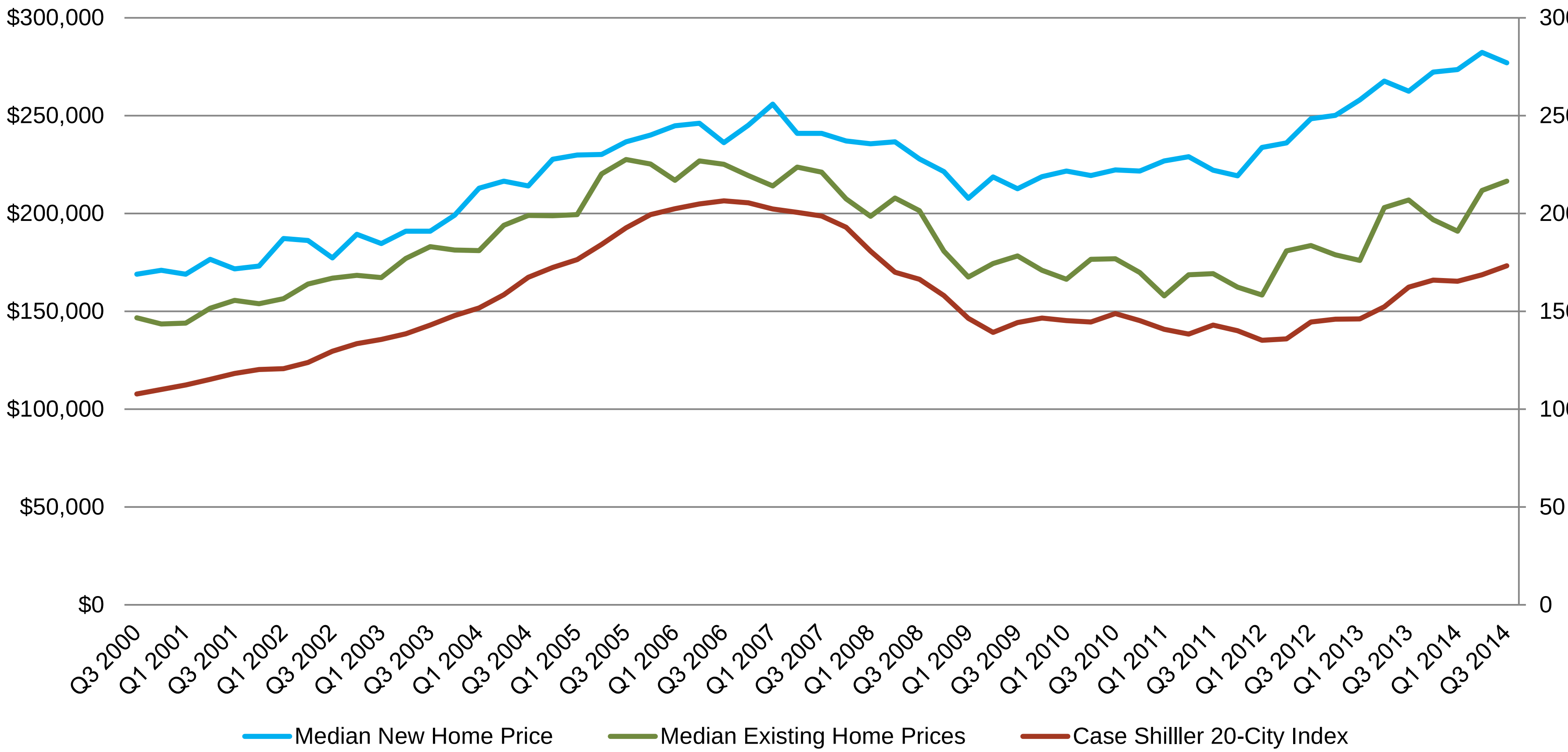
Note: Home supply includes single-family detached, condo, and townhomes.
Source: NAR; RCLCO

New Home Prices Recovered While Existing Home Prices Are Still Below Peak Levels

New home prices decreased by 2% in the third quarter of 2014, however levels are still 8% higher than peak prices in early 2007.

Existing home prices continued to rebound strongly from a depressed winter sales period, as they increased 2.2% in Q3 2014 after increasing by 10.9% in Q2. Existing home prices have not yet reached peak 2007 pricing.

Median Home Price and Case Shiller 20-City Price Index (2000 – Q3 September 2014)



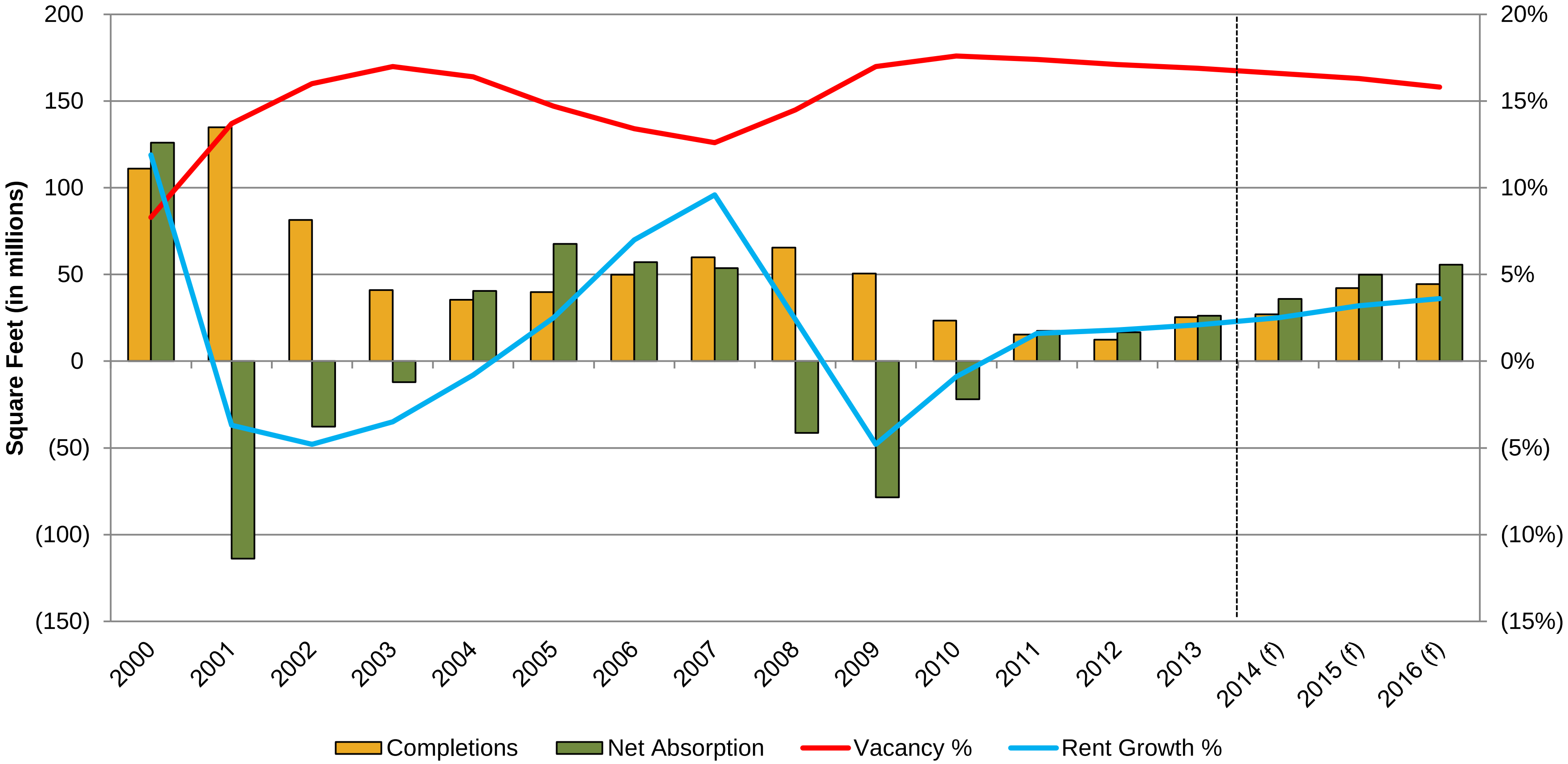
Source: U.S. Census; National Association of Realtors; S&P; Wall Street Journal

Office Fundamentals

U.S. Office Vacancy Slowly Improving

Despite continued significant office-using employment growth, Q3 2014 office vacancy remained flat quarter-over-quarter (for the second consecutive quarter) at 16.8%. Year-over-year, office vacancy declined only 10 bps as tenants continue to absorb extra space but decrease space usage per worker. Office absorption is expected to slightly outpace completions during the next three years nationally as office jobs are growing at a quick clip, particularly in major urban centers. The slow forecast recovery masks regional differences. Poorly located or configured properties are likely to face higher obsolescence risk, while properties in prime locations are expected to experience high rent growth in the near-term as rents recover from the downturn.

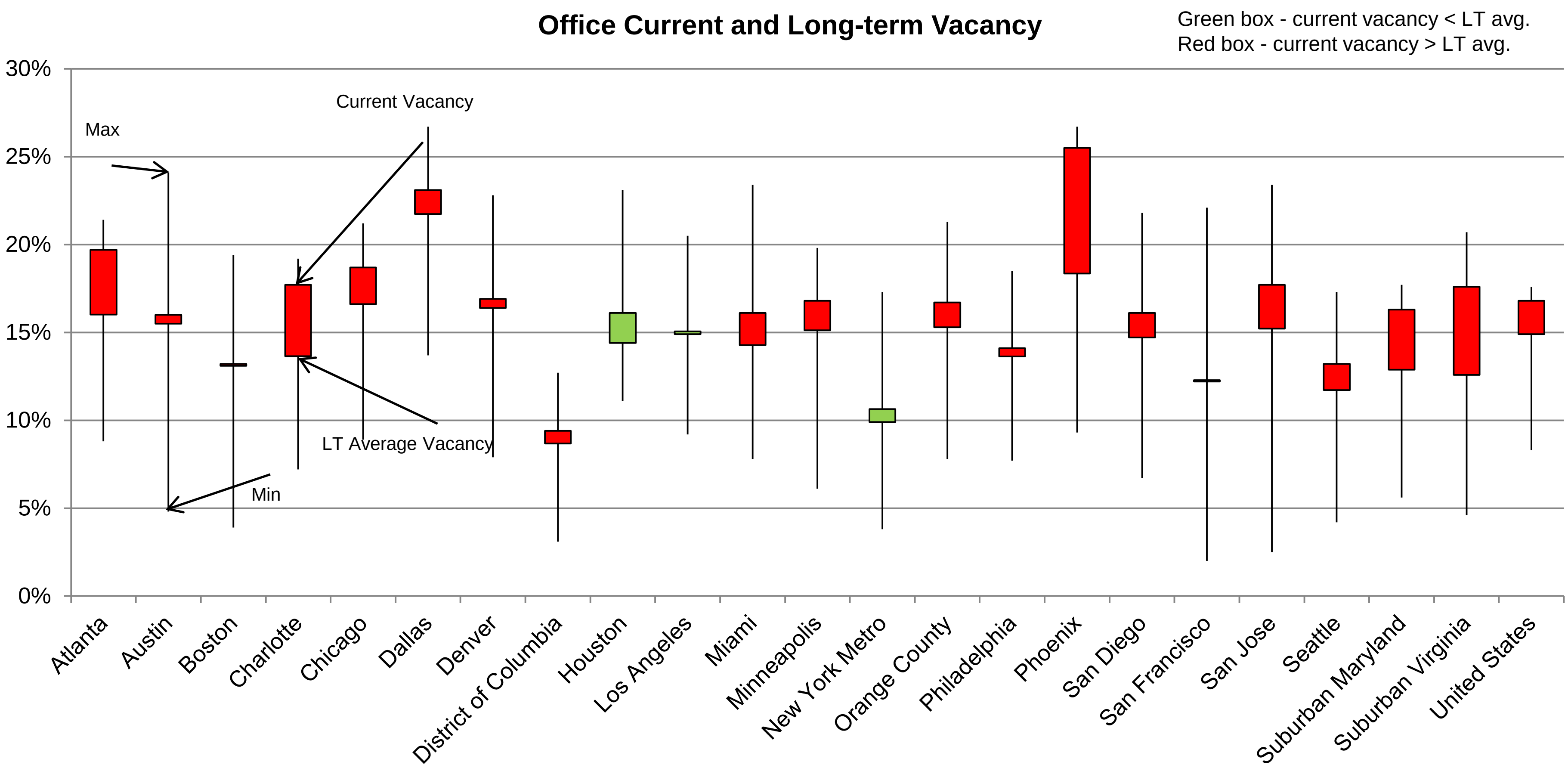
U.S. Office Absorption, Vacancy, Rent Growth



Source: Reis, Inc.; RCLCO

Office Vacancy Still High

Most major U.S. office markets continue to experience higher current vacancy than their long-term average (1990 - Q2 2014). Phoenix has the highest current vacancy rate of these major markets at 25.5%. The only three markets with below-average vacancy are Houston, San Francisco, and NYC at 14.4%, 12.2%, and 9.9%, respectively.



Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; RCLCO

U.S. Office: Market Risk Indicator

Texas and the Pacific Northwest continue to construct new office, with Austin, Houston, Seattle, and San Jose adding 6.1%, 5.9%, 4.8%, and 5.0% respectively as a percent of current inventory.

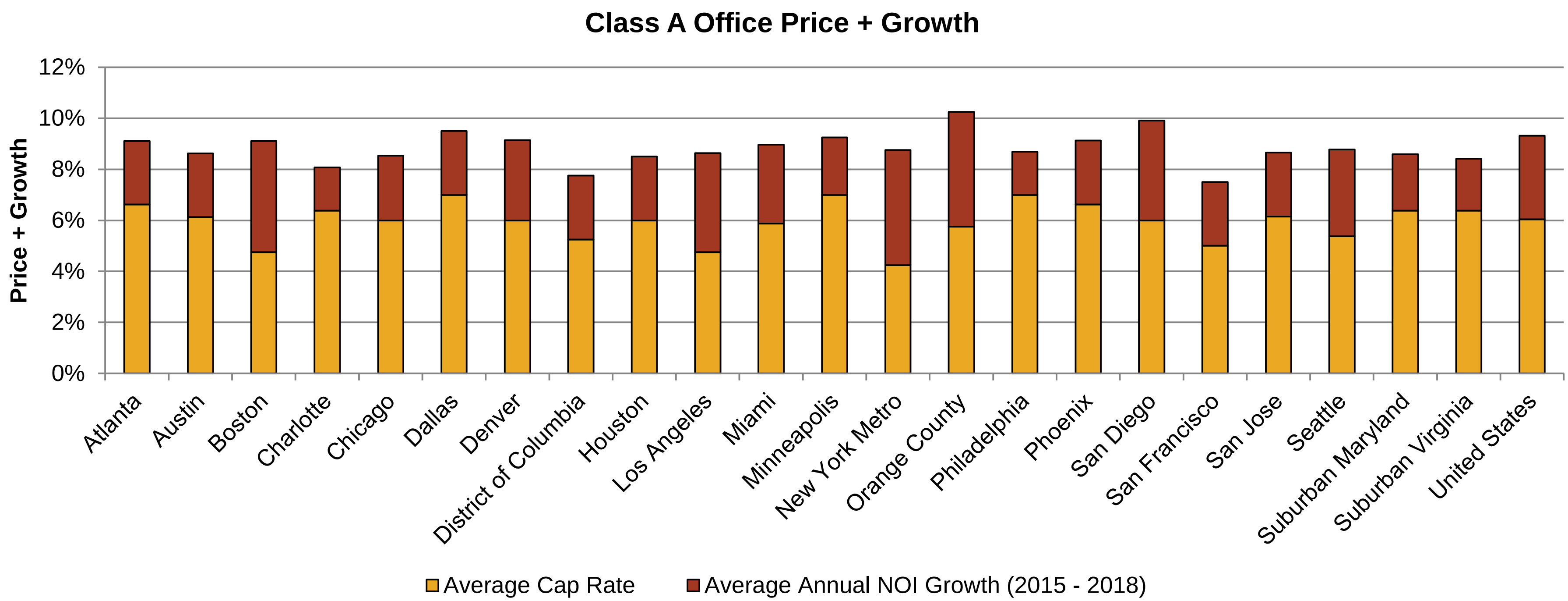
Rents in all of the below markets grew in the second quarter and year-over-year, with tech- and oil-centric economic hubs, as well as Boston, Los Angeles, Orange County, Seattle, and San Francisco growing at faster rates.

	Net Absorption % of Stock Current* Quarter	Completions % of Stock Current* Quarter**	Under Constr % of Stock Current* Quarter***	Occupancy****	Q-o-Q Occupancy Change	Y-o-Y Occupancy Change	Q-o-Q Rent Growth	Y-o-Y Rent Growth
Atlanta	0.2%	0.0%	1.3%	80.3%	0.1%	0.7%	0.4%	1.4%
Austin	0.6%	1.3%	6.1%	84.0%	(0.4%)	0.4%	0.7%	2.0%
Boston	0.3%	0.0%	1.9%	86.8%	0.3%	0.7%	0.8%	3.6%
Charlotte	0.0%	0.0%	1.3%	82.3%	0.0%	0.1%	0.2%	1.1%
Chicago	(0.0%)	0.0%	0.7%	81.3%	0.0%	0.0%	0.3%	2.0%
Dallas	0.3%	0.1%	2.8%	76.9%	0.2%	0.0%	1.0%	5.2%
Denver	0.4%	0.1%	1.2%	83.1%	0.2%	0.6%	0.5%	2.1%
District of Columbia	0.2%	0.0%	1.5%	90.6%	0.2%	0.2%	0.1%	1.8%
Houston	0.3%	0.4%	5.9%	85.6%	0.0%	(0.2%)	0.4%	4.4%
Los Angeles	0.5%	0.0%	1.0%	85.1%	0.5%	1.0%	0.6%	3.5%
Miami	0.5%	0.0%	0.4%	83.9%	0.4%	0.8%	0.4%	1.6%
Minneapolis	0.3%	0.0%	1.2%	83.2%	0.4%	0.5%	0.2%	0.8%
New York Metro	0.2%	0.0%	1.3%	90.1%	0.1%	(0.2%)	0.7%	3.9%
Orange County	0.3%	0.2%	0.4%	83.3%	0.1%	0.6%	0.2%	3.6%
Philadelphia	0.1%	0.2%	0.1%	85.9%	(0.1%)	0.0%	0.0%	1.0%
Phoenix	0.0%	0.5%	1.4%	74.5%	(0.3%)	0.1%	0.5%	1.9%
San Diego	0.1%	0.0%	1.0%	83.9%	0.1%	0.2%	0.5%	3.5%
San Francisco	0.5%	0.0%	4.4%	87.8%	0.4%	1.1%	1.3%	5.1%
San Jose	1.4%	1.1%	5.0%	82.3%	0.4%	0.9%	0.9%	6.7%
Seattle	0.6%	0.5%	4.8%	86.8%	0.2%	0.5%	0.9%	3.5%
Suburban Maryland	(0.2%)	0.3%	0.3%	83.7%	(0.5%)	(1.1%)	0.2%	1.0%
Suburban Virginia	0.1%	0.4%	1.7%	82.4%	(0.2%)	(0.6%)	0.1%	0.5%
United States	0.2%	0.1%	1.5%	83.2%	0.0%	0.1%	0.5%	2.7%

*Current quarter defined as Q3 2014
**Completions highlighted in Red if above 0.25% of Stock
***Under Construction highlighted in Red if above 1% of Stock
****Green if above market's historical average since 1990
Note; Above data does not include Medical Office
Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; RCLCO

Office Pricing and Growth Expectations

Pricing varies significantly by market, with cap rates well below 6% for Class A office buildings on average in prime markets such as Boston, Washington, D.C., New York, Los Angeles, and San Francisco. The graph below shows average cap rates and average expected NOI growth for the next five years, including expected improvements in occupancies and rents. While NOI growth is expected to be strong in several markets, growing construction pipelines in markets such as Washington, D.C., may limit income growth and influence return expectations. Meanwhile, supply is lagging in many secondary markets, which are typically high yield / high construction markets. These may be good short-term plays with occupancy gains likely to continue in the near-term.



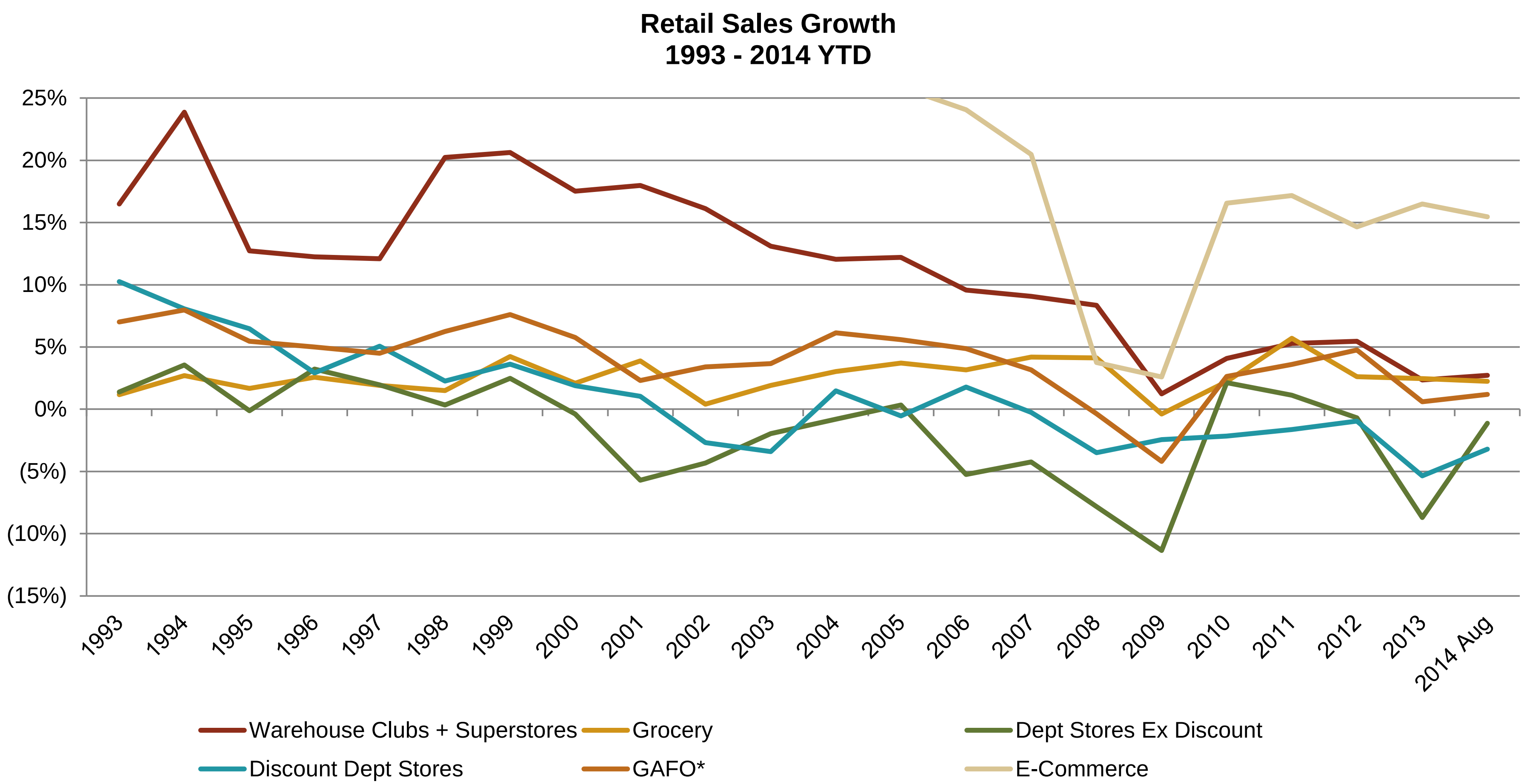
Initial yield and cash flow growth over the hold period are significant contributors to unlevered total return expectations. Low cap rates should thus be accompanied by higher growth expectations. While the above graph is an incomplete view, it does provide some indications of markets that should be particularly reviewed for further insights. For example, markets with low bars in the graph above may have less growth than needed to offset lower yields, or the growth may be more back-ended in a 10-year hold. Conversely, markets with high bars may be positioned to experience significant growth as compared to current pricing, or may be markets that are considered to be more risky and thus justify higher expected returns.

Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; CBRE; RCLCO

Retail Fundamentals

Retail Formats Continue to Change

Retail sales growth remains positive overall, however sales activity stagnated in late 2013 and into Q3 2014. Recent pressures from e-commerce continue to influence brick and mortar, as retailers are changing store layouts and shifting resources to online sales departments. eMarketer.com projects that e-commerce will continue its double-digit growth rate for at least the next three years. Department store sales have been in decline for most of the past 15 years.

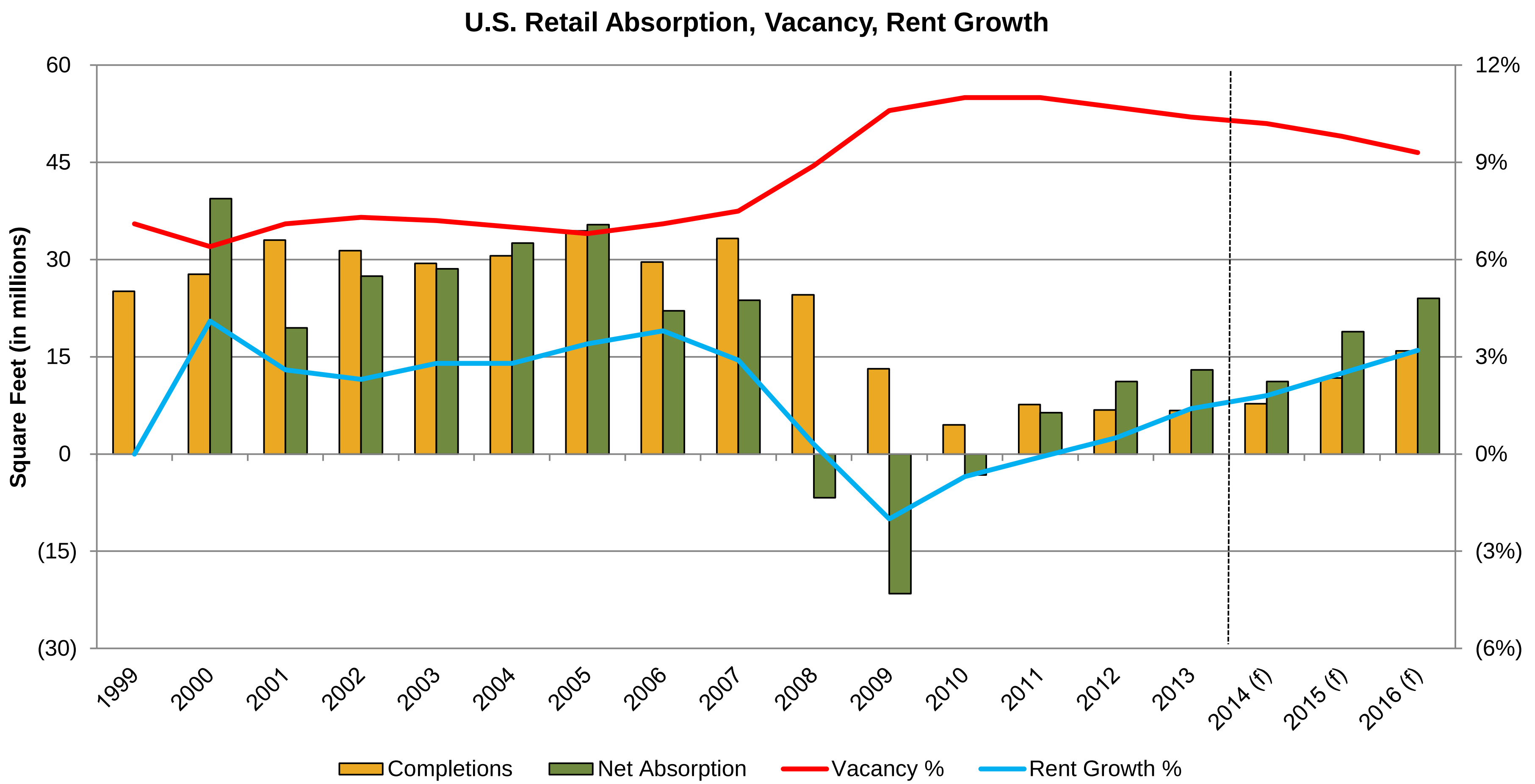


**GAFO = general apparel, furniture, and other mall-type stores*
Source: U.S. Census; ICSC; RCLCO

U.S. Neighborhood/Community Retail Absorption Positive

The neighborhood/community retail sector is slowly gaining momentum as increased demand resulted in increased rent growth and declining vacancy rates from Q3 2013 to Q3 2014.

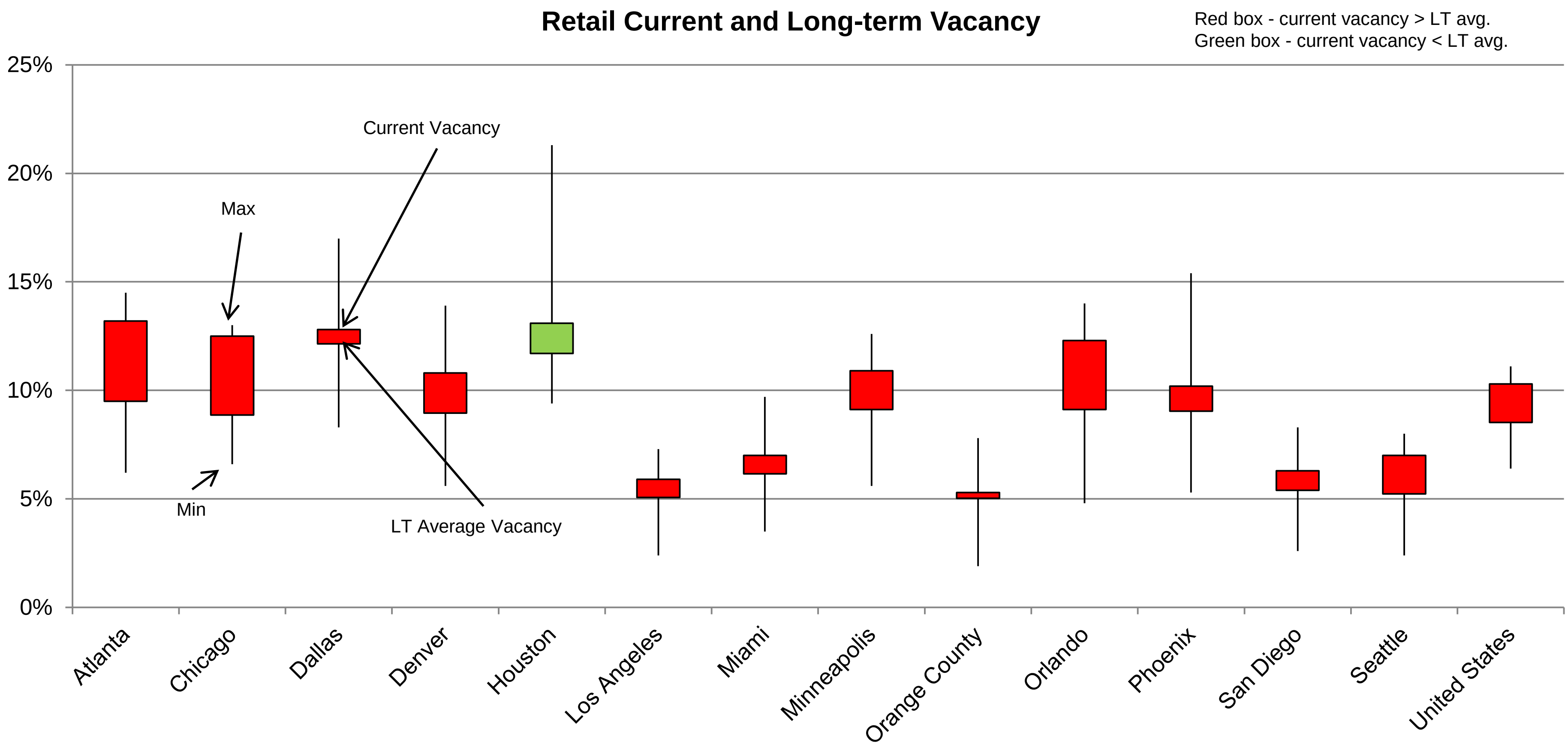
Conditions are improving incrementally, with pent-up demand starting to drive new construction in a few prime areas. Expectations are that growth overall will remain well below levels of the past decade.



Note: Above data is for neighborhood & community centers only.
Source: Reis, Inc.; RCLCO

Retail Vacancy Generally Still High

All of the major U.S. retail markets are experiencing higher current vacancy than their long-term (1990-present) average except for Houston. Atlanta, Chicago, and Orlando are above their long-term averages by the widest margins, while Miami and Southern California retail markets are only slightly less occupied than normal. Occupancies should continue to improve given the limited construction pipeline.



Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets
Source: Reis, Inc.; RCLCO

U.S. Retail (N/C Centers): Market Risk Indicator

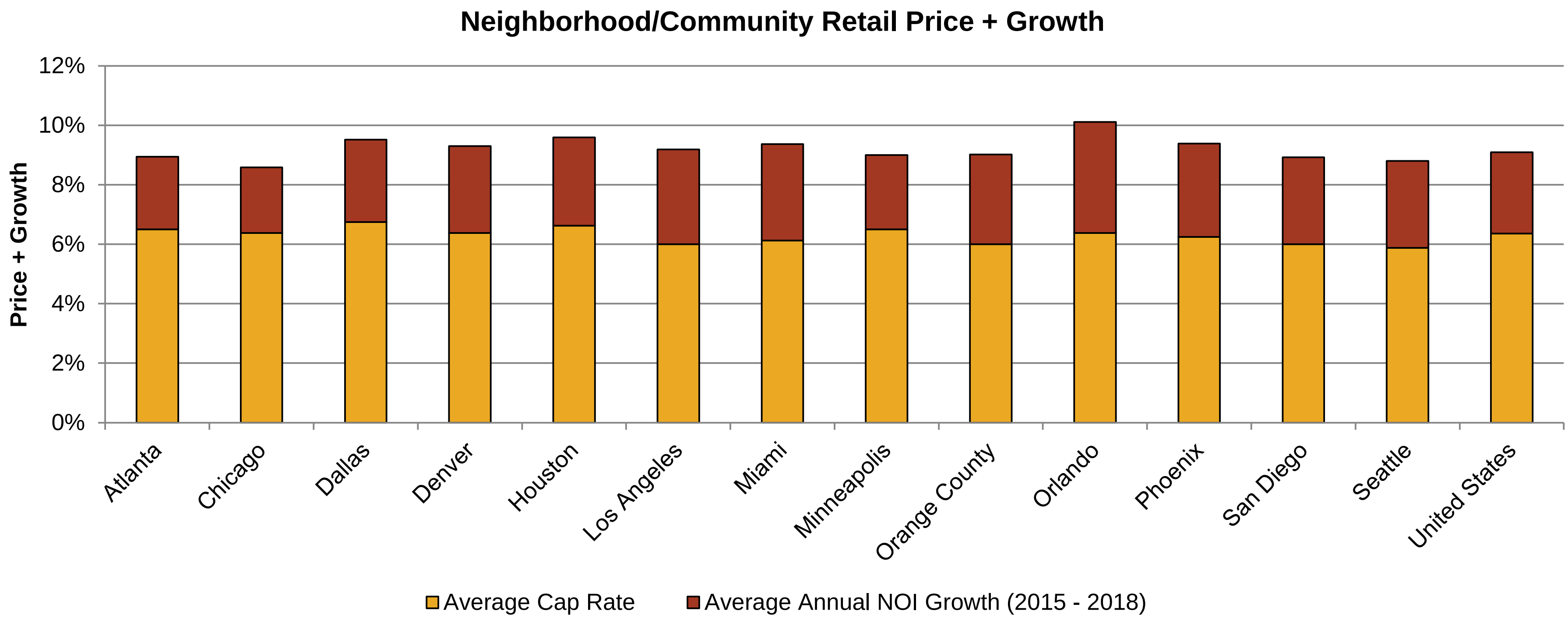
Given relatively high vacancy rates vs. historical averages and other sectoral changes to the retail industry, there is very little retail construction currently in the pipeline. Texas markets, given strong household and employment growth, are currently enhancing their supply at a greater rate than other cities where new demand is focused on a few prime sites.

	Net Absorption % of Stock Current* Quarter	Completions % of Stock Current* Quarter**	Under Constr % of Stock Current* Quarter***	Occupancy****	Q-o-Q Occupancy Change	Y-o-Y Occupancy Change	Q-o-Q Rent Growth	Y-o-Y Rent Growth
Atlanta	0.2%	0.0%	0.0%	86.8%	0.2%	0.7%	0.3%	0.9%
Chicago	0.2%	0.0%	0.9%	87.5%	0.2%	(1.3%)	0.2%	1.5%
Dallas	0.2%	0.0%	1.8%	87.2%	0.2%	0.6%	0.7%	2.2%
Denver	(0.1%)	0.0%	0.6%	89.2%	(0.1%)	0.9%	0.5%	2.1%
Houston	0.2%	0.0%	0.7%	88.3%	0.2%	0.3%	0.6%	3.0%
Los Angeles	0.0%	0.0%	0.5%	94.1%	0.0%	0.3%	0.9%	2.7%
Miami	0.2%	0.0%	0.0%	93.0%	0.2%	0.1%	1.0%	2.9%
Minneapolis	0.1%	0.2%	0.6%	89.1%	(0.1%)	0.0%	0.8%	2.5%
Orange County	0.3%	0.1%	0.0%	94.7%	0.1%	0.3%	0.0%	1.6%
Orlando	(0.1%)	0.1%	0.4%	87.7%	(0.1%)	0.4%	0.6%	3.0%
Phoenix	0.2%	0.0%	0.2%	89.8%	0.1%	0.7%	0.2%	2.4%
San Diego	0.1%	0.0%	0.4%	93.7%	0.0%	(0.1%)	0.8%	2.7%
Seattle	0.1%	0.0%	0.0%	93.0%	0.1%	(0.2%)	0.7%	1.8%
United States	0.1%	0.1%	0.7%	89.7%	0.0%	0.2%	0.5%	1.9%

*Current quarter defined as Q3 2014
**Completions highlighted in Red if above 0.25% of Stock
***Under Construction highlighted in Red if above 1% of Stock
****Green if above city's historical average since 1990
Note: Above data includes only Neighborhood/Community centers; does NOT include power centers, regional malls, or lifestyle retail centers
Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; RCLCO

Neighborhood/Community Retail Pricing and Growth Expectations

Pricing variation by geographic market in retail is not as differentiated as in other property types, as retail yields vary more by sub-category and strength of the location. The graph below shows average cap rates and average expected NOI growth for the next five years, including expected improvements in occupancies and rents. **NOI growth for most markets is expected to be moderate as retail occupancies and rents did not fall in the downturn as much as some property types**, and also reflects reluctance of retailers to increase space needs amid strong e-commerce competition.



Initial yield and cash flow growth over the hold period are significant contributors to unlevered total return expectations. Low cap rates should thus be accompanied by higher growth expectations. While the above graph is an incomplete view, it does provide some indications of markets that should be particularly reviewed for further insights. For example, markets with low bars in the graph above may have less growth than needed to offset lower yields, or the growth may be more back-ended in a ten-year hold. Conversely, markets with high bars may be positioned to experience significant growth as compared to current pricing, or may be markets that are considered to be more risky and thus justify higher expected returns.

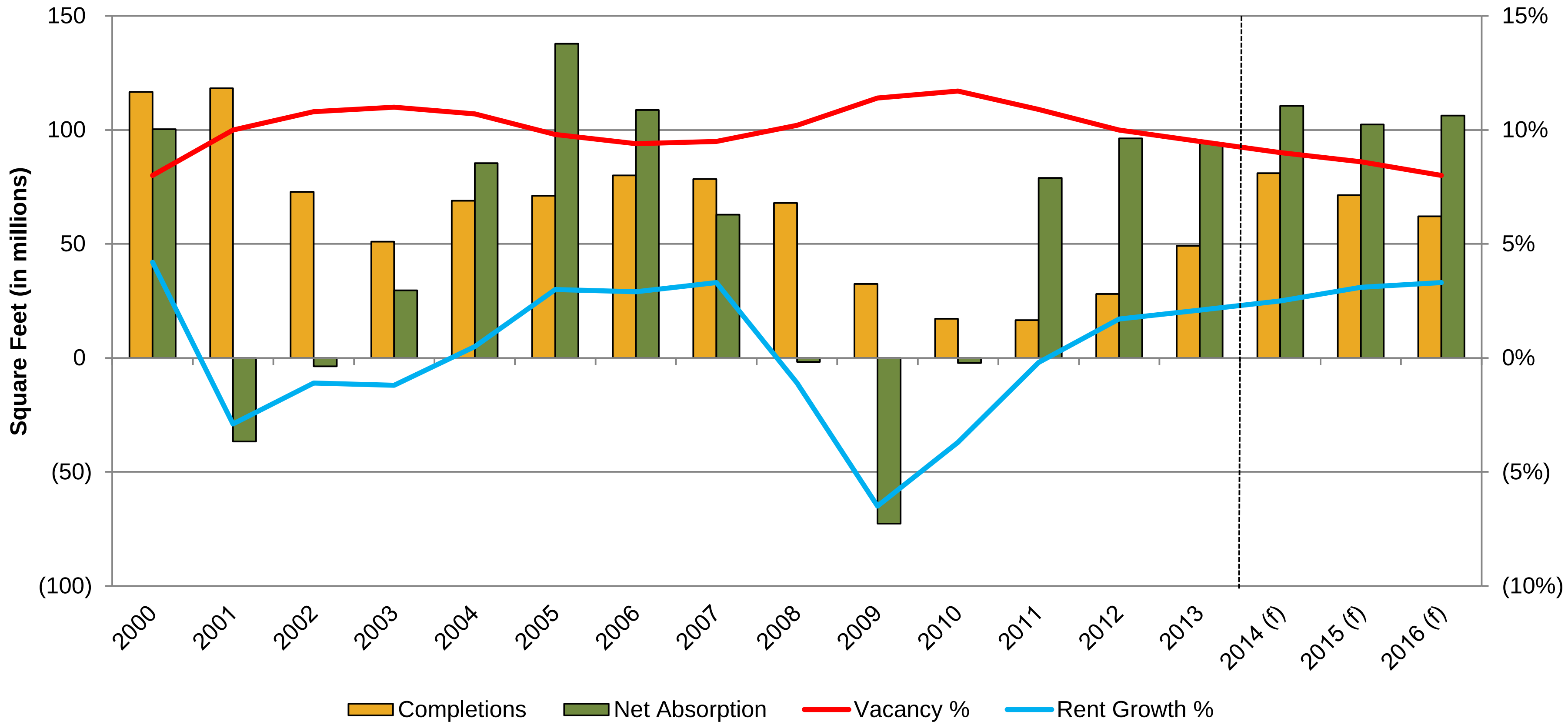
Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; CBRE; RCLCO

Industrial Fundamentals

U.S. Industrial Absorption Remains Strong

Industrial absorption recovered strongly from the depths of the downturn, and net absorption continues to outpace completions by a significant margin. The strong demand for industrial space is due in large part to significant increases in e-commerce activity, which has enhanced the need for large warehouse space, and the planned expansion of the Panama Canal that is expected to change the path of goods throughout the U.S. Vacancy has also improved relative to the previous market cycle, as rates have dropped to less than 10% and are projected to continue their downward trend. Rent growth is expected to continue to be positive, although the supply pipeline is rising in several markets.

U.S. Industrial Absorption, Vacancy, Rent Growth

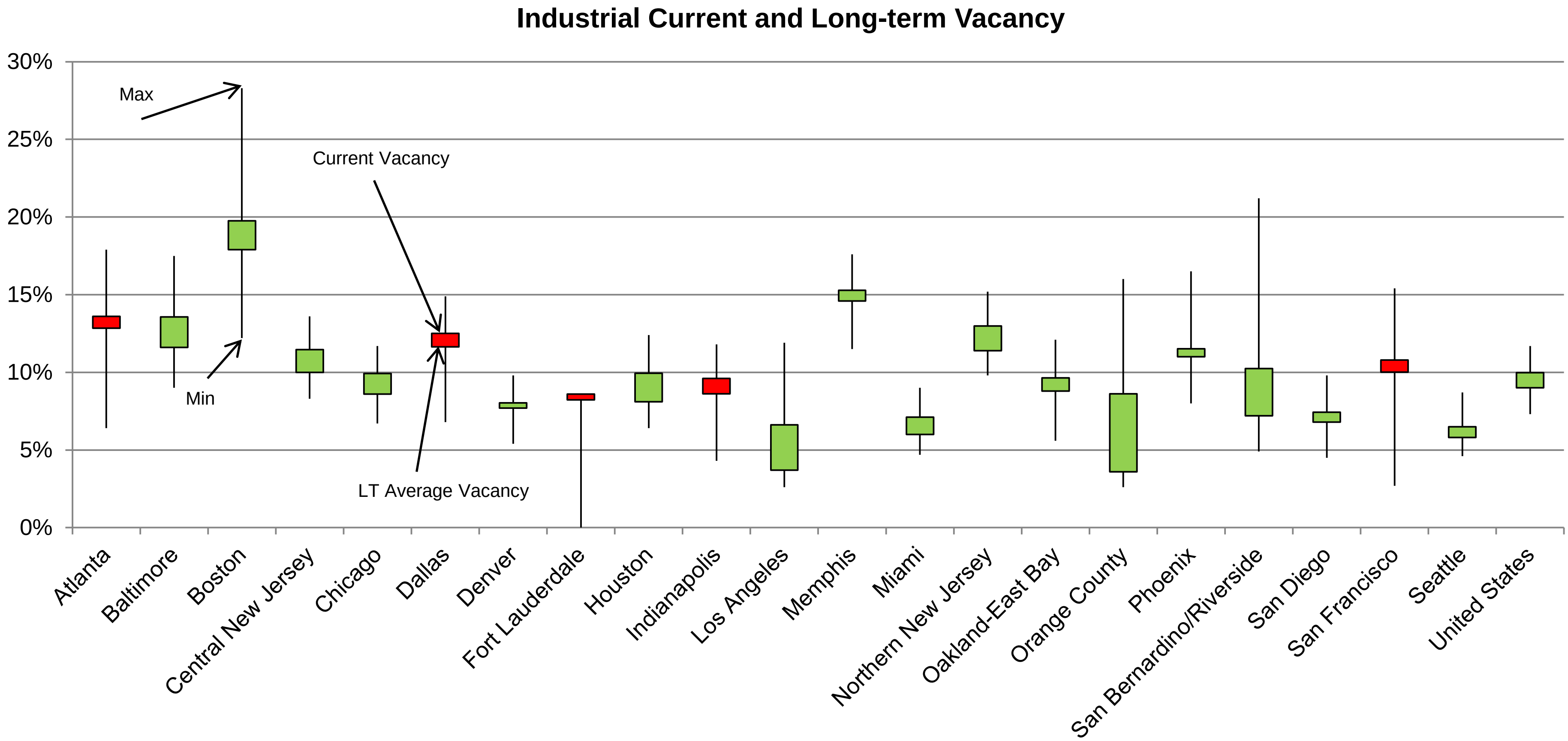


Source: Reis, Inc.; RCLCO

Industrial Vacancy Falling

Most major U.S. industrial markets continue to experience declining vacancies, and vacancy rates in most markets are currently lower than their long-term averages (1990-present).

New construction has started to pick up, but is not keeping pace with demand in most markets. Consequently, vacancy rates are projected to continue on a downward trend, and rents are projected to increase by nearly 2.5% in 2014.



Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets
Source: Reis, Inc.; RCLCO

U.S. Warehouse: Market Risk Indicator

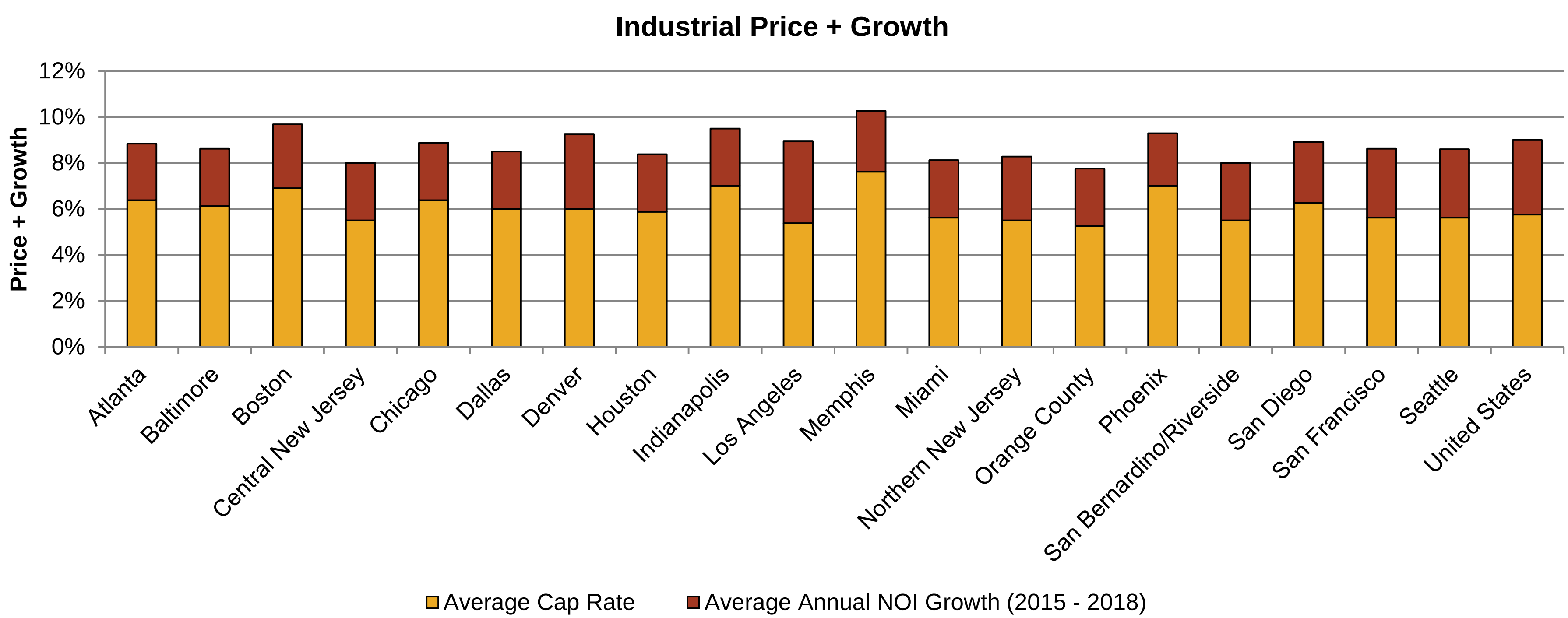
While rent levels continue to improve in the major warehouse markets, supply pipelines are significant in several markets and many markets experienced Q-o-Q vacancy increases in Q3 2014. Given the quick construction times and sparse pre-leasing of new industrial construction, construction data can change quickly. Demand has been high in both high-growth local markets and some big distribution markets, such as Dallas and Atlanta.

	Net Absorption % of Stock Current* Year	Completions % of Stock Current* Year**	Under Constr % of Stock Current***	Occupancy****	QoQ Occupancy Change	Y-o-Y Occupancy Change	QoQ Rent Growth	Y-o-Y Rent Growth
Atlanta	1.3%	0.8%	1.3%	86.2%	(0.1%)	0.6%	0.6%	3.2%
Baltimore	2.4%	3.1%	0.8%	89.3%	(0.2%)	0.0%	0.4%	1.5%
Boston	1.1%	0.0%	0.0%	90.2%	0.7%	1.0%	0.7%	1.3%
Central New Jersey	1.4%	0.8%	0.7%	90.0%	(0.4%)	0.2%	0.7%	2.2%
Chicago	1.4%	0.4%	2.0%	86.9%	0.4%	1.1%	1.0%	4.1%
Dallas	3.1%	4.2%	5.0%	86.1%	(0.5%)	0.1%	0.8%	2.9%
Denver	0.9%	0.6%	1.6%	90.6%	(0.2%)	0.0%	0.7%	2.7%
Fort Lauderdale	1.0%	0.4%	0.5%	90.4%	(0.3%)	(0.2%)	0.4%	1.8%
Houston	2.3%	3.0%	2.2%	91.3%	0.0%	(0.2%)	1.1%	4.3%
Indianapolis	1.5%	1.6%	1.4%	89.2%	0.0%	(0.4%)	0.6%	1.1%
Los Angeles	1.0%	0.2%	0.2%	93.3%	0.2%	0.6%	1.4%	3.9%
Memphis	0.8%	0.8%	0.2%	84.0%	(0.3%)	0.0%	1.8%	3.6%
Miami	0.6%	1.0%	0.6%	92.2%	(0.1%)	(0.2%)	0.3%	1.3%
Northern New Jersey	1.4%	0.8%	0.4%	88.6%	0.0%	0.9%	0.4%	2.0%
Oakland-East Bay	1.6%	1.3%	0.9%	90.0%	0.8%	0.8%	0.9%	2.6%
Orange County	0.6%	0.9%	1.0%	91.4%	(0.8%)	(0.3%)	0.2%	1.4%
Phoenix	1.5%	1.0%	0.9%	83.6%	0.2%	0.9%	1.0%	3.5%
San Bernardino/Riverside	2.0%	2.6%	3.2%	89.1%	(0.4%)	(0.5%)	0.5%	3.1%
San Diego	1.6%	0.4%	0.0%	90.2%	0.4%	0.6%	0.4%	1.2%
San Francisco	0.5%	0.0%	0.0%	92.1%	0.2%	0.8%	0.6%	1.6%
Seattle	0.9%	0.6%	2.1%	91.5%	(0.1%)	0.4%	0.5%	2.0%
United States	1.4%	1.0%	0.5%	88.9%	0.1%	0.5%	0.7%	2.3%

*Current quarter defined as Q3 2014; current year defined as 2014. Current year figures are projections for full year 2014
**Completions highlighted in Red if above 1% of Stock
***Under Construction highlighted in Red if above 1% of Stock
****Green if above city's historical average since 1990
Note: Above data includes only Warehouse's; does NOT include other industrial buildings
Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets.
Source: Reis, Inc.; CoStar; RCLCO

Industrial Pricing and Growth Expectations

Pricing varies significantly by market, with cap rates below 6% on average in several port oriented markets like those in Miami, California, and New Jersey. The graph below shows average cap rates and average expected NOI growth for the next five years, including expected improvements in occupancies and rents. West coast cap rates are generally lower, but are not always accompanied by higher expected cash flow growth. Pricing in the big five distribution markets (ATL, DAL, NNJ, CHI, and RIV) is split, with San Bernardino/Riverside and Northern New Jersey at low cap rates and the other three moderately priced.



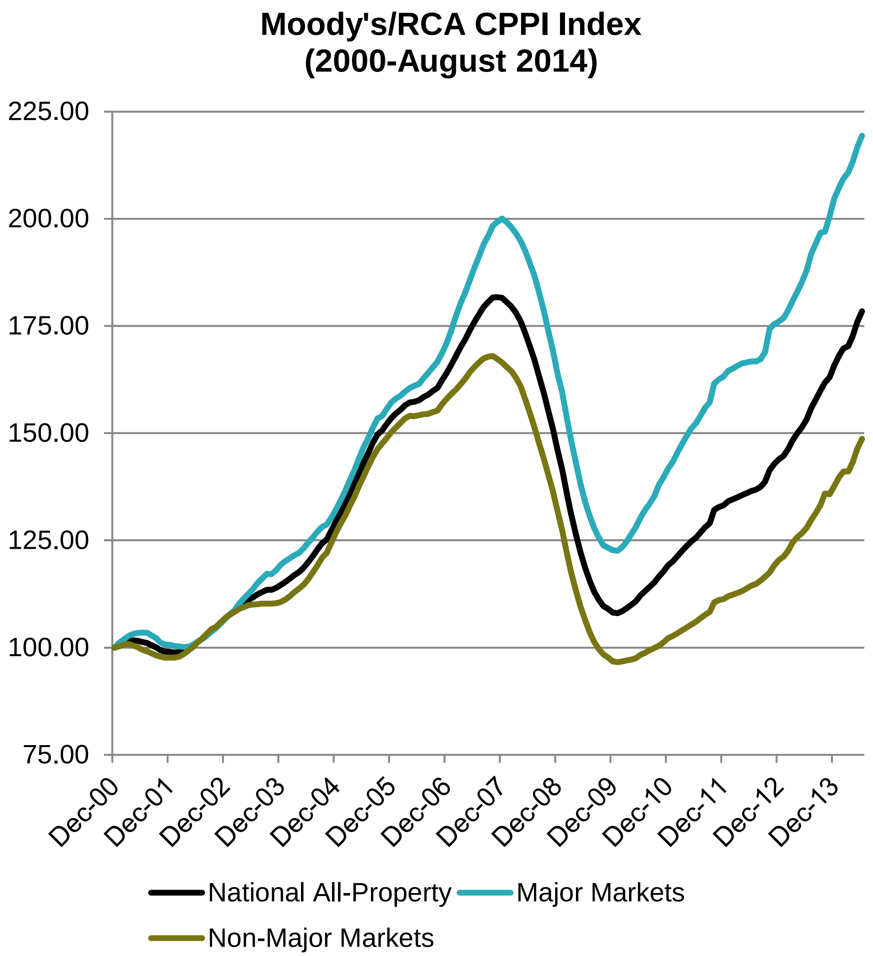
Initial yield and cash flow growth over the hold period are significant contributors to unlevered total return expectations. Low cap rates should thus be accompanied by higher growth expectations. While the above graph is an incomplete view, it does provide some indications of markets that should be particularly reviewed for further insights. For example, markets with low bars in the graph above may have less growth than needed to offset lower yields, or the growth may be more back-ended in a ten-year hold. Conversely, markets with high bars may be positioned to experience significant growth as compared to current pricing, or may be markets that are considered to be more risky and thus justify higher expected returns.

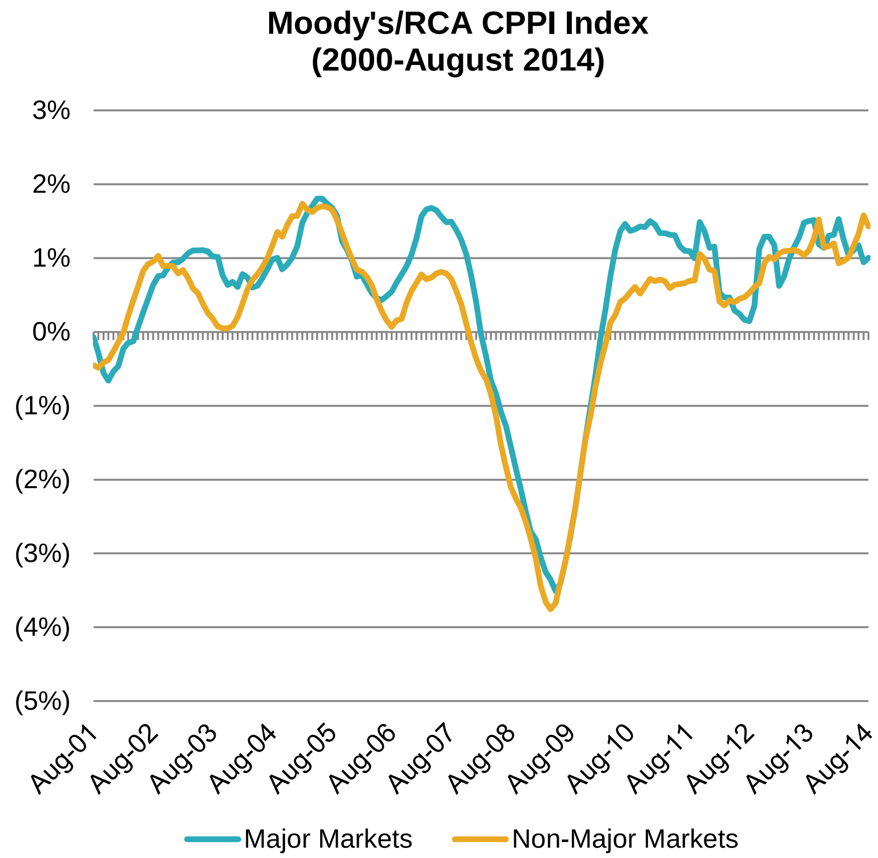
Note: The markets in the above chart are not necessarily MSAs or central cities, but are Reis-defined real estate markets
Source: Reis, Inc.; CBRE; RCLCO

U.S. Capital Market Trends

Pricing in Major Markets Hits New Highs

Bubble questions have been triggered again as pricing in the major markets has surpassed the previous peak. Even average Class A buildings in average locations in New York are fetching prices in excess of $1,000 psf. While secondary markets are not back to peak pricing, values have been rising just as quickly as in the primary markets as value-add funds have targeted these markets in the past couple of years, drawn by higher cap rates than the major markets and improving occupancy rates.



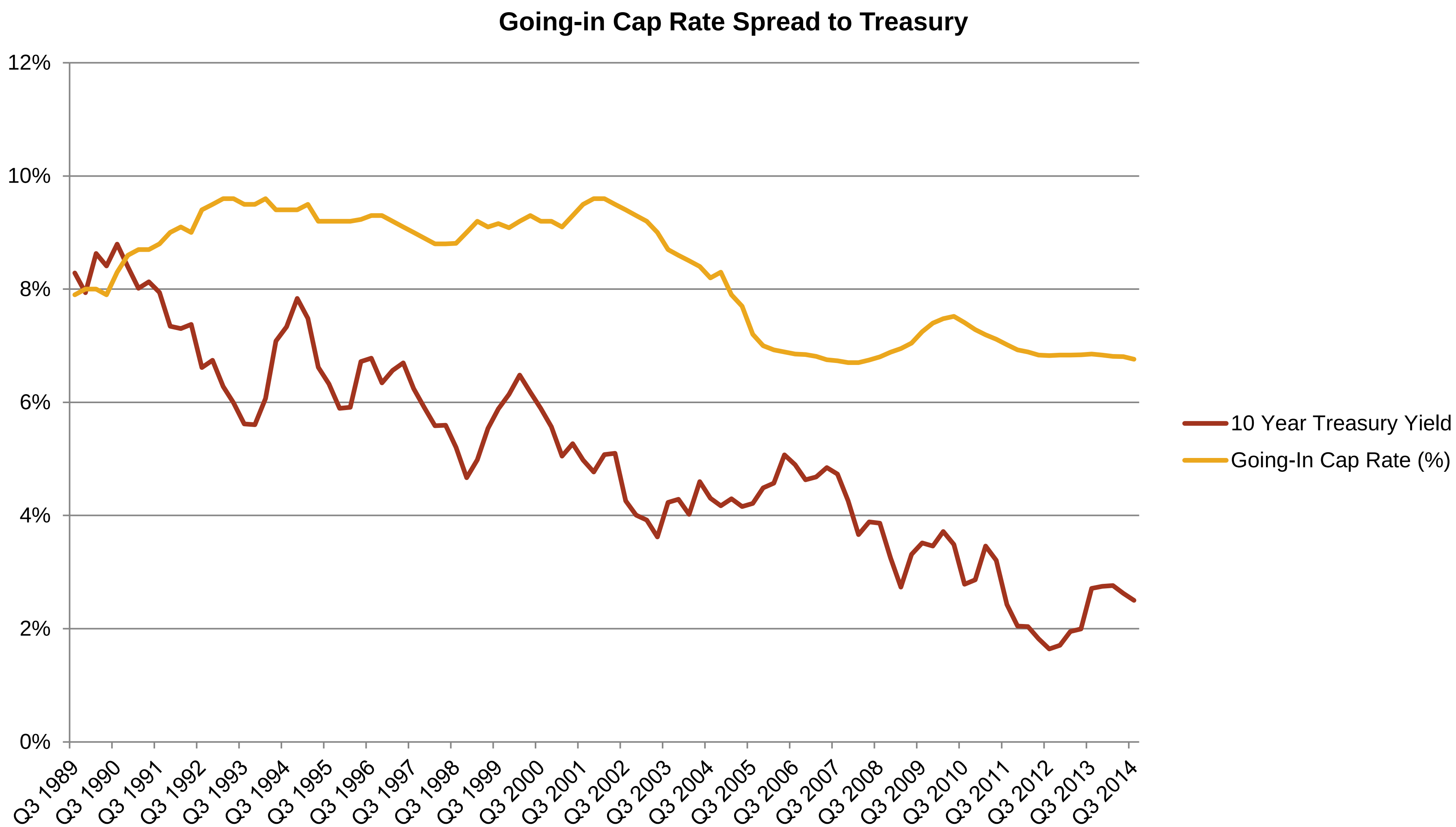


Source: RCA; Moody's Analytics; RCLCO

Cap Rate Spreads to Treasury Yields Are Still Wide

From Q3 2012 through Q1 2014, cap rate spreads to Treasuries compressed from 5.2% to 4.0% as interest rates rose. Yet spreads have increased in Q2 and Q3 2014 such that the spread is now 4.3%.

In any event, spreads continue to be wide by historical standards, indicating significant breathing room between current cap rates and Treasury yields if interest rates would start to rise.

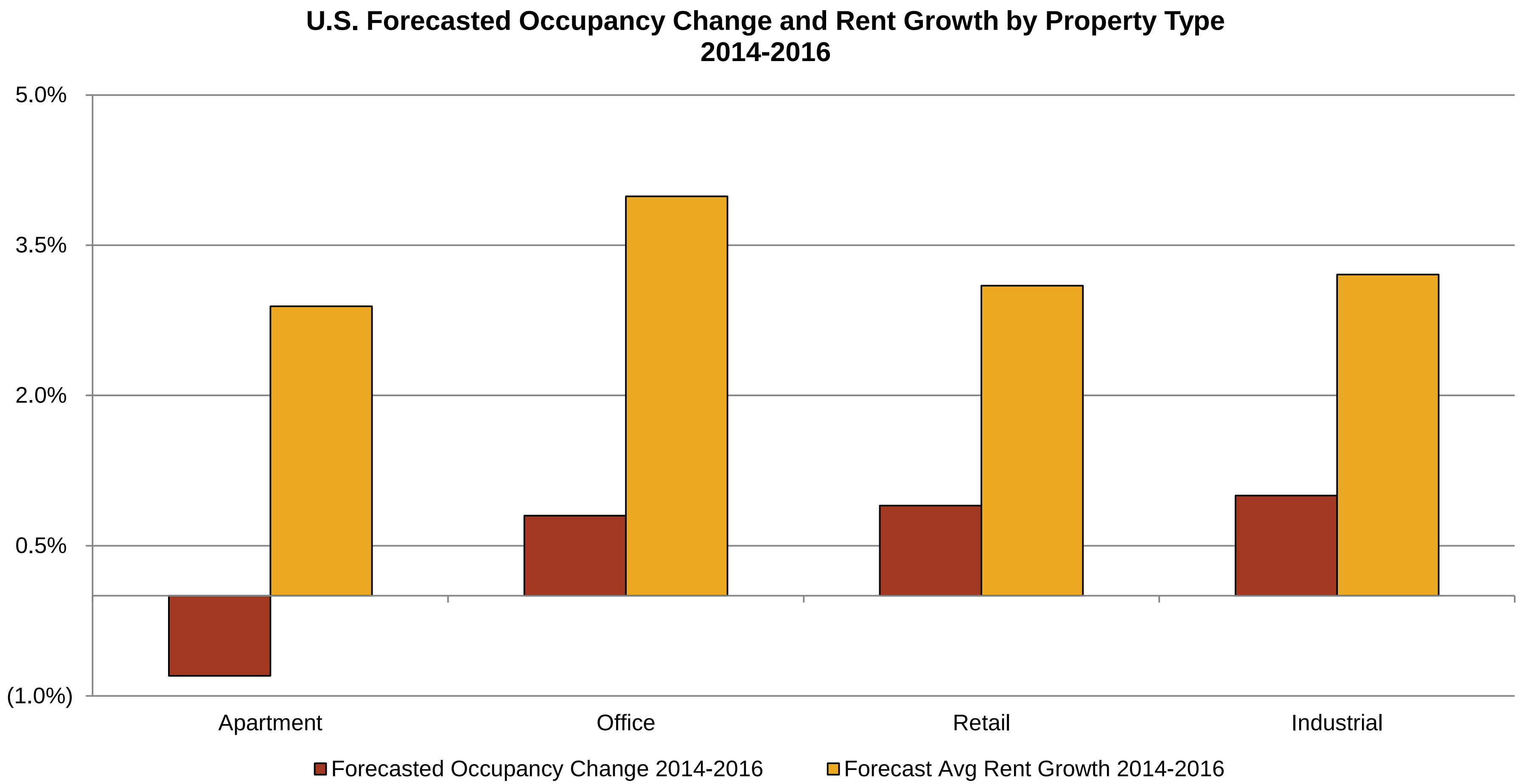


Source: RERC; Real Capital Analytics; Federal Reserve

RCLCO

But Most Forecasts Are for Positive NOI Growth

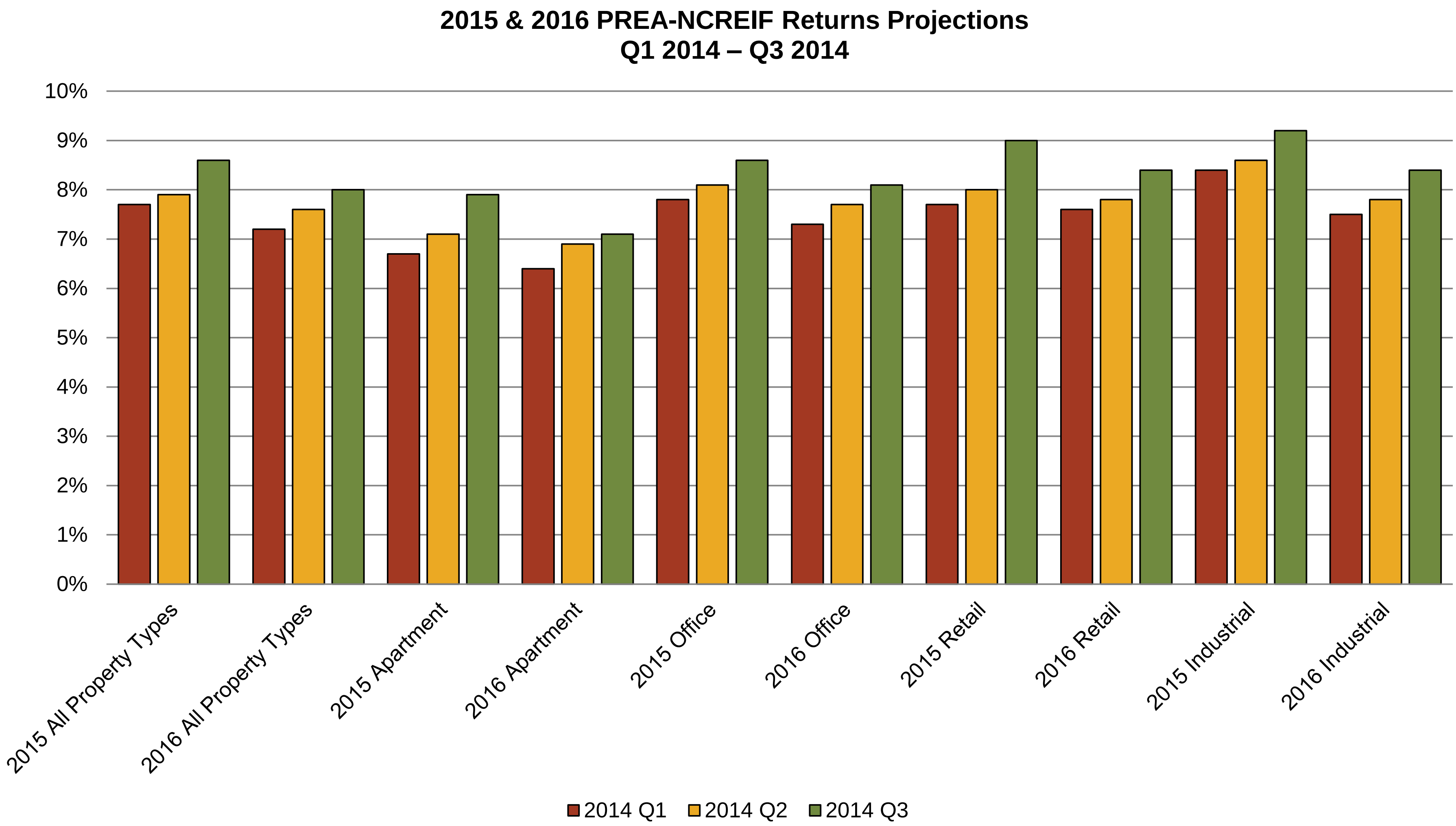
Another bright sign—with demand running ahead of construction, both occupancy and rents are expected to improve in the next few years in most markets. However, the outlook varies both by locality and property type. One example is the apartment sector. While apartment occupancy remains high at 96%, it was unchanged in Q2 and is expected to fall behind the fast pace of construction in the next couple of years.



Source: Reis, Inc.

Returns Projections for All Product Types More Optimistic

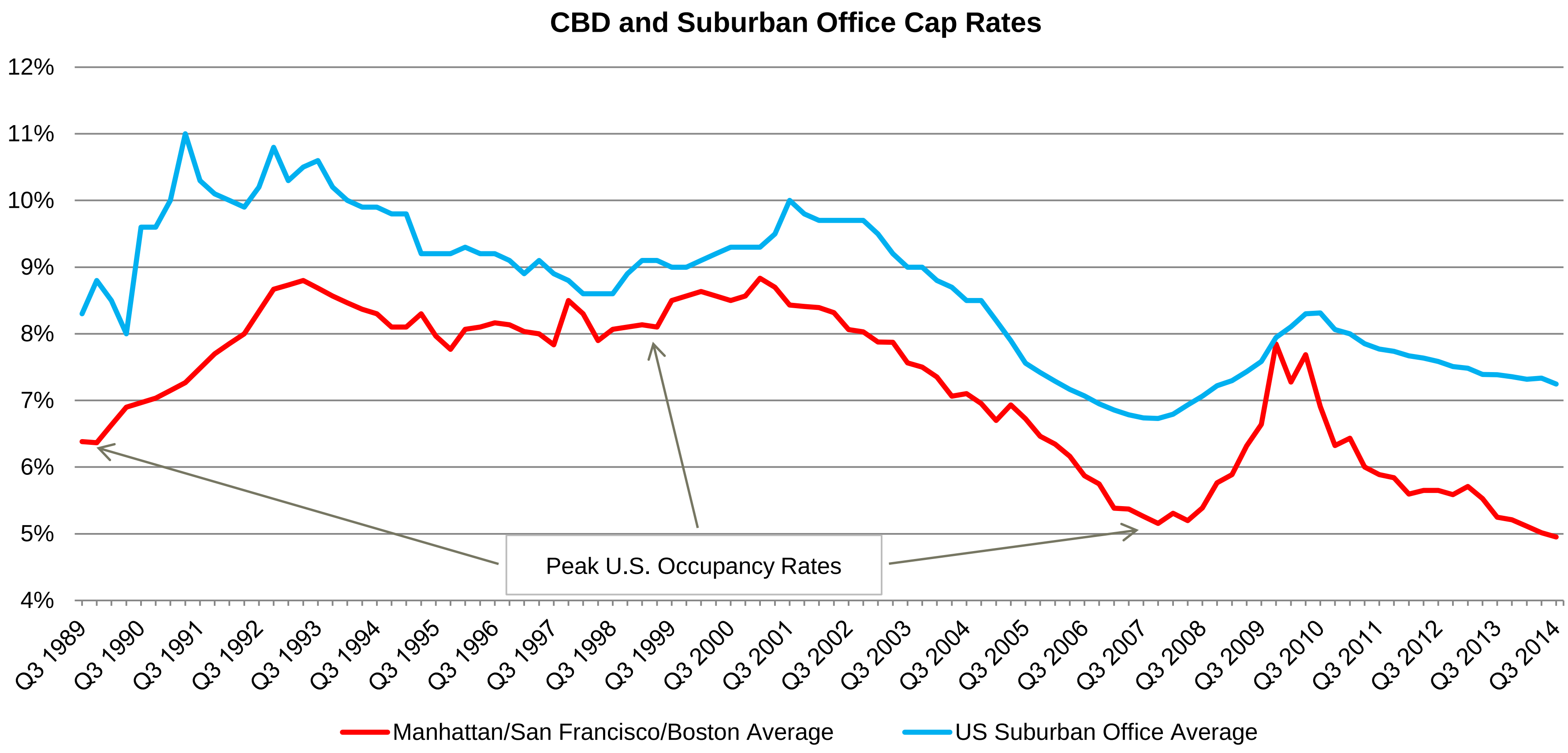
Increased optimism for appreciation-based return levels for 2014, 2015, and 2016 have driven up total returns in all asset classes. Projections for 2014 returns have increased by 270 bps since Q4 2013, while 2015 and 2016 projections have increased by 130 and 80 bps respectively since Q1 2014.



Source: PREA; NCREIF

Prime Markets also Experience Cap Rate Rises

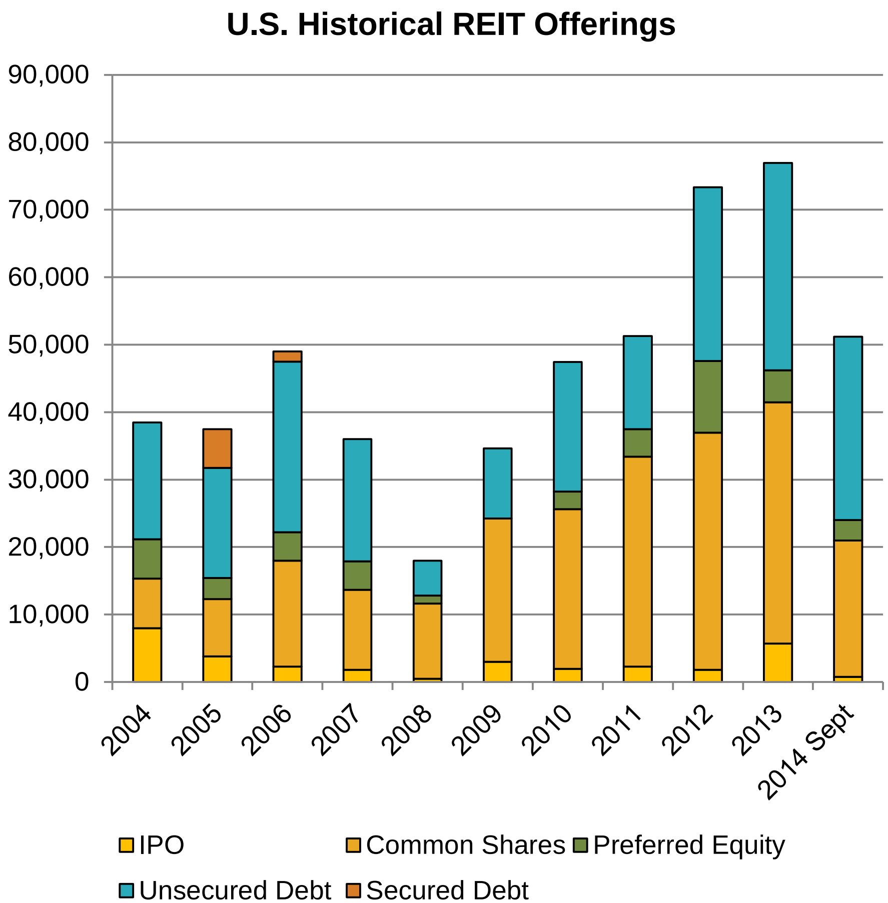
We sometimes hear an argument that cap rates in prime markets do not experience fluctuations as in other markets. However, market evidence indicates otherwise. The below graph shows office cap rates for New York, San Francisco, and Boston (reflective of "prime" markets) as compared with average suburban office cap rates. While prime markets do experience significantly lower cap rates during times of peak occupancy, prime cap rates do rise significantly in periods of market distress. These periods are generally associated with lower sales volumes, but nevertheless indicate significant changes in pricing. **Even if a property continues to produce cash flow and is not sold, annual valuations will reflect lower values as market cap rates climb.**

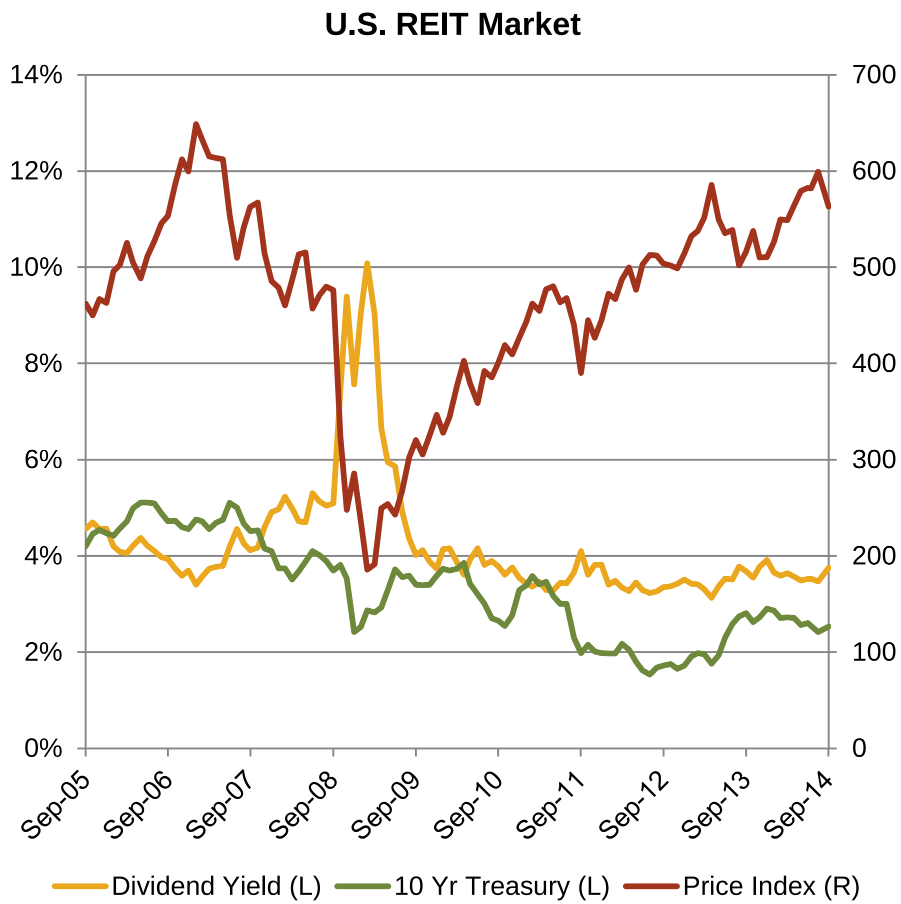


Source: NREI; PwC; RERC; RCLCO

REIT Prices Flatten

The U.S. REIT market, which sometimes leads the private market by six to nine months, is starting to show some signs of toppiness. Offerings hit an all-time high in 2013, yet so far in 2014 are not on pace to reach 2013 levels in any part of the capital stack. The market also showed some signs of nervousness ahead of the Fed's September interest rate guidance comments, with prices off by more than 5% in mid-September, the biggest price adjustment of the year.



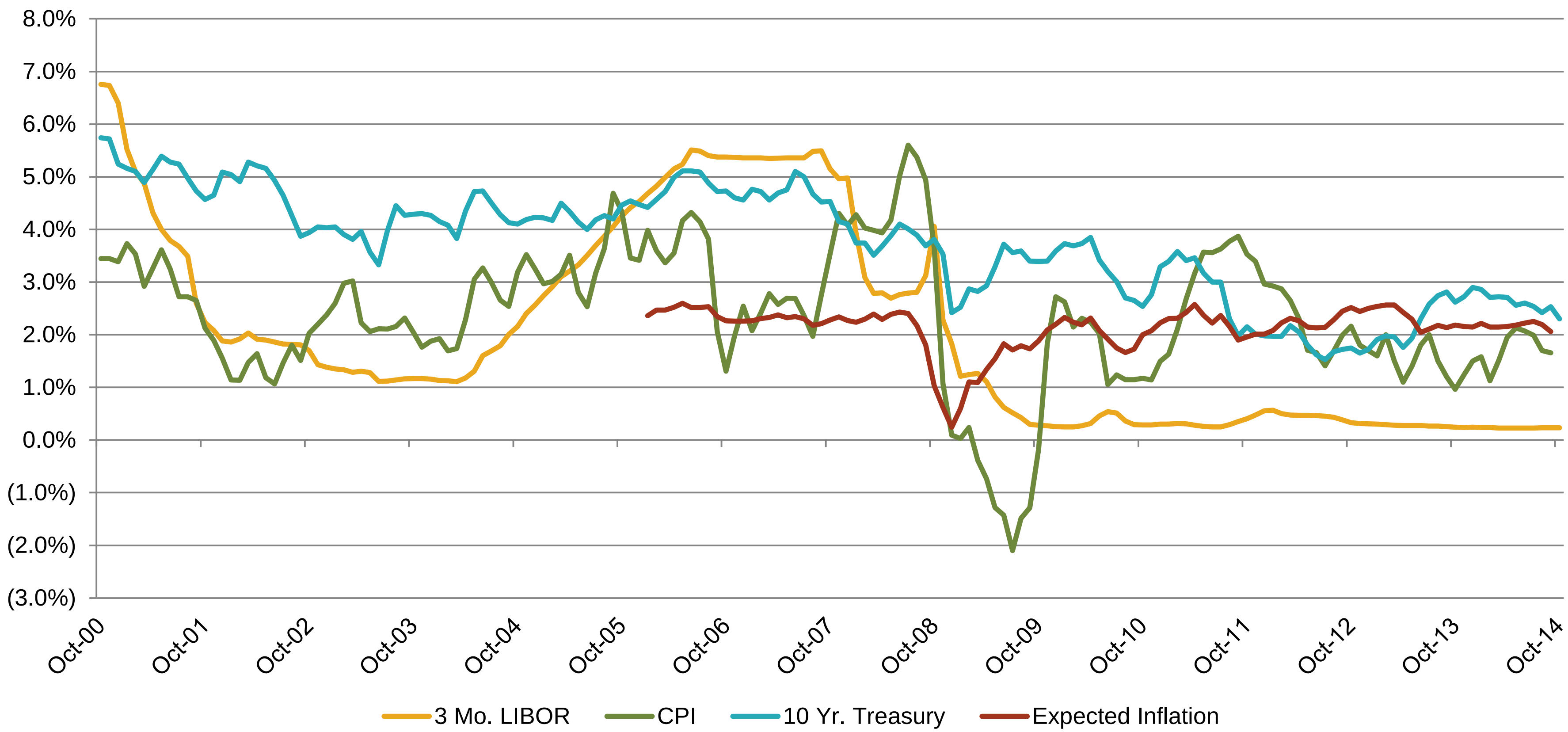


Source: SNL; NAREIT; RCLCO

Interest Rates and Inflation Remain Subdued

Despite rising to 3% at the end of 2013, 10-year Treasury yields have generally declined in 2014. Both actual and expected inflation remain low, which is giving the Fed pause in its eventual monetary tightening plans. Our estimates indicate another 50 to 150 bps+ increase in 10-year Treasury yields is likely just to return to normalized real rates. The question is when and how quickly this will happen. October 10-year Treasury yields are down to a point lower than any month since June of 2013, although it is unlikely that this will result in a prolonged downward trend. Cap rates are expected to be less volatile, and are unlikely to face significant pressure until Treasury yields surpass 3.5%.

Nominal Interest Rates and Inflation
2000 - 2014 YTD

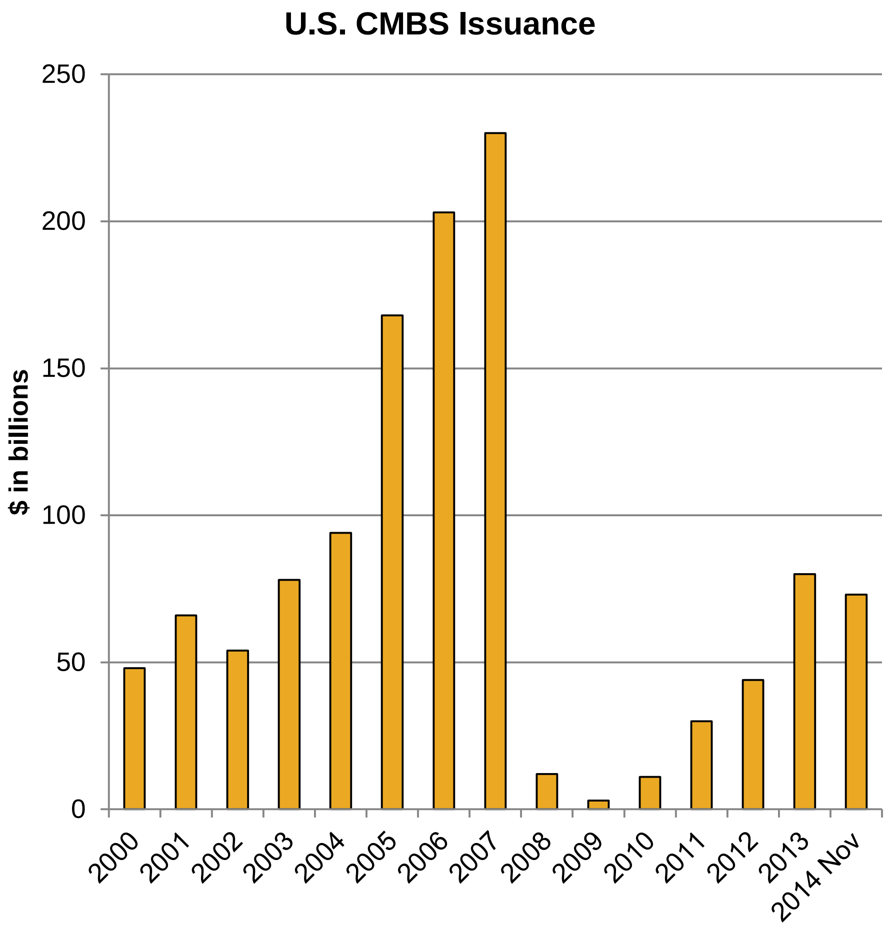


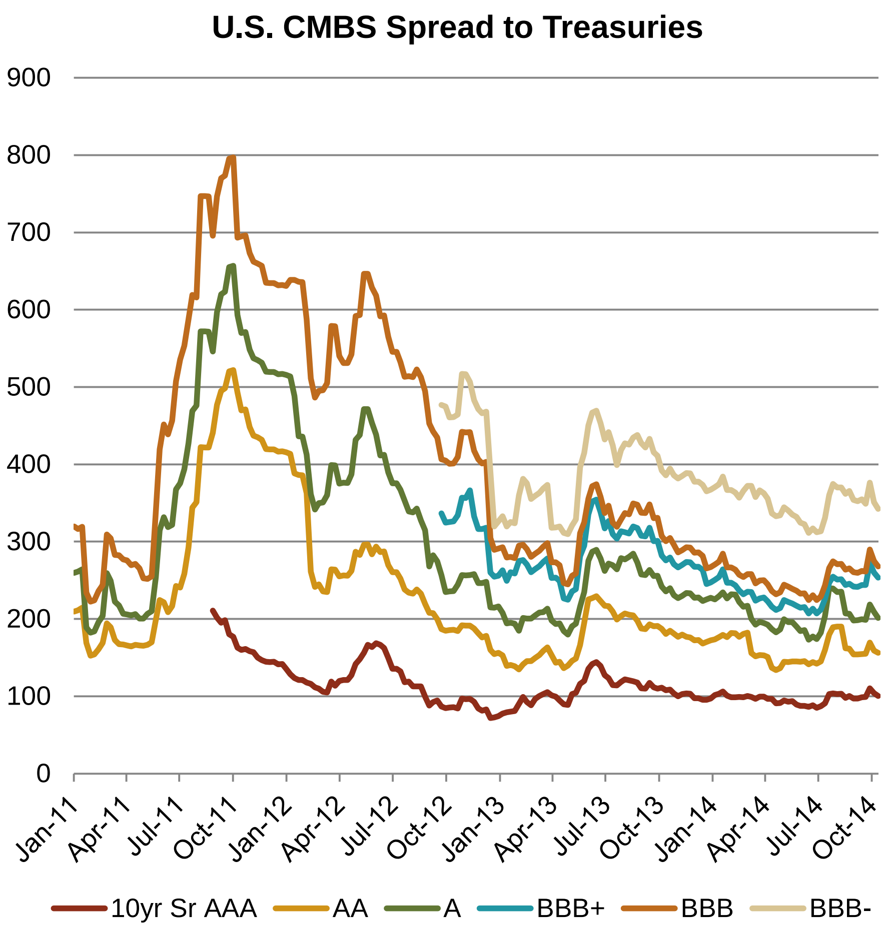
Source: BLS; Federal Reserve, www.fedprimerate.com; RCLCO

CMBS Market Recovering

The CMBS market continues to recover, albeit slowly, with improvements in both issuance and pricing. CMBS issuance in 2014 is outpacing 2013 issuance, and 2014 will likely mark the 5th straight year of CMBS issuance growth.

After spiking a year ago, CMBS spreads have gradually descended (despite a quick uptick in September), reflecting generally positive property fundamentals.

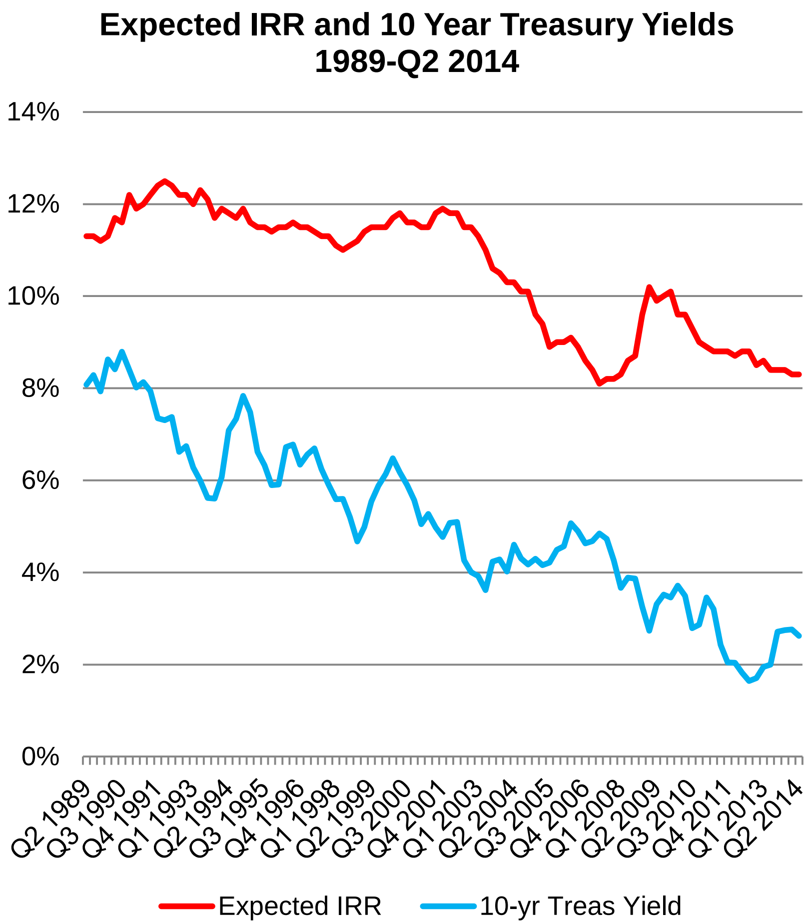


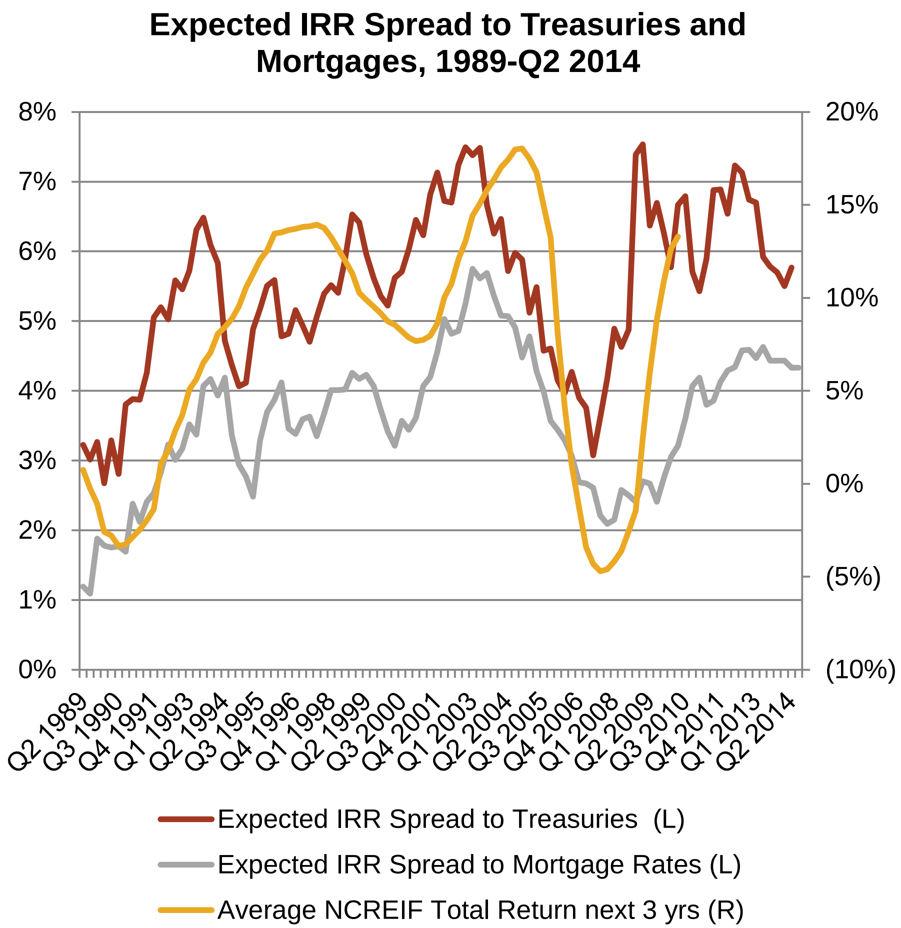


Source: CRE Finance Council; JP Morgan; ULI; RCLCO

Total Return Expectations Are also in Line with Capital Markets

A more complete picture is to view total return expectations, which take into account both current pricing and future cash flow expectations. Historically, while not a perfect indicator, when total return expectations were at narrow spreads to Treasury yields, actual returns in the next three years generally underperform. **While the spread between total return expectations for commercial real estate to Treasuries is narrowing, the spread is wide enough to indicate positive returns over the next few years.**

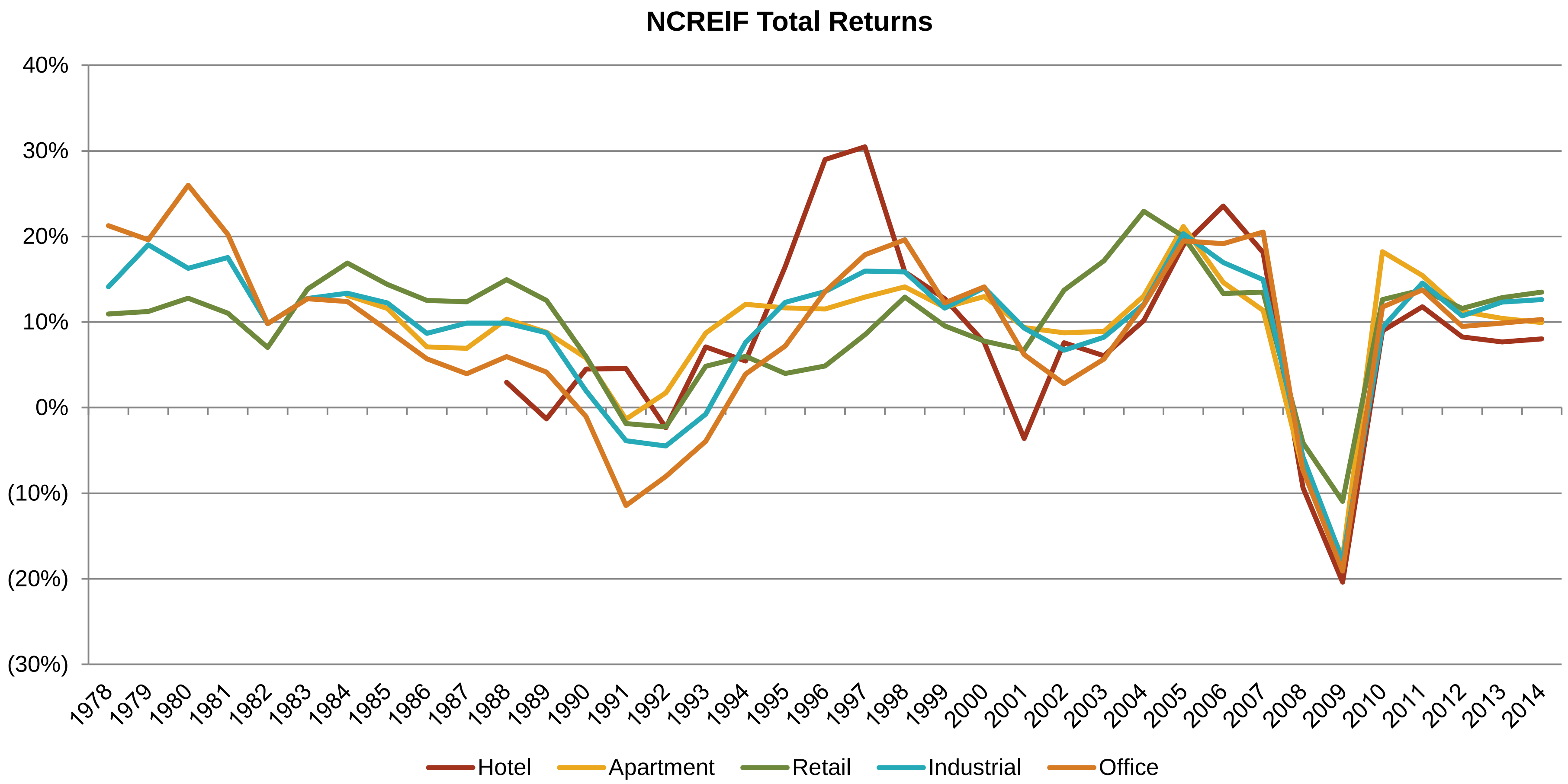




Source: RERC

Retail Slows, Hotel Shows Life in Q3

Q3 2014 total returns for the five major property types potentially mark a shift in the performance of these asset classes. While retail assets have generally outperformed the other four property types since 2012, retail assets delivered the lowest returns of any property type in Q3 2014. Hotel assets had the highest returns of any asset class in Q3, and this was the first time this has happened since Q1 2011.



Note: 2014 is a rolling four quarter average of Q4 2013 through Q3 2014
Source: NCREIF; RCLCO

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