

US Real Estate Capital Market Commentary: August 2011

"The distinction between the past, present, and future is only a stubbornly persistent illusion" – Albert Einstein

Back to the Basics

So much for summer vacations. Not to dwell on the frenetic stream of news during the past few weeks, but let's briefly recap several events: Standard & Poor's (S&P) downgraded the U.S. 'AAA' credit rating; the VIX has nearly doubled; the REIT index dropped nearly 20% then recovered half of this loss; S&P pulled their ratings on a \$1.5 billion CRE securitization; CMBS super-duper AAA spreads have gapped-out by 80+bps, essentially putting this market on ice; the European Union is facing renewed significant financial and economic pressures; and, U.S. and Euro-zone growth rates have been scaled back fairly dramatically. Taken in its entirety, it appears that the global economy remains mired by asset-level deflation and price-level inflation. Welcome to the New Normal.

It is time for us to remember that commercial real estate is a cyclical business - supply and demand fundamentals, as well as the cost and availability of capital, are linked to the broader economy and inevitably prone to virtuous and vicious cycles. Investors need to look through the recent volatility and incorporate an outlook for both property fundamentals and real estate capital markets into their investment decision making process. Therefore, we have formulated some quick thoughts on the current strengths, weaknesses, and outlooks of each property segment and various capital sources.

Property Segments

Declining rents and deteriorating demand typically hits asset types with shorter lease terms early in a recession, such as retail and multifamily. However, multifamily has benefited from stable demand (thank you, "Extend and Pretend") and government sponsored financing (FNMA and FHLMC). In-line space of grocery-anchored retail has been impacted, but on more of a geographic basis (again, the relationship to the broader economy is important). Cadence Capital Group currently believes that well-located multifamily and grocery-anchored retail will continue to experience better fundamentals and investor liquidity compared with other property sectors. As investors continue to gravitate to these property types, they will continue to bolster liquidity and value.

Despite the federal government's unspoken weak-dollar policy, the U.S. has yet to increase its manufacturing base, and consumption now comprises over 70% of gross domestic product (GDP). We concur with the small chorus of investors who believe production will trend upward, particularly as China's consumption increases. Nevertheless, our currently stagnated economy will hinder any dramatic changes in industrial fundamentals. Cadence Capital Group currently believes top-tier distribution facilities and select light manufacturing properties located in cities with a skilled and educated labor force could produce "better than expected" operating results.

Persistently high unemployment, long-term leases and gently shifting consumer spending habits have eroded the fundamentals for regional malls and office buildings. However, the long-term nature of these leases has dampened the impact on cash flow, particularly office markets with a mix of industry exposure (the technology sector continues to expand). Not only will online retail spending and decreased disposable income weigh on mall cash flows, the recent setback in the securitization market will suppress much movement in value. Cadence Capital currently believes regional malls and office buildings will continue to experience remarkably inconsistent fundamentals depending on the geographic location. This will result in clear investor preference for stronger properties/markets ("core assets, core markets") over weaker properties/markets ("non-core assets, non-core markets").

Capital Sources

Public Equity - A good short-term investment: Liquidity and transparency continue to color investor's decision-making process. Intriguing broad market valuations (~12.5x earnings) and strong corporate balance-sheets make stocks appealing, but the relatively high dividend yield of REITs equities appear more appealing in the near-term.

Public Debt - Mixed emotions: The low interest rate environment will continue to favor REIT debt, while CMBS performance will remain spotty, weighed-down due to opaque and uncertain credit performance. New issuance will remain very tepid through yearend 2011.

Private Equity - Very favorable outlook: Equity investors are increasingly thinking the era of "extend and pretend" is coming to a close, thus resulting in a growing interest in distressed opportunities within non-core products and markets. Preferred equity is available for the "right sponsors" (no foreclosures). Bulge bracket funds remain flush with cash while middle market funds are stuck piecing together syndicated deals.

Private Debt - Mixed emotions: Most balance sheet lenders have taken a step back in recent weeks, but appear likely to increase lending (on their terms) after the summer vacation season concludes. Underwriting standards could be favorably impacted by the pull-back in activity by the securitization shops.

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Property Sector Strengths/Weaknesses and Outlook

Property Sector	Strengths	Weaknesses	Outlook
Multifamily	<ul style="list-style-type: none"> * strong support from foreign & domestic investors * favorable demographic outlook * availability of financing from GSE's 	<ul style="list-style-type: none"> * supply pipeline has increased in 2011 * persistent unemployment hinders household formation * resident migration negatively impacts older assets 	Positive
Retail: grocery-anchored	<ul style="list-style-type: none"> * necessity-based demand drivers * supply remains relatively modest * modest availability of financing 	<ul style="list-style-type: none"> * in-line tenants continue to feel economic pressure * consumer retrenchment from high-end grocers * older product at risk from low barriers to entry 	Positive
Industrial	<ul style="list-style-type: none"> * supply remains relatively modest * outlook for global trade remains positive * gateway markets remain supply constrained 	<ul style="list-style-type: none"> * distribution demand is linked to retail industry * slow economic recovery will be a drag on demand * protectionist trade stance will be a drag on demand 	Neutral
Retail: regional malls	<ul style="list-style-type: none"> * retailers may have survived worse of economic woes * malls continue to serve as social "centers" * well-located assets are always in demand 	<ul style="list-style-type: none"> * pent-up consumer demand may never materialize * vacancy rates have risen dramatically * rental rate recovery is historically drawn-out 	Negative / Selective
Office	<ul style="list-style-type: none"> * urban supply pipeline remains modest * shadow/sublet space may have stabilized * corporate balance sheets remain healthy 	<ul style="list-style-type: none"> * uncertain demand outlook due to persistent unemployment * fundamentals are lagging * uncertain outlook from start-ups 	Negative / Selective

Source: Cadence Capital Group, LLC

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%	--	2.07%
S&P 500	-38.5%	3.24%	23.5%	2.03%	12.6%	1.83%	-10.3%	2.15%
FTSE NAREIT Equity REIT Index	-37.7%	7.56%	28.0%	3.73%	28.0%	3.54%	-2.9%	3.96%
Apartments	-25.1%	7.52%	30.4%	4.32%	47.0%	3.31%	9.7%	2.93%
Shopping Centers	-38.8%	8.51%	-1.7%	4.27%	30.8%	3.55%	-6.1%	4.02%
Industrial	-67.5%	11.25%	12.2%	4.56%	18.9%	3.51%	-15.7%	4.38%
Regional Malls	-60.6%	8.67%	63.0%	1.04%	34.6%	3.12%	4.4%	3.12%
Office	-41.1%	7.35%	35.6%	3.52%	18.4%	3.37%	-1.7%	3.73%
NCREIF Property Index (NPI)	-6.5%	5.10%	-16.9%	6.20%	13.1%	6.80%	3.65%	--

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 Aug. 19, 2011.

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