

US Real Estate Capital Market Commentary: June 2011

"Performance is your reality. Forget everything else." -Harold Geneen, CEO of ITT ('59-'77)

What is the public REIT market performance telling us about investor sentiment?

Year-to-date total return for the FTSE All Equity REIT index is up 7% through June 14, down from its peak of 14% at May 31 due to renewed concerns about the broader economy, whereas the S&P 500 is up just 3% during the same time period. The solid performance by REIT equities builds on the 28% total return generated by REITs in 2010. This performance is also significantly better than the NCREIF index by a margin of nearly 2:1. In fact, the valuations of many REITs are at or near their pre-credit crises high. While we hope this positive momentum continues, "hope" is a notoriously bad investment strategy. What has driven this performance? Is it earnings-driven? Is it balance sheet-driven? Is it relative value-driven?

REIT earnings (FFO-based) have been solid, improving by nearly 10% over 2010, but essentially in-line with analysts' expectations. The positive earnings news coming from REITs signals a stabilizing of property fundamentals. Each property sector clearly has its own supply/demand characteristics but it is safe to broadly say that landlords are starting to experience a shift in pricing power for space across property types. The improved earnings situation is also benefiting dividend payouts as a steady stream of REITs continues to raise their dividends.

A recent Wells Fargo report cited the strong balance sheet liquidity of most REITs, driven primarily by availability on lines of credit and bolstered by the continually improving mortgage market. Lines of credit are a keystone of REIT balance sheets, providing them with a ready war chest of cash to meet debt maturities, as well as fund acquisitions and developments. Despite a recent hiccup in the CMBS market, mortgage liquidity is also signaling a much needed thawing of risk tolerance in the capital markets.

The out-performance of REITs relative to the S&P 500 clearly indicates improved investor sentiment toward real estate but hardly signals a belief that REITs are under-valued on a relative basis. In fact, most investors with whom we spoke in the past month are increasingly monitoring REIT valuations. By many metrics, including net asset value (NAV) and price-to-earnings (P/E) ratios, these companies are "priced to perfection". However, in the current low-interest rate environment, it can be argued that a 4% REIT dividend yield coupled with expectations for modest price appreciation indicate that REITs are quite attractive and possibly under-valued. In a stagnated economy, dividend yield and discounted cash flow (DCF) models will continue to trump NAV and P/E metrics.

Public market performance is signaling investors' appreciation of liquidity

Investor interest in REITs is undeniably influenced by improved earnings, strong balance sheets, superior access to capital, and good relative value (on a yield-basis). More importantly however, Cadence Capital Group believes institutional investors favor the liquidity offered by the public markets as contrasted by the historically illiquid nature of private equity fund investing. The private markets are taking note of this and will develop structural features to increase investment liquidity.

There is a growing trend among institutional investors to take more risk in real estate. Opportunities in non-core products and non-core markets are piquing investor interest, although due diligence periods remain painfully drawn-out. Interest in recapitalizing quality operators and good properties with mezzanine capital is on the rise, as is preferred equity for select development projects. But investors are keen to avoid the illiquidity trap of the prior cycle. Control provisions, redemption language, and fee structures (yes, high fees tend to negatively impact liquidity) are still very much driven by institutional investors.

The emergence of co-investment pools, entity-level investments, "flipper" mortgages, and other twists on existing structures are being devised and will continue to evolve in parallel with institutional investor demands. In fact, many of these private market structures will likely incorporate public market exit strategies, enhancing the overall future liquidity of these structures. Cadence Capital Group believes financial innovation will forge new private market structures to satisfy liquidity concerns.

REIT preferred equity: a possible antidote for concerns over common stock valuations?

Preferred equity is a hybrid component of the capital stack, exhibiting many attributes of debt but few of the corresponding control provisions. As a result, REIT equity investors tend to shy away from preferred equity leaving REIT managers to utilize the deeper mortgage and unsecured bond markets. The REIT preferred equity universe is relatively shallow with just under \$20 billion of securities outstanding (excluding mortgage and hospitality REITs) and is currently trading at a dividend yield of just over 7.0%. This compares very favorably to the common stock dividend for these same companies of roughly 4.0%.

The proper investment analysis for preferred stock entails estimating the enterprise value of the issuer, determining the directionality of the issuer's credit profile and then estimating the appropriate risk premium for this tranche of capital. Cadence Capital Group continues to believe that preferred stock offers strong risk-adjusted returns for investors skittish about common stock valuations.

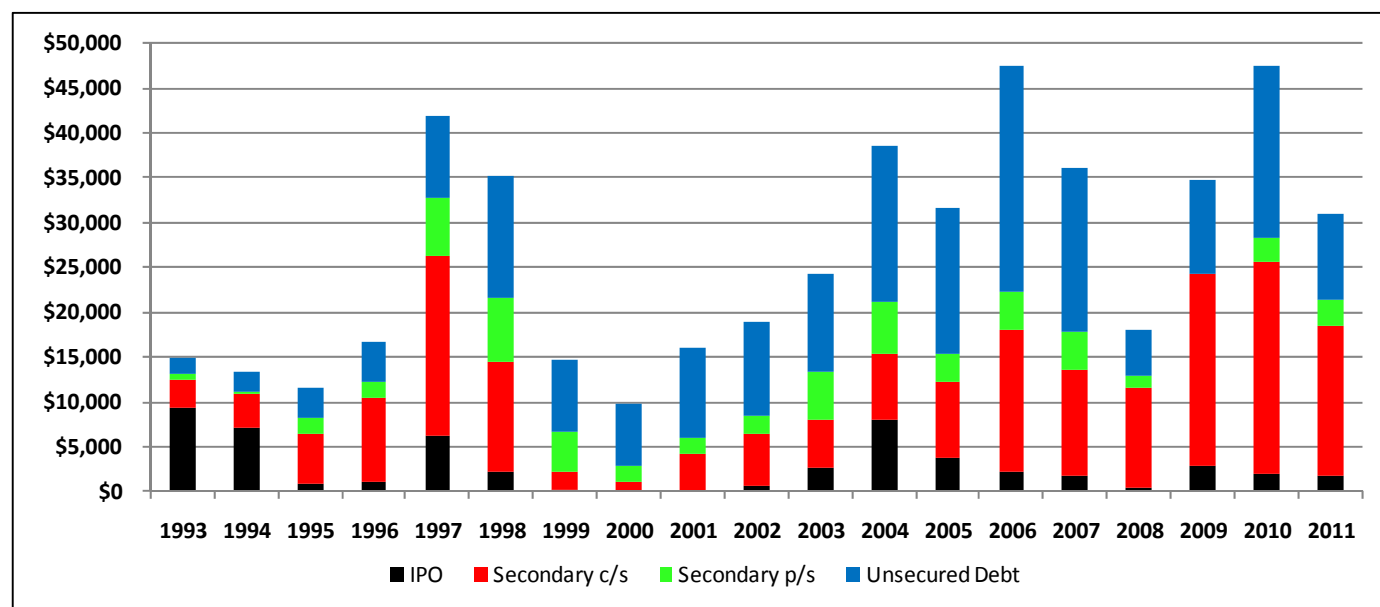
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RETURN & YIELD MATRIX

	2008		2009		2010		2011 (YTD)	
	Total Return	Dividend Yield	Total Return	Dividend Yield	Total Return	Dividend Yield	Total Return	Dividend Yield
US 10 Year Treasury	--	2.25%	--	3.85%	--	3.30%	--	2.93%
S&P 500	-38.5%	3.24%	23.5%	2.03%	12.6%	1.83%	0.9%	1.83%
FTSE NAREIT Equity REIT Index	-37.7%	7.56%	28.0%	3.73%	28.0%	3.54%	14.1%	3.28%
Apartments	-25.1%	7.52%	30.4%	4.32%	47.0%	3.31%	16.9%	2.69%
Shopping Centers	-38.8%	8.51%	-1.7%	4.27%	30.8%	3.55%	17.6%	3.45%
Industrial	-67.5%	11.25%	12.2%	4.56%	18.9%	3.51%	16.1%	3.07%
Regional Malls	-60.6%	8.67%	63.0%	1.04%	34.6%	3.12%	17.6%	2.66%
Office	-41.1%	7.35%	35.6%	3.52%	18.4%	3.37%	17.8%	3.06%
NCREIF Property Index (NPI)	-6.5%	5.10%	-16.9%	6.20%	13.1%	6.80%	3.36%	--

Source: Cadence Capital Group, LLC; Treasury.gov; Standard & Poors; Robert Shiller; NAREIT; NCREIF
 S&P and reit-related dividend yield as of year-end; YTD as of 5/31/11

REIT CAPITAL OFFERINGS



Source: Cadence Capital Group, LLC; NAREIT

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