

2009

Kennedy Real Estate Outlook

A Forecast of the U.S. Economy and Real Estate Markets

KENNEDY ASSOCIATES
REAL ESTATE COUNSEL, LP
Institutional Advisors Since 1978

January 2009

Kennedy Associates Real Estate Counsel, LP, a full-service registered real estate investment advisor, brings 30 years of entrepreneurial real estate investment expertise to a select number of public, corporate and Taft-Hartley retirement systems, as well as major university endowments. Kennedy has invested in and managed \$13 billion in development, redevelopment, and existing properties. Throughout its history, Kennedy has brought superior value-added results on separate accounts to some of the country's largest institutional investors as well as the Multi-Employer Property Trust (MEPT) and closed partnerships.

Kennedy Associates is a leader in Responsible Property Investing (RPI). RPI considers environmental and social ramifications as well as fiduciary responsibilities in managing real estate investments by expanding the traditional business reporting framework to include people and the planet as well as profit. Kennedy Associates has practiced many of the RPI principles since the company's inception in 1978, including the use of responsible contractors, having built or in the process of developing \$2 billion of Leadership in Energy and Environmental Design (LEED) buildings and being carbon-neutral as a company. Kennedy was recently named one of the EPA's Energy Star Partner of the Year. Last year, the company was honored for its innovative RPI Initiative at the inaugural Sustainable Cities Award competition, which the Financial Times and Urban Land Institute sponsored www.kennedyusa.com

Multi-Employer Property Trust (MEPT) is an open-end commingled real estate equity fund that invests in a diversified portfolio of institutional-quality real estate assets in the United States. MEPT's seasoned management team has created a diversified portfolio of top-quality, core, income-producing assets through acquisition, development, rehabilitation, or repositioning of undervalued assets. The Fund invests in office buildings, warehouses, flex/research and development facilities, apartments, retail centers, and hotels. The Fund is managed by three entities: Kennedy Associates Real Estate Counsel, LP, (Kennedy) of Seattle, Washington, serves as the real estate investment advisor, Landon Butler & Company, LPTM (LBC) provides investor relations and marketing services to MEPT, and NewTower Trust Company (NewTower), of Bethesda, Maryland, serves as the trustee and fiduciary of the Fund. www.mept.com

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What Happened?

The current recession was caused by excessive use of leverage and a significant disregard for risk by a variety of market participants in the U.S. and abroad— consumers, businesses, financial institutions rating agencies, regulatory bodies and other “gate keepers” have all played a role. This caused a number of asset price bubbles that were first amplified — and then burst — by the use of complex financial instruments.

The cure to this problem is to find new market clearing prices for these assets, absent the use of high levels of inexpensive debt. This will take time, and there are no quick fixes. But, until this process plays out, historically wide credit spreads will persist because investors, consumers, and businesses will remain extremely wary of anything that has even a hint of risk. To date, fiscal policy has been very limited, but as we look into 2009 and a new administration, expectations are high that a large fiscal stimulus package is forth coming. We hope that this package is directed at long-term investments that address structural imbalances in the real economy and providing appropriate incentives to get the private sector “back in the game”.

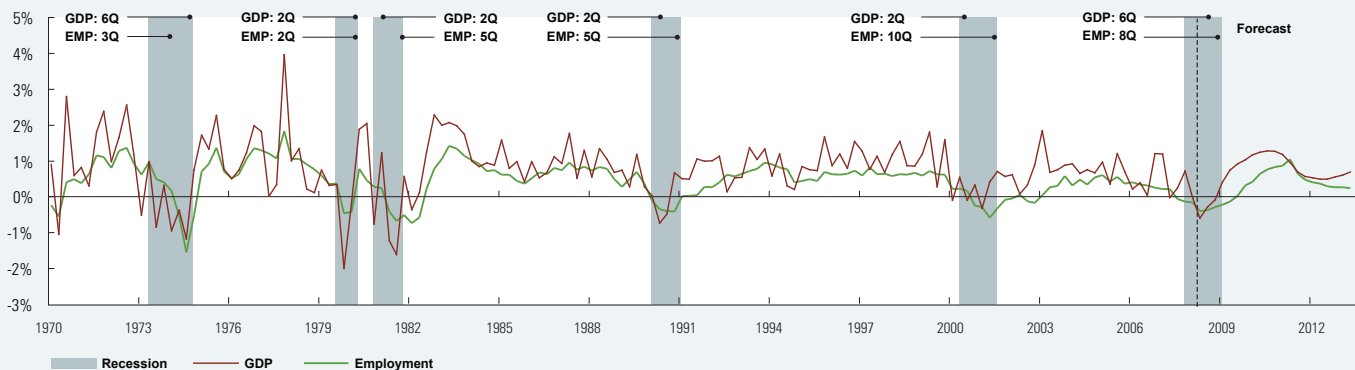
Monetary policy to date has helped stabilize the financial system. While lower interest rates probably won't hurt the situation, emphasis should be put on policies that promote trust and confidence-- further transparency will do that. Specifically, market participants need to be able to effectively evaluate the risk of making an investment. Risks are inherent across a broad front; market risk, financial risk, operational risk and counterparty risk. Actions geared to helping consumers, businesses and investors evaluate and manage these risks will go a long way towards helping financial markets and the global economy begin to recover.

Beyond the U.S. Government's and Federal Reserve Bank's actions domestically, we are encouraged by the concerted and coordinated efforts by governments and central banks around the world which have emphasized cooperation and collaboration on serious problems in the global financial system.

U.S. Recession

- The current recession originated in the financial sector, through linkages to the residential real estate market. It has spread broadly across the U.S. and other economies around the world.
 - The resulting contraction in available credit has been non-discriminating and has impacted a wide spectrum of consumers, businesses and investors, many of whom have done nothing wrong.
- Our current expectation is for job losses to continue through year-end 2009.
 - The U.S. economy lost 2.6 million jobs in 2008; most of these losses occurred in the second half of the year.
 - We expect the U.S. economy to shed another 2.6 million jobs in 2009.
 - The unemployment rate will likely peak around 9% in 2010.

U.S. Recessions Since 1970



Source : Economy.com, Kennedy Associates

Recession in Context

- Our expectation is that this will be the longest and deepest recession we have experienced since the Great Depression.
 - The consensus view is that the recession started in first quarter 2008.
- We expect job growth to turn mildly positive in early 2010. It will not be until 2011 that it feels like the U.S. economy is creating jobs at a “normal” pace.
- We expect that the economy will recover all the jobs lost during this recession by the middle of 2012.

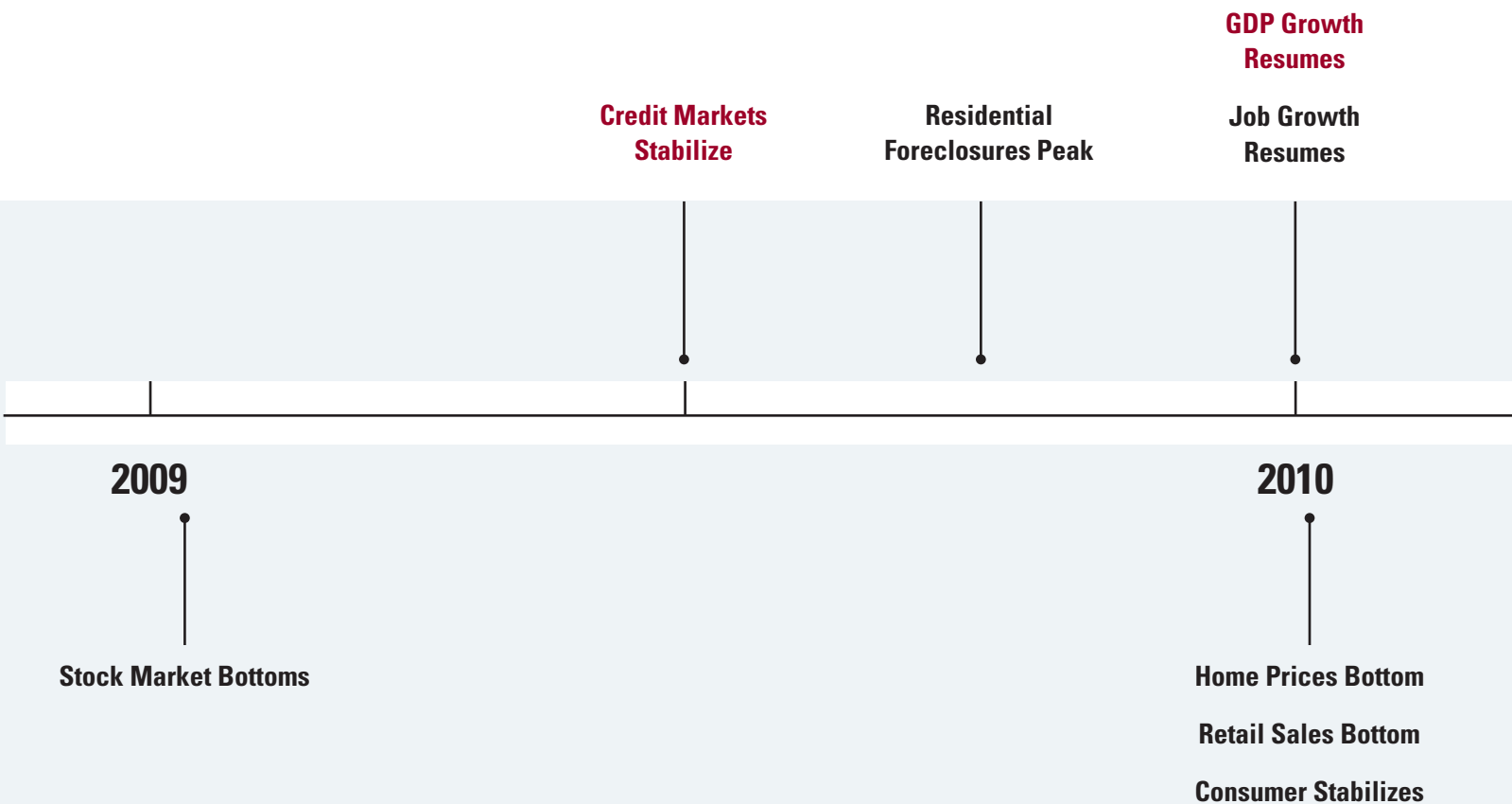
Jobs					
Recession	GDP Contraction	Number of Quarters for Jobs Contraction	Number of Quarters for Jobs Recovery	Number of Jobs Lost During Contraction (Millions)	Percentage of Jobs Lost to Total Labor Force
1973	6 Q	3 Q	7 Q	2.1	2.7%
1980	2 Q	2 Q	4 Q	0.85	1.0%
1982	2 Q	5 Q	9 Q	1.9	2.1%
1990	2 Q	5 Q	11 Q	1.5	1.4%
2001	2 Q	10 Q	16 Q	2.7	2.0%
2008/2009	7 Q	8 Q	18 Q	5	2.8% - 3.6%

What Now?

The U.S. economy and global financial system appear to have averted a complete meltdown, and both are now working through the leverage problems that triggered the current recession. The upside is that the current credit crisis has a finite life because we know when the bulk of “bad” mortgages were originated and when borrowers will experience their first interest rate resets. The peak in first time resets was in September of 2008, and after the start of 2009, they fall precipitously. By some time in the second half of 2009, the “healing process” can begin in earnest.

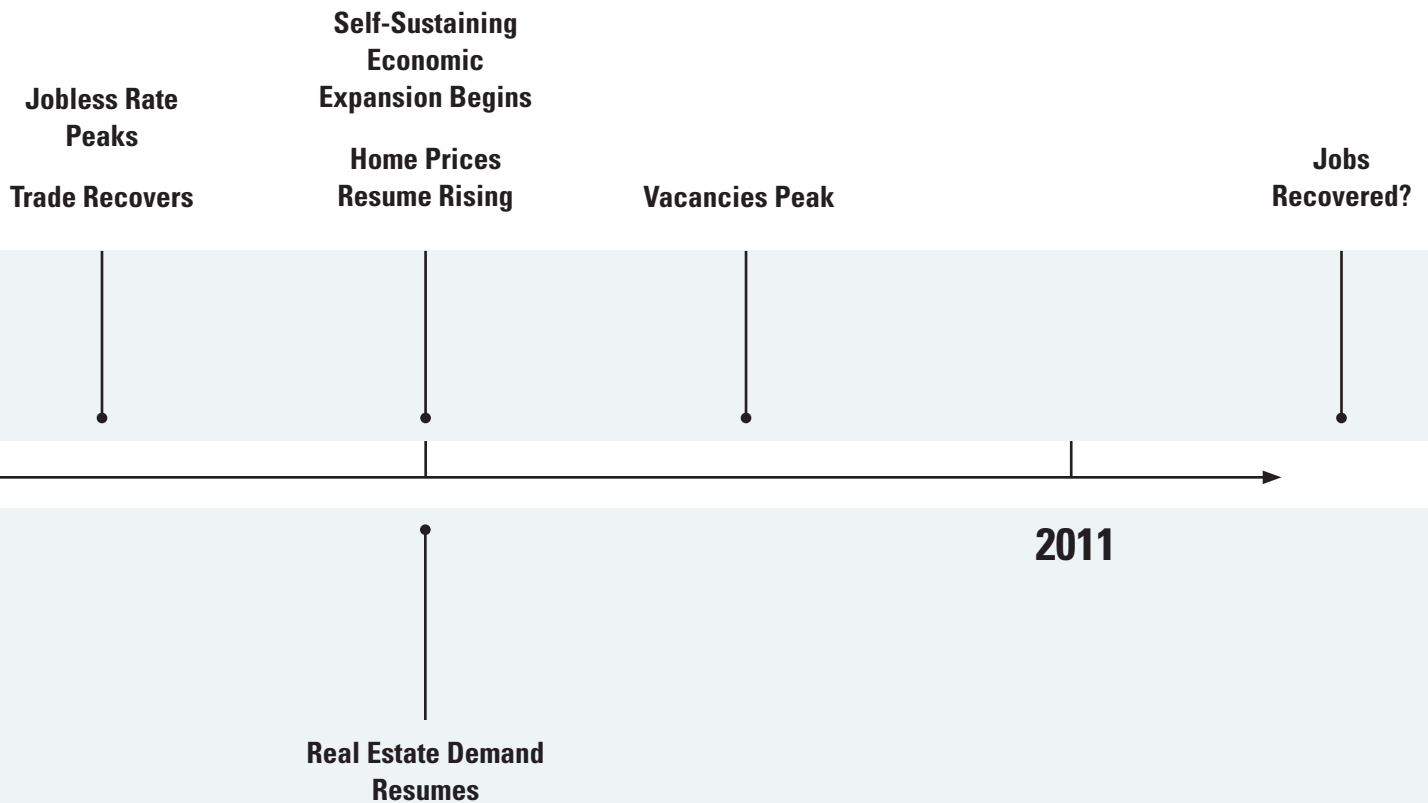
We believe that moratoriums on foreclosures, while well intentioned, will most likely only delay the determination of market clearing prices in the residential housing market and could result in a more prolonged economic downturn.

Time will tell if the actions taken so far will be sufficient. We believe that remedies need to be more focused, and carefully designed incentives need to be properly placed because “throwing money” at the problems will not promote long term stability and sustainable benefits.



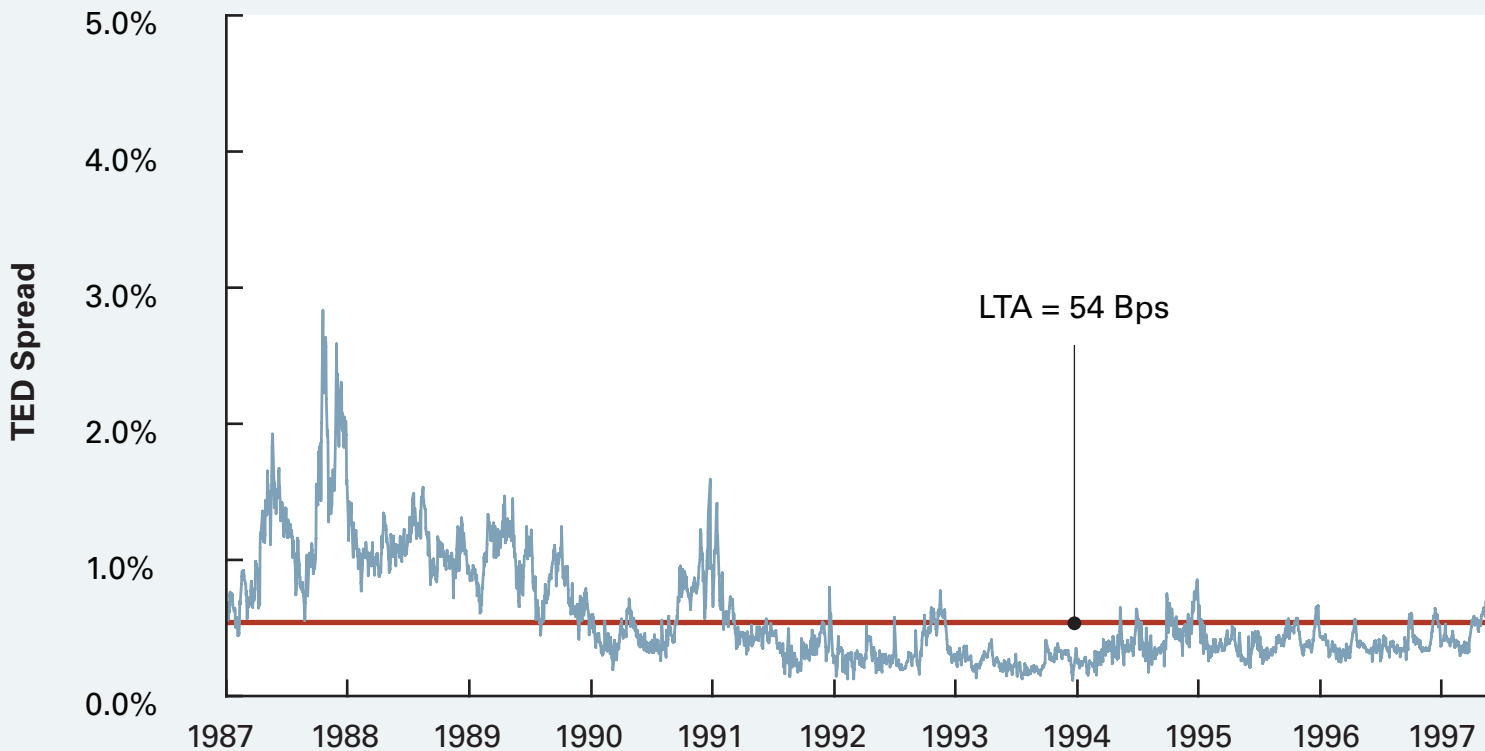
Emphasis should be on:

- Saving the financial system – Consumers and businesses of all sizes need a functioning financial system to engage in normal “economic” activities and grow. This is not a Main Street vs. Wall Street issue. Without Wall Street there is no Main Street.
- Stabilizing home prices – Help those home owners who have behaved rationally and responsibly and can afford to stay in their homes, while quickly but humanely working out those who cannot.
- Investing in the future – Focus should be on education, alternative energy, health care, and infrastructure.
- Increasing personal savings – The U.S. Government needs to promote increased savings. The U.S. cannot continue as a net debtor nation.



It's all About Trust and Confidence!

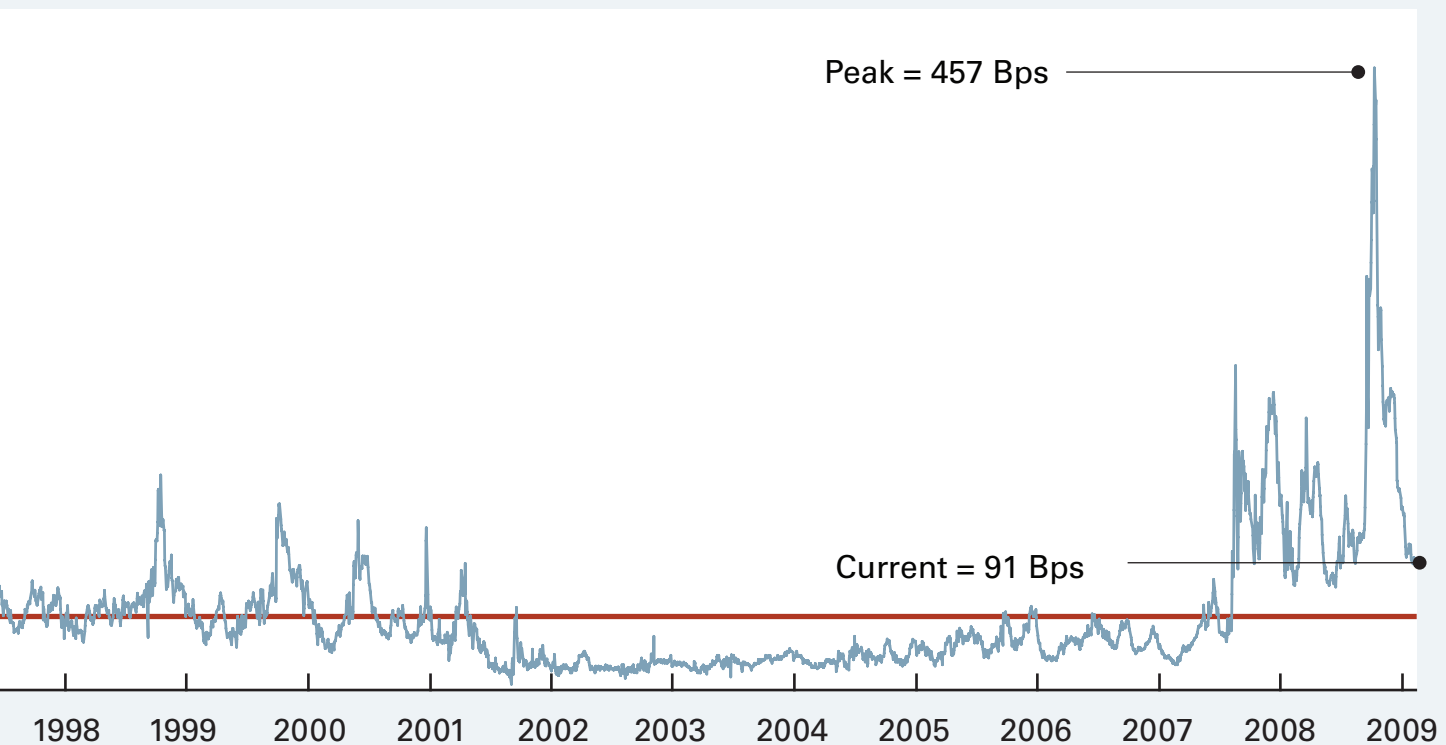
- Trust and confidence are the backbone of properly functioning markets.
- The “TED” spread, a broad measure of credit risk in global markets, is a strong proxy for the level of trust and confidence that exists between investors and institutions in the global financial system.
 - The TED spread is the difference between the 90-Day LIBOR yield (the rate that banks charge each other for short-term borrowing) and the yield on 90-Day U.S. Treasuries (an equivalent maturity risk-free rate).
 - The spread is a measure of the perceived risk that banks believe exists in each other's balance sheets.
 - The historical spread has averaged 50 basis points.



Sources: *Economy.com, Kennedy Associates*

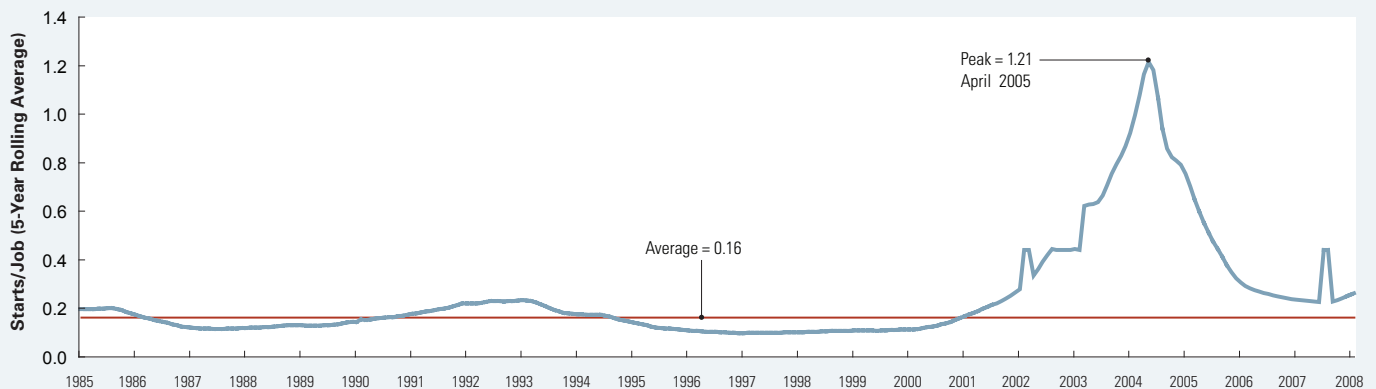
A Crisis of Confidence Starts to Recede

- As the credit markets seized up in the fall of 2008, the TED spread ballooned to 457 basis points.
 - Investors who were tracking this measure of risk knew there were significant problems at the core of the global financial system in the middle of 2007.
- Coordinated governmental and international central bank intervention narrowed the spread to approximately 100 bps by the start of 2009.
- We look for the TED spread to narrow further and stabilize below 100 basis points, with less government intervention, as a signal that trust and confidence are returning to the credit markets.
 - This is the necessary first step towards a recovery of the U.S. and global economies.
 - This process has already started and will continue to play out 2009.



The Housing Market Is Overbuilt

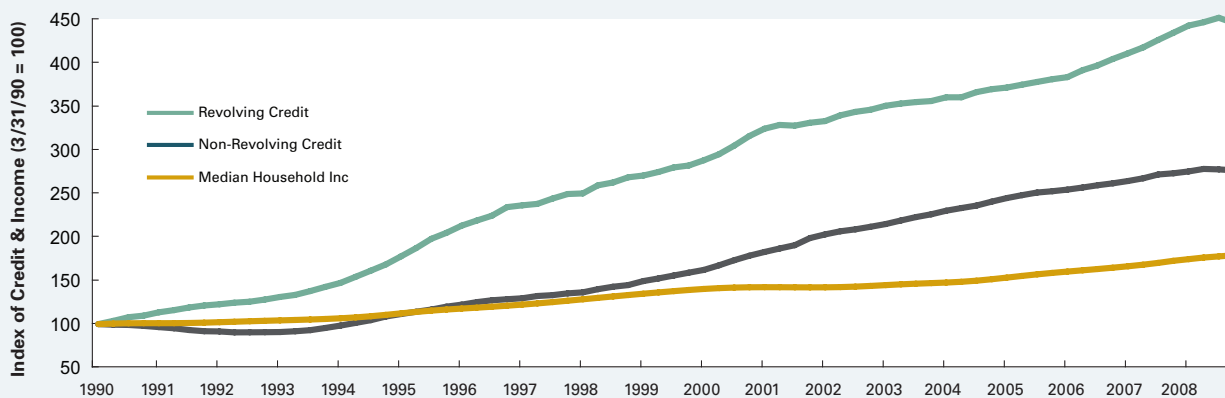
- Primary to the determination of prices is the relationship between supply and demand, which is significantly out of balance in the housing sector because:
 - Too many houses were built to satisfy an illusory level of demand.
 - Easy credit allowed unqualified households to purchase homes.
- Historically, the U.S. has averaged 0.16 homes (single and multi-family) started for every job created. We look at this on a rolling five-year average to smooth out short-term imbalances. Based on this measure, the peak in new housing starts during the boom occurred over the five-year period ending in the first quarter of 2005. During this time, approximately 1.21 homes were started for every job created.
- While markets around the U.S. were affected differently, those in southern California, south Florida, Phoenix and a few other markets around the U.S. were hit the hardest.
- As a result of these supply and demand imbalances, prices will probably fall below levels indicated by traditional earnings-to-home price relationships before a sustainable recovery gets underway.



Sources: BLS, Census, Economy.com

Consumers Will Deleverage

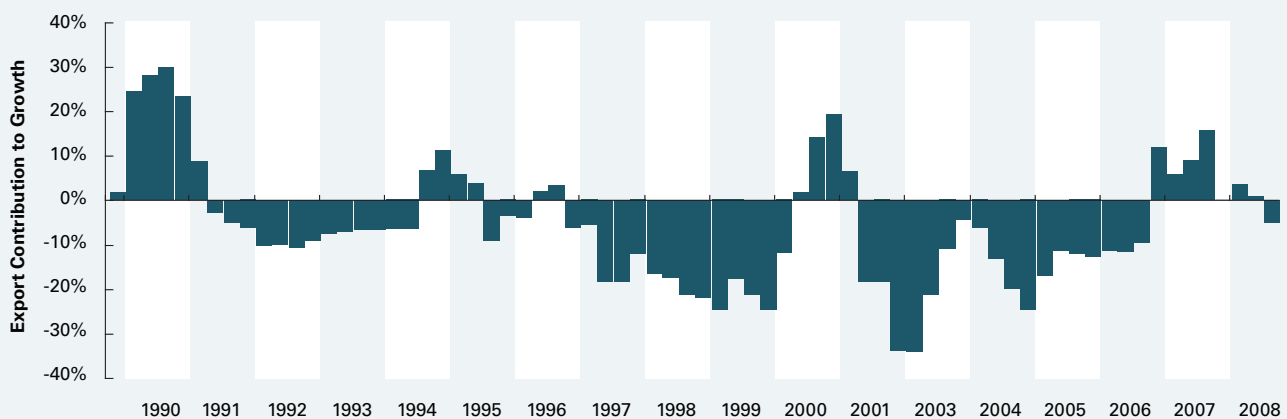
- Rising debt burdens and ebbing confidence have been the “one-two knockout punch” to the U.S. consumption-driven economy.
- There has been significant growth in all types consumer credit, not just mortgages. Installment loan and credit card balances have also ballooned.
 - The average outstanding debt burden of each person 19+ years old is \$14,000. This is a 64% increase over 10 years ago.
 - The average outstanding revolving credit (credit cards and home equity lines) for the same group is \$5,300 per person. This is a 52% increase over 10 years ago.
- Consumer deleveraging has started and will have several important consequences.
 - The cost of consumer credit will remain higher than “normal” to help stimulate deleveraging. This is a simple supply/demand relationship. The demand for credit is greater than its supply, so the cost of credit must go up. The increased cost can take many different forms, including higher interest rates, lower credit limits, higher down payments or stricter loan covenants.
 - Retail sales, especially of discretionary goods, will be suppressed during the deleveraging process.
 - Consumer debt burdens will fall, which will result in an increased savings rate and higher average net worth.



Sources: Federal Reserve Board, Census, Economy.com

Trade a Short-Term Drag

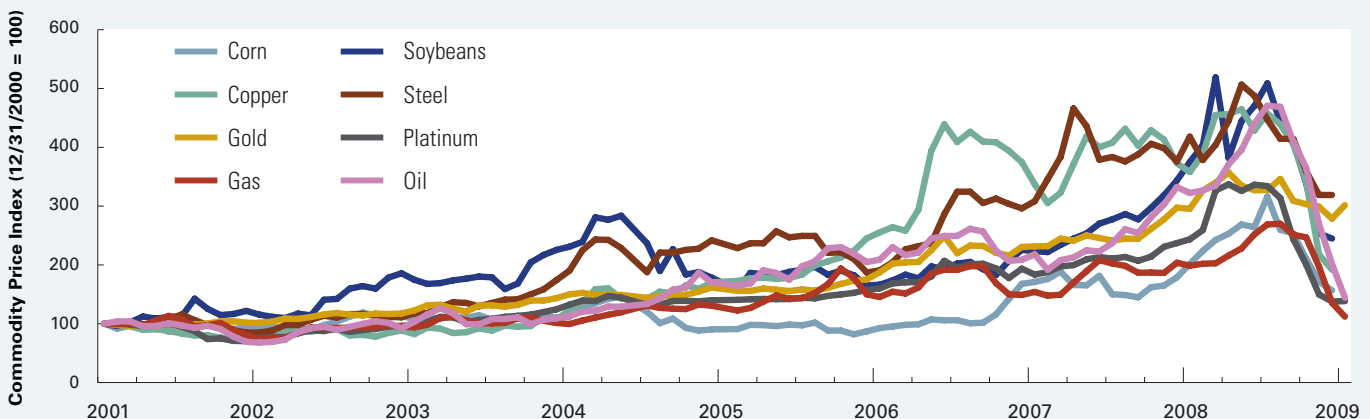
- Over the past decade trade has provided a significant benefit to the U.S. consumer as evidenced by the falling cost of a wide variety of goods ranging from non-durable goods, such as food and clothing, to durable goods, such as cars, electronics and appliances. At the same time, the U.S. trade imbalance (we import more than we export) acted as a counter weight to growth because the U.S. current account deficit (the aggregate dollar difference between the amount we sell to countries around the globe and the amount we buy from them collectively) ballooned.
- In 2007, and the first half of 2008, the weak dollar combined with strong European and Asian economies reversed the growing imbalance, and trade became a positive contributor to U.S. GDP growth.
- In the second half of 2008, trade again became a drag on the U.S. economy because of the following:
 - Rising U.S. dollar - As the dollar rises in value relative to other currencies, U.S.-produced goods and services become more expensive to foreign buyers.
 - Faltering global economy - The recession that hit first in the U.S. has quickly traveled around the world and the U.S., Eurozone, and Japan (51% of global output) are officially in recession, and many other Asian economies are deteriorating quickly.
- Trade, and the growing global linkages between economies, will bring the U.S and other economies out of this recession quicker.
 - WHY? Trade increases the demand for many of the goods and services that each country produces because economies around the world are not perfectly correlated. Demand for a country's goods and services will increase sooner and at a higher volume if they trade and are not limited by demand in their domestic market.
- A primary risk to a solid and sustainable global economic recovery is potential for growing protectionist sentiment in the public policy debate.



Sources: BLS, Economy.com

Commodities a Double Edged Sword

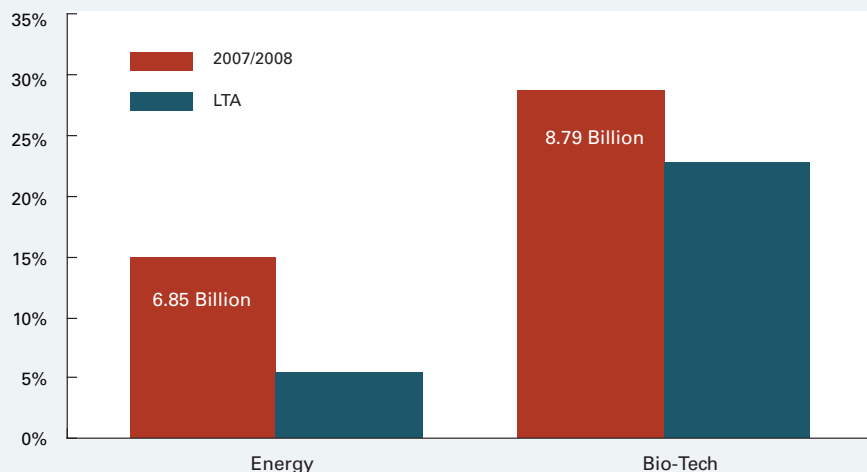
- The run up in commodity prices over the past several years was a bubble —it has burst.
- In the U.S., several markets in Texas and north through the Plains states and the Mountain states benefited from this bubble as the prices received for commodities ranging from oil to corn and wood doubled, tripled and even quadrupled in price. Going forward, these economies will slow as revenues fall with prices and marginal projects meant to increase production are shelved.
- Conversely, lower energy costs will disproportionately benefit markets where workers have longer commute times to work and public transportation is less available. Additionally, markets with more pronounced seasonal fluctuations (this results in more days running air conditioning and heating) will also benefit from falling energy costs. Consumers in these markets just received a huge “pay increase”!
- Despite persistent predictions, we believe commodity prices will remain under downward pricing pressure for an extended period of time for two reasons:
 - The bubble mentality is fading from investor’s minds. Therefore, the demand for commodities as an investment option is also fading, which is removing speculation from price determination.
 - Inventories are skyrocketing and capacity utilization is plummeting. As a result, further cutbacks in production will have a limited effect on pricing.



Sources: Commodity Research Bureau, WSJ, kitco.com, Economy.com

Knowledge and Technology Support Recovery

- Much emphasis is currently being placed on what will help drive the U.S. economy forward. For the most part, many of the same industries that have driven growth over the past two to three decades will drive growth again, once they have been reorganized and made more efficient through this recession.
- The U.S. enjoys a distinct advantage in “knowledge” industries where new technologies and processes are developed that then enhance the products and services produced and consumed by a wide spectrum of businesses and households around the world.
- As we look towards a recovery, investments in alternative energy and bio-tech will be large contributors to the U.S. knowledge economy over the next growth cycle. Each of these sectors has strong backing from the Obama administration, but more importantly, private investment has already started.
 - Venture capital funding for the sectors increased significantly in 2007 and 2008: investment in energy increased from 6% to 15% of total venture capital dollars and bio-tech increased to 30% from 22% of total venture capital dollars.
 - This pattern will continue for years to come and benefit local economies where the research is being performed, but eventually percolate out to markets across the U.S. as new innovations are put to use.



Sources: PWC, Economy.com

Economic Takeaways

The next couple of years are going to be very challenging to economies around the world. In the short-term, we think it is most important to minimize the downside risk associated with the economic contraction. At the same time, it is important to be looking forward to identify which sectors of the economy and geographic regions of the U.S. are going to emerge from this contraction better positioned for growth in a post-recession world. To accomplish both of these, we believe investors should focus on answering the following questions:

- Where are consumers less leveraged?
- Which housing markets are more in balance?
- Who benefits from falling commodity prices?
 - Who doesn't?
- Where is energy and bio-technical research strongest?
 - Who benefits from this? Where do they live?
- Where is international trade important?



Real Estate Fundamentals

Current Situation

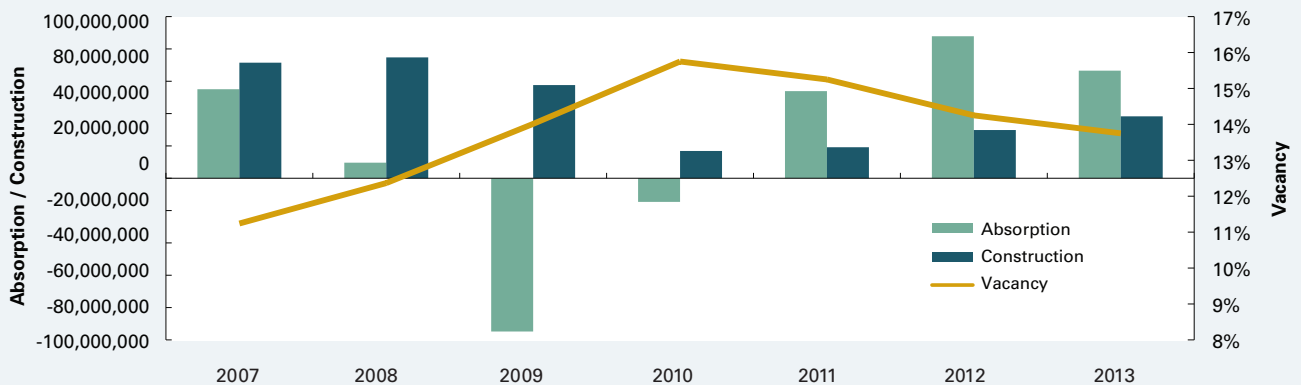
- Where one starts a race can have a significant impact on how quickly he or she reaches the finish line. For commercial real estate the current “race” is to get markets back into equilibrium so that rents start to grow again. While the depth and duration of the current recession will play a large role in determining how long it will take real estate fundamentals to bottom and then start to recover, so too will the vacancy rate that existed as the recession started and the amount of construction overhang (the amount of new supply that has already been started and will be delivered over the next couple of years) that exists. We measure construction overhang through a measure known as “Year’s Supply”.
- Year’s Supply combines construction currently underway with the difference between the current vacancy rate and the long-term “equilibrium” vacancy rate to determine the amount of stock that needs to be absorbed for the property sector to move back into equilibrium. When this statistic is divided by average annual absorption it produces a measure of Year’s Supply; an estimate of how long, under normalized market conditions, it will take to move back into equilibrium.
- Each of the four major property types entered the current economic downturn in slightly different positions when compared to past recessions.
 - The office and industrial sectors each have a significantly smaller Year’s Supply than they did in past downturns.
 - The retail sector has significantly larger Year’s Supply than it did in the last downturn.
 - The apartment sector has a moderately larger Year’s Supply than it did in past downturns, but the magnitude of unsold single family and condominium units that will enter the for-rent housing market and compete with traditional apartment units is not reflected in these numbers.

Property Type	Current Stock	Vacancy				Years Supply		
		1991	2001	2008 Q3	LTA	1991	2001	2008
Office	3,697,579,827	18.9%	13.7%	11.7%	12.9%	4.5	2.9	0.6
Industrial	5,485,257,801	NA	6.6%	7.3%	9.0%	NA	1.8	0.7
Apartment	4,295,967	5.8%	5.4%	5.5%	5.2%	1.3	1.4	1.9
Retail	2,936,820,810	NA	1.4%	5.5%	2.6%	NA	1.5	3.2

Office

- National office vacancy ended 2008 at 12%¹, still below its long-term equilibrium rate of 12.9%. Vacancy was 11.7% at the end of the third quarter, and 11% a year ago. Weaker market conditions in the second half of 2008 caused rents to fall by 1.2% in the second half and end the year at \$25.00 per square foot (“psf”), but still up marginally from \$24.83 psf at the end of 2007.
- Relatively strong occupancy levels and limited construction overhang put the office sector in a fair position at the start of this recession, but the demand side of the equation is the big challenge for the office sector, and it will determine performance in 2009.
 - The U.S. economy is expected to lose 1.5 million office using jobs by the end of 2009.
 - The current contraction started in the financial sector and first impacted select Central Business Districts (CBD) and some suburban office markets earlier in 2008.
 - At the start of 2009, the contraction has spread across sectors and markets and is now broadly reducing demand. Indeed, we expect demand to be negative across all office markets in 2009, with vacancies peaking in the mid- to high-teens in 2010.
 - We expect demand to show modest signs of recovery in the second half of 2010. However, it will not be until the middle of 2011 that it feels like a sustainable period of absorption and growth is occurring again.
- Rents started falling in the second half of 2008 in many markets, and are expected to fall across all primary office markets in 2009, as contracting demand shifts negotiating strength away from owners and in favor of tenants. The degree to which rents fall in individual markets will vary and will be driven locally by the weakness in demand and the availability of alternative space options.
- Investors should focus on the larger and most liquid markets and modern, energy-efficient properties that have limited or no lease rollover exposure until after 2011.

¹ Historical market statistics for the office sector are collected and reported by CoStar. All forecasts are based on proprietary models developed and managed by the research team at Kennedy Associates.

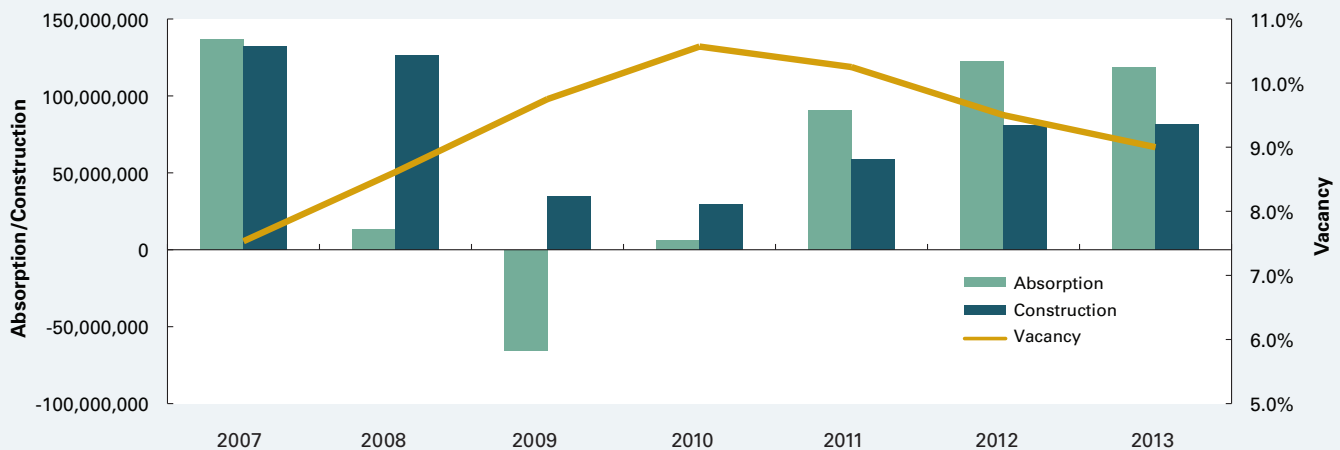


Source: Kennedy Associates

Industrial

- National industrial vacancy ended 2008 at 8.9%¹, in-line with its long-term equilibrium rate of 9.0%. Vacancy was 8.6% at the end of the third quarter, and 8.1% a year ago. Weaker market conditions in the second half of 2008 caused rents to flatten and ended the year at \$6.28 psf, compared to \$6.21 psf at the end of 2007.
- As with the office sector, the performance of the industrial sector in 2009 will be all about demand. The “virtuous” cycle of robust international trade in 2005, 2006, and 2007 drove strong demand for space by both importers and exporters. With the U.S. and other major economies around the world contracting through the year, we expect the fall-off in manufacturing, retail sales and international trade to turn demand for industrial space negative across all major markets in the U.S.
 - We expect national vacancy to peak around 11% in 2010.
 - Demand will recover with GDP growth, which we expect to occur at the end of 2009.
 - As a result, we believe fundamentals in this sector will start improving before other property types.
- Rising vacancies will put downward pressure on rents during 2009. With limited new construction in most primary markets, the degree that rents fall locally will depend on the quality of stock and the strength of local linkages to the global economy. These linkages include both primary ports and markets that produce above average levels of goods that are sold abroad.
- Investors should focus on modern space in primary distribution nodes with high-quality tenants. The risks to this sector are growing protectionist sentiments and the still unknown depth and duration of the global downturn; both of these could delay a recovery in this sector.

¹ Historical market statistics for the industrial sector are collected and reported by CoStar. All forecasts are based on proprietary models developed and managed by the research team at Kennedy Associates.

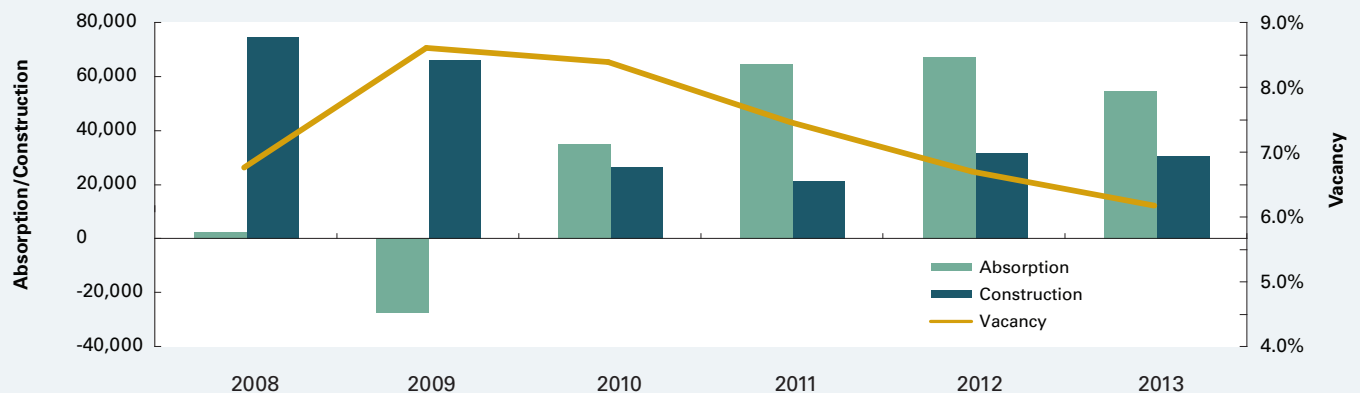


Source: Kennedy Associates

Apartment

- National apartment vacancy ended 2008 at 6.7%¹, above its long-term equilibrium rate of 5.8%. Vacancy was 6.3% at the end of the third quarter, and 5.8% a year ago. Weaker market conditions in the second half of 2008 caused rents to flatten and ended the year at \$1,074 per unit, compared to \$1,049 per unit at the end of 2007. Free rent (on a one-year lease) approached three weeks at the end of 2008, with properties in some of the weaker markets and submarkets providing two or more months of free rent to attract tenants.
 - We expect vacancy to peak above 8.5% in late 2009.
 - Demand will turn positive in 2010, but it will be 2011 before it appears “normal”.
 - Oversupply in the for-sale condominium and single-family segments provide “unique” uncertainty to our outlook for this sector.
- Contrary to recent and oft-quoted “conventional wisdom”, a poor for-sale housing market is not necessarily good for the for-rent market. There are several reasons for this:
 - Falling home prices reduce monthly occupancy costs and narrow the gap between the cost of renting and the cost of ownership.
 - Growing inventories of unsold homes are often rented until demand picks up. This increases the stock of for-rent housing units.
 - Poor for-sale housing markets are strongly correlated with poor economic conditions, which severely constrict household formations and are not supportive of rental demand.
- In markets that are experiencing more severe housing corrections, apartment investors need to understand how much of the single family and condominium market is being rented as these are stealing demand. This will hold down rents in overbuilt markets as traditional for-sale housing competes with for-rent housing. This trend will likely persist for a few years as the overall economy recovers and the excess housing stock is absorbed.
- Investors should also focus on the shift in renter profile from 35-44 year olds (1990’s) to 19-24 year olds (emerging echo-boom) as these two groups are very different from an earnings perspective and what amenity packages they value. As a result, “in-demand” unit mixes and price points will change over the coming years.

¹ Historical market statistics for the apartment sector are collected and reported by Reis. All forecasts are based on proprietary models developed and managed by the research team at Kennedy Associates.



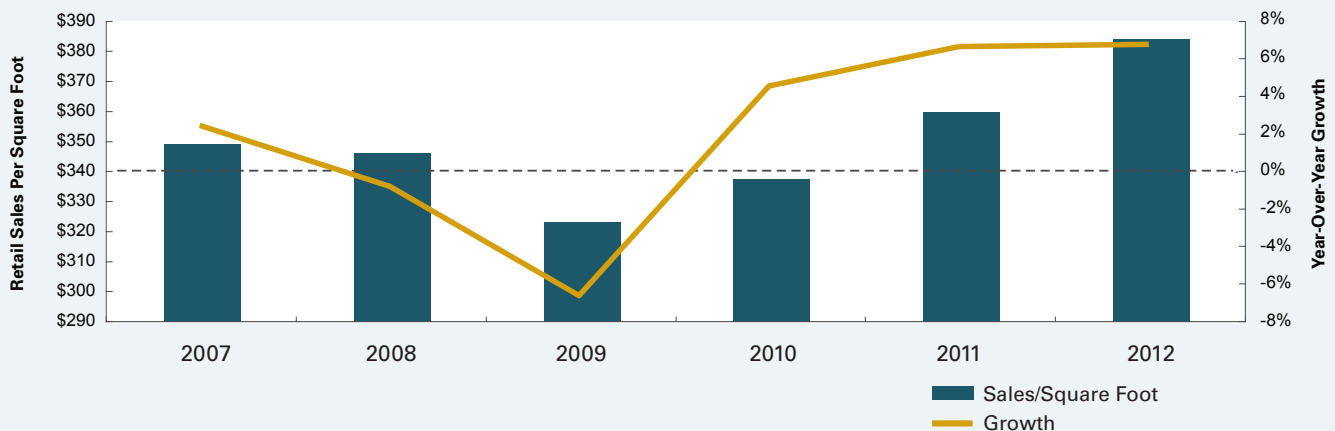
Source: Reis, Kennedy Associates

Retail

- National retail vacancy ended 2008 at 6.7%¹, well above its historical average rate² of 2.6%. Vacancy was 6.5% at the end of the third quarter, and 6.1% a year ago. Weaker market conditions in the second half of 2008 caused rents to flatten and ended the year at \$17.69 psf, compared to \$17.40 psf at the end of 2007.
 - It is important to note that aggregate vacancy rates, even at a market or submarket level, are less informative than they are for the office, industrial or apartment sectors due to the very local nature of the retail sector; you may drive an hour to work but you will not drive an hour to the grocery store.
 - In addition, retailers conduct the vast majority of their business in the fourth quarter, occupancies often “peak” during that period as retailers seek to “make their year” in that time. Many retailers who were able to sustain themselves to year-end may not be able to survive beyond the first quarter or second quarter of 2009, which will cause ballooning vacancy rates and put severe downward pressure on rents.
- Looking forward, the retail sector will be most affected by the forced deleveraging of the U.S. consumer, which will impact this sector well past 2009. Added risk comes from the fact that we do not know which retailers are going to make it through this downturn. As a result, performance in the retail sector in 2009 and beyond will turn out to be a story of the haves and have-nots. Owners with tenants that don’t go bankrupt will be the haves and those with tenants that do go bankrupt will be the have-nots. Unfortunately, at this time, it is hard to differentiate between these two groups.
- As the consumer pulls pack through 2009, the construction overhang will magnify the contraction in sales per square foot, with the top 20 retail markets expected to experience a 6.7% reduction in sales per square foot for the year after falling by nearly 1% in 2008.
- From an investment perspective, retail is slightly different from the other property sectors in that there are always great centers in any market that will provide stability in the downturn and outperformance in the recovery. Investors should only focus on the newest formats in the best locations, and emphasize properties with tenant mixes that are heavily weighted towards the sale of necessity goods.

¹ Historical market statistics for the retail sector are collected and reported by Costar. All forecasts are based on proprietary models developed and managed by the research team at Kennedy Associates.

² We reference a historical average rate for retail, and not a long-term equilibrium rate. The collection of retail market statistics is much less standardized and complete when compared to what is collected in the office, industrial and retail sectors.



Sources: Economy.com, CoStar, Kennedy Associates

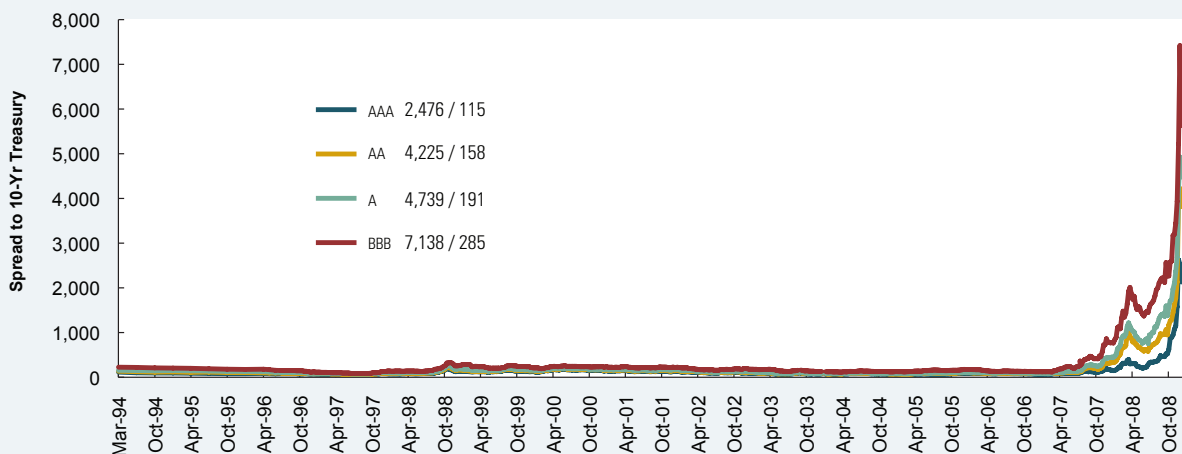


Capital Markets



Credit Markets Remain Tight

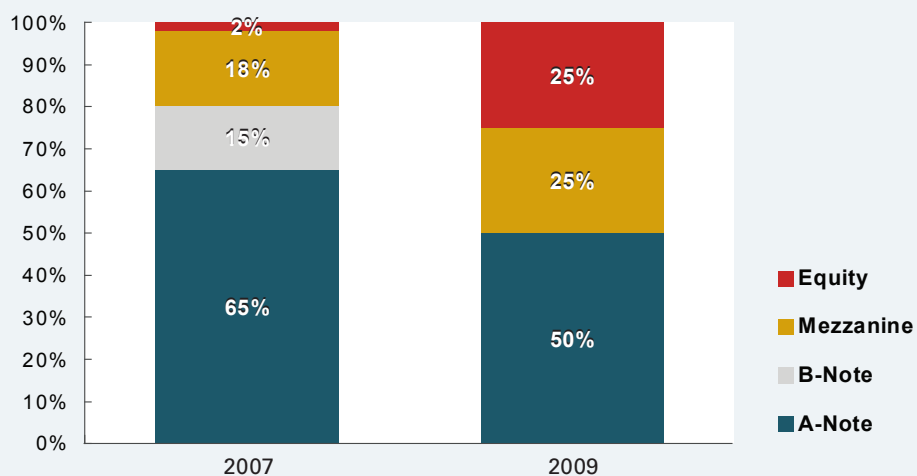
- Credit markets around the world began contracting in late 2007, culminating in a complete “freezing” in the third quarter of 2008. In conjunction with this, commercial real estate investors are witnessing one of the worst credit contractions in history. CMBS spreads widened to historical levels as investors reintroduced risk into the pricing equation and began underwriting weaker fundamentals.
- As we start 2009, spreads in the secondary market for existing CMBS bonds remain at all time wide levels. And, the real estate securitization market remains essentially closed. Indeed, data from the Federal Reserve’s U.S. Flow of Funds report indicated that CMBS issuance contracted by \$30.5 billion through the first three quarters of 2008, compared to new CMBS issuance of \$147 billion in 2007.



Sources: Real Capital Analytics, ML

The Capital Stack Then and Now

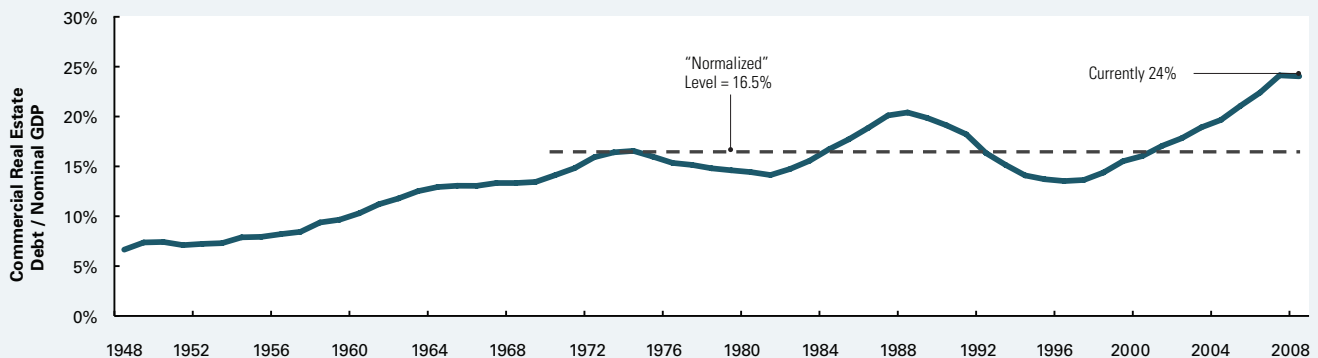
- The combination of the reintroduction of risk and ensuing recession has caused the capital structure for transactions to be changed dramatically:
 - Lenders are lending less and requiring owners/investors to contribute more equity
 - Debt structures are simpler
 - Loan-to-value constraints are not being calculated on purchase price, but instead on lender's estimate of value
 - Lenders are more focused on "coverage" (i.e., the size and quality of property's rental stream and its ability to "cover" the mortgage payment) rather than the property's "value".



Source: Kennedy Associates

The Equity Shortfall

- Historically-wide spreads and changing debt structures are symptoms of the ongoing deleveraging of commercial real estate, combined with expected losses on recently issued mortgages.
- Between 2005 and the end of 2007, the commercial real estate industry experienced a dramatic increase in the issuance of new debt, both in the private whole loan and public securitized markets.
 - New commercial mortgage debt issuance averaged \$344.7 billion per year between 2005 and year-end 2007.
 - Between 1991 and year-end 2004, new issuance of commercial mortgage debt averaged \$84.9 billion per year.
- As a result of the strong level of issuance, commercial mortgage debt as a share of U.S. nominal GDP grew from 19% in 2004 to 24.1% in 2007. Over the next several years, we expect the amount of outstanding commercial mortgage debt to contract so that it again represents a “normalized” share of nominal GDP, which we estimate to be around 16.5%.
 - The deleveraging of commercial real estate will result in the need to replace approximately \$300 billion in outstanding mortgage debt with equity over the next few years.
- At the same time investors are reducing their exposure to commercial real estate debt, the reintroduction of risk combined with weaker growth assumptions in the pricing of commercial real estate is causing property values to fall. As mortgages mature, or lenders have properties reappraised, the difference between current Cap rates and the Cap rate at which the property was purchased and/or when it was last valued for mortgage origination purposes could result in a loss of equity and, in some cases, a loss of principal for debt holders.
 - We estimate the potential loss in value for all commercial real estate to be approximately \$125 billion.
 - Properties that will be most negatively effected had mortgages originated between 2005 and the end of 2007, when Cap rates were at historically low levels. Approximately 80% of this debt was issued with 10-year terms and will not start maturing until 2015.
 - As a result, short term losses will be most influenced by a borrower’s ability to make debt payments and not maturities.



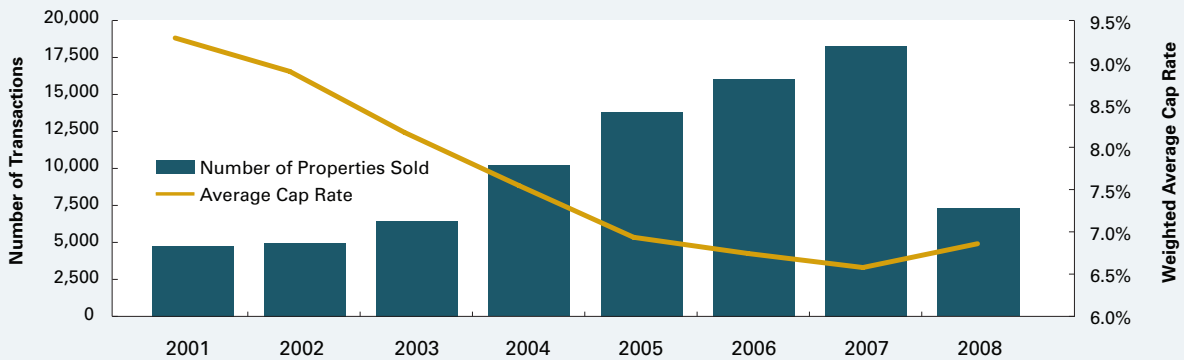
Sources: FBR, Economy.com

Transactions Activity and Cap Rates Respond

- There were 18,291 recorded transactions of commercial properties valued at over \$5 million dollars in 2007. With the ensuing credit crunch during 2008, transaction activity fell by more than 60%, and only 7,423 transactions were completed during the year.
- The start of the deleveraging process, along with a deteriorating outlook for fundamentals has also affected pricing. With the cost of debt rising, Cap rates on purchase/sale transactions rose 45 basis points in 2008 to 6.97% at year-end.

A Capitalization rate (Cap rate) is an approximation of expected current income return determined by dividing net operating income (NOI) by the purchase price or value.

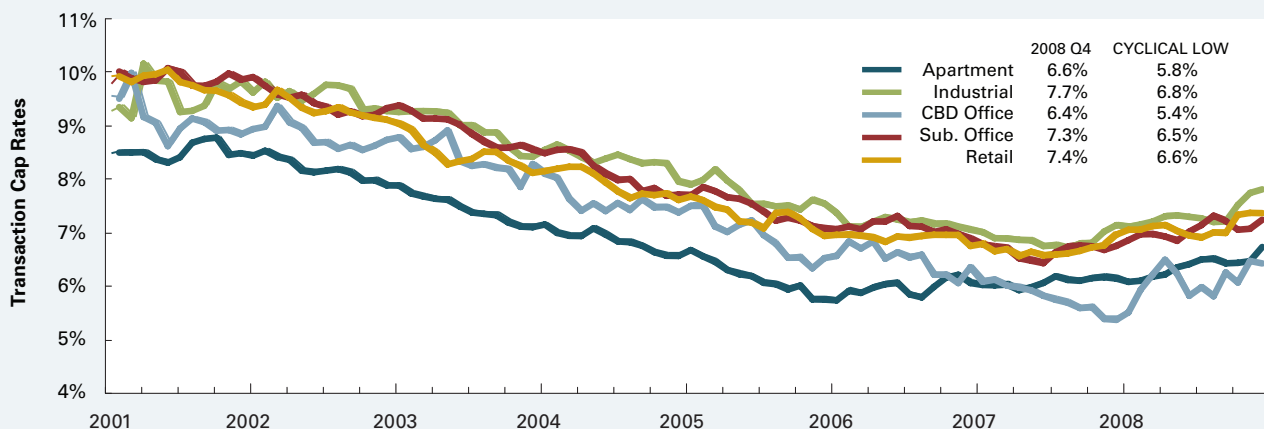
$$\text{Cap rate} = \left[\frac{\text{NOI}}{\text{Purchase Price or Value}} \right]$$



Source: Real Capital Analytics

Cap Rates by Property Sector

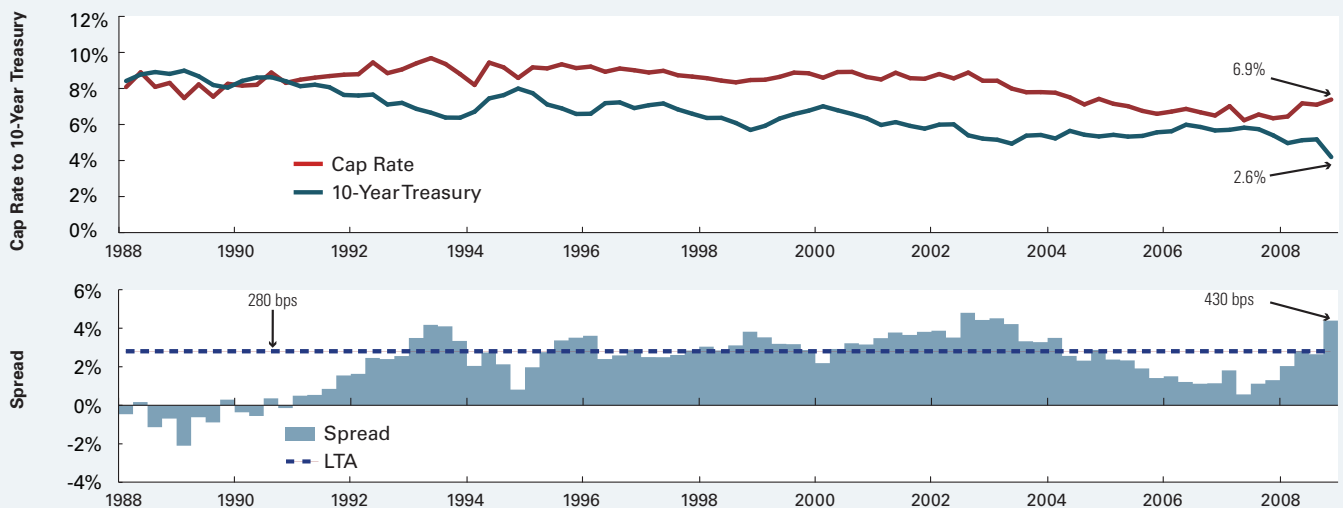
- At the property sector level, CBD office Cap rates moved up the most in 2008, and are currently 86 basis points higher nationally than they were at the end of 2007. The industrial and retail sectors have experienced the next largest expansion in average Cap rates, followed by suburban office and apartments.
- While there is still much debate about how much Cap rates may rise (we provide our outlook in the next section), we believe that once investors have completed their revaluation of risk there will be a wider range of Cap rates across markets and properties. As a result:
 - Secondary and tertiary markets with less liquidity will experience a larger expansion in Cap rates as investors relearn the value of liquidity, especially in times of crisis.
 - Property sectors and subsectors that became the most overheated during the height of the last cycle will also experience a larger expansion of Cap rates.
 - Older properties and properties in secondary locations, even if they are in primary markets, will experience a larger expansion in Cap rates.



Source: Real Capital Analytics

Pricing: A Yield Comparison Approach

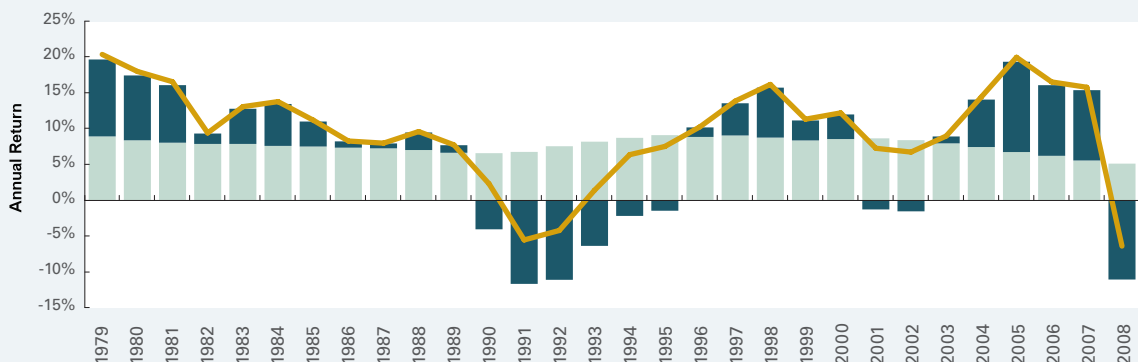
- A property's Cap rate represents the expected income return of a property, and is often compared to the yield on a U.S. Treasury bond with an equivalent maturity, or "hold". The difference between the average Cap rate and, for example, a 10-year Treasury, represents the additional return an investor requires to compensate for the risk of investing in commercial real estate. In other words, the spread between the two yields represents the risk premium.
 - As mentioned previously, transaction data suggested that average Cap rates had risen 45 basis points during 2008 to approximately 6.9%.
 - With the 10-year Treasury hovering around 2.6% at the time of this report, current pricing equates to a 430 basis point risk premium — well above real estate's historical risk premium range of 250 - 300 basis points.
- This does not necessarily mean that real estate is currently under-priced, but rather that the 10-year Treasury has been temporarily "mispriced" as investors search for absolute security in a more risk-averse environment. As markets stabilize over the intermediate term, we expect the 10-year Treasury yield to revert to a "normalized" level between 4.5% and 5.0%.
 - We estimate this yield by dividing the yield on the 10-year Treasury into two components: the long-term real growth potential of the U.S. economy of 2.5% to 3.0% and an inflation expectation of 2%.
- Adding the historical risk premium to a normalized Treasury yield suggest that Cap rates should stabilize in a range of 7% – 8%. With this said, there is significant diversity across markets and properties. As a result, better properties in more space-constrained markets should trade at the low end of this range, or even lower, while inferior properties in markets lacking sufficient barriers to entry may trade above the range.



Sources: NCREIF, Kennedy Associates

Pricing: A Components of Return Approach

- Core real estate is somewhat unique as an asset class because it provides the growth characteristics of a stock and the stable income stream of a bond. About 80% of core commercial real estate’s historical return has come from its stable, bond-like income return, which is attributable to long-term tenant leases. The other 20% has come from appreciation, which is attributable to the fact that a property is, in many ways, equivalent to a business where owners can add value by actively managing the property to maximize performance.
- Over the past 30 years, private equity real estate has provided a real return to investors of approximately 6% — and if a 2% target inflation rate is assumed, then a “fair” return for investing in core private equity commercial real estate would be approximately 8%.
 - If investors expect to receive 20% of their return from appreciation, this suggests an average Cap rate of 6.5%. Similarly, it would suggest an average Cap rate closer to 8%, if, due to prevailing economic conditions or market or property-specific circumstances, investors expect to derive little of their return from appreciation.
- If investors’ perception of the risk associated with investing in core real estate has gone up, or their inflation expectation is higher than 2%, Cap rates may adjust upward accordingly.
- In the near to medium term, we think a reasonable expectation is for Cap rates to climb to the higher end of the 6.5% – 8% range, in which case they may need to rise another 100 basis points to provide what investors deem an appropriate return.
 - This means that property values could fall another 10% to 20% in 2009 in order for yields to meet investor expectations.
- Investors with a longer-term investment horizon can benefit in this current environment because they can invest at higher yields today and then sell into a recovered economy when risk premiums have narrowed again and there is a greater expectation for growth and appreciation.



Sources: NCREIF, Kennedy Associates

Conclusions

Go slow in 2009!

- Lack of clarity in the first half of year will hinder price discovery for all asset classes. This will keep the credit markets “closed”, at least for the first half of the year.
- Clarity should begin to develop in the second half of 2009 and start to “open” the real estate debt and equity markets. But, because of the deleveraging process, access to debt capital will probably remain limited well into 2010.
- New investments will provide higher going-in-yields on more conservative assumptions. Once again, core investors will be able to buy assets that produce the majority of their return from income, and not capital appreciation, as has been the case over the past few years.
- With limited availability of debt financing, especially in 2009, investors will have to invest more equity, which will result in less risky investments going forward.

In 2009, investments should be all about income and stability.

- Core investors will have some of the best opportunities.
- Traditional value-add investors will find putting money to work in new investments more challenging because the contracting economy will limit repositioning/redevelopment opportunities for the next two to three years.
- Investors with a higher risk appetite will be able to make investments in the troubled asset market, but we urge caution. Despite the size of the problems in this market segment (+/- \$100 billion), deeply discounted prices relative to fundamental values that investors remember from the early 1990's may be more limited. Our reasoning for this is two-fold:
 - There is a lot of money chasing these investments. This may eliminate the arbitrage on better assets in top markets and force investors down the quality spectrum.
 - Relative to the early 1990's, there is significantly more transparency in both the real estate space markets and in the real estate capital markets. This will result in distressed assets being bought more efficiently.
 - We believe that investors targeting these areas need to develop narrowly defined niche strategies to be successful.

Conclusions

- As we focus on different property sectors — office, industrial, retail, and apartment — the intersection of the economy, property sector fundamentals, and pricing lead us to believe that the best opportunities will be found in the industrial and apartment sectors, followed by retail, and finally, office.
- For office investments, we recommend focusing on the major markets and properties with limited or no roll-over exposure until after 2011. As office markets soften, tenant improvements, leasing commissions and other capital expenditures will magnify the impact of falling rents, reducing returns.
- Demand in the industrial sector will recover with GDP growth, which will occur before job growth resumes. As a result, we expect fundamentals in this sector to start improving first. Investors should focus on modern space in primary distribution nodes with high-quality tenants. The risks to this sector are growing protectionist sentiments and the still unknown depth and duration of the global downturn; both of these could delay a recovery in this sector.
- A poor for-sale housing market is not necessarily good for the for-rent market. In markets that are experiencing more severe housing corrections, apartment investors need to understand how much of the single family and condominium market is being rented because that will steal demand. This trend will likely persist for a few years as the overall economy recovers. Investors also need to focus on the shift in renter profile from 35-44 year olds (1990's) to 19-24 year olds (emerging echo-boom) as these two groups are very different from an earnings perspective and the amenities they value. As a result, "in-demand" unit mixes and price points may change over the coming years.
- The retail sector will be most impacted by the forced deleveraging of the U.S. consumer, and in aggregate will be depressed through 2009 and 2010. Added risk comes from the belief that we do not know which retailers are going to make it through this period. Retail is unlike any of the other property sectors in that there are always great centers in any market that will provide stability in the downturn and outperformance in the recovery. Investors should focus only on the newest formats in the best locations.

Kennedy Associates Real Estate Counsel, LP



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Mr. Munger graduated from the University of Maryland with a Bachelor of Arts degree in Urban Studies and earned a Master of Science degree in Real Estate and Land Development from Texas A&M University. Mr. Munger is active within the Urban Land Institute and many real estate research organizations.

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