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US Real Estate Capital Market Commentary: November 3, 2009

"Anyone can hold the helm when the sea is calm" –Publilius Syrus

REIT Equity: perhaps price volatility is the new normal

Real Estate Investment Trusts have clearly been a darling of the investment community since early March when the MSCI REIT Index ("RMZ") bottomed out at 287. The RMZ delivered a nearly 13% (price-only) year-to-date return through mid-October. The primary drivers behind the improved investor sentiment toward REITs include: an appreciation that values were ridiculously cheap earlier this year; an easing of default fears supported by nearly $26.7 billion of capital raised so far in 2009 ($18.7 billion of equity and $7.7 billion of unsecured debt); and broader-market sentiment that the economy may be moving into a period of recovery.

However, investors became rightfully skittish during October and drove the RMZ back down below 550; the RMZ delivered a loss of 4.9% (price-only) in October. The markets' skittishness is clearly reflected in the RMZ's 2009 beta of approximately 2.0 relative to the S&P 500. This is substantially higher than its historical beta of 0.91. This uncertainty stems from a murky earnings outlook and lofty REIT equity valuations. REITs will likely remain more volatile until commercial property fundamentals clearly enter into the recovery phase and REITs can demonstrate an ability to make significantly accretive acquisitions.

Many REIT analysts are expecting year-over-year earnings to contract by 10% or more in 2010. We agree with this gloomy assessment for commercial property fundamentals but expect that better REIT management teams will not only outperform sub-market fundamentals, but will more accurately communicate earnings expectations to investors. Despite the pessimistic outlook for earnings, "buy" recommendations among sell-side analysts remain prevalent. While most investors believe REITs have superior access to capital and will likely be heavy acquirers of cyclical buying opportunities, the timing of such buying opportunities is unknown.

We believe it is a dangerous prospect to buy REITs at a significant premium to the capitalized value of their underlying property portfolio. Many individual names were trading at premiums to Net Asset Value ("NAV") ranging from 30 and 50% in September. While an argument can be made for the "alpha" generated by specific REIT management teams, we believe it is too soon in the property recovery cycle to accept more than a slight premium to the underlying value of the portfolio for managerial alpha.

<u>Cadence Capital Group believes a detailed understanding of property fundamentals and the capabilities of individual REIT management teams are mandatory prerequisites to navigating this high-beta period.</u>

REIT Preferred Equity: is the additional spread sufficient for the additional credit risk?

Preferred equity resides in an awkward space in REIT capital structures; it can be deeply subordinated to secured debt, but may not be dramatically worse off than some unsecured debt issues. Its relative position in the capital stack of course depends on the estimate of an individual company's enterprise value. Additionally, liquidity is the single largest driver of risk premia in this segment thereby keeping many investment-grade investors out of these securities. Nevertheless, the recapitalization efforts of many REITs has reduced credit risk leaving investors with potentially enticing yield spreads, assuming they can pursue toothless equity investments.

REIT Senior Unsecured Debt: credit fundamentals may have stabilized, but what about property fundamentals?

The REIT debt market has also performed remarkably well this year with spreads contracting roughly 900bps. This performance reflects improved conditions in broader credit-markets but also the recapitalization efforts of REITs earlier this year. Key credit metrics remain relatively unchanged from early 2007: according to recent reports, Fixed Charge coverage (recurring EBITDA / Interest Expense + Capitalized Interest + Preferred Dividends) is essentially unchanged at 2.3x while Leverage (Debt / LTM EBITDA) is flat at 6.9x. Nevertheless, CRE fundamentals will continue to deteriorate and could limit additional near-term spread contraction.

<u>Cadence Capital Group believes a realistic estimation of credit risk and enterprise value can generate significant risk-adjusted unsecured debt and preferred equity investment returns.</u>

 See page 3 for important disclosures

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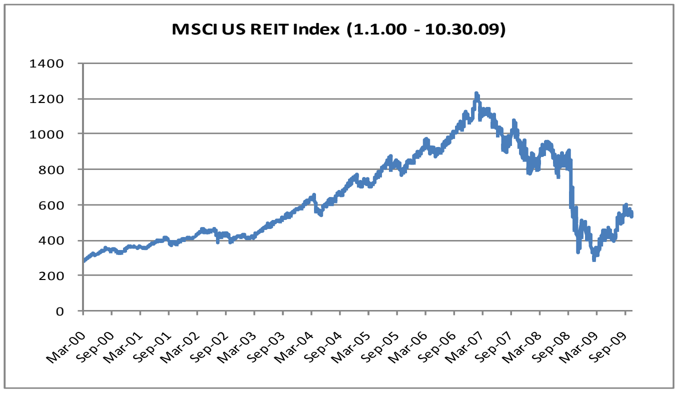
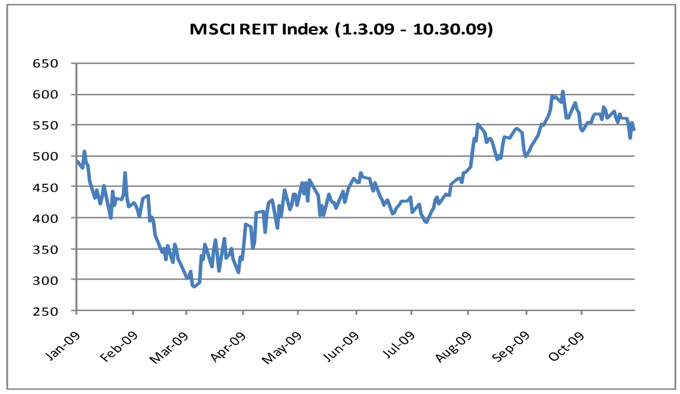
MSCI US REIT Index ("RMZ")

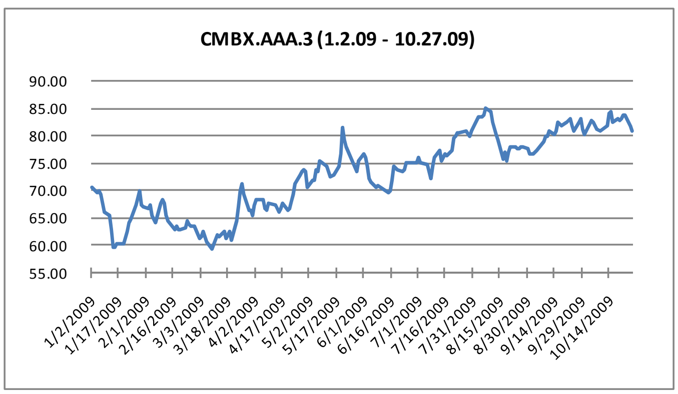


Source: MSCI, Cadence Capital Group, LLC

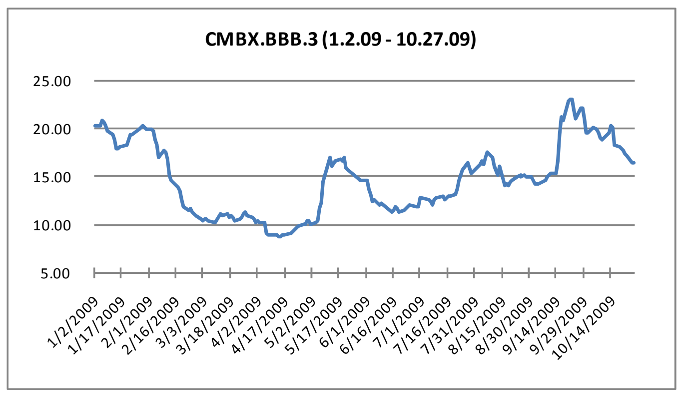


Source: MSCI, Cadence Capital Group, LLC

CMBX pricing (year-to-date)



Source: Markit, Macquarie Capital (USA), Cadence Capital Group, LLC



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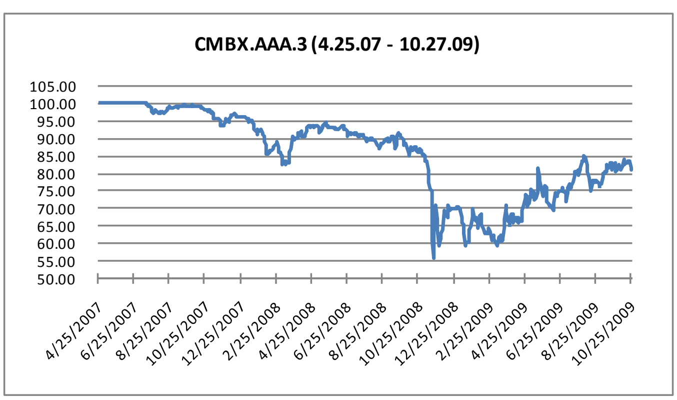
CMBX pricing (historical)



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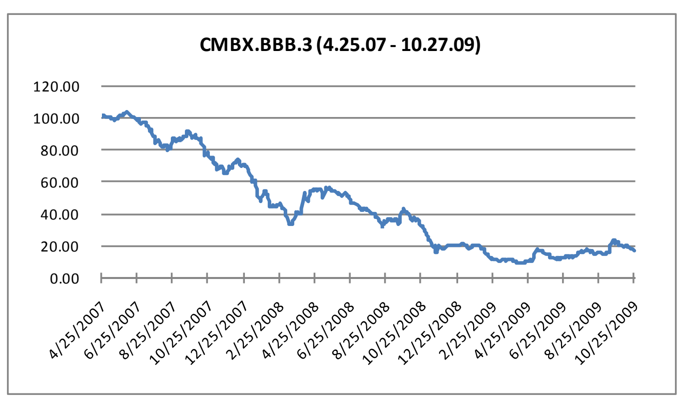

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Cadence Capital Group, LLC provides capital advisory and investment management services to the real estate industry with a primary emphasis on the capital markets. Through a unique combination of experienced real estate professionals, extensive industry contacts and relevant insight, Cadence Capital Group has the specialized skills required to help our clients successfully navigate these markets.