

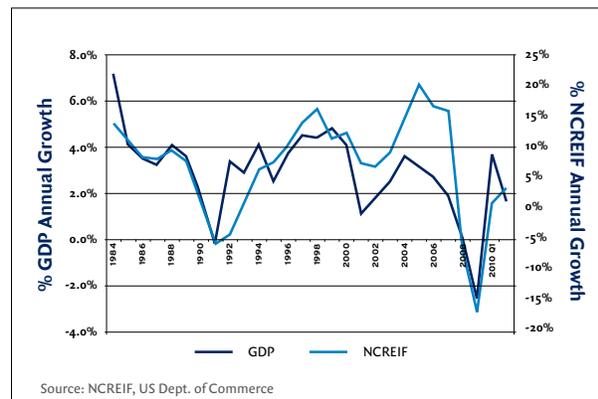
Market Commentary: October 2010

“Where’s the beef?”

As the third quarter comes to a close, the global capital markets continue to send mixed signals. After narrowly avoiding a European sovereign debt crisis and recovering from the May “flash crash”, investors are sifting through conflicting data to identify what other potential risks are just beyond the horizon. While the likelihood of a double-dip recession appears to have declined, the prospect for sustainable economic growth over the next several years is in question and this is increasingly a cause for concern. After a strong start in 2010, economic growth in the U.S., as measured by annual change in gross domestic product, continues to lose momentum, and unemployment remains stuck at 9.6%. Despite a total return of 8.9% for the S&P 500 in September, valuation multiples are below historical averages. The S&P 500 index is trading at 16.0x trailing earnings compared to the 20-year average of 20.5x, which can in part be attributed to investors’ skepticism regarding the ability of companies to generate sustainable earnings growth over the next several years.

Against this backdrop, we have been unable to determine what is different about real estate that is driving cap rates down (and multiples up), in the face of low growth expectations for operating fundamentals – not to mention the wall of debt maturities facing the industry. Without economic growth, or the confidence in the prospect for economic growth, corporations and individuals limit their spending. For commercial real estate, corporate and individual spending is the main driver of operating fundamentals and cash flow. To state the obvious, less spending translates to less hiring and therefore less demand for office space; lower inventories and therefore less need for warehouse space; less business and leisure travel and therefore less demand for hotel rooms; and less personal spending and therefore lower retail sales. Of course, “less” is a relative concept and more directional than quantifiable, but clearly growth or upside is likely to be muted. While real estate remains a local business, a look at historical trends confirms that over time, total returns for real estate are highly correlated to economic growth (i.e., GDP). As long as corporations and individuals remain cautious about spending, real estate fundamentals are not likely to improve.

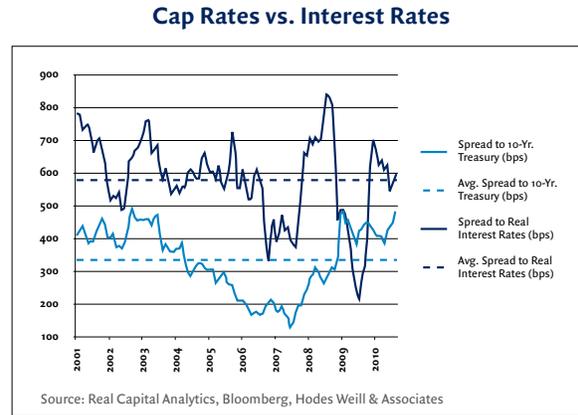
Correlation of U.S. GDP and Real Estate Returns



As a result, many seasoned real estate investors are scratching their heads at the valuations associated with recent property sales, in particular the cap rates paid by buyers for well-leased properties with limited opportunity to add value. In some instances, you can defend these values as a function of the low cost of debt financing. This, in itself, is a little disconcerting since one of the hallmarks of the recent pricing bubble was underwriting based on leveraged returns with little regard for the fundamental pricing of the real estate. While current valuations still reflect a discount relative to peak pricing from late in the recent cycle, much of the discount has gone away for well located, fully-leased core assets. You could rely on the old standby “real estate is an inflation hedge”, and then hope for a little inflation. Or, you can rely on the “relative return” argument – that real estate returns offer a decent risk-adjusted premium to money market or other fixed income alternatives.

These rationales offer some reassurance. However, we remain unconvinced that recent cap rates for well-leased properties are justified in terms of future growth in operating cash flow. Well-leased buildings purchased at low cap rates may actually be more risky than investing in under-leased or capital-stressed investments where the opportunity exists to drive cash flow and add value. Acquiring core assets at low cap rates (with no place to go but up), and little or no underwritable growth, does not appear to be a good risk-adjusted investment. An asset with low leverage or high occupancy does not ensure that the investment is without risk.

Real estate is typically valued on a discounted cash flow basis, taking into account the going-in and exit cap rates, along with the projected operating cash flow of the asset and ongoing capital expenditures. Today, investors appear to be targeting unleveraged returns as low as 8.0% to 9.5% for real estate; we believe this is 150-200 basis points below long-term, historical averages. We assume, in part, that the decline in return expectations can be justified by the return premium relative to risk-free rates. But is that really justification for pricing levels at this point in the real estate and economic cycle? Putting aside the fact that real estate investments are not bonds, today’s return premiums should be viewed against real interest rates (i.e., adjusted for inflation). After adjusting for today’s low inflation levels, return premiums are more in line with historical averages.



Recent transactions have been occurring in the 5.5% to 6.5% cap rate range. Assuming cap rates remain flat (and we would argue that cap rates are more likely to trend up than down over the next 5 to 10 years), operating cash flow needs to grow in excess of 2% per year to support 8.0% to 9.5% total unleveraged returns (assuming a 5-year hold period). This rate of growth is indicative of long-term trends, and may be a decent bet coming out of a market downturn. However, if growth is flat over the next several years, or if there is another recession before 2%+ growth resumes, then unleveraged returns will be closer to 7%. And under this scenario, if cap rates rise 100 basis points, unleveraged returns will be closer to 4%. Today’s cap rates do not seem justifiable in the current economic environment, unless one believes that there has been a more fundamental re-pricing of risk-based returns across asset classes, e.g. “real estate provides an attractive relative return”.

Unleveraged Returns: Cap Rate and NOI Growth Sensitivity

| | | Exit Cap Rate vs. Initial Cap Rate | | | | | |
|---|---------|------------------------------------|------|------|-------|-------|-------|
| | | -50bp | 0bp | 50bp | 100bp | 150bp | 200bp |
| Annual NOI Growth (Yr1, Yr2, thereafter) | -2,0,2% | 7.9% | 6.3% | 4.9% | 3.6% | 2.5% | 1.4% |
| | 0,0,2% | 8.3% | 6.8% | 5.3% | 4.1% | 2.9% | 1.8% |
| | 0,2,2% | 8.8% | 7.2% | 5.8% | 4.5% | 3.3% | 2.2% |
| | 2,2,2% | 9.2% | 7.6% | 6.2% | 4.9% | 3.7% | 2.7% |
| | 2,2,3% | 9.8% | 8.2% | 6.8% | 5.5% | 4.3% | 3.2% |
| | 2,3,3% | 10.0% | 8.4% | 7.0% | 5.7% | 4.5% | 3.4% |
| | 3,3,3% | 10.2% | 8.6% | 7.2% | 5.9% | 4.7% | 3.6% |

Source: Analysis prepared by Hodes Weill & Associates

Over the past 6 months, several well-leased office buildings have traded in Manhattan. Brokers described the demand for these assets as a “feeding frenzy”, with 30+ bidders showing up for each auction. Although the buildings traded at a 30% discount to peak per square foot pricing, the implied cap rates were as low as 5.0%. In a recent conversation at an industry breakfast, several brokers concurred that in order to be competitive in an auction for these buildings, buyers had to underwrite significant near-term growth in market rents just to maintain the going in yield (as expiring rents roll to market). In order to achieve an IRR in excess of the going in yield, some underwrote rent growth of as much as 10% per year over the next three years.

By definition, an investor must have some level of optimism to buy anything, in order to believe that an acceptable return is achievable. But how much growth should a buyer underwrite in today’s uncertain economic environment? Furthermore, if pricing cannot be supported by growth prospects, does it not stand to reason that investors should be net sellers of stable, core assets (and assets that will be perceived as such), at least to take some chips off the table?

This would be contrary to what many institutions are doing today; rather, many are shifting real estate allocations to core and away from value-add and distressed strategies. It feels like we’ve seen this movie before – in the recent past, most institutions shifted from core to opportunistic investing in the build up to the recent market peak (in hindsight, an ill-timed decision).

Returns are not only influenced by strategy, timing, leverage and asset management capabilities, but by capital flows – and moving with the crowd can increase risk. When exit queues from the open end funds are replaced with entry queues in a matter of months, the “behavior of the crowd” in institutional capital flows is apparent. We do not believe that real estate is a 20% IRR business year-in and year-out and agree that allocations, over a full cycle, should be weighted towards core. But, there is significant competition and risk at the core end of the spectrum, and we would suggest a measured approach regarding a portfolio re-alignment and that institutions shift their portfolio weightings over a 3-5 year period.



In the meantime, we believe that a window will open over the next several years to invest in distressed assets and capital-constrained situations at attractive returns. The investors best positioned to take advantage of these opportunities will be those with operating expertise and a track record of investing in distress. Unfortunately, many of today’s investment professionals did not experience the last big downturn, so choosing the right partner will be crucial. Patience will be rewarded and it is prudent to wait for investments that pencil out on a “price per pound” basis, as opposed to underwriting that requires a rebound in operating fundamentals.

In this uncertain economic environment, growth should be the gravy on the investment, not the beef.

HODES WEILL & ASSOCIATES

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