RCLCO U.S. Real Estate Chart Book

SECOND QUARTER 2013

RCLCO

ROBERT CHARLES LESSER & CO.

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

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RCLCO

RCLCO has been the "first call" for strategic and tactical advice regarding property investment, planning and development since 1967. With more than 40 staff in four locations, RCLCO provides consulting services in the areas of Institutional Advisory Services, Urban Real Estate Advisory, Community and Resort Advisory, Public Strategies, and Strategic Planning and Litigation Support. RCLCO is an employee-owned firm that exclusively provides consulting services.

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

- Strategic planning and investment policies
- Portfolio development and manager selection
- Portfolio analysis and monitoring
- Investment analysis
- Market analysis and independent research

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RCLCO OUTLOOK – FROM THE GROUND UP

A 100 bp rise in U.S. 10-year treasury rates in May and June caused temporary disruption in the mortgage and sales markets in June as investors and lenders alike attempted to sort out where interest rates would land. There has since been some improvement in the public markets, including treasuries, CMBS spreads, and REIT prices (although volatility remains), indicating that we may at least temporarily be staying somewhere near 2.5% to 3% treasury rates with less drastic increases in mortgage rates and cap rates.

Longer-term, given expected inflation in the 2% to 2.5% range, 10-year treasury rates near 3.5% or higher are more likely as quantitative easing slows and the bond markets return to more normalized spreads. Fortunately, cap rates for most property types have already priced in higher bond rates and are still pricing at wide spreads to treasuries. Our fair value cap rate model indicates some upward, but not significant, pressure on cap rates (p. 40) as of Q2 2013. If treasuries start approaching 3.5% or higher, our analysis indicates upward pressure on cap rates of 25-50 bps with the most pressure on several apartment markets and prime CBD office that are already priced near peak rates and are experiencing a significant amount of new construction. Also watch for assets with characteristics that increase interest rate risk, such as low growth or unstable cash flows, high leverage, low debt service coverage ratios, short hold periods, variable rate financing, or near-term financing needs. See RCLCO's special publication, "Interest Rates and Real Estate Pricing Risk," for a more detailed analysis of this topic.

The good news is that property markets are generally improving, with positive momentum in both occupancy and rents. Occupancy gains are particularly strong in both local industrial markets (Austin, Boston, San Diego) and national distribution hubs such as Atlanta, Riverside, and Memphis, as well as several office markets, including Orange County, San Diego, and San Jose. Construction is picking up across all property types, with strong activity in many apartment markets and some prime CBD office markets, namely New York and the D.C. and San Francisco Bay regions.

The slow growth U.S. economic figures are masking significant regional growth in many areas. Goods producing jobs are being supported by significant improvements in the residential construction and energy sectors. Even manufacturing employment is up y-o-y in a number of regions as of June. In addition to several states in the Mountain Northwest, Michigan joins the ranks of top performers with manufacturing employment up by 2.5% y-o-y in June.

-Paige Mueller, Director of Institutional Advisory Services

SECTOR FUNDAMENTALS

U.S. REAL ESTATE CYCLE

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

Multifamily
Prime CBD Office
Hotel
Industrial
Single Family
Suburban Office
Retail

Multifamily is leading the real estate cycle with new construction underway in several markets. Construction is also picking up in prime CBD and some hotel segments. The single-family sector improved significantly in the first half of the year.

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

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

SOURCE: RCLCO

APARTMENT FUNDAMENTALS

U.S. APARTMENT ABSORPTION CONTINUES TO OUTPACE COMPLETIONS

2nd Quarter 2013 apartment vacancy was unchanged quarter-over-quarter at 4.3% but was down 50 bps year-over-year as new completions met demand. Owners have pricing power as they leverage low vacancies into rent growth for the 14th straight quarter. Vacancies are expected to hit cycle lows this year, with completions outpacing absorption from 2014 through 2017 as developers take advantage of high rents and occupancy. The rent growth forecast below could face some downward pressure if new construction occurs faster than expected.

U.S. APARTMENT ABSORPTION, VACANCY, RENT GROWTH

Square Feet (in millions)

250 | 200 | 150 | 100 | 50 | 0 | -50

12.5% | 10.0% | 7.5% | 5.0% | 2.5% | 0.0% | -2.5%

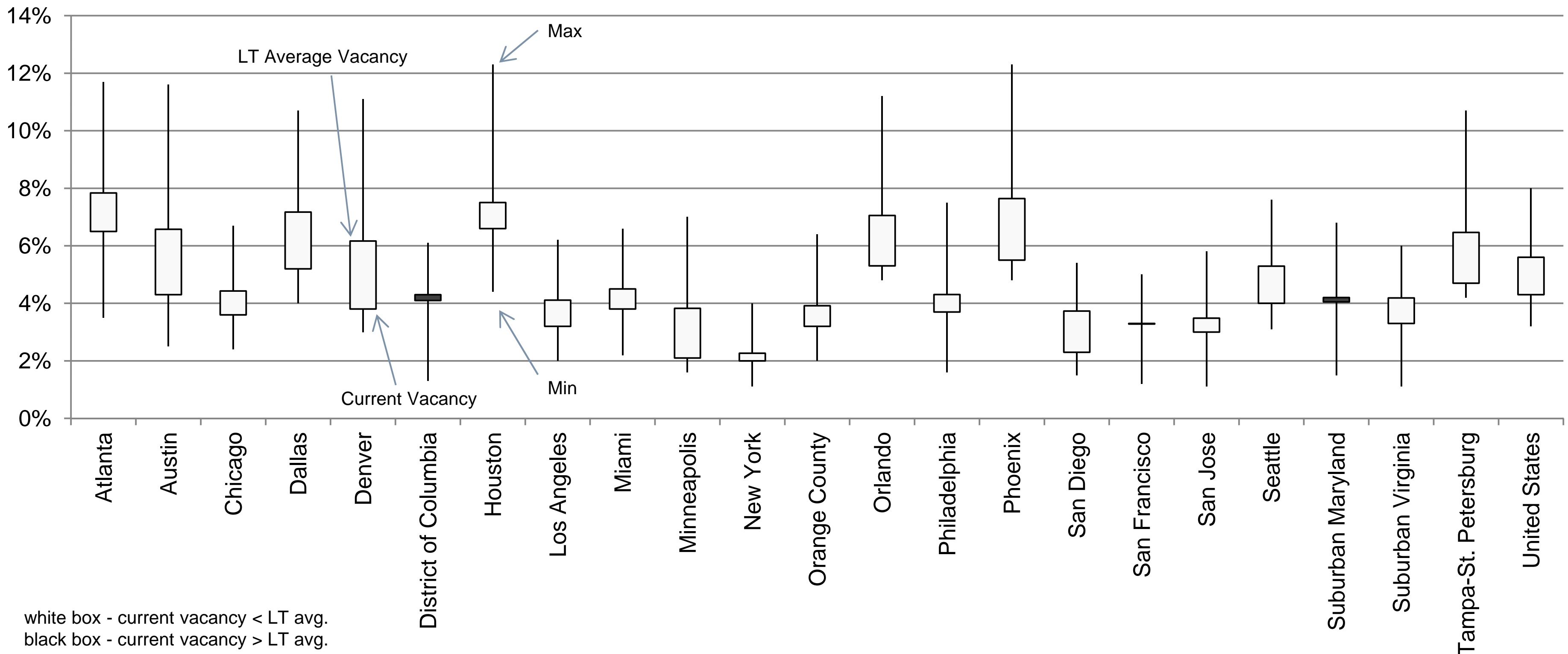
1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 (f) | 2014 (f) | 2015 (f) | 2016 (f) | 2017 (f)

Completions | Net Absorption | Vacancy % | Rent Growth %

SOURCE: Reis, Inc.

APARTMENT VACANCY HISTORICALLY LOW

Most major U.S. apartment markets are experiencing much lower current vacancy than their long-term (1990-present) average. Denver, with its sub-4% vacancy rates, is more than 200 bps below its historical average. The only two markets with above-average vacancy are Washington, D.C. (with its neighbor Suburban Maryland) and San Francisco at 4.3% and 3.3%, respectively.



NOTE: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.

U.S. APARTMENT: TOP METROS RISK INDICATOR

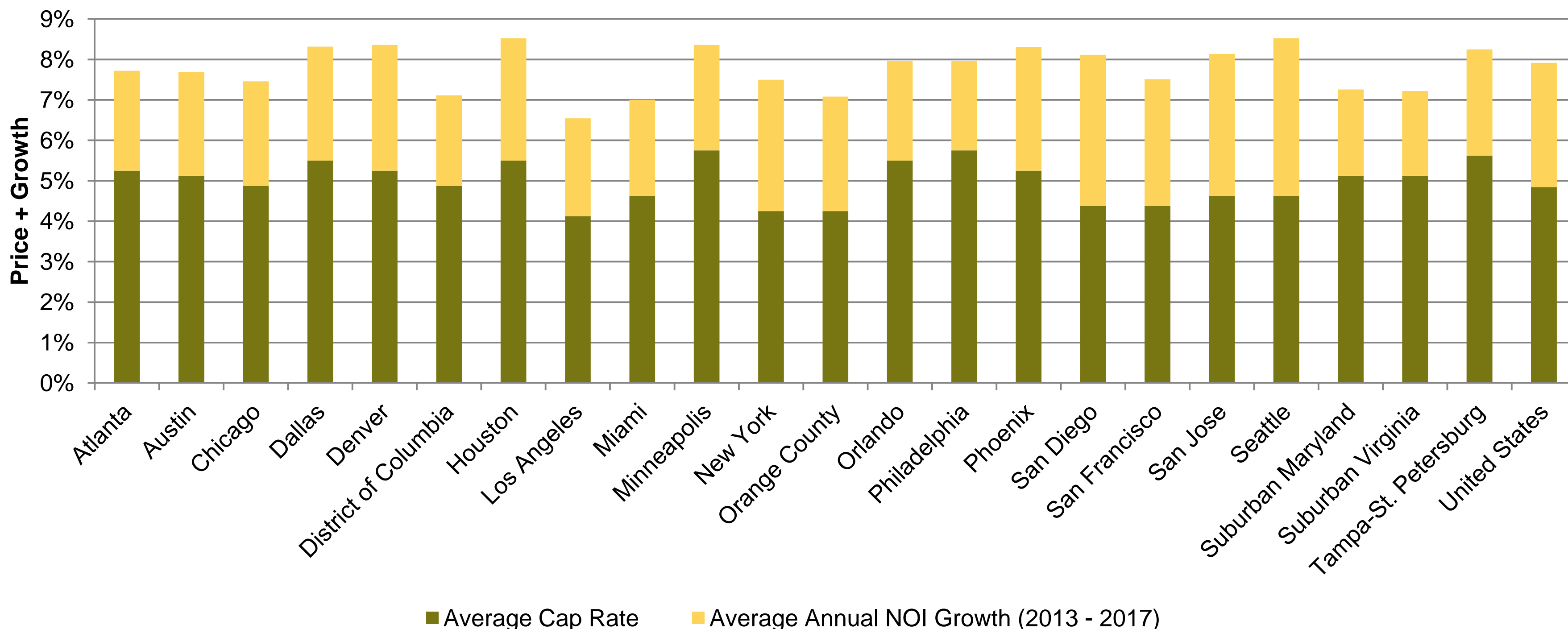
Occupancy and rents continue to rise in most major apartment cities, with year-over-year rent growth surpassing 6% in Seattle. Due to historically high occupancy and rent levels, construction has picked up in most cities and is greater than 4% of current inventory in many cities.

	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%	0.18%	1.20%	93.5%	0.1%	0.9%	0.6%	2.2%
Austin	0.5%	0.87%	7.33%	95.7%	-0.3%	0.0%	0.7%	2.9%
Chicago	0.2%	0.12%	1.22%	96.4%	0.1%	0.5%	0.6%	2.5%
Dallas	0.6%	0.51%	3.95%	94.8%	0.0%	0.6%	0.9%	3.0%
District of Columbia	0.3%	0.47%	6.89%	95.7%	-0.1%	-0.1%	0.6%	1.9%
Denver	0.6%	0.56%	4.73%	96.2%	0.1%	0.4%	1.0%	3.5%
Houston	0.5%	0.32%	3.27%	93.4%	0.2%	1.1%	0.8%	4.3%
Los Angeles	0.2%	0.20%	1.21%	96.8%	0.0%	0.4%	0.6%	2.8%
Miami	0.4%	0.45%	2.36%	96.2%	0.0%	0.5%	0.6%	2.3%
Minneapolis	0.4%	0.25%	3.33%	97.9%	0.2%	0.3%	0.7%	3.1%
New York	0.3%	0.37%	4.83%	98.0%	-0.1%	0.2%	1.0%	2.6%
Orange County	0.2%	0.00%	1.50%	96.8%	0.2%	0.4%	0.7%	2.8%
Orlando	0.4%	0.26%	3.16%	94.7%	0.1%	0.9%	0.8%	3.5%
Philadelphia	0.2%	0.38%	1.31%	96.3%	-0.2%	0.2%	0.9%	2.5%
Phoenix	0.3%	0.25%	1.70%	94.5%	0.1%	1.0%	0.7%	2.4%
San Diego	0.0%	0.19%	1.91%	97.7%	0.1%	0.7%	0.6%	2.7%
Seattle	0.5%	0.39%	5.34%	96.0%	0.1%	0.2%	1.3%	6.2%
San Francisco	0.3%	0.40%	2.48%	96.7%	-0.1%	-0.2%	1.1%	4.1%
San Jose	0.9%	1.47%	4.50%	97.0%	-0.5%	-0.5%	1.4%	4.5%
Suburban Maryland	0.2%	0.40%	4.84%	95.8%	-0.2%	0.0%	0.4%	2.6%
Suburban Virginia	0.3%	0.39%	5.86%	96.7%	-0.1%	0.3%	0.5%	2.4%
Tampa-St. Petersburg	0.4%	0.00%	2.32%	95.3%	0.4%	1.2%	0.6%	2.9%
United States	0.3%	0.27%	2.65%	95.7%	0.0%	0.5%	0.7%	2.8%

*Current quarter defined as Q2 2013
**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 cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.

APARTMENT PRICING AND GROWTH EXPECTATIONS

Investors continue to favor the low vacancy rates of the apartment sector with average Class A cap rates of around 5% or lower. The below graph shows average Class A cap rates and average expected NOI growth for the next five years including expected changes in occupancies and rents. While NOI growth going forward is expected to be strong overall as a reflection of current low vacancy rates, forecasts could be moderated downward going forward if construction picks up faster than expected.



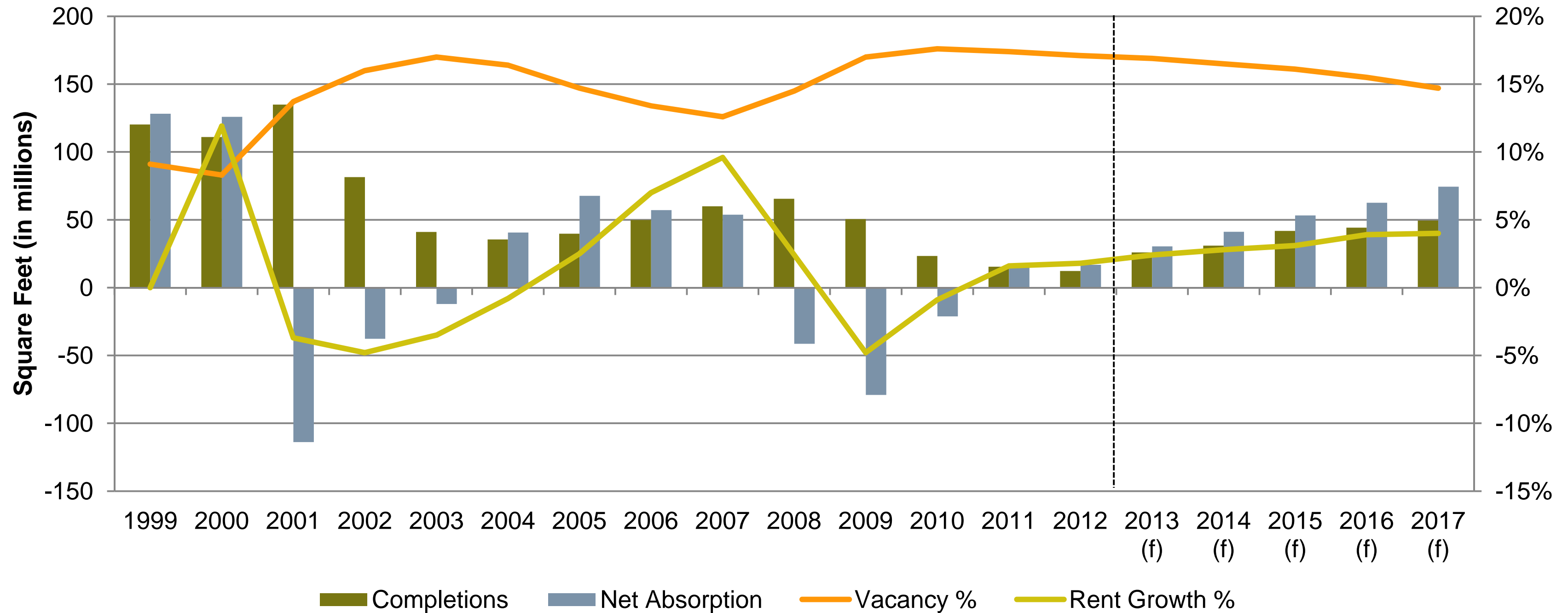
Initial yield and cash flow growth over the hold period are significant contributors to unlevered total return expectations. Low cap rates should thus be accompanied by higher growth expectations. While the above graph is an incomplete view, it does provide some indications of markets that should be 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 cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.; CBRE

OFFICE FUNDAMENTALS

U.S. OFFICE ABSORPTION IMPROVES

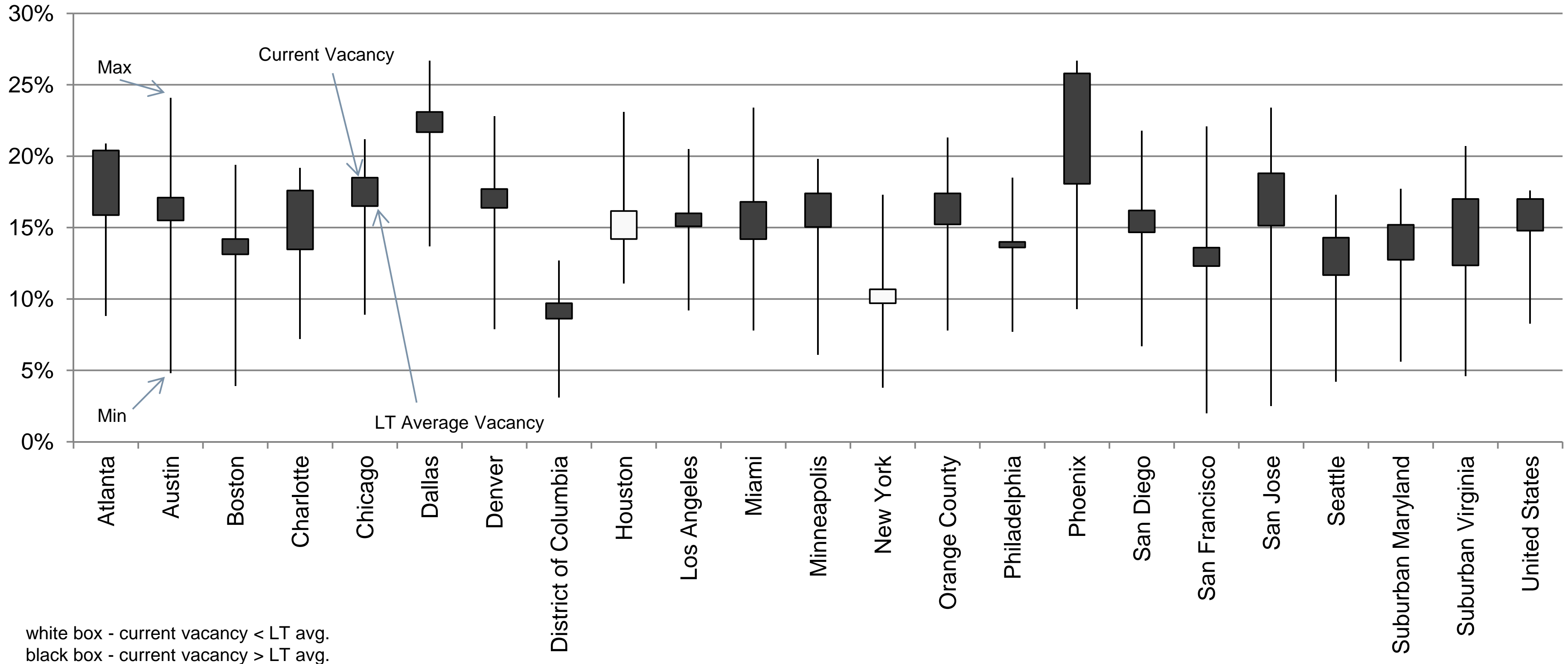
2nd Quarter 2013 office vacancy was unchanged quarter-over-quarter at 17.0% but was down by 30 bps year-over-year. Net demand was slightly positive in Q2 2013 as the economy and service sector employees continue to recover from the downturn. With office absorption expected to outpace completions over the next three years nationally, vacancy is expected to fall to below 15% by 2017.



SOURCE: Reis, Inc.

OFFICE VACANCY GENERALLY STILL HIGH

Most major U.S. office markets are experiencing higher current vacancy than their long-term (1990-present) average. Phoenix has the highest current vacancy rate of these major markets at 26%. The only two markets with below-average vacancy are Houston and NYC at 14.2% and 9.7%, respectively.



NOTE: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.

U.S. OFFICE: TOP METROS RISK INDICATOR

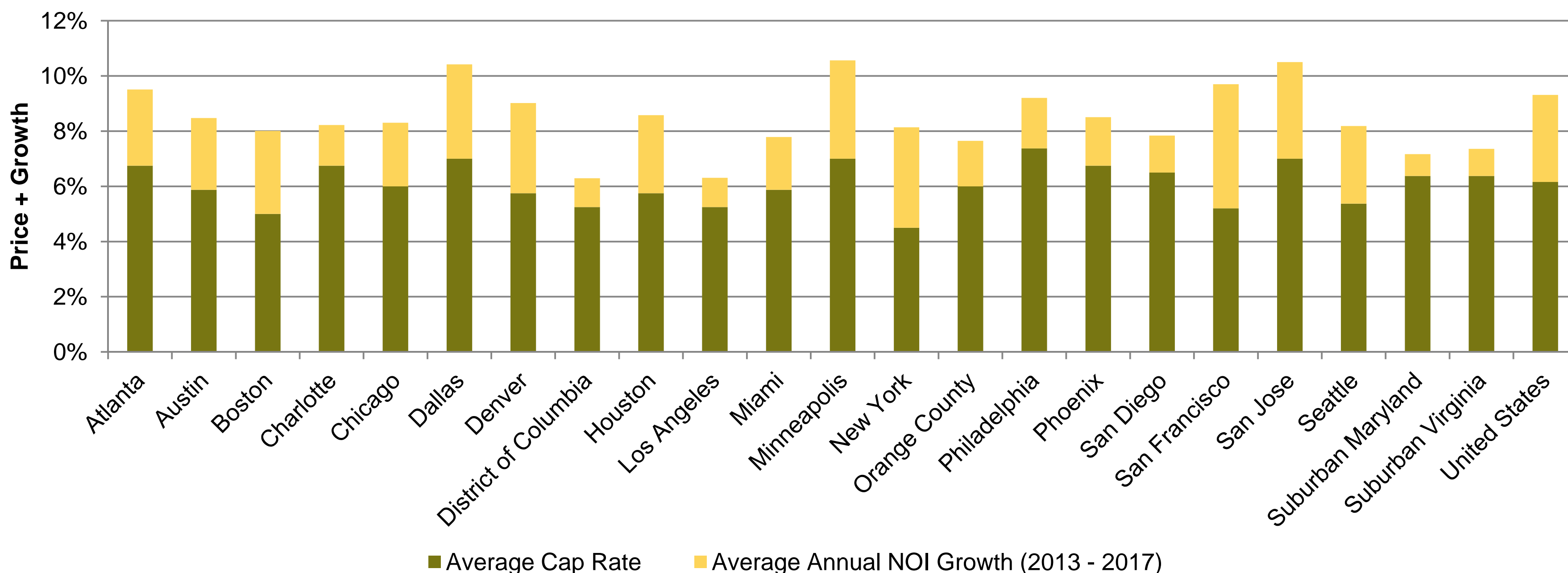
Occupancy levels continue to rise in most major office cities, yet they remain lower than their historical city averages. Rents continue to increase, and are beginning to reach levels that are high enough to justify new construction as pipelines are picking up from current levels in several cities.

	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	0.4%	0.25%	0.4%	79.6%	0.2%	0.4%	0.2%	1.1%
Austin	0.1%	0.07%	2.6%	82.9%	0.0%	0.2%	0.6%	2.0%
Boston	0.1%	0.25%	2.3%	85.8%	-0.1%	0.4%	0.6%	1.7%
Chicago	0.0%	0.02%	0.5%	81.5%	0.0%	0.2%	0.4%	2.2%
Charlotte	-0.1%	0.00%	0.2%	82.4%	-0.1%	-1.2%	0.4%	1.9%
Dallas	0.4%	0.16%	2.8%	76.9%	0.2%	0.5%	0.6%	3.2%
District of Columbia	-0.1%	0.03%	1.6%	90.3%	-0.2%	-0.6%	-0.1%	0.9%
Denver	0.3%	0.00%	0.3%	82.3%	0.3%	0.9%	0.5%	1.8%
Houston	0.6%	0.83%	2.5%	85.8%	-0.1%	0.4%	0.6%	4.0%
Los Angeles	-0.3%	0.01%	0.4%	84.0%	-0.3%	-0.5%	0.2%	1.5%
Miami	0.3%	0.00%	0.4%	83.2%	0.2%	0.8%	0.5%	1.0%
Minneapolis	0.4%	0.00%	0.0%	82.6%	0.4%	1.0%	0.2%	1.7%
Northern New Jersey	0.2%	0.25%	0.0%	80.9%	0.0%	-0.4%	0.0%	-0.1%
New York	0.2%	0.10%	2.9%	90.3%	0.1%	0.5%	0.8%	4.5%
Orange County	0.3%	0.00%	0.6%	82.6%	0.3%	2.0%	0.5%	2.0%
Philadelphia	0.5%	0.09%	0.0%	86.0%	0.5%	1.0%	0.2%	0.9%
Phoenix	0.3%	0.17%	0.3%	74.2%	0.2%	0.1%	0.3%	0.8%
San Diego	0.5%	0.39%	1.1%	83.8%	0.2%	1.1%	0.5%	1.4%
Seattle	-0.2%	0.02%	2.3%	85.7%	-0.2%	0.1%	0.8%	2.3%
San Francisco	-0.1%	0.00%	1.7%	86.4%	-0.1%	0.3%	1.2%	7.2%
San Jose	1.1%	0.95%	4.6%	81.2%	0.3%	1.1%	1.6%	4.6%
Suburban Maryland	0.7%	1.12%	1.2%	84.8%	-0.3%	-0.1%	0.4%	0.9%
Suburban Virginia	-0.3%	0.36%	2.3%	83.0%	-0.7%	-1.7%	0.2%	0.6%
United States	0.2%	0.19%	1.2%	83.0%	0.0%	0.3%	0.4%	2.2%

*Current quarter defined as Q2 2013
**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 does not include Medical Office
NOTE: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.

OFFICE PRICING AND GROWTH EXPECTATIONS

Pricing varies significantly by market with cap rates below 6% (for Class A office buildings) on average in prime markets such as Boston, Washington, D.C., New York, and San Francisco. The below graph shows average cap rates and average expected NOI growth for the next five years, including expected improvements in occupancies and rents. While NOI growth going forward is expected to be strong in markets such as San Francisco and San Jose, aggressive construction pipelines in markets such as Washington, D.C. may limit returns. Meanwhile, yields are much higher in markets such as Dallas and Houston, which are experiencing strong employment growth, but will require some tolerance of lease-up risk.



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.

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SOURCE: RCLCO; Reis, Inc.; CBRE

RETAIL FUNDAMENTALS

U.S. RETAIL ABSORPTION IMPROVES

Neighborhood and Community Center (N/C) net absorption at 0.1% of stock in Q2 2013 continued the positive demand trend from 2012. N/C vacancy peaked at 11.0% in 2011, the highest rate since 1991, but was down by 10 bps quarter-over-quarter at 10.5% in Q2 2013 with minimal new completions. Although we expect a gradually strengthening retail sector over the next few years, bricks and mortar retail is facing long-term headwinds from both slow demographic growth and e-commerce. With weak forecasted demand, vacancy is expected to remain above 10% through 2013.

U.S. RETAIL ABSORPTION, VACANCY, RENT GROWTH

Square Feet (in millions)

60
45
30
15
0
-15
-30

12%
9%
6%
3%
0%
-3%
-6%

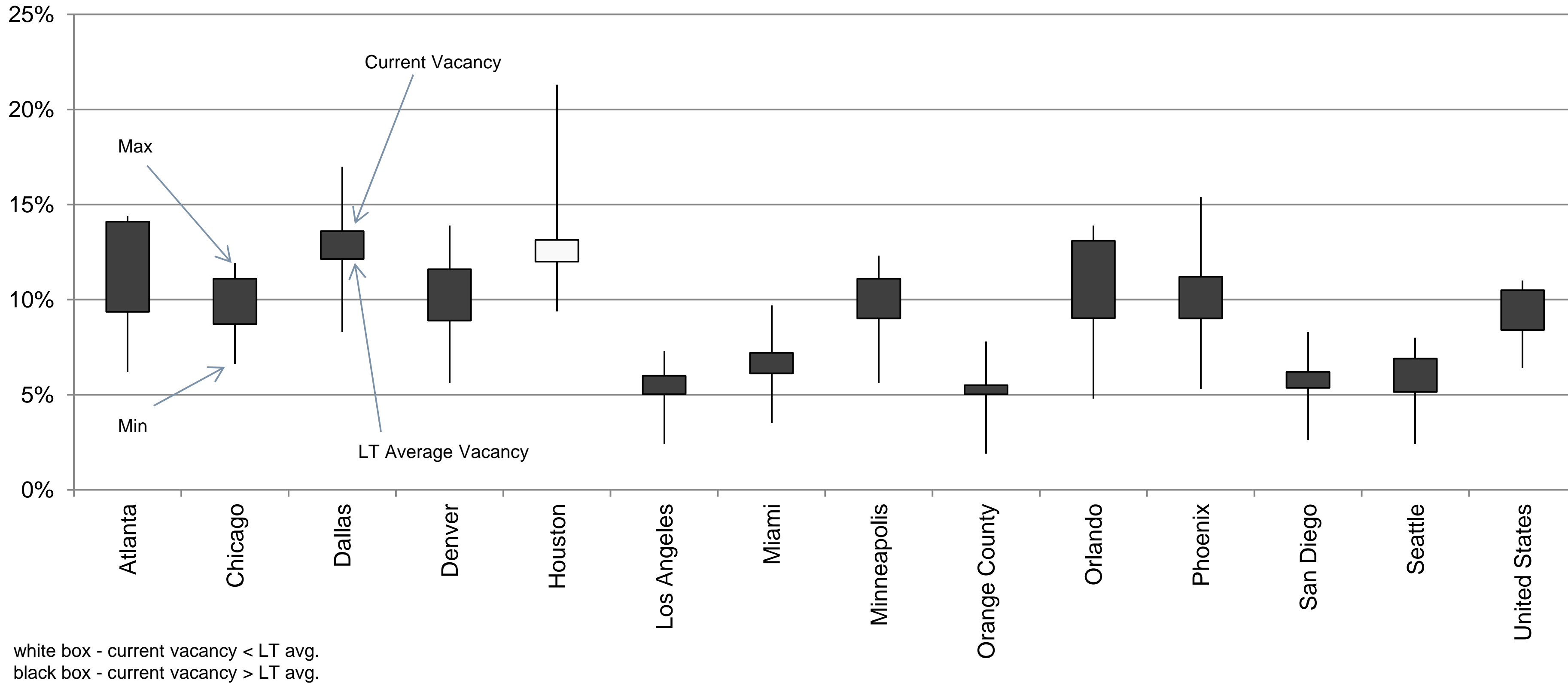
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 (f) 2014 (f) 2015 (f) 2016 (f) 2017 (f)

Completions Net Absorption Vacancy % Rent Growth %

SOURCE: Reis, Inc.

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, which has recently increased its occupancy levels to 88% (better than its long-term average of 87%). Atlanta and Orlando are off their long-term averages by the widest margins, while Miami and Southern California retail markets are only slightly less occupied than normal.



white box - current vacancy < LT avg.
black box - current vacancy > LT avg.

NOTE: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.

U.S. RETAIL: TOP METROS RISK INDICATOR

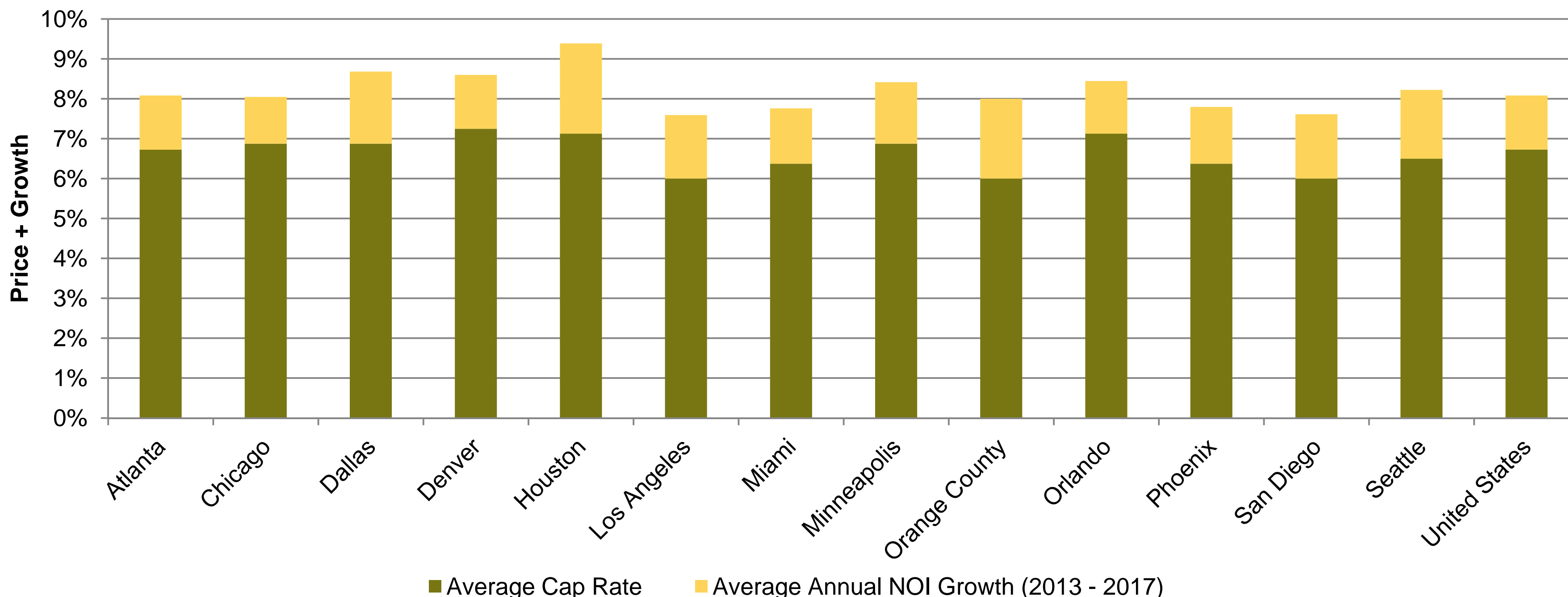
Occupancy levels continue to rise in most major retail cities, yet they remain lower than their historical averages. Rents continue to grow. While new construction is minimal, it is beginning to pick up, particularly in Chicago, Los Angeles, Orange County, San Diego, and Seattle.

	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%	0.00%	0.78%	85.9%	0.1%	0.1%	-0.1%	0.4%
Chicago	-0.1%	0.04%	1.06%	88.9%	-0.1%	0.5%	0.1%	0.2%
Dallas	0.2%	0.25%	0.91%	86.4%	0.0%	0.7%	0.5%	1.7%
Denver	0.2%	0.00%	0.19%	88.4%	0.3%	0.1%	0.3%	0.5%
Houston	0.5%	0.26%	0.51%	88.0%	0.3%	0.6%	0.4%	2.0%
Los Angeles	0.1%	0.04%	1.95%	94.0%	0.1%	0.3%	0.2%	1.3%
Miami	0.0%	0.00%	0.30%	92.8%	0.0%	-0.2%	0.5%	0.3%
Minneapolis	0.2%	0.03%	0.68%	88.9%	0.2%	0.4%	0.3%	1.7%
Orange County	0.2%	0.22%	1.03%	94.5%	0.0%	0.4%	0.4%	1.9%
Orlando	0.5%	0.00%	0.23%	86.9%	0.5%	0.8%	0.7%	2.0%
Phoenix	0.1%	0.00%	0.01%	88.8%	0.1%	0.3%	0.1%	0.8%
San Diego	0.2%	0.00%	1.39%	93.8%	0.2%	0.1%	-0.1%	0.9%
Seattle	0.0%	0.02%	1.36%	93.1%	0.1%	0.4%	0.5%	0.6%
United States	0.1%	0.05%	0.00%	89.5%	0.1%	0.3%	0.3%	0.8%

*Current quarter defined as Q2 2013
**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: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
NOTE: Above data includes only Neighborhood/Community centers; does NOT include power centers, regional malls, or lifestyle retail centers
SOURCE: RCLCO; Reis, Inc.

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 property type and strength of the location and retailers. The below graph 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, reflecting reluctance of retailers to increase space needs and strong e-commerce competition.



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SOURCE: RCLCO; Reis, Inc.; CBRE

INDUSTRIAL FUNDAMENTALS

U.S. INDUSTRIAL ABSORPTION IMPROVES

Industrial vacancy rates have improved from previous peak levels, dropping to under 10% by Q2 2013. Rent growth is expected to continue to be positive, with significant upside in several markets as rents remain more than 20% below peak levels.

U.S. INDUSTRIAL ABSORPTION, VACANCY, RENT GROWTH

Square Feet (in millions)

150
100
50
0
-50
-100

15%
10%
5%
0%
-5%
-10%

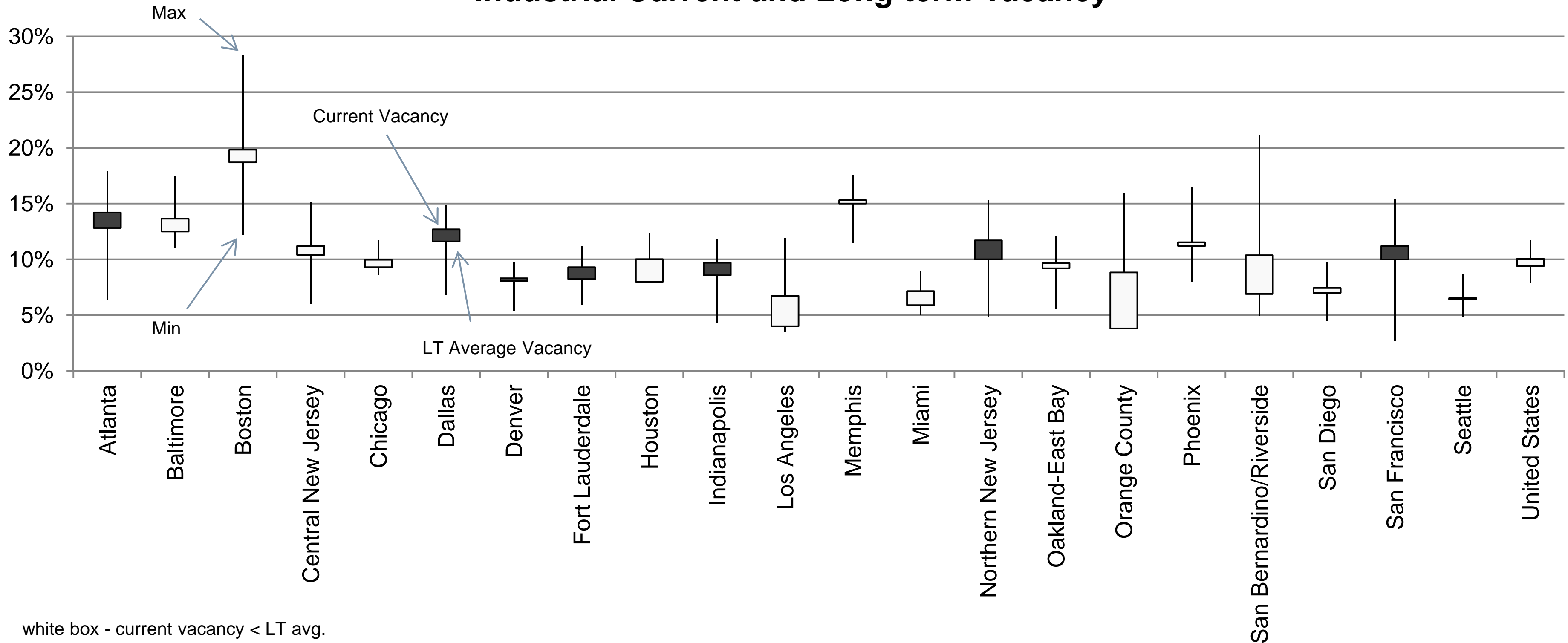
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 (f) 2014 (f) 2015 (f) 2016 (f) 2017 (f)

Completions | Net Absorption | Vacancy % | Rent Growth %

SOURCE: Reis, Inc.

INDUSTRIAL VACANCY GENERALLY STILL HIGH

Most major U.S. industrial markets are experiencing slightly lower current vacancy than their long-term (1990-present) average, which represents a change from just a year ago, when vacancies were higher than their historical average. New construction is not keeping pace with demand in most markets, so vacancy continues to fall.



white box - current vacancy < LT avg.
black box - current vacancy > LT avg.

NOTE: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.

U.S. INDUSTRIAL: TOP METROS RISK INDICATOR

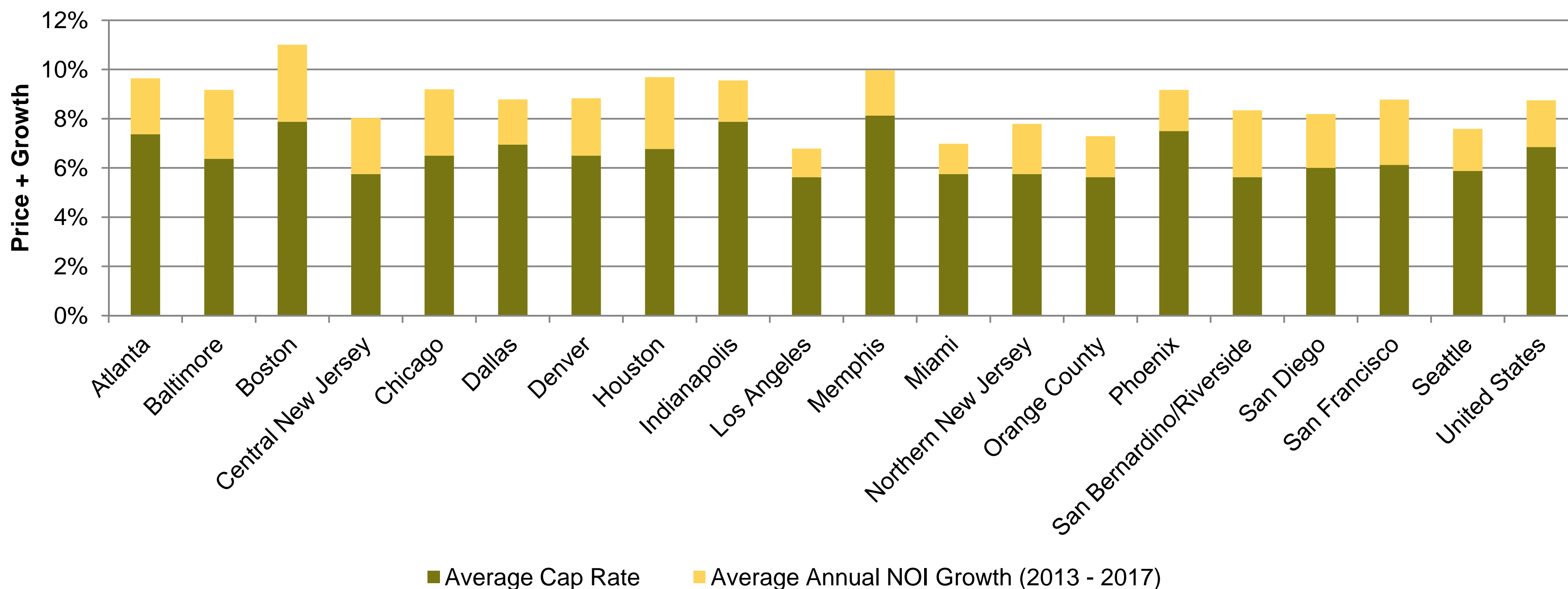
Occupancy and rent levels continue to improve in all major industrial cities. New inventory has hit the market during the last year, but demand is expected to outpace supply over the next several years.

	Net Absorption % of Stock Current* Year	Completions % of Stock Current* Year**	Under Constr % of Stock Current***	Occupancy****	Y-o-Y Occupancy Change	Y-o-Y Rent Growth
Atlanta	1.4%	0.62%	0.36%	85.8%	0.9%	2.3%
Baltimore	1.6%	0.45%	0.07%	87.5%	1.2%	2.7%
Boston	1.7%	1.00%	1.44%	81.3%	0.9%	2.7%
Central New Jersey	1.1%	1.01%	0.97%	89.6%	0.2%	3.1%
Chicago	1.0%	0.32%	0.30%	90.7%	0.7%	2.8%
Dallas	2.0%	1.64%	2.27%	87.3%	0.6%	2.3%
Denver	1.3%	0.84%	0.62%	91.7%	0.5%	2.7%
Fort Lauderdale	1.4%	0.89%	0.39%	90.7%	0.6%	2.4%
Houston	1.7%	1.29%	1.97%	92.0%	0.5%	3.8%
Indianapolis	1.1%	0.77%	0.73%	90.3%	0.4%	2.3%
Los Angeles	0.7%	0.31%	0.13%	96.0%	0.4%	2.0%
Memphis	1.2%	0.26%	1.10%	85.0%	1.0%	2.2%
Miami	1.2%	0.62%	0.31%	94.1%	0.6%	2.1%
Northern New Jersey	1.3%	0.50%	1.51%	88.3%	0.9%	2.0%
Oakland-East Bay	1.2%	0.38%	0.10%	90.8%	0.9%	3.0%
Orange County	0.9%	0.27%	0.05%	96.2%	0.6%	3.0%
Phoenix	2.1%	1.45%	2.36%	88.8%	0.8%	2.6%
San Bernardino/Riverside	3.2%	2.33%	2.15%	93.1%	1.1%	3.5%
San Diego	1.2%	0.20%	0.12%	93.0%	1.0%	2.4%
San Francisco	1.0%	0.20%	0.03%	88.8%	0.8%	2.7%
Seattle	1.0%	0.28%	0.51%	93.6%	0.7%	2.4%
United States	1.2%	0.57%	0.69%	90.6%	0.6%	2.4%

*Current year defined as 2013
**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: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.

INDUSTRIAL PRICING AND GROWTH EXPECTATIONS

Pricing varies significantly by market, with cap rates below 6% on average in port-oriented markets such as Los Angeles and Miami. The below graph 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. While the big five distribution markets (ATL, DAL, NNJ, CHI, and RIV) other than Riverside continue to be moderately priced, several local warehouse markets (e.g. Minneapolis, Nashville, and Portland) have higher cap rates and good expected economic growth.



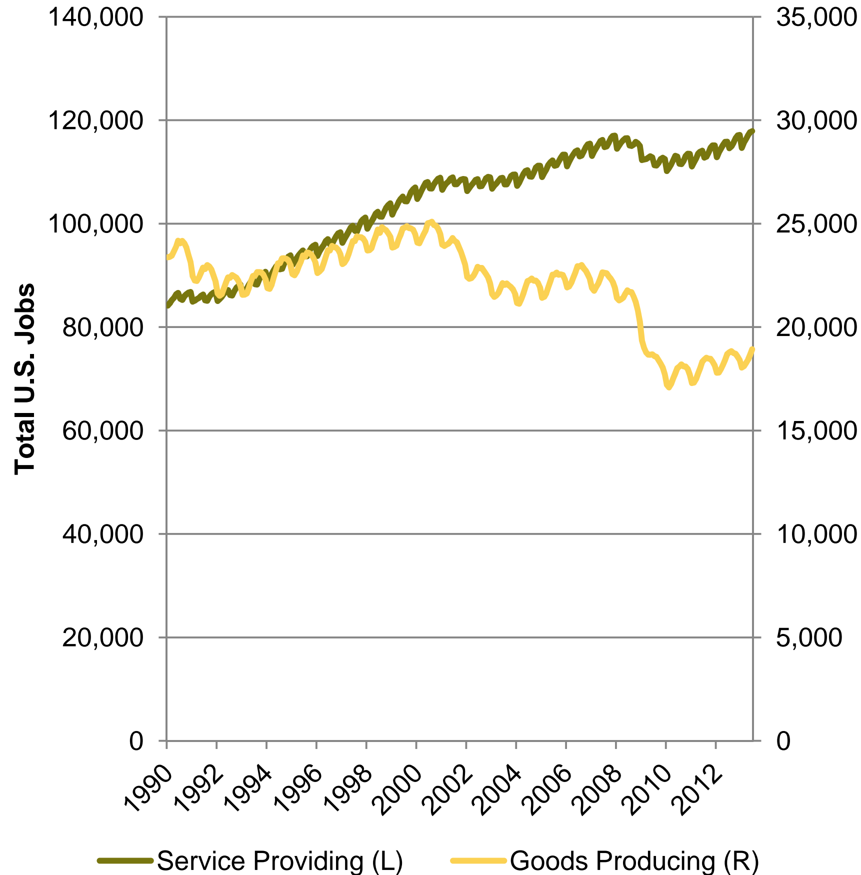
Initial yield and cash flow growth over the hold period are significant contributors to unlevered total return expectations. Low cap rates should thus be accompanied by higher growth expectations. While the above graph is an incomplete view, it does provide some indications of markets that should be 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.

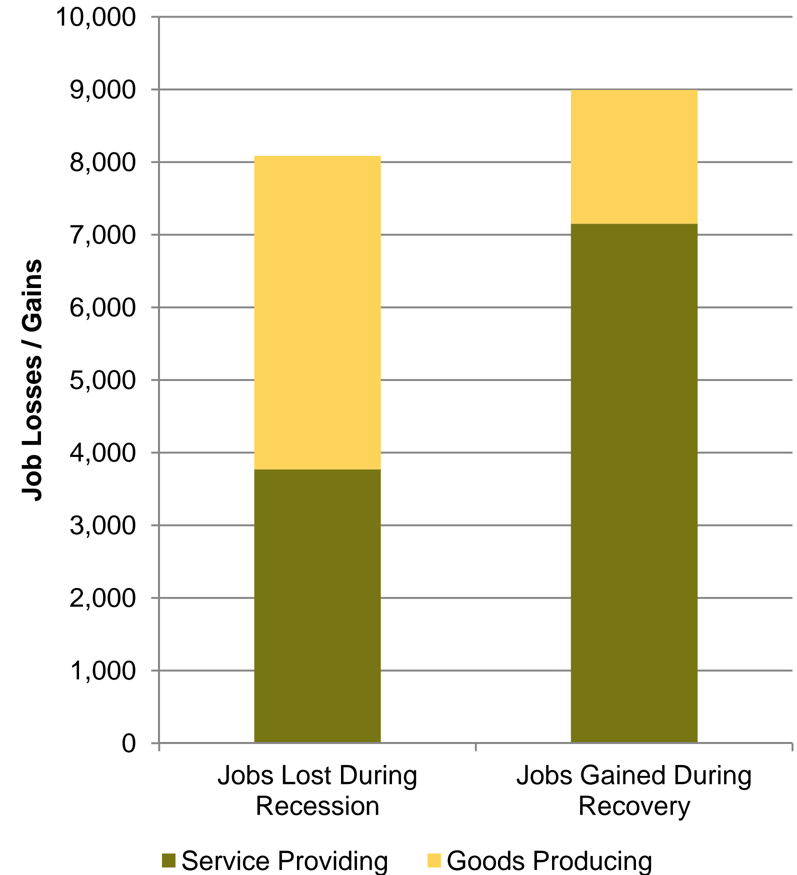
NOTE: The cities in the above chart are not necessarily MSAs or central cities, but are geographical areas defined by Reis, Inc.
SOURCE: RCLCO; Reis, Inc.; CBRE

ECONOMIC BACKDROP

U.S. EMPLOYMENT GROWTH

Employment composition continues to change. While service producing jobs have recovered from the downturn, goods producing jobs are recovering very slowly.

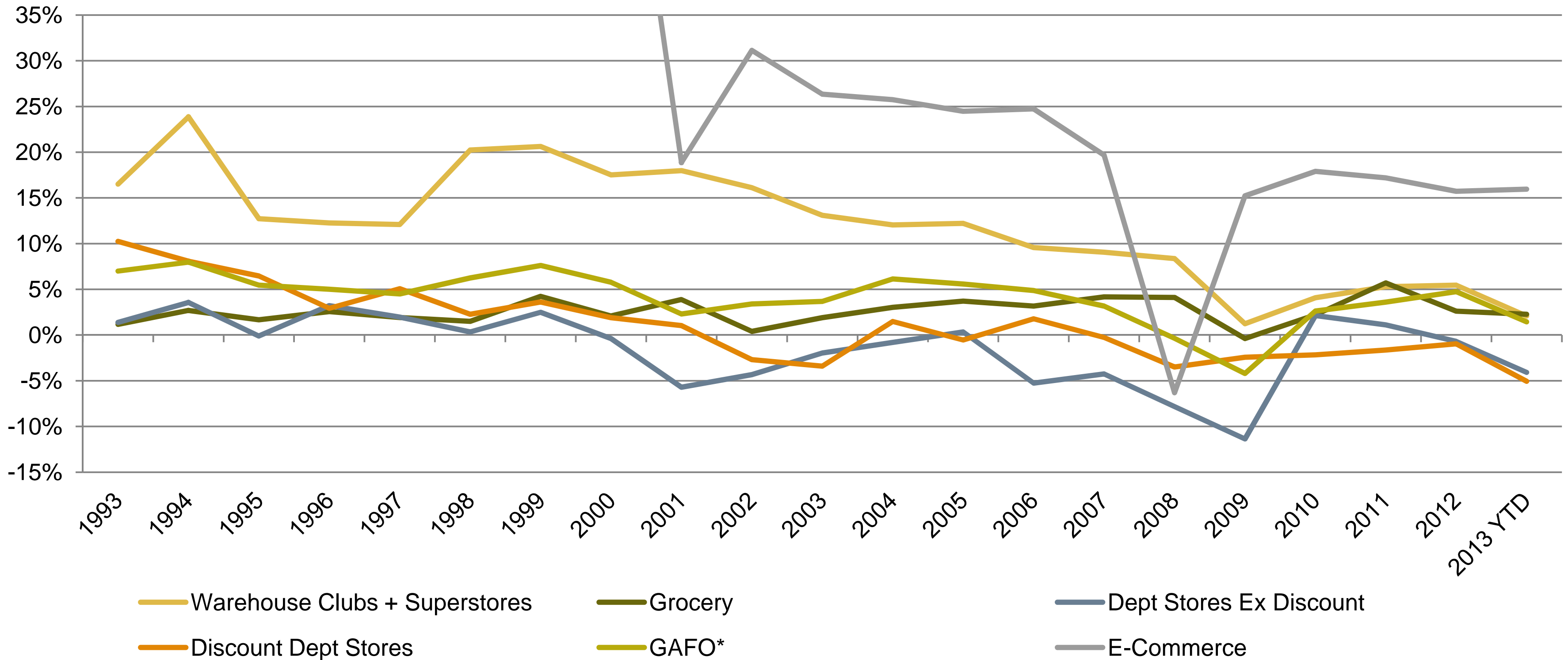




NOTE: Seasonally adjusted at annual rates
SOURCE: Bureau of Economic Analysis

RETAIL SALES GROWTH

The retail sector continues to be a world of haves and have-nots. Warehouse clubs, which had previously been taking market share, are now showing signs of maturation, while e-commerce sales continue to gain. High-end retailers are also outperforming, with weakness even in discount department stores which had previously been outpacing traditional department store sales.

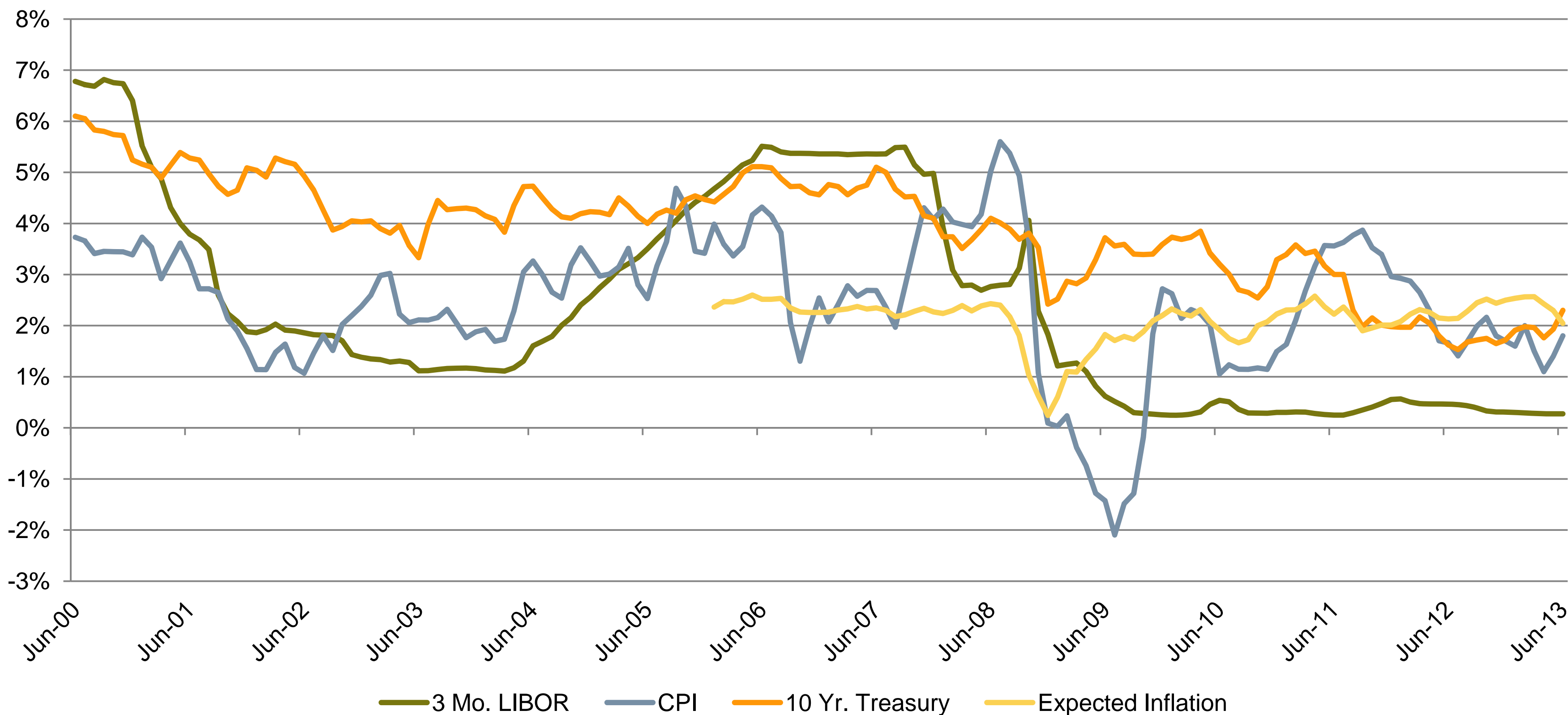


NOTE: 2013 YTD data is through May
SOURCE: U.S. Census; ICSC

*GAFO = general apparel, furniture, and other mall-type stores

NOMINAL INTEREST RATES AND INFLATION

Interest rates have recently begun to make their ascent—but for how long? Our estimates indicate another 100 bps+ increase in 10-year treasuries is likely just to return to normalized real rates. The question is when and how quickly this will happen. The Fed indicates that federal funds rates will not increase until unemployment reaches 6.5%—more than a full percentage point lower than current levels. Cap rates are expected to be less volatile, and are unlikely to face significant pressure until treasury yields surpass 3.5%.

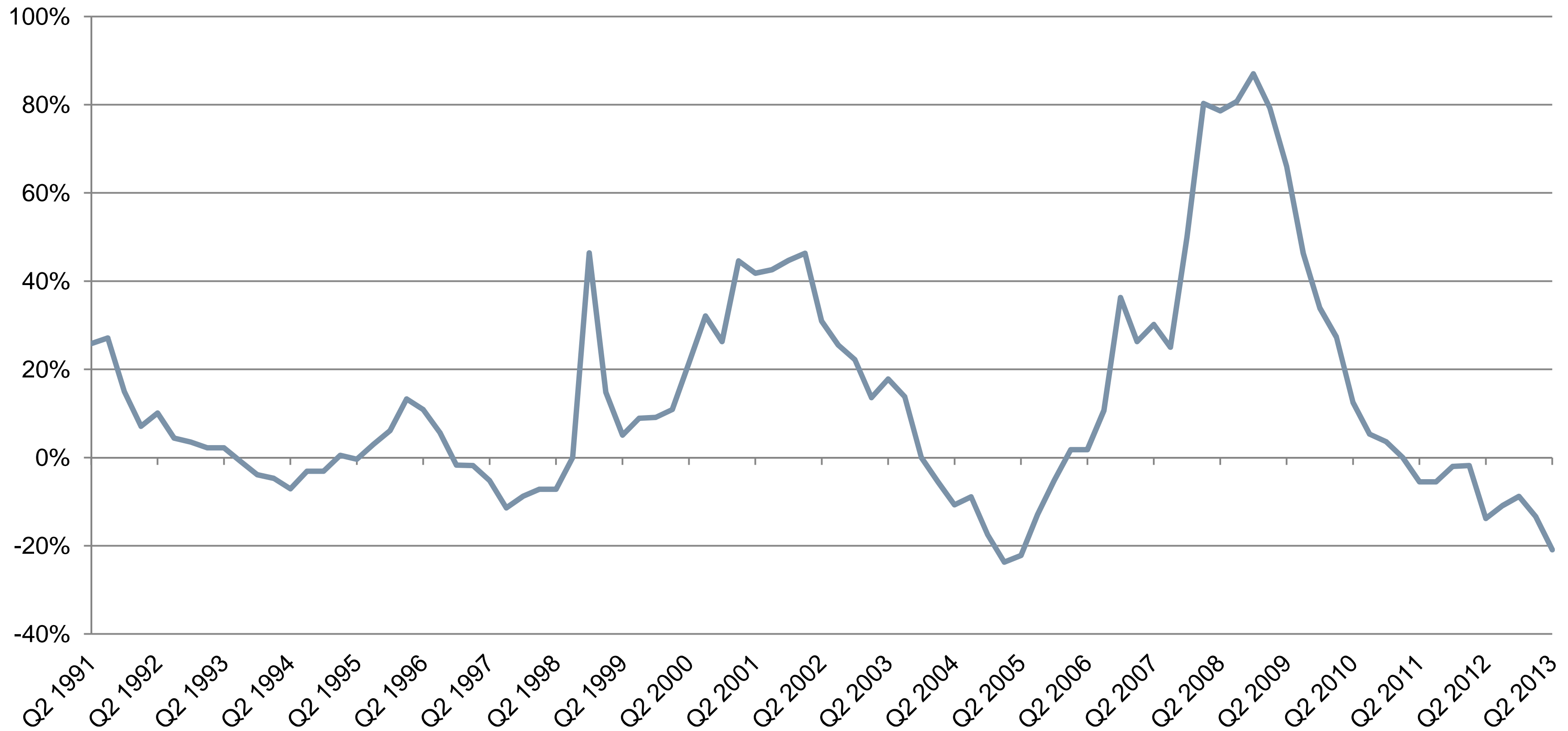


SOURCE: BLS; Federal Reserve, www.fedprimerate.com

CAPITAL MARKETS

LENDING STANDARDS EASING

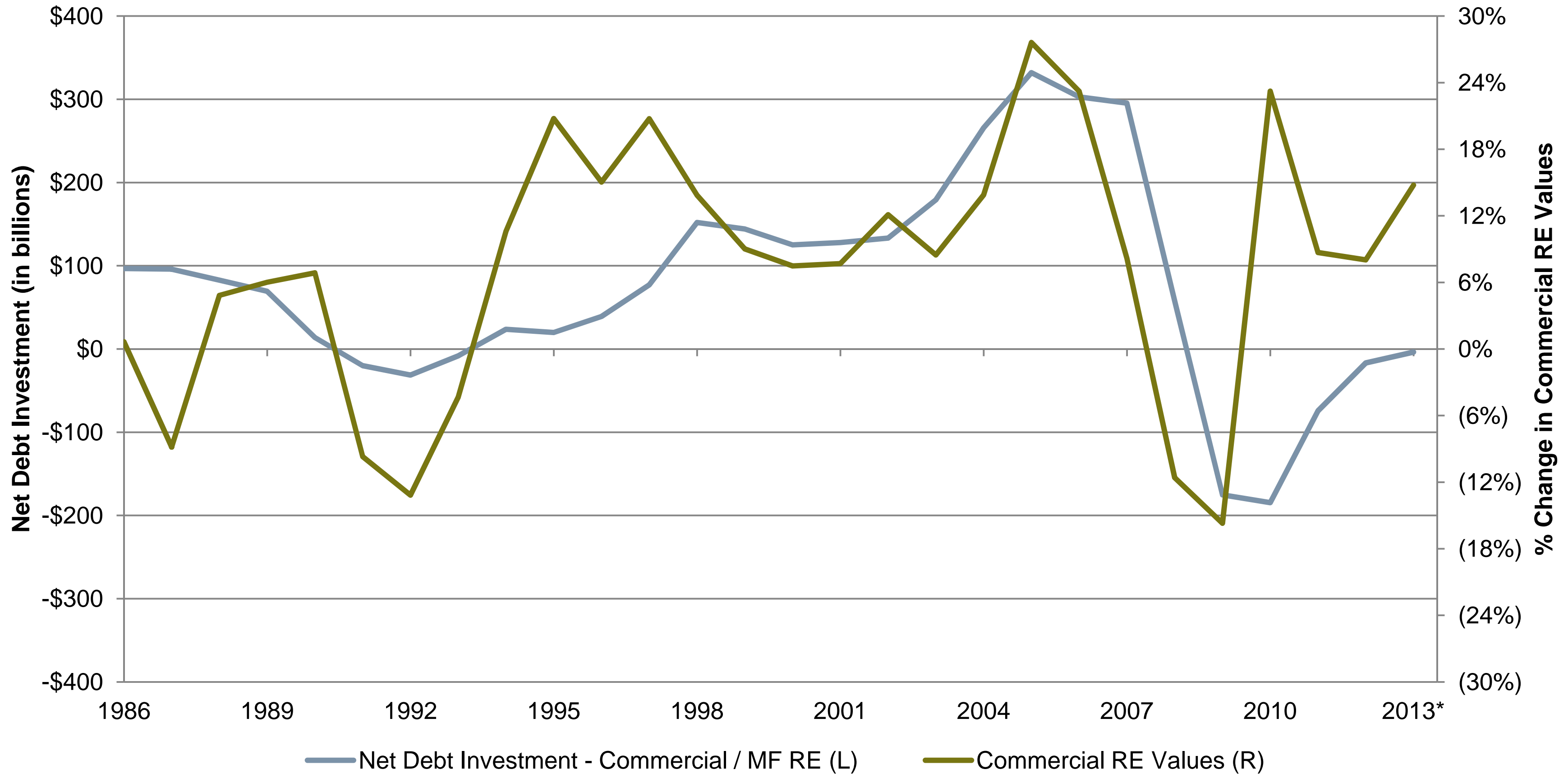
Banks are loosening their purse strings. Not only has there recently been a move away from the popular and somewhat necessary tightening lending standards of the Great Recession, but, since the first quarter of 2011, banks continue to loosen lending standards for commercial real estate, following improving occupancy and pricing.



SOURCE: Federal Reserve

LENDING IMPROVING, BUT LAGGING THE IMPROVEMENT IN PROPERTY VALUES

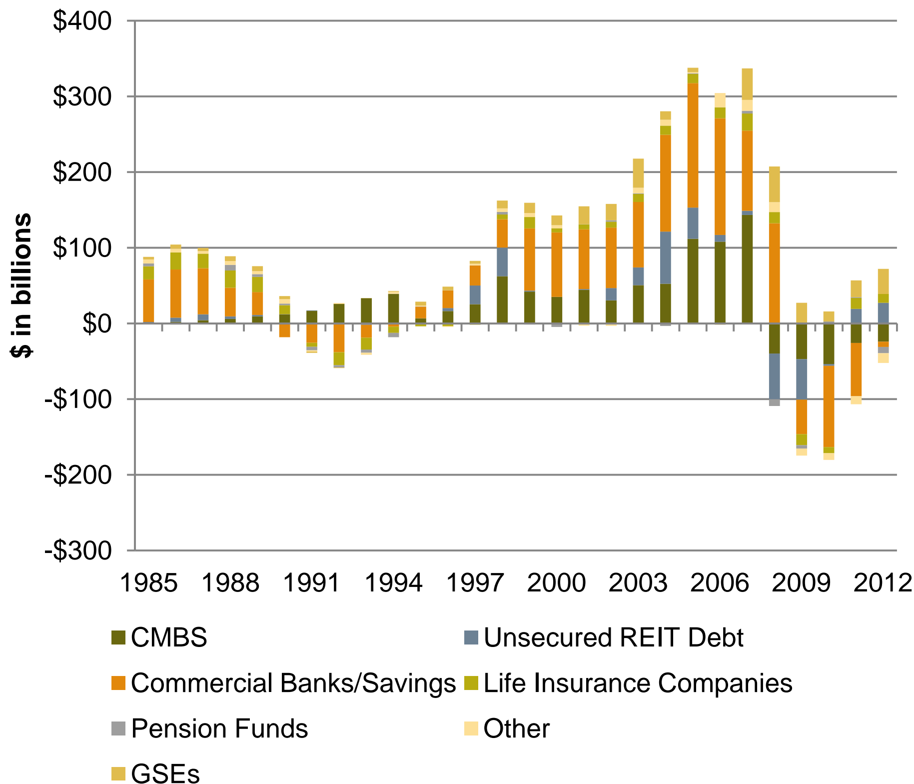
Net lending volumes continue to lag the improvement in property values. Despite the recent rise in interest rates, we expect lending to continue to increase as a result of improving occupancy and rental rates.

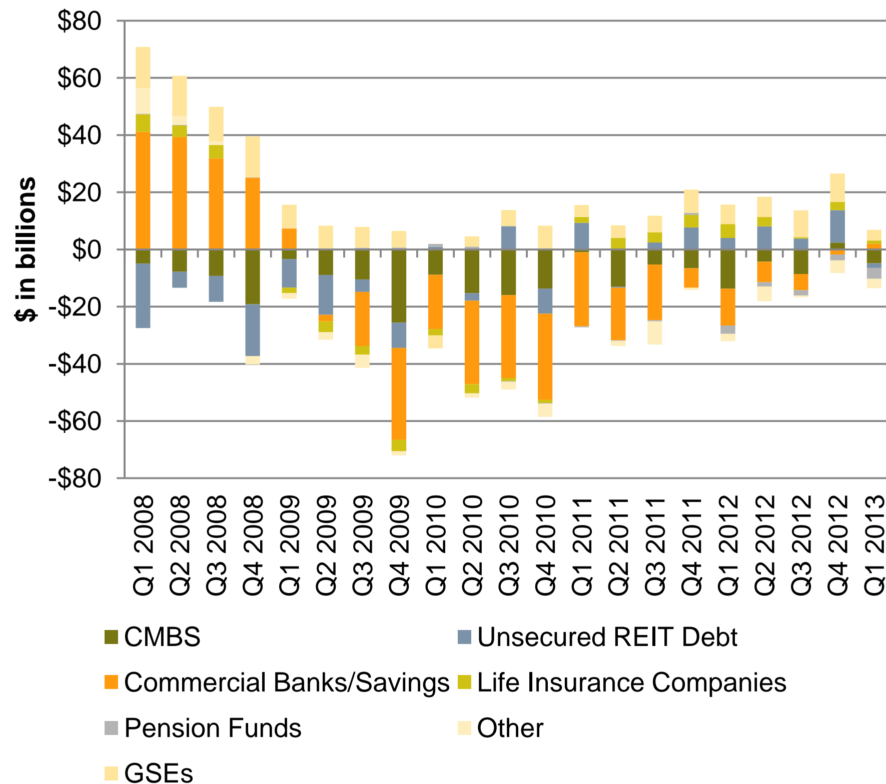


*2013 is a rolling four quarter percentage from Q2 2012 through Q2 2013
SOURCE: Federal Reserve, NCREIF

DELEVERAGING CONTINUING BUT SLOWING

In 2012, more loans were issued than matured, due primarily to a Q4 increase in commercial bank lending. GSEs, including Fannie Mae and Freddie Mac, public debt markets, and life insurance companies, are net positive lenders.



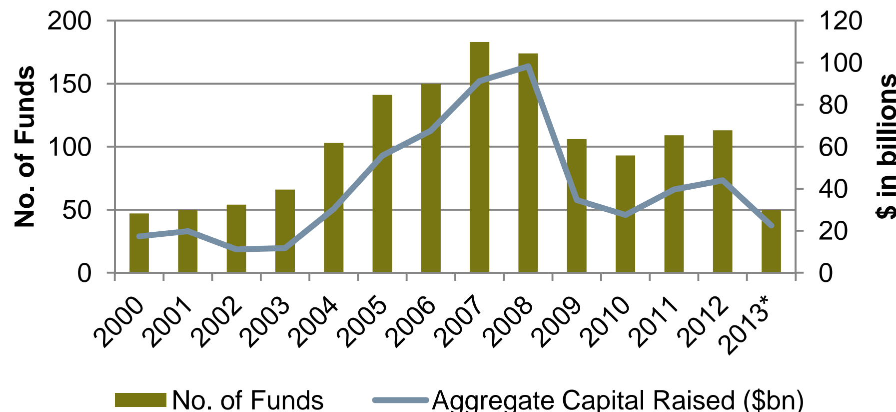


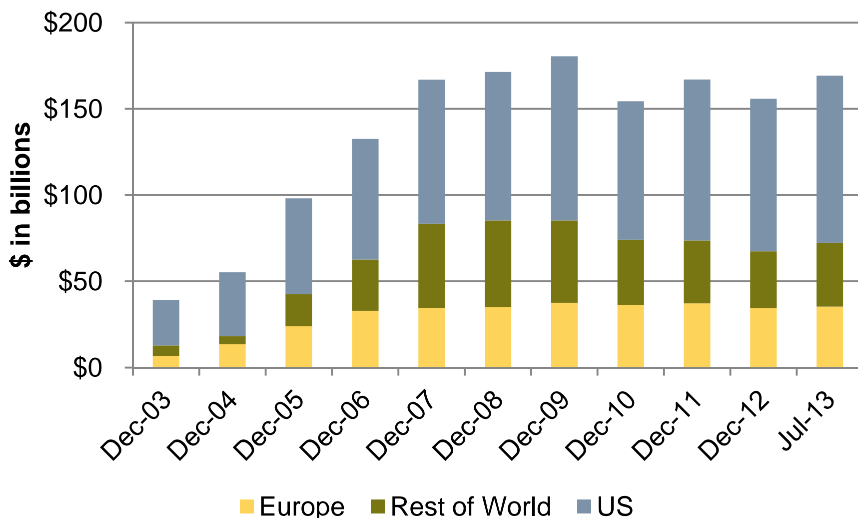
SOURCE: Federal Reserve; NAREIT

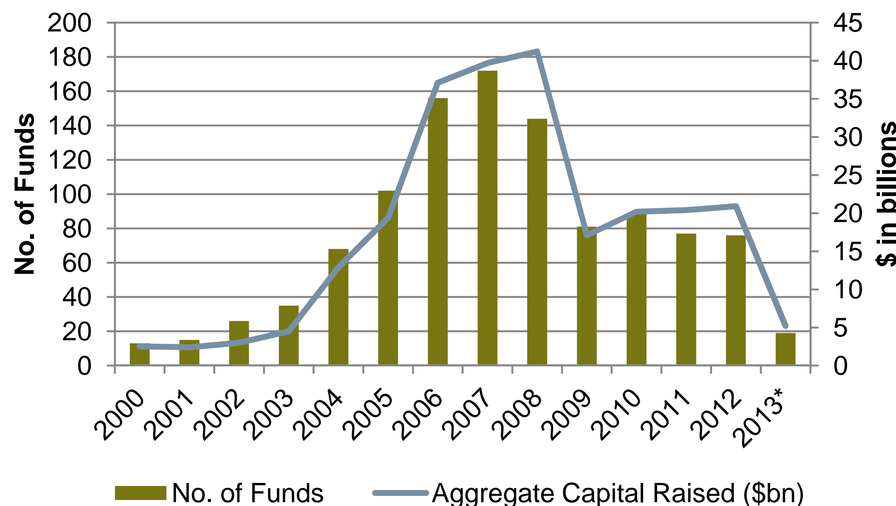
FUNDRAISING YET TO TAKE OFF

Thus far in 2013 investors have stayed home, with more fundraising in the U.S. than for non-U.S. funds. PE fundraising in 2013 in the U.S. and abroad is not on track yet to eclipse 2012 fundraising totals.

Dry powder worldwide increased substantially from 2003–2007, as fundraising outgrew the ability to deploy capital at investors' required returns. Dry powder has remained at slightly over $150 billion every year since then, although some of this could have been used to restructure deals.





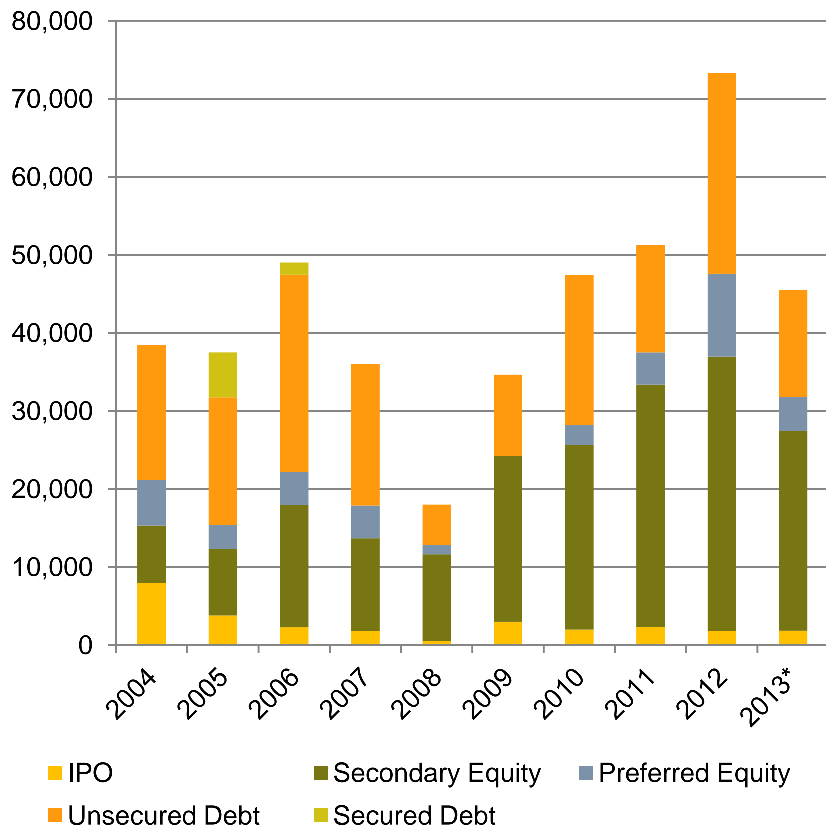


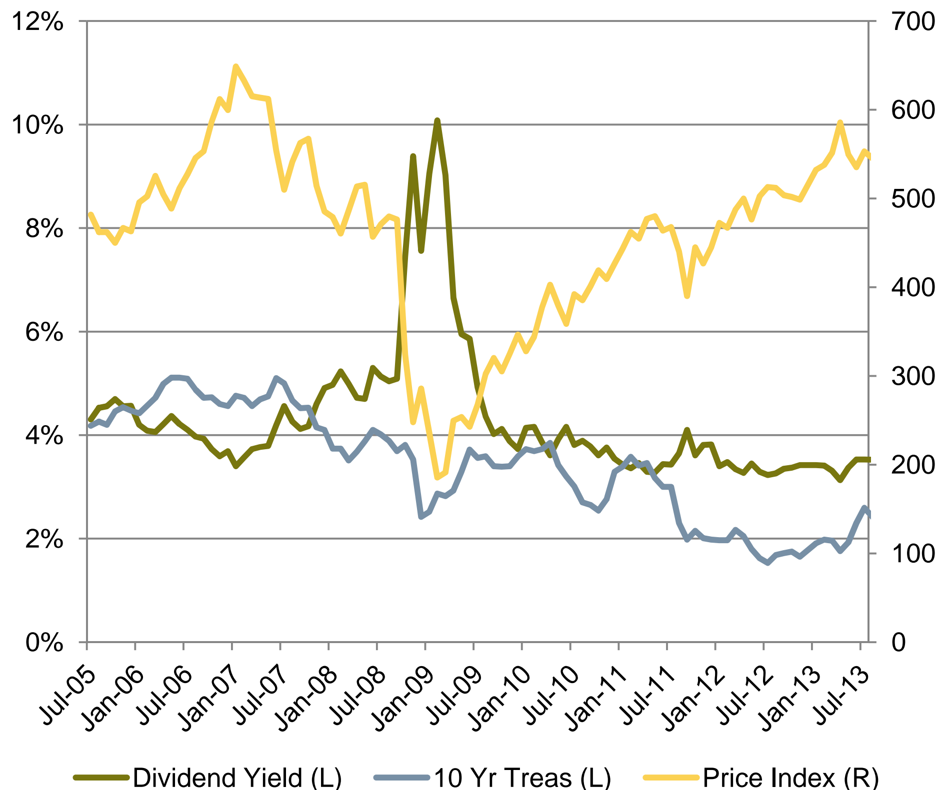
** Private equity cash reserves held to fund future obligations*

SOURCE: Preqin

REIT OFFERINGS AT AN ALL-TIME HIGH

Although the 10-year Treasury yield began its creep upwards in May and June, treasury yields remain historically low, and yield seekers continue their move into the REIT world of 3.4% average dividend yields, further driving up prices and creating more capital-raising opportunities. REIT offerings in 2012 were at an all-time peak level, and 2013 appears poised to eclipse 2012 totals.



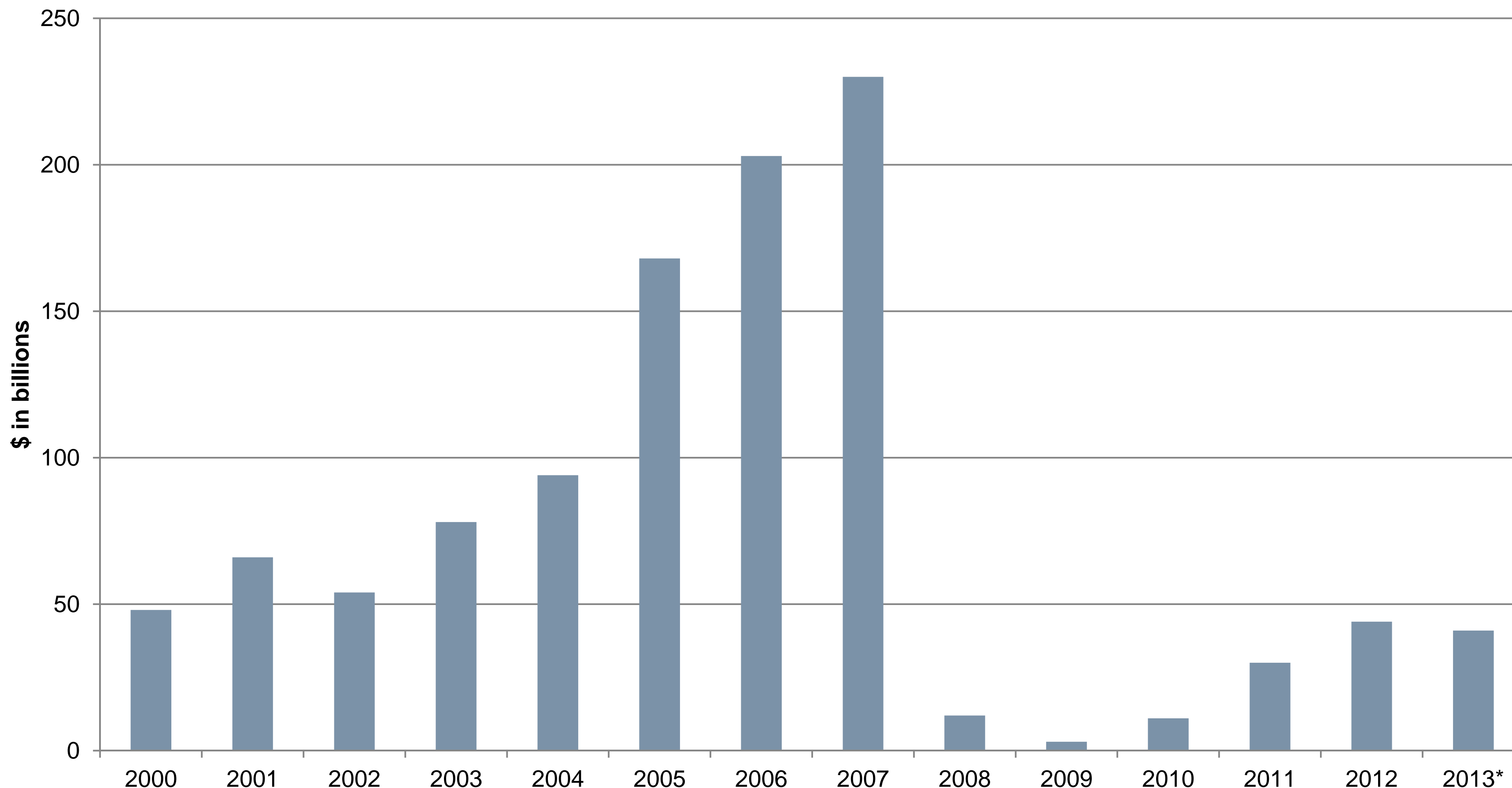


*2013 is as of June 28

SOURCE: SNL; NAREIT

CMBS MARKET SLOWLY RECOVERS

After the collapse of Bear and Lehman, Wall Street's CMBS division reorganizations, and new government regulations**, the CMBS market is now beginning to rebound, reaching $41 billion so far in 2013—nearly eclipsing 2012 totals by July 1st.**

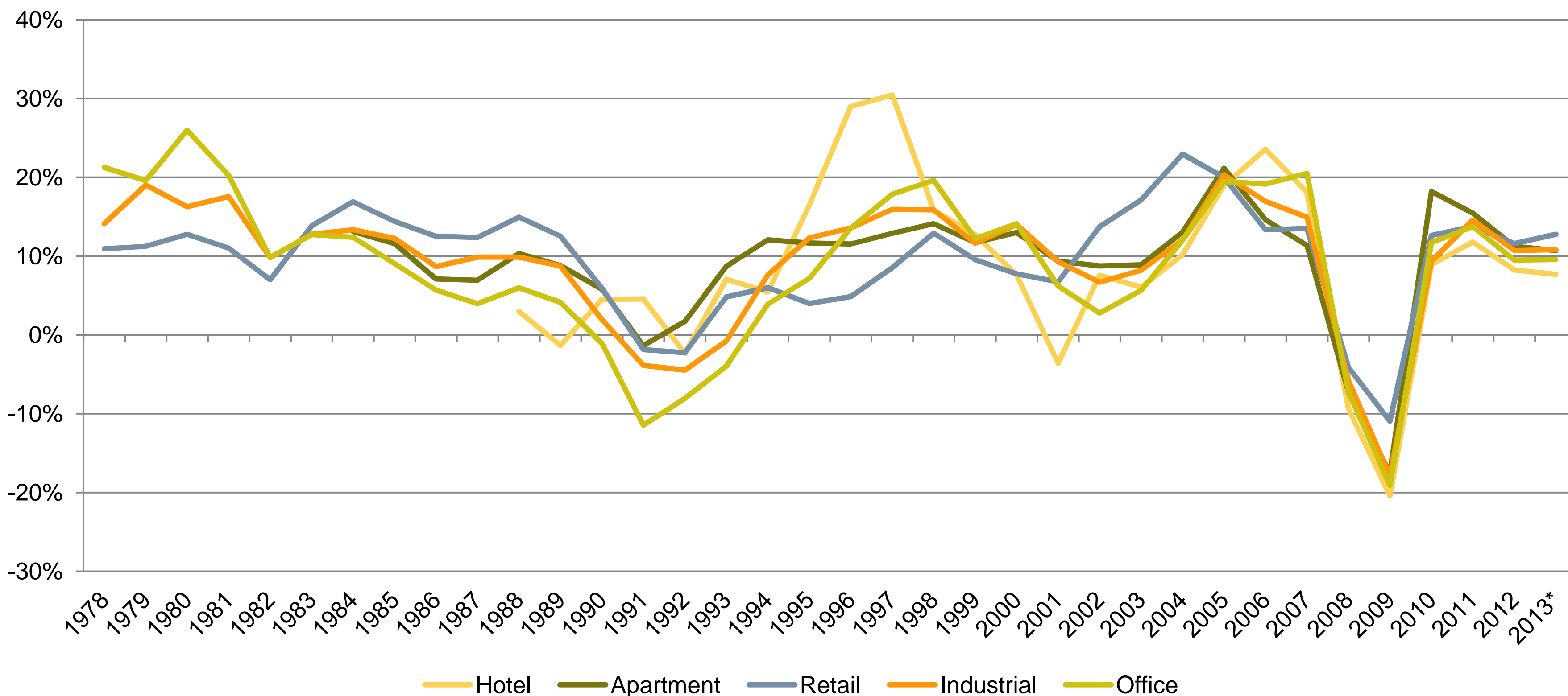


*2013 is as of July 1st

SOURCE: CRE Finance Council

RETAIL LEADS RETURNS

Hotels, not surprisingly, were the hardest-hit sector during the downturn of 2008-2009, but perhaps the most surprising asset class is retail, having not dropped as precipitously during the downturn and maintaining solid growth during the rebound. The incredibly high correlation of returns from 2008-2009 seems to be waning, though, as markets begin to return to "normal." The strongest performer throughout the downturn was retail, having only dropped 11% in 2009—only half the fall of the other sectors. Retail is continuing its relatively strong performance, achieving the highest Q2 2013 total return of 12.8%.

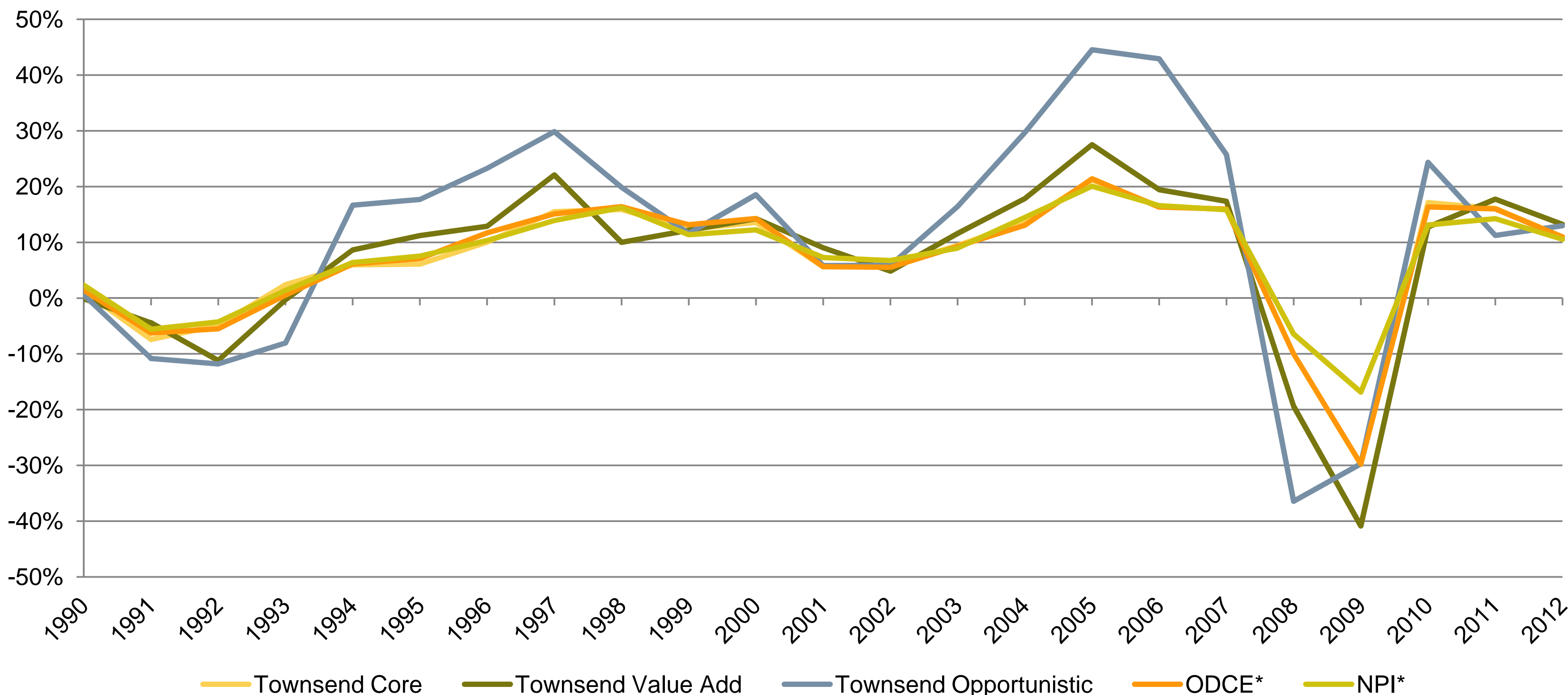


*2013 is rolling four quarter

SOURCE: NCREIF

OPPORTUNITY FUNDS YET TO OUTPERFORM

Opportunity funds fell from a gain of 26% in 2007 to a loss of 36% and 30% in 2008 and 2009, respectively. Value-add investments, however, hold the pole for the largest one-year loss—41% in 2009. Since 1990, Core and Opportunistic investments have delivered consistently higher risk-adjusted returns than Value-add investments.

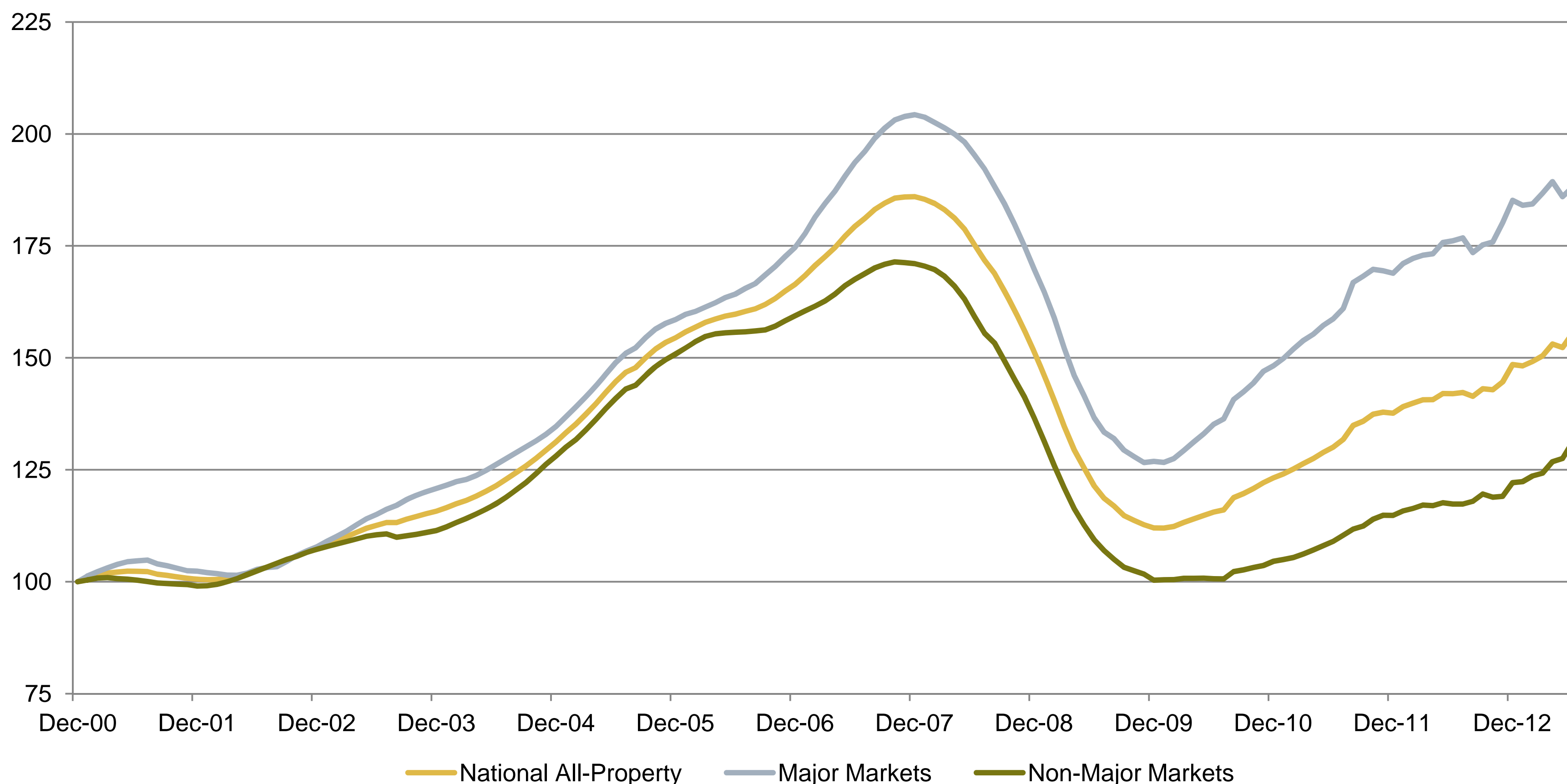


*ODCE: NCREIF open-end diversified core equity index
*NPI: NCREIF property appraisal-based index

SOURCE: NCREIF

PRICE RECOVERY FOCUSED IN MAJOR MARKETS

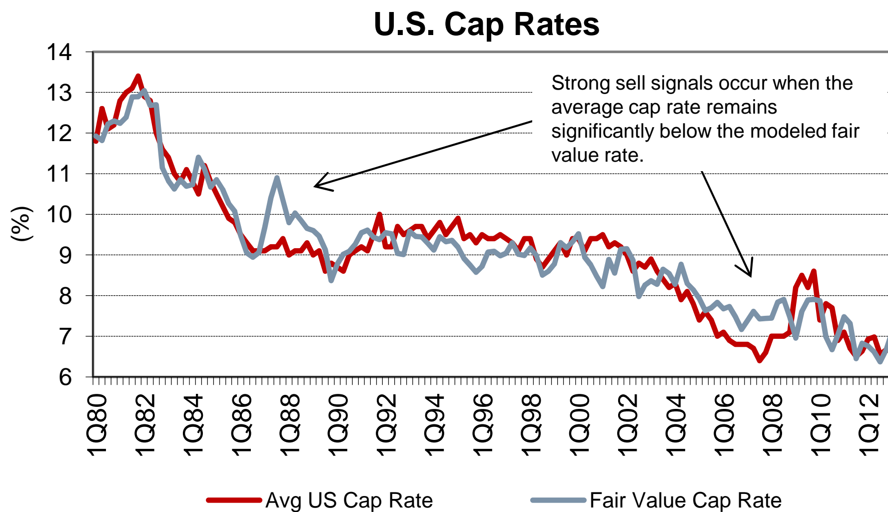
Major markets have consistently sold at a premium to non-major markets since the turn of the cycle, and the delta between the two is increasing as investors make their flight to quality in this post-recession landscape. The unusually large gap may present investment opportunities if investors can get comfortable with lease-up risk.



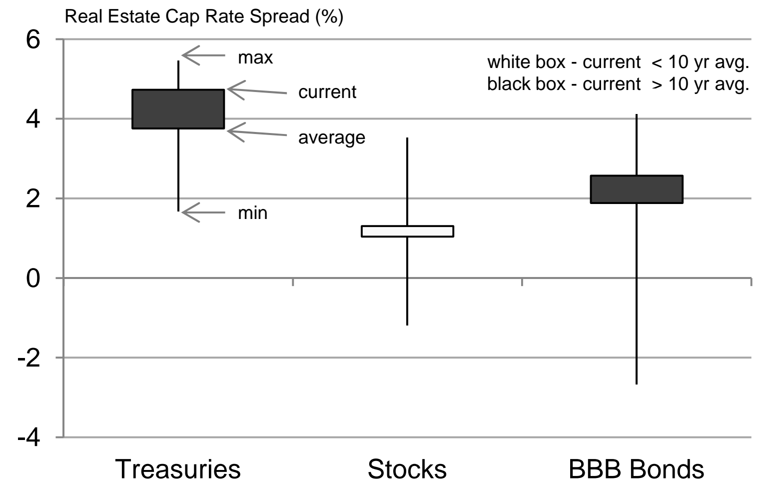
SOURCE: RCA; Moody's Analytics

CAPITAL MARKETS SHOWING SOME CAUTIONARY SIGNS

Commercial real estate continues to be favorably priced as compared with U.S. treasuries and BBB corporate bonds and is priced slightly more aggressively than the 10-year average spread to U.S. stocks. Our fair value cap rate model, which measures real estate pricing as compared to other asset classes, indicates some upward pressure on cap rates as the modeled fair value cap rate is slightly higher than actual cap rates. We do not yet consider this noteworthy as the model should be flashing higher for at least two quarters to indicate a significant trend. A more detailed analysis* indicates that 10-year U.S. treasury yields need to move to 3.5% or higher to have a significant impact on real estate pricing.



The RCLCO cap rate model is a capital markets based model that is intended to indicate when real estate pricing is departing from other asset classes and capital market conditions based on trends over the past 50 years. When the actual cap rate index (red line) remains significantly below the fair value (blue) line for at least two quarters or more, the model indicates overheated real estate prices as compared to other asset classes.



U.S. real estate is priced favorably as compared to U.S. treasuries and corporate BBB bonds, but slightly aggressively as compared to U.S. stocks (S&P 500 Index).

*See RCLCO special report "Interest Rates and Real Estate Pricing"

SOURCE: RCLCO; ACLI; ycharts.com; Federal Reserve Bank of St. Louis; BofA Merrill Lynch; Economy.com