

# US Commercial Real Estate: The Turning Point?



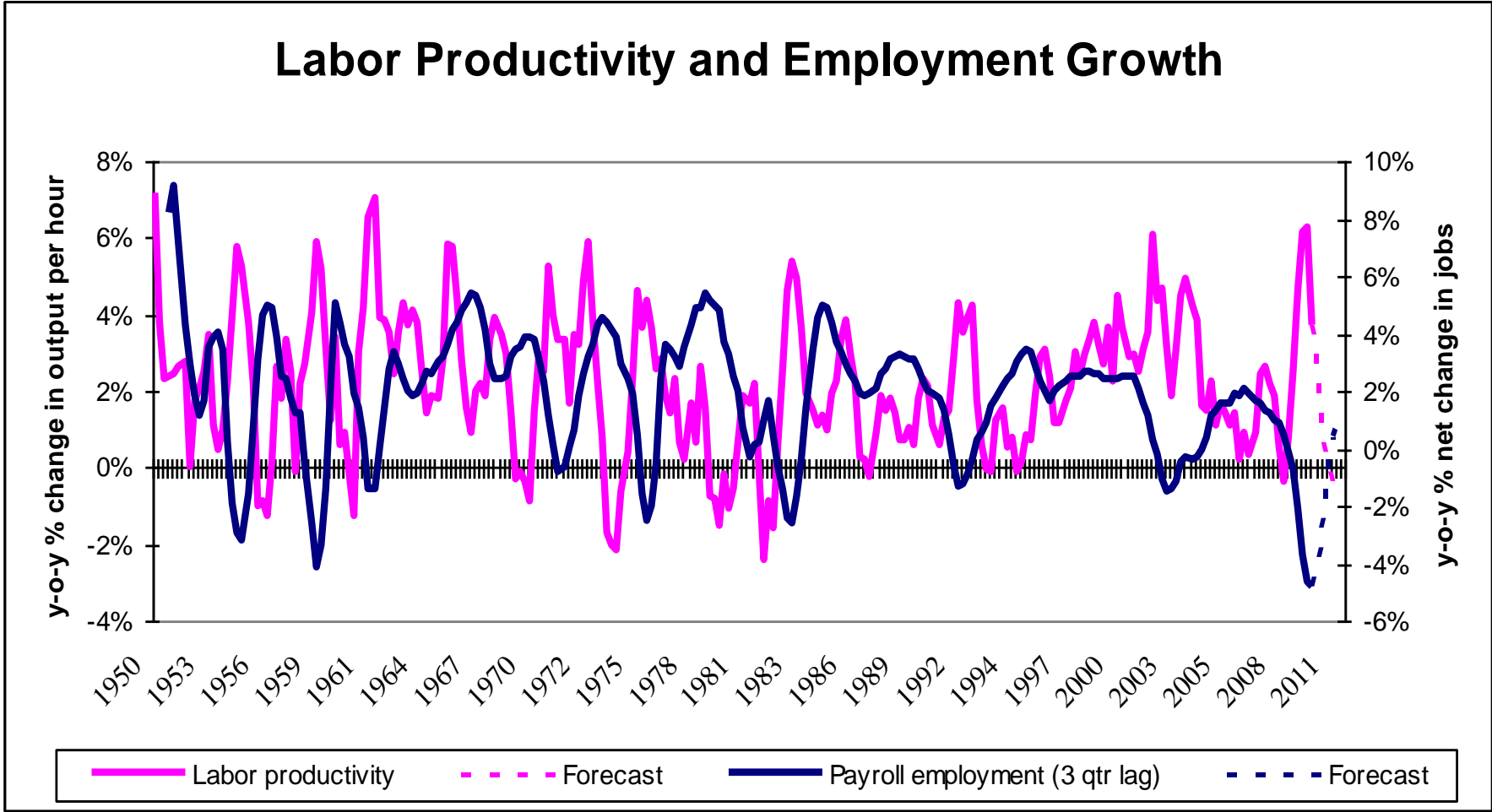
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- Global credit crisis and recession synchronized due to systemic nature of downturn
- But a decoupling economic recovery underway
  - Increasing concerns about strength and sustainability of global recovery
  - Emerging markets leading recovery, despite uncertainty about China property market and soft or hard landing
  - Europe's post export-boost outlook in question as austerity kicks in
  - Concerns about double dip recession and jobless recovery in U.S.
- Despite global decoupling, a common thread → increased government intervention and heightened presence across the world's economies
  - Policy error now the primary downside risk
  - Sovereign risk: is the credit crisis over, or just transferred from the private to the public sector?
  - QE2 meets QT1, as nations seek to limit capital inflows from carry trade
  - Competitive currency devaluation: the fight for export market share

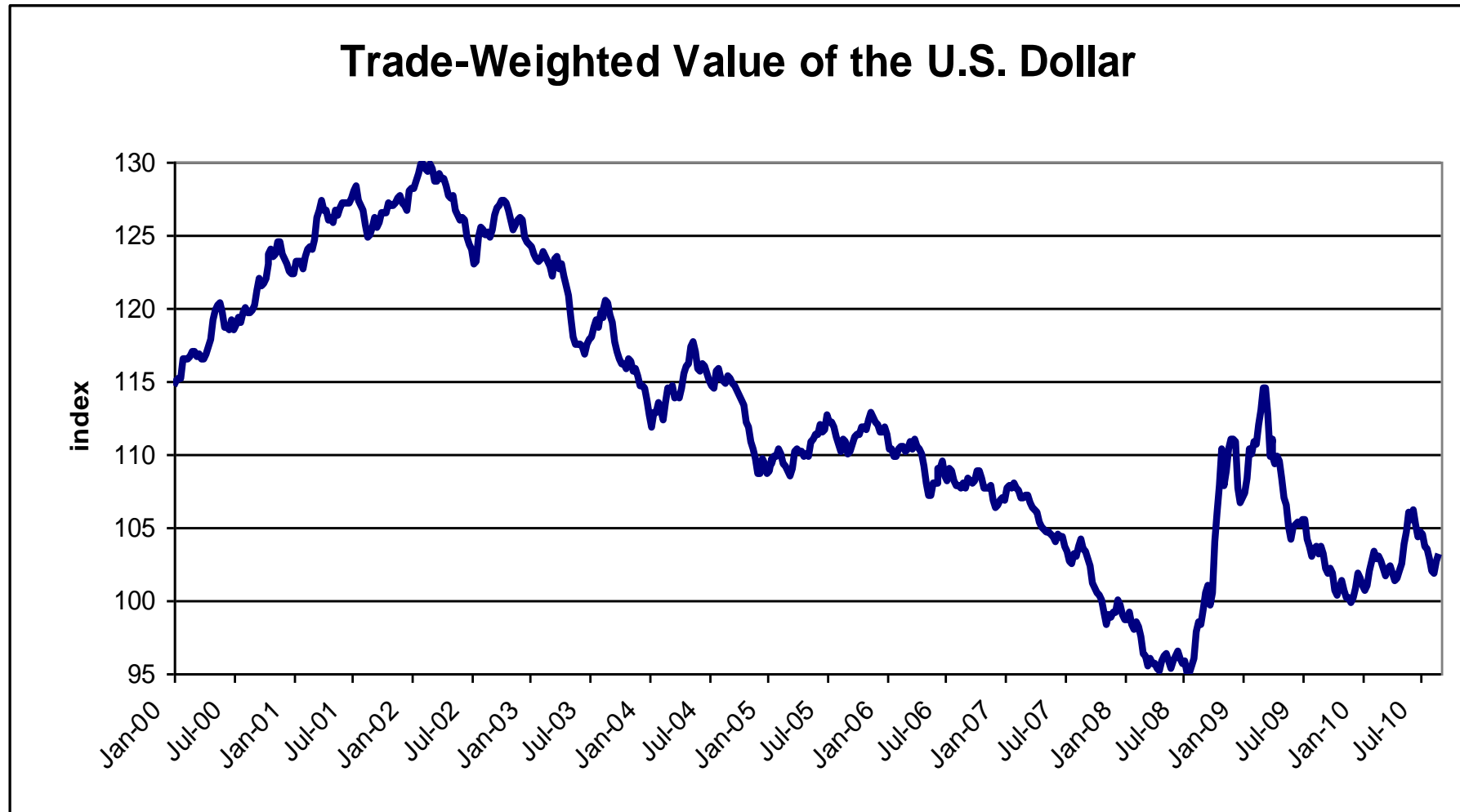
- Primary areas of concern for U.S. economy
  - High unemployment rates: cyclical or structural?
  - Still unresolved issue of credit access by small businesses (the major source of job creation)
  - Housing market remains weak
  - Deteriorating fiscal condition of state and local governments
  - Risk of poor policy decisions, including tax policy, protectionism, overregulation and failure to rein in federal government spending
  - QE2 aftermath: is the Fed applying a cyclical solution to a structural economic problem?
  - Double dip ---- or just an extended soft patch?

- Reasons for optimism in 2011
  - Political gridlock → lowers incremental risk of major policy error
  - Pace of bank failures should begin to ease in 2011
  - Stabilizing commercial real estate values should help accelerate resolution of problem loans and free up lending capacity to small business
  - Continued household deleveraging and higher savings rates → a consumer base that is less likely to go into retrenchment mode
  - Continued favorable outlook for corporate earnings in 2011
  - Weak dollar should drive export growth
  - Asset reflation-friendly actions by Fed (while increasing the risk of longer term inflationary pressures) are supportive of asset values over the near to intermediate term
  - Declining labor productivity historically correlated (on a lagged basis) with improved job growth



Source: Bureau of Labor Statistics, Principal Global Investors September 2010

# U.S. Export Outlook Improving, as Dollar Fades

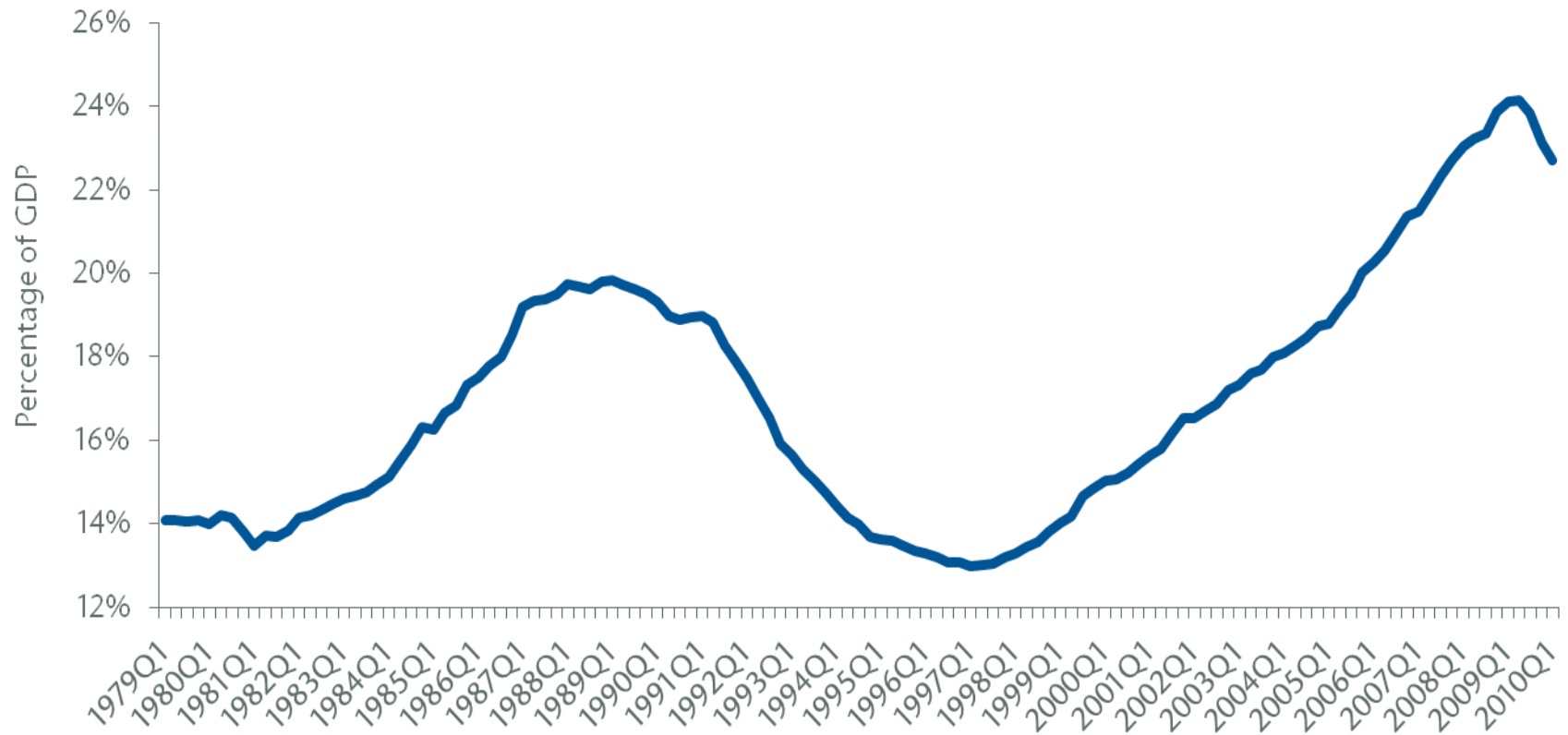


SOURCE: FEDERAL RESERVE BANK, SEPTEMBER 2010

- Both space and capital markets have improved in 2010, but particularly the latter
- Significant capital allocations to core property
  - Highly competitive lending activity driving spreads in
  - Strong acquisition bid activity, especially gateway markets and high quality
  - CMBS issuance market making a gradual comeback
- Less capital flowing to value-add or opportunistic, but even that is improving
- All four quadrants appear to have now reached bottom of price correction and turned upwards, barring a double dip recession
- Real estate deleveraging process underway

# Another Real Estate Turning Point

Commercial Mortgage Debt Outstanding as % of GDP

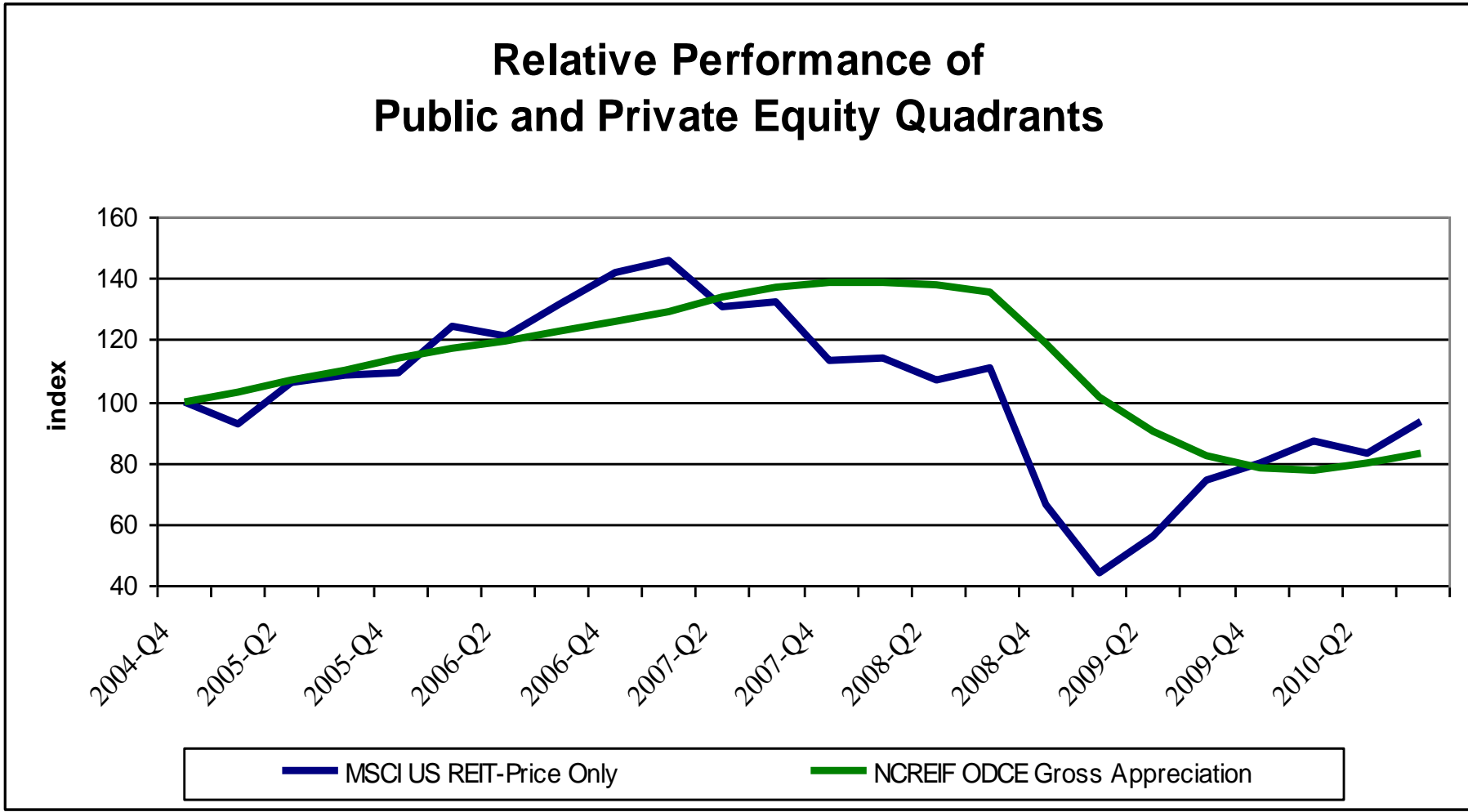


SOURCE: FEDERAL RESERVE FLOW OF FUNDS, BUREAU OF ECONOMIC ANALYSIS, JULY 2010



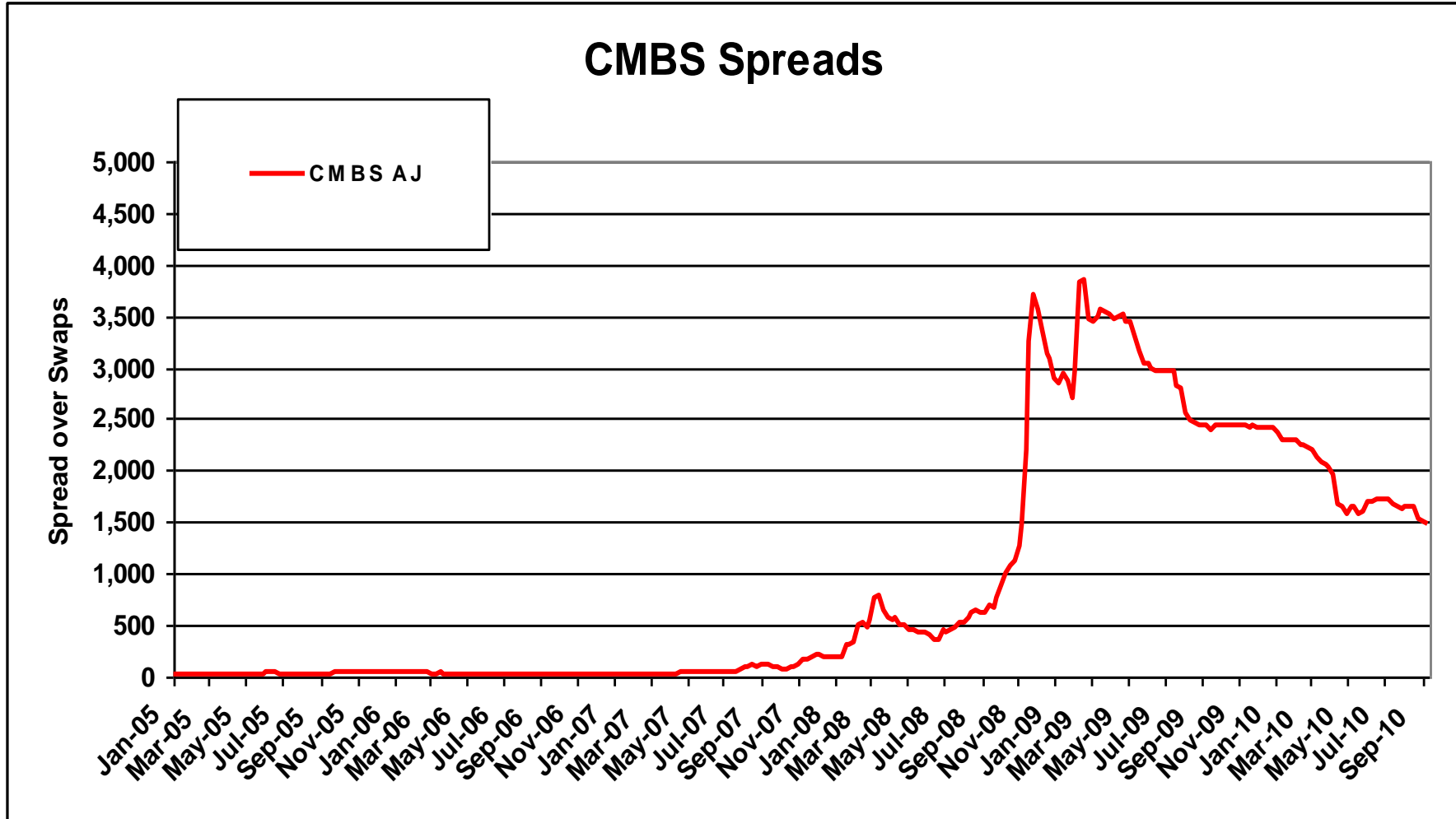
# Real Estate Values on the Upswing

## Relative Performance of Public and Private Equity Quadrants



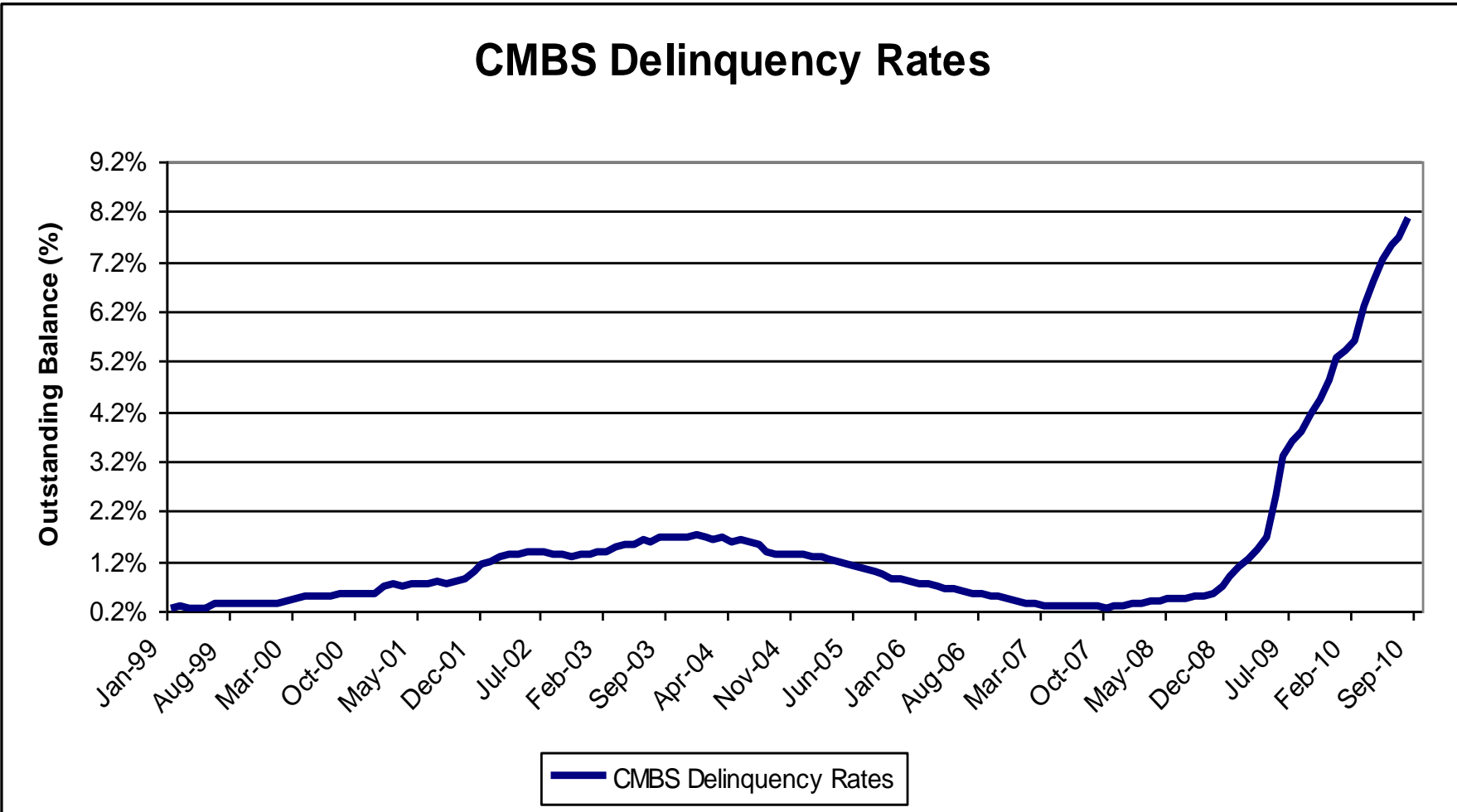
SOURCES: MORGAN STANLEY, NCREIF, JULY 2010

# Strong Rally in CMBS Prices...



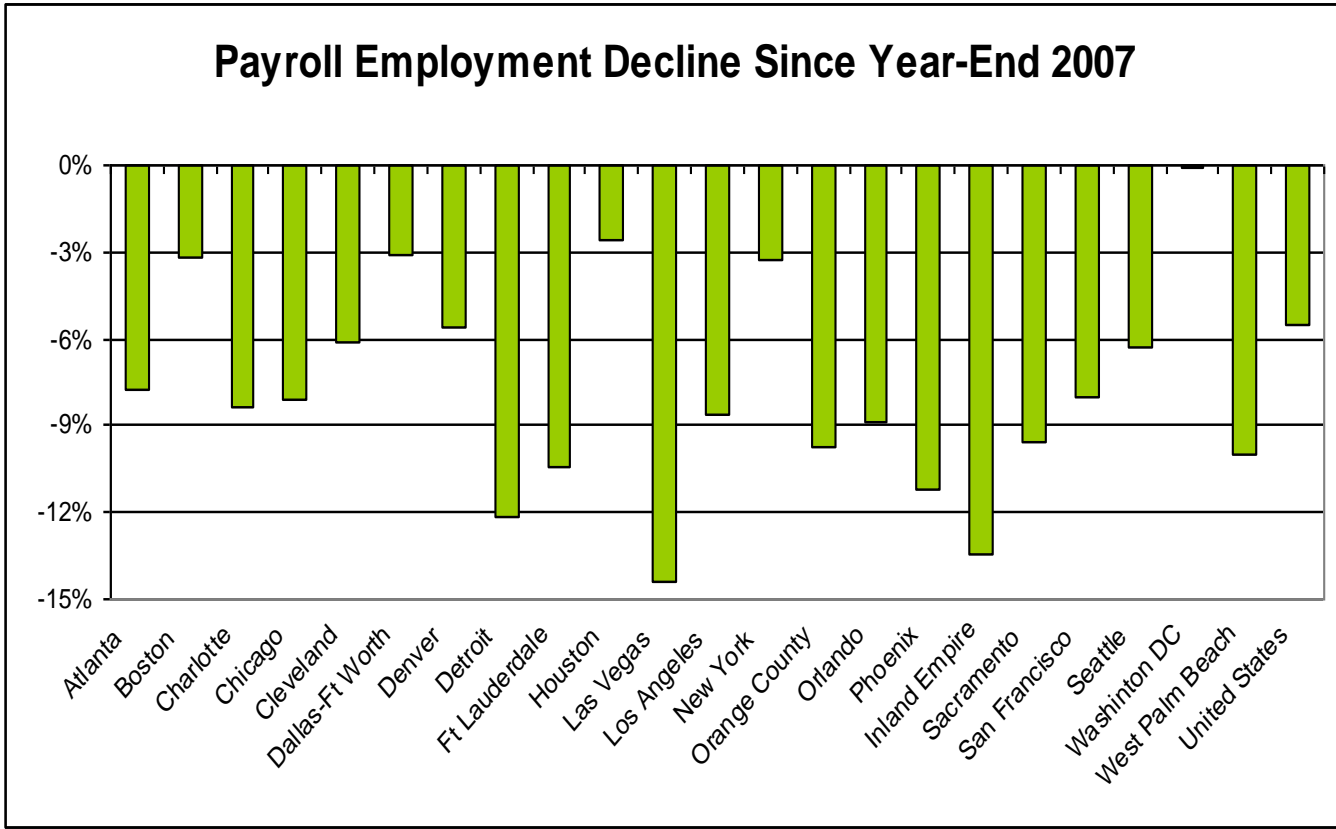
# ...Despite Rising Delinquency Rates

## CMBS Delinquency Rates



# Real Estate Space Markets

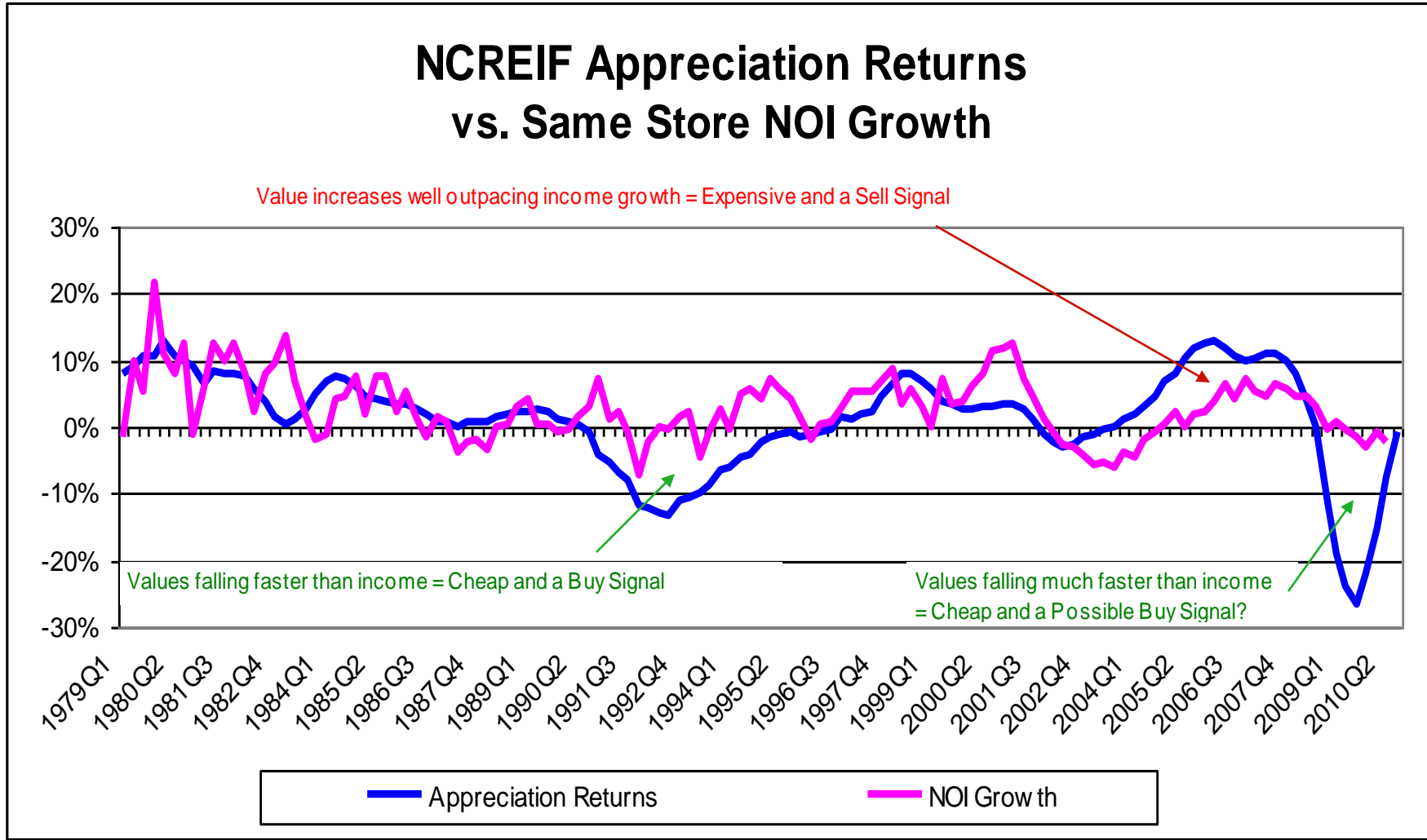
- Vacancy rates nearing cyclical peak
- Office and warehouse net absorption has turned positive
- Near-record multifamily absorption
- Retail net absorption still flat
- Very little new supply coming on line for any property types, so primary issue is demand recovery
- Effective rents beginning to increase for most property types, but significant variance across markets



Source: Bureau of Labor Statistics, September 2010

# Real Estate Cheap/Expensive Signals

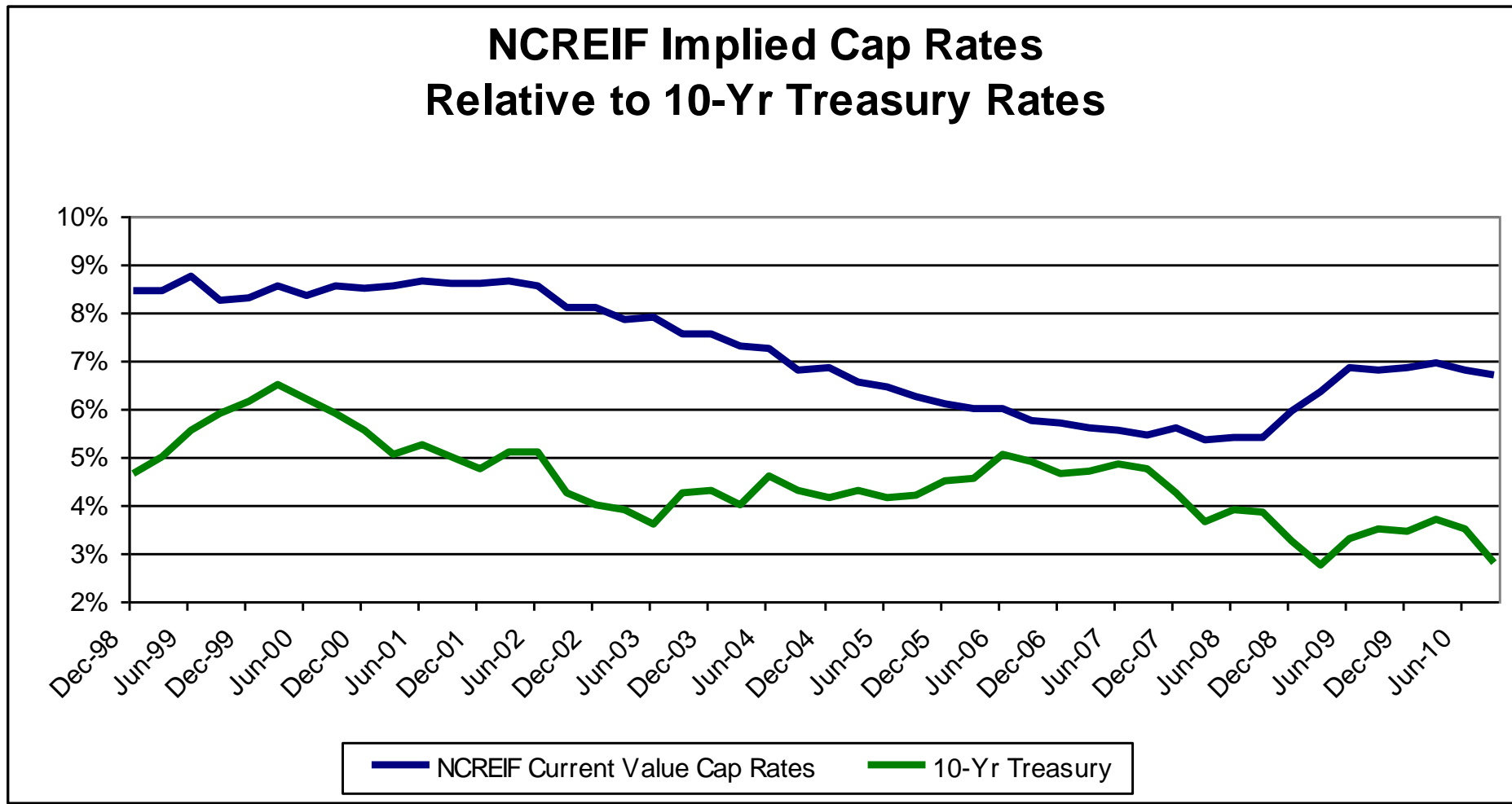
## NCREIF Appreciation Returns vs. Same Store NOI Growth



SOURCE: NCREIF, MARCH 2010

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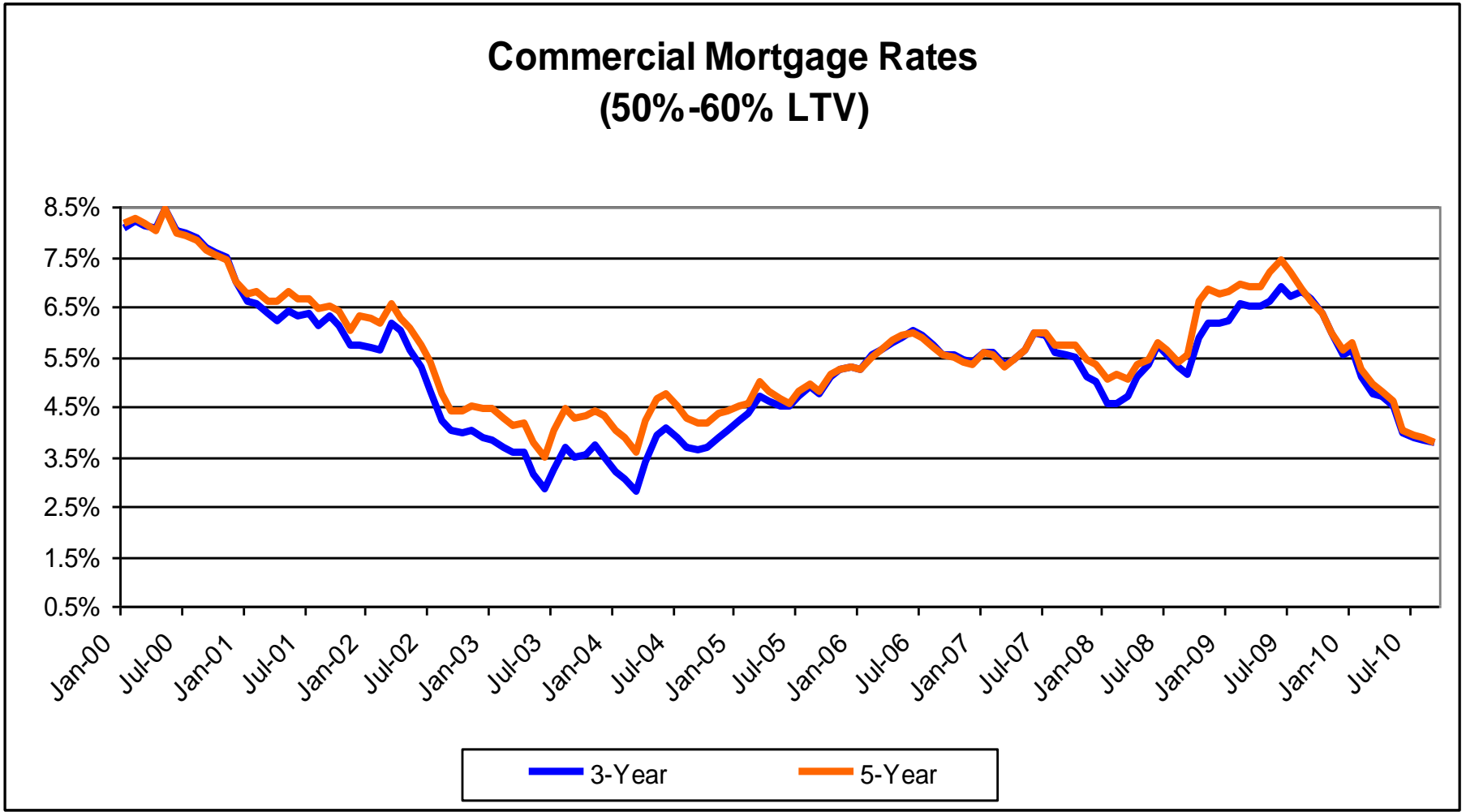
## NCREIF Implied Cap Rates Relative to 10-Yr Treasury Rates



SOURCE: NCREIF, U.S. TREASURY, JULY 2010

# Falling Cost of Debt Capital

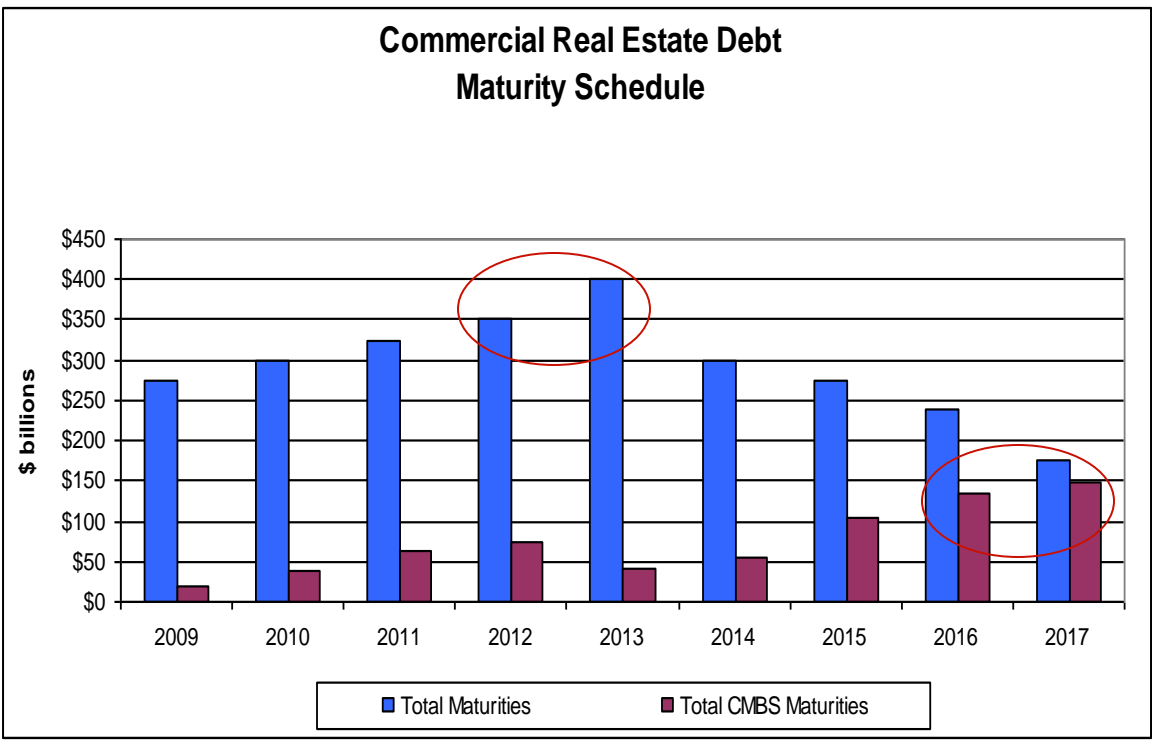
### Commercial Mortgage Rates (50%-60% LTV)



Source: Principal Real Estate Investors, September 2010

# But A Need for Investor Caution

- Deleveraging has a long way to go and faces dual refinancing hurdles
  - Portfolio lenders
  - Shadow banking
- Eventual reversal of QE2 and ultra-accommodative monetary policy
  - A race between space market improvement and potential upward pressure on cap rates and interest rates
- Uneven space markets → high degree of investor selectivity needed across markets



SOURCES: ACLI, Federal Reserve, Deutsche Bank, Intex, Trepp, Principal Real Estate Investors, August 2010



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