

## Cycle Monitor - Real Estate Market Cycles

Second Quarter 2007 Analysis  
August 2007

### Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.

The sub-prime mortgage loan problems have hit the entire real estate industry lending market, even though sub-prime loans have NOTHING to do with commercial real estate. Spreads on commercial loans have widened even though the fundamentals of occupancies and rents continue to improve in all property sectors with the exception of retail. This market disarray may spell opportunity for many of the cash buyers who have been outbid by leveraged buyers in the past.

Office occupancies increased 0.2% for 2Q07 with rent growth of 7% expected over the next year.

Industrial occupancy was flat for 2Q07, but rents grew 1.5% and we expect 3% rent growth over the next year.

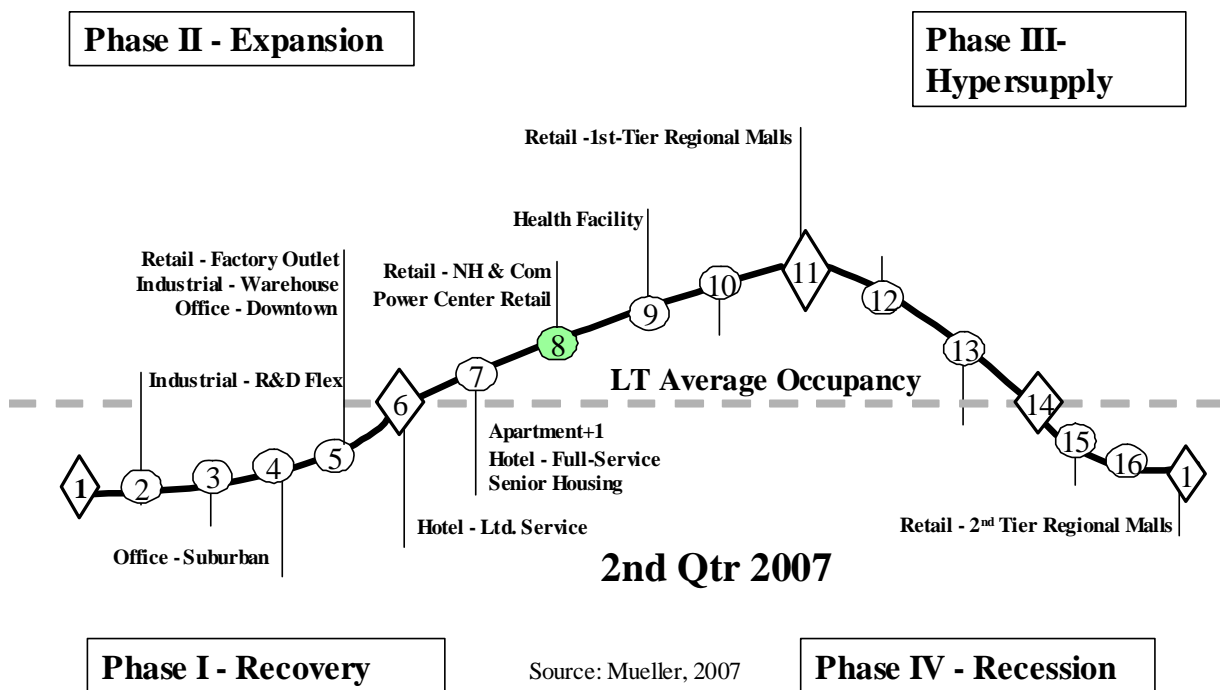
Apartment occupancy improved 0.5% year-over-year in 2Q07 and we forecast 4% to 5% rent growth over the next year.

Retail occupancy declined 0.2% in 2Q07 with rent growth of only 0.3%. We forecast 2.5% rent growth for the next year.

Hotel occupancies improved 0.4% in 2Q07 and forecast RevPAR growth of 6% over the next year.

The National Property Type Cycle Graph shows relative positions of most subproperty types - major markets are reviewed inside.

### National Property Type Cycle Locations



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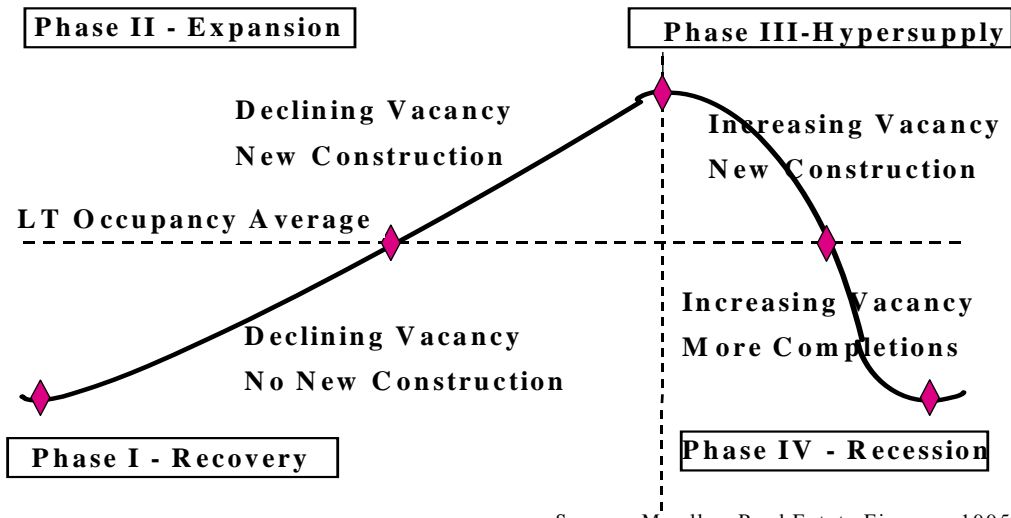
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All relevant disclosures and certifications appear on page 9 of this report.

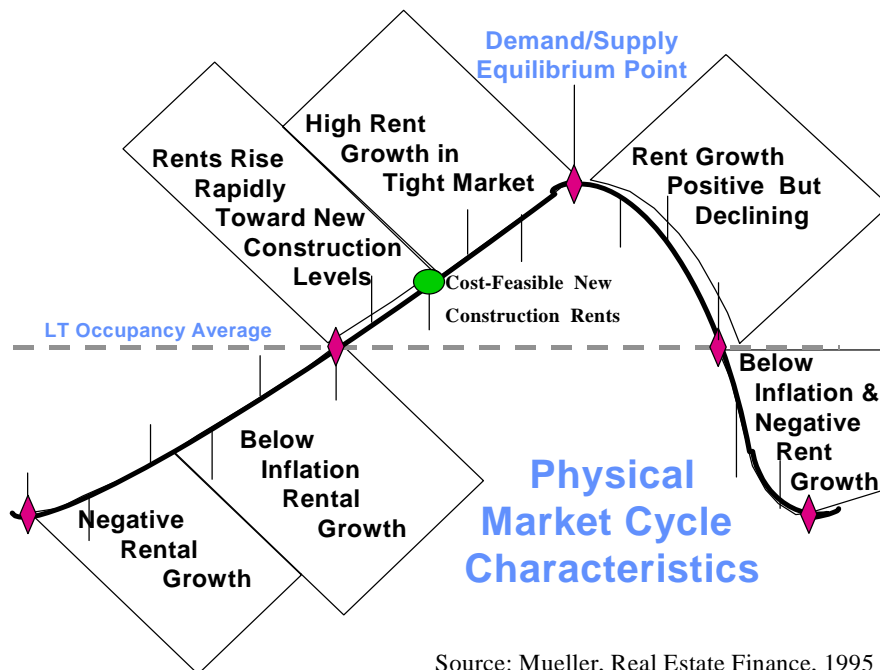
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that analyze occupancy levels and rental growth rates to provide the foundation for long-term investment success. Real estate markets are cyclical due to the lagged relationship between demand and supply for physical space. The long-term occupancy average is different for each market and each property type. *Long-term occupancy average* is a key factor in determining rental growth rates—a key factor that affects real estate returns.

### Market Cycle Quadrants



Source: Mueller, Real Estate Finance, 1995

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

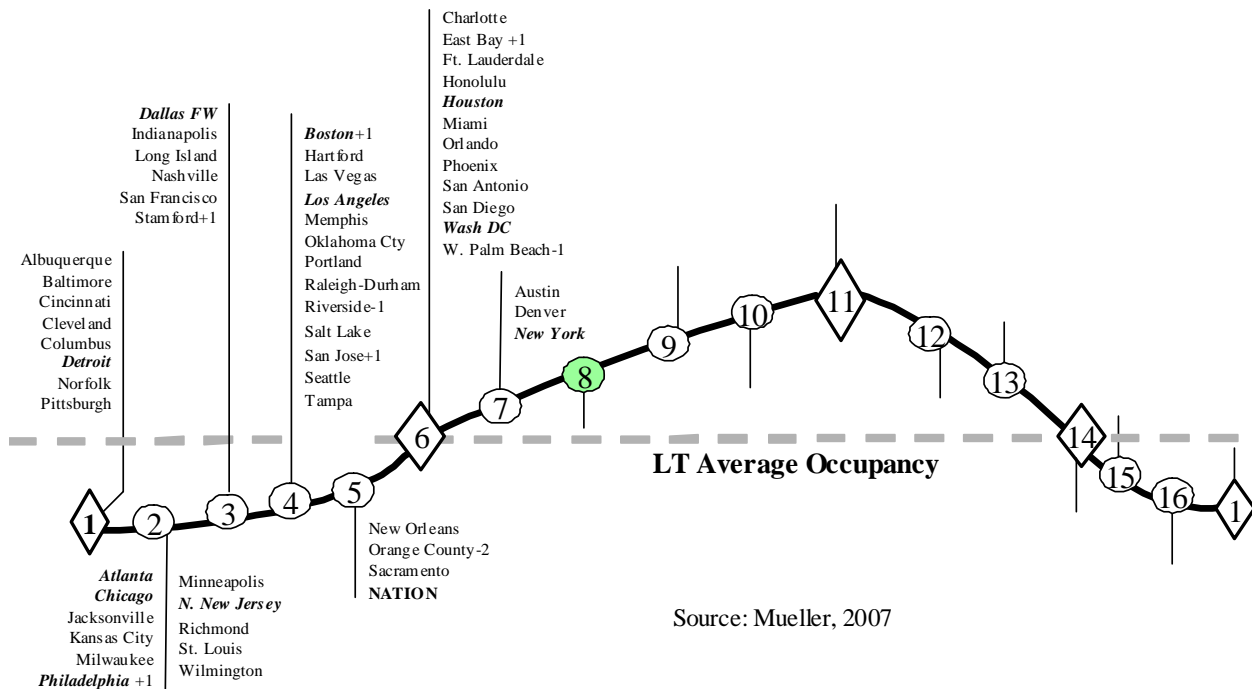


Source: Mueller, Real Estate Finance, 1995

## OFFICE

National office occupancy improved between 0.1% and 0.3% in 2Q07, depending upon the data source. Absorption totaled over 21 million square feet of space for the quarter (the highest absorption rate since 4Q05). A few markets are being affected negatively by new supply being higher than demand, while demand decline was notable in only two markets (Orange County and Riverside) where the sub-prime mortgage companies are putting space on the sub-lease market. Half the office markets covered had very minor occupancy improvements, while only 14 had minor occupancy declines. Positive but low employment growth should keep office markets moving forward for the next year. Rent growth for second quarter 2007 averaged 2.1% and was almost 8% year-over-year. The rent growth forecast for 2007 has now improved to more than 7%, even with a slowing economic forecast.

### Office Market Cycle Analysis 2nd Quarter, 2007



Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor.

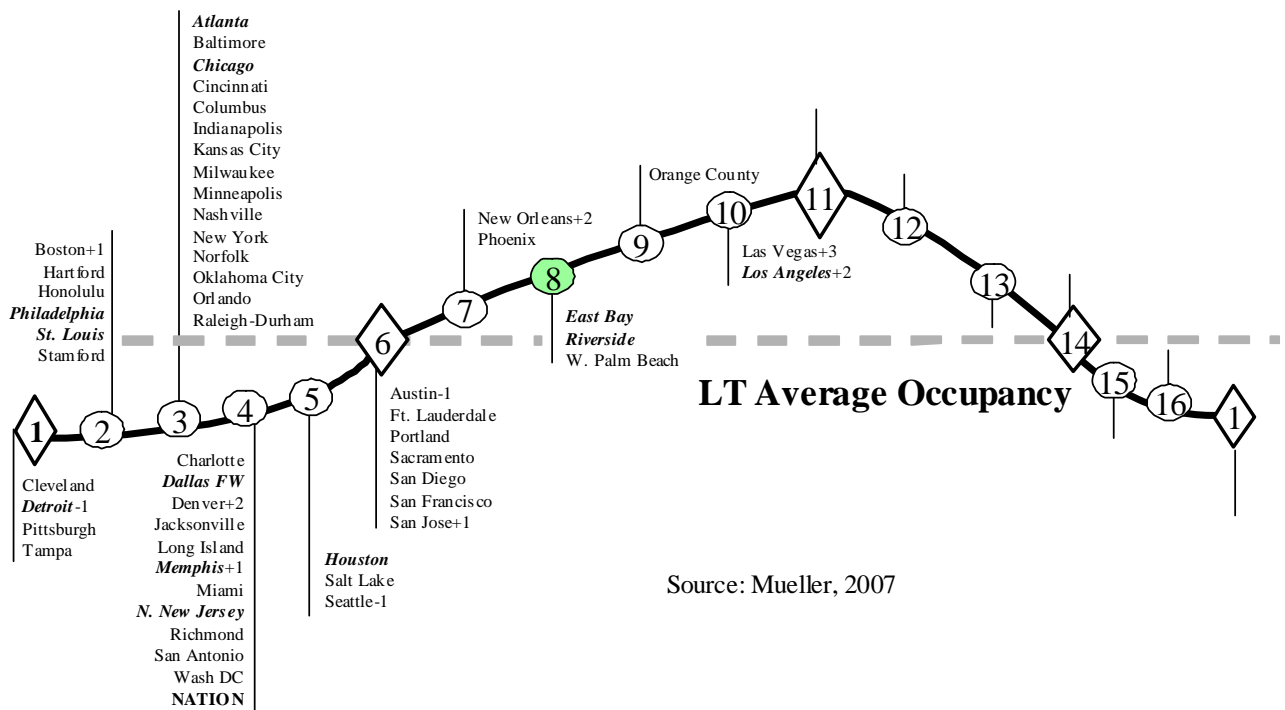
Thus, the 11-largest office markets are in **bold italic** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## INDUSTRIAL

Industrial occupancies did not change quarter to quarter for the second quarter of 2007. There were six markets that improved occupancies enough to move forward one or two cycle positions and all of these were in the west, with the exception of Memphis, Tennessee. Demand for space is moderate as retail growth is slowing, but new supply has behaved well keeping markets in balance. Occupancy rates are now only 0.1% better than a year ago. Second quarter 2007 saw rent growth of about 1.5% providing a year-over-year growth of 4%, but the slowing economy causes us to reduce our annual forecast to a 2% to 3% rent growth for the next year.

### Industrial Market Cycle Analysis 2nd Quarter, 2007



Source: Mueller, 2007

Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space we monitor.

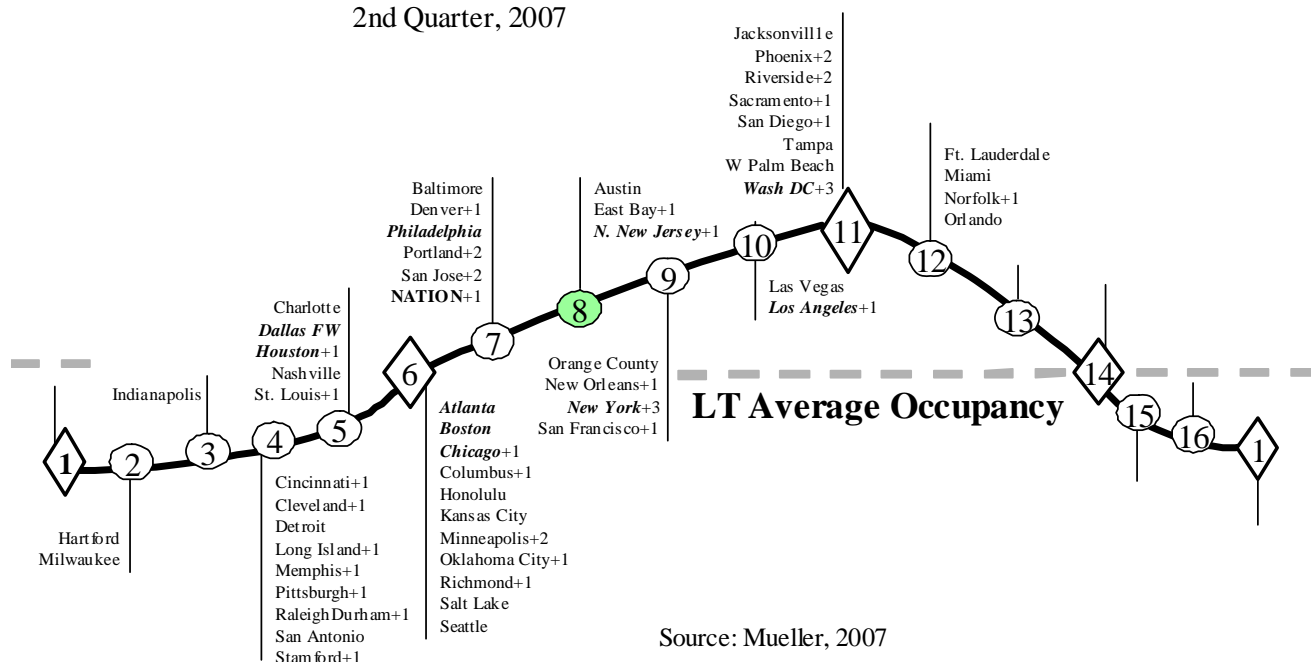
Thus, the 12-largest industrial markets are in **bold italic** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## APARTMENT

Apartment occupancy improved 0.1% in 2Q07 and is about 0.5% better year-over-year. We have moved the national average to position seven, which is the start of the growth phase of the cycle. We note that there are now 15 markets with vacancy rates below 5% and 16 additional markets with vacancy rates between 5% and 6%. Thirty markets improved their cycle position by one or more points on the graph. New construction is now cost justified in more than 2/3 of all markets. Norfolk was the only market to come off its peak occupancy and join the Florida markets that slowed in 1Q07. Continued employment growth (though slow) along with sub-prime foreclosures should keep apartment demand healthy for the next year. Rent growth was up 1.3% for 2Q07 and up 5.5% year-over-year. We continue to estimate rental growth to average 4% to 5% for 2007.

### Apartment Market Cycle Analysis 2nd Quarter, 2007



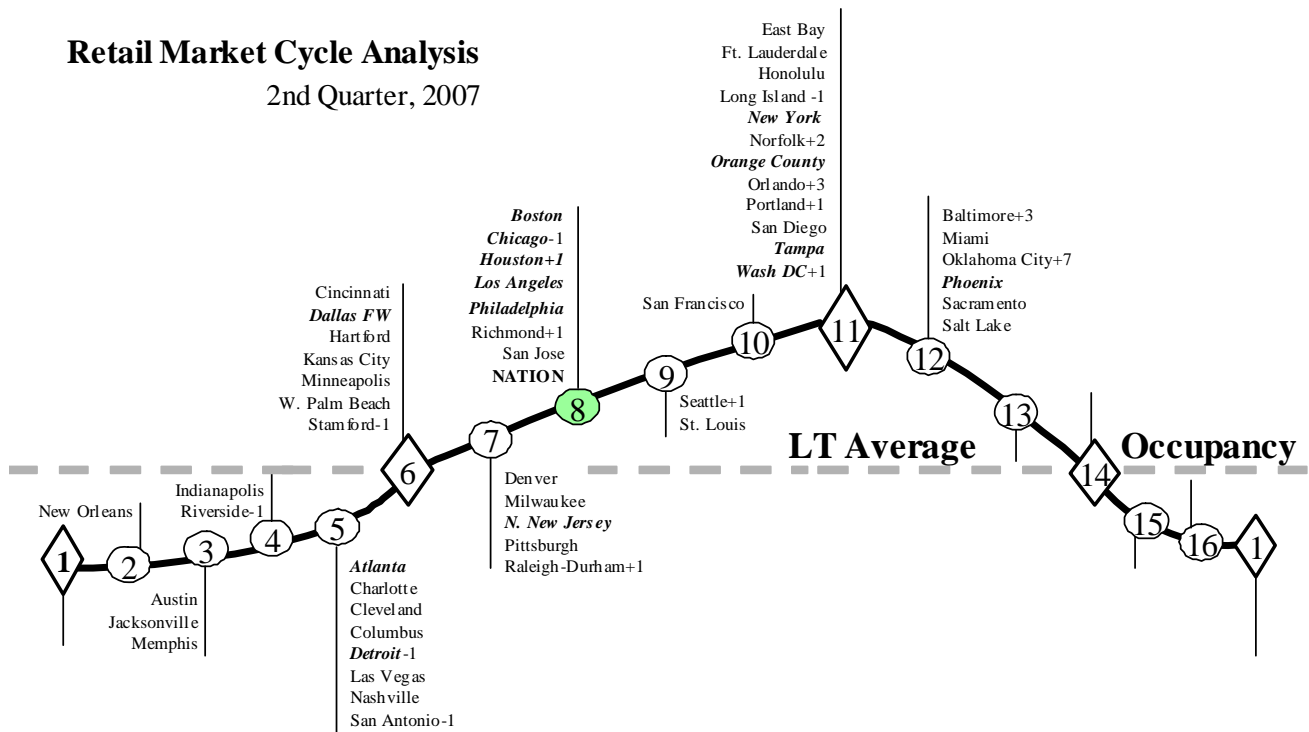
Source: Mueller, 2007

Note: The 10-largest apartment markets make up 50% of the total square footage of multifamily space we monitor. Thus, the 10-largest apartment markets are in **bold italic** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## RETAIL

Retail occupancies declined 0.2% in 2Q07 as retailers became more cautious about expanding in a slowing economy. The decline in the consumer confidence index and declining home values are also caution signs for lower retail sales going forward. These signals should make retailers more careful with their store expansion plans and reduce demand in the next year or more. Big Box retail will probably be hit hardest of all the property sectors. Year-over-year occupancies are now down 0.6%, but still high enough to create annual rental growth of 3.4%, but only 0.3% came from 2Q07. Our occupancy forecast now shows a full 1% decline in retail occupancy for the next full year and we are reducing the rent growth forecast to 2.5% for the next full year.



Source: Mueller, 2007

Note: The 15-largest retail markets make up 50% of the total square footage of retail space we monitor. Thus, the 15-largest retail markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

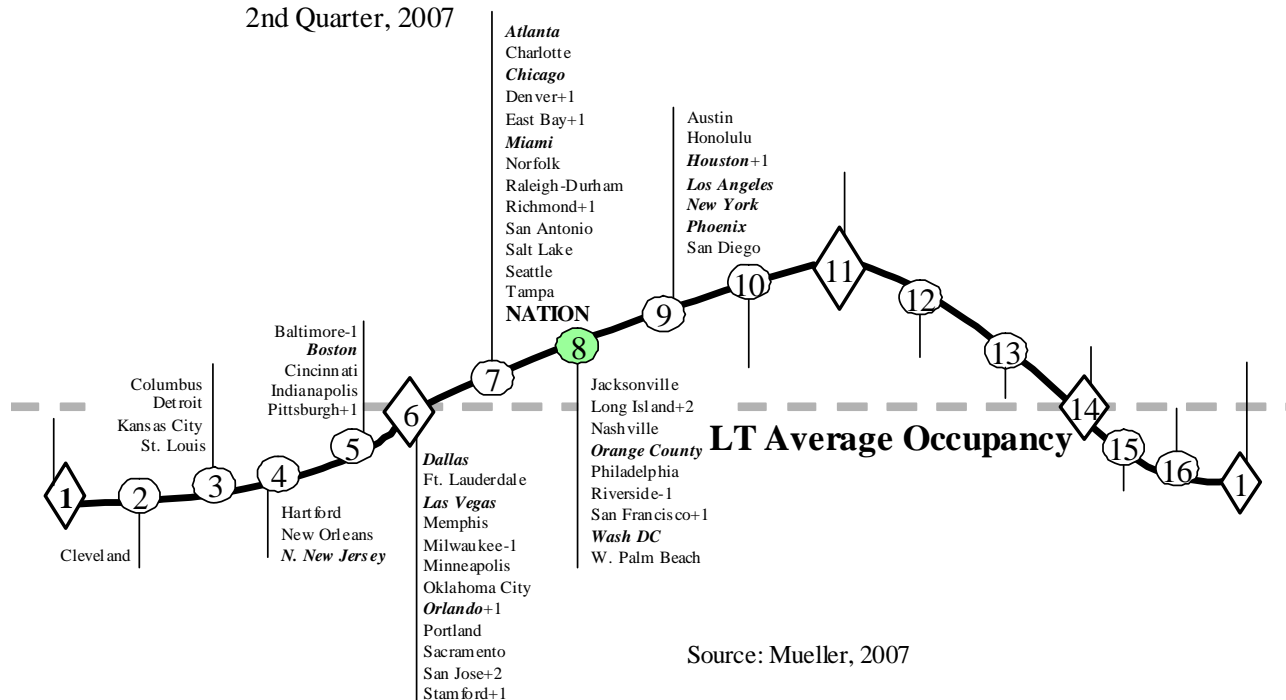
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

## HOTEL

Hotel occupancies improved by a strong 0.4% for 2Q07 and continue to improve above the 67% occupancy level. This is a full 2% above the historic 65% level needed to have good profitability. Airlines reported their flights averaged more than 90% capacity in July, the highest level ever reported, thus people are continuing to enjoy their leisure time despite a slowing economy. This demand may be due to continued high employment levels. The majority of markets left in the recovery phase of the cycle are in the Midwest where business growth is slow and tourism is not strong. RevPAR growth was a strong 7.8% annualized for 2Q07, with a year-over-year growth close to 6%. We expect RevPAR growth for 2007 to run near the 6% range assuming GDP growth holds above 2% for the next year.

### Hotel Market Cycle Analysis

2nd Quarter, 2007



Note: The 14-largest hotel markets make up 50% of the total square footage of hotel space that we monitor.

Thus, the 14-largest hotel markets are in boldface italics to help distinguish how the weighted national average is affected.

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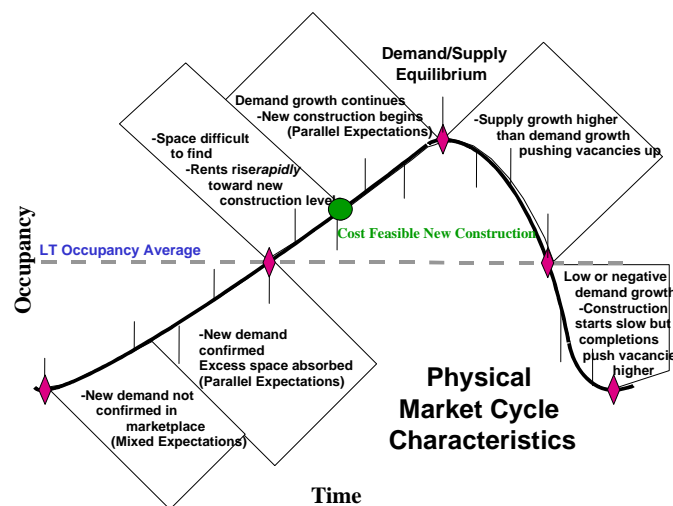
**MARKET CYCLE ANALYSIS — Explanation**

**Supply and demand interaction is important to understand. Starting in Recovery Phase I at the bottom of a cycle** (see chart below), the marketplace is in a state of oversupply from previous new construction or negative demand growth. At this bottom point, occupancy is at its trough. Typically, the market bottom occurs when the excess construction from the previous cycle stops. As the cycle bottom is passed, demand growth begins to slowly absorb the existing oversupply and supply growth is nonexistent or very low. As excess space is absorbed, vacancy rates fall, allowing rental rates in the market to stabilize and even begin to increase. As this recovery phase continues, positive expectations about the market allow landlords to increase rents at a slow pace (typically at or below inflation). Eventually, each local market reaches its *long-term occupancy average* whereby rental *growth is equal to inflation*.

**In Expansion Phase II, demand growth continues at increasing levels, creating a need for additional space.** As vacancy rates fall below the *long-term occupancy average*, signaling that supply is tightening in the marketplace, rents begin to rise rapidly until they reach a cost-feasible level that allows new construction to commence. In this period of tight supply, rapid rental growth can be experienced, which some observers call “rent spikes.” (Some developers may also begin speculative construction in anticipation of cost-feasible rents if they are able to obtain financing.) Once cost-feasible rents are achieved in the marketplace, demand growth is still ahead of supply growth — a lag in providing new space due to the time to construct. Long expansionary periods are possible and many historical real estate cycles show that the overall up-cycle is a slow, long-term uphill climb. As long as demand growth rates are higher than supply growth rates, vacancy rates will continue to fall. The cycle peak point is where demand and supply are growing at the same rate *or equilibrium*. Before equilibrium, demand grows faster than supply; after equilibrium, supply grows faster than demand.

**Hypersupply Phase III of the real estate cycle commences after the peak/equilibrium point #11 — where demand growth equals supply growth.** Most real estate participants do not recognize this peak/equilibrium’s passing, as occupancy rates are at their highest and well above long-term averages, a strong and tight market. During Phase III, supply growth is higher than demand growth (hypersupply), causing vacancy rates to rise back toward the long-term occupancy average. While there is no painful oversupply during this period, new supply completions compete for tenants in the marketplace. As more space is delivered to the market, rental growth slows. Eventually, market participants realize that the market has turned down and commitments to new construction should slow or stop. If new supply grows faster than demand once the long-term occupancy average is passed, the market falls into Phase IV.

**Recession Phase IV begins as the market moves past the long-term occupancy average with high supply growth and low or negative demand growth.** The extent of the market down-cycle will be determined by the difference (excess) between the market supply growth and demand growth. Massive oversupply, coupled with negative demand growth (that started when the market passed through long-term occupancy average in 1984), sent most U.S. office markets into the largest down-cycle ever experienced. During Phase IV, landlords realize that they will quickly lose market share if their rental rates are not competitive; they then lower rents to capture tenants, even if only to cover their buildings’ fixed expenses. Market liquidity is also low or nonexistent in this phase, as the bid-ask spread in property prices is too wide. The cycle eventually reaches bottom as new construction and completions cease, or as demand growth turns up and begins to grow at rates higher than that of new supply added to the marketplace.



Source: Mueller, Real Estate Finance, 1995

This Research currently monitors five property types in more than 50 major markets. We gather data from numerous sources to evaluate and forecast market movements. The market cycle model we developed looks at the interaction of supply and demand to estimate future vacancy and rental rates. Our individual market models are combined to create a national average model for all U.S. markets. This model examines the current cycle locations for each property type and can be used for asset allocation and acquisition decisions.

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