

## 2009 U.S. Real Estate Investment Outlook and Market Perspective

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### Overview

Along with the overall economy, the real estate investment market experienced a dramatic fall in the past year. Following several years of outsized double-digit annual returns, pricing for real estate achieved unsustainably high pricing levels in 2007, fueled by highly available and inexpensive debt along with unrealistic assumptions regarding future income growth. With the debt markets turning decidedly against commercial properties in 2008, valuations became difficult to determine and transaction volume fell to levels last seen in 2003. Although investors and appraisers have been slow to recognize valuation declines, RREEF Research estimates that values have fallen by 30 percent or more since the 2007 peak. Even the NCREIF property index, which is typically slow to recognize market changes, depreciated by over 11 percent in 2008 and provided a total return of negative 6.5 percent. The index should largely catch up with transaction values during 2009. RREEF Research forecasts a total return of between negative 11 percent and negative 9 percent in 2009.

The US economy is in a dire situation and it is expected to continue to deteriorate further in the coming year. Economic output is expected to drop for at least four consecutive quarters and annual GDP will likely contract further in 2009 than in any year since 1946. The official recession will likely last a minimum of six quarters, the longest in post-WWII history.

Recovery in the economy depends on stabilization of the housing and financial markets, which we expect to occur later in the year. In the meantime, the economy is expected to remain weak and tenuous. Restoration of market confidence will be key to allowing a recovery to begin. Aggressive monetary policy and intervention in the financial markets has begun to stabilize the economy, but confidence is still weak. Fiscal policy will be the next major boost to the economy, including a large stimulus package and several measures aimed at stabilizing the financial markets. Assuming federal policy is reasonably well designed, the US economy should stabilize later in the year producing flat or weak growth, but a stronger recovery will not likely begin until 2011. Economic growth during recovery is likely to be anemic compared to other economic recoveries, given the resultant high federal debt levels and probable inflationary pressures.

Stress in the capital markets began to severely impact commercial real estate in 2008 and transaction volume dropped to levels not seen since 2003. Capital is typically seeking either very low risk havens, such as short-term Treasuries, or very high return opportunities. Many of those who purchased properties during 2008 now feel that they got in too early.

Modestly increased interest in core real estate is being evidenced in early 2009, as sellers become more motivated, and buyers are attracted by previously rare pricing. As the year progresses, we believe that interest in high quality stable properties in the best markets will increase from investors seeking strong long-term returns. RREEF Research believes that highly attractive opportunities will be available, allowing investors to buy early into a recovery. However, we recommend a highly selective approach to acquisitions, targeting markets and sectors with the least down-side risk and greatest longer-term potential.

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Exceptionally high quality properties are expected to be available at historically low pricing. Any underwriting for such acquisitions will need to recognize that real estate fundamentals will be quite weak over at least the next two years. Concerns over accelerated inflation in 2012 are developing and real estate's traditional role as a long-term inflation hedge should be increasingly valued.

Value-added properties, with occupancy or other issues, suffered more substantial valuation declines in 2008. In the weak current economy, assumptions for leasing during the next two years should be very conservative. The number of distressed sellers that need to raise equity is growing and, accordingly, early signs are emerging of buyers who are underwriting to reflect returns on current, rather than stabilized, income. RREEF Research believes that 2009 should provide attractive opportunities for higher risk investors.

Properties under development or recently completed but with high vacancy will be particularly problematic for investors, and many such properties are likely to revert to their lenders. While many such properties should come to market later in the year, but given the weak economy and poor property market fundamentals such investments should only be considered by investors having a high tolerance for risk.

Apartments, particularly in preferred supply-constrained long-term growth markets, should be favored in the medium-term given a relatively early forecast recovery. Industrial properties, also in favored supply-constrained markets, should be strongly considered. However, particular care should be exerted in any near-term office or retail acquisitions, as these will be the most problematic sectors.

Buyers should target metro area markets that have the least down-side risk in the next few years, but which also have favorable longer-term fundamentals. At the top of the list of stronger metros is Washington DC, which is expected to lose the fewest number of employees in the next two years largely due to anticipated government spending and investment. Baltimore should also be viewed favorably both due to its proximity to Washington DC and its many agencies, and also due to the BRAC realignment, which is planned to concentrate many military jobs south of Baltimore. Other metros where down-side risk is relatively limited include Boston, Seattle and San Francisco. Metros that are experiencing more severe job losses in the near-term, but which have exceptional longer-term prospects include San Jose, New York, Fort Lauderdale, Miami, Los Angeles, San Diego, Denver and Orange County.

With the Dow Jones Wilshire REIT Index down by approximately 50 percent from its early 2007 peak and trading at market values around 20 percent below net asset value, real estate securities appear to be attractively priced. Pricing is likely to remain restrained in the near-term as property fundamentals remain weak, but it should be noted that securities pricing typically rallies in advance of the private market. 2009 should present opportunities to enter or expand in this market.

Real estate debt is trading on the secondary market at a discount to par. In spite of some stress expected in the CMBS market, especially for lower rated and more recent vintage paper, attractive risk adjusted returns can be found in investment grade CMBS. Investors should be cautious and pay particular attention when analyzing deals to vintage, underwriter and underlying loans within the collateral pool.

Value-added and opportunistic real estate should be treated with caution in 2009. Given that a high percentage of ongoing development projects, including completed properties with large vacancies, will become distressed in the coming year as loans become due or lenders re-margin, numerous opportunities for acquisitions will be available. However, most sectors and markets will require two or more years before seeing healthy growth. Underwriting will

therefore require a significant hold period, possibly with negative cash flow. Sellers will likely be desperate, however, so pricing should fall sufficiently to produce attractive opportunities.

The following are our top predictions for 2009:

- **Capital Flows.** Capital flows to real estate will remain subdued throughout the year. But as pricing clarifies and the economy and housing market stabilize, capital will reenter the market and transaction volume will increase later in the year.
- **Pricing.** Valuations will continue to correct in 2009. It is likely that values will depreciate at least 30 percent from their 2007 peak. Value-added and opportunistic investments will likely suffer the most in the coming year. Properties in infill location and CBD properties will likely hold value stronger than others.
- **Private Real Estate Equity Returns.** The NCREIF property index (NPI) will likely return between negative 9 percent and negative 11 percent during the coming year. It should be noted that the index tends to lag the property market, and cap rate movements in the NPI are generally much slower than in what are reported through transactions. Core investment prices are adjusting and properly underwritten properties acquired in 2009 will likely be able to achieve between 7 and 9 percent annual returns over a medium-term hold period.
- **Publicly Traded REITs.** High quality REITs will prevail as lower quality companies will fall from the market. Opportunities in REITs should open in the next 18 months as values have corrected much quicker than in the direct market.
- **The Economy.** The near-term economic outlook is bleak, but some stabilization should become evident later in the year, with improving financial and housing markets.
- **Property Markets.** In general, apartment and industrial markets should be less negatively impacted by market fundamentals in the near-term, with strong fundamentals longer-term making them less risky investments. In the longer-term, beyond a two year outlook, office and retail markets should also recover but will exhibit more volatility in the near-term.
- **Apartment Properties.** Although virtually all markets will suffer occupancy and rent losses over the next two years due to employment losses, properties located in supply constrained markets near employment centers will hold up the best of all property sectors. Apartments in markets that have been heavily supplied with for-sale housing will underperform in the short-term. Nevertheless, favorable demographic trends, coinciding with forecast recovery in most employment markets in the three-to-five year term, are expected to position apartments as the best performing of the four property sectors.
- **Industrial Properties.** Drivers of industrial demand will be weak during the coming year. Rent declines may be large in many markets, but occupancy should only decrease marginally as most businesses are stable.
- **Office Properties.** Office-using employment is shrinking and even as the economy enters recovery, demand for space will grow slower. Construction will halt in 2009 as funding remains costly.
- **Retail Properties.** The consumer is pulling back after several years of spending. Vacancy will likely increase in 2009 as retailers halt expansion and some enter bankruptcy. Longer lease terms will keep property values from falling quickly but recovery in this sector will likely take longer.

- **Green Investing.** Increasing pressure is being placed on establishing green credentials for investment real estate. More tenants or users of buildings are demanding some level of green certification, whether it be LEEDS, EnergyStar or other. In addition, investors are also increasingly aware of the enhanced long-term value of green properties. As part of any acquisition, an assessment of the property's green credentials or retrofit potential should be explored.
- **Implications.** Although transaction volume provides few data points, RREEF Research believes that core commercial real estate has already substantially repriced, as discussed above. As a result, we believe that the coming year will provide attractive opportunities for long-term equity investors, at pricing and yields that have not been available in at least five years. Acquisitions in the coming year would be in advance of an economic and property market recovery, providing the potential for attractive long-term returns.

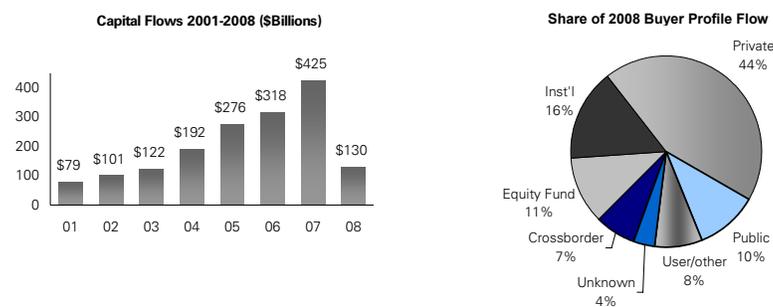
## Real Estate Returns

### Capital Flows

Capital flows to real estate peaked in second quarter 2007 signaling the end of several years of cap rate compression. As debt became illiquid mid-year, transaction volume fell precipitously and nearly halved from fourth quarter 2007 to first quarter 2008. Transaction volume remained subdued for the remainder of 2008 and total volume reached a little more than a quarter of the level achieved in 2007. The composition of type of buyers changed drastically from 2007 to 2008 as lending standards became more stringent and loan-to-value requirements fell. The share of equity and institutional buyers of property dropped in 2008 while the share of private buyers increased. Transaction volume was low for every type of purchaser and although private buyers achieved the highest volume, they only purchased 40 percent of their 2007 total volume.

Transaction volume should remain restrained through 2009. Even as liquidity returns to the market, underwriting standards will remain more stringent than in 2006 and 2007, preventing higher leveraged purchases. Transactions should occur more frequently in the second half of the year and in 2010, but total volume will remain much lower than during the height of the market.

**Exhibit 1**  
**Real Estate Transaction Volumes**  
as of December 2008



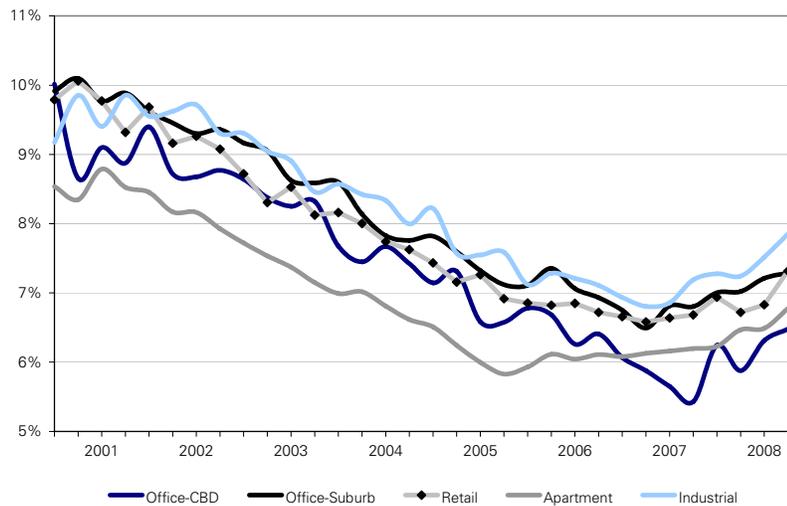
Source: Real Capital Analytics and RREEF Research

## Pricing & Capitalization Rates

The commercial real estate market remains in a state of transition. As investors reassess market risk, they are demanding higher yields from investments and accordingly, market cap rates are moving upward. This trend should continue in 2009 and cap rates should move 150 to 200 basis points from the market peak to its trough. This roughly correlates with 20 to 30 percent depreciation in market values, with office and retail properties likely declining more than industrial or apartments.

Pricing will become more attractive in 2009 and 2010 and, as a market bottom is established, transaction volume should increase. Real estate will revert to its historical role as an income generator and appreciation will remain secondary through the medium-term. As a result, investors will focus on properties that provide the strongest income growth. Interest rates are expected to remain low by historic standards, which will facilitate investments underwritten with substantial equity and realistic assumptions regarding income growth.

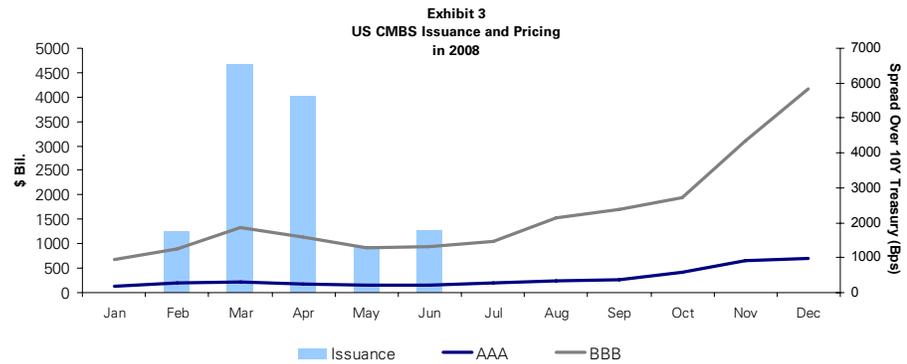
Exhibit 2  
Capitalization Rate Trends  
(Average Rates)



Source: Real Capital Analytics

## Debt Market

Commercial real estate lending slowed to a crawl in 2008 and is continuing at a similar pace in 2009. Freezing of the wider credit markets closed the CMBS machine and there is no sign of a recovery in the near future. Secondary spreads rose to previously unthinkable levels, peaking at extraordinary highs in November 2008. As a result, conduit desks are closed and it is unlikely that any new conduit lending will occur over the next 12-18 months.



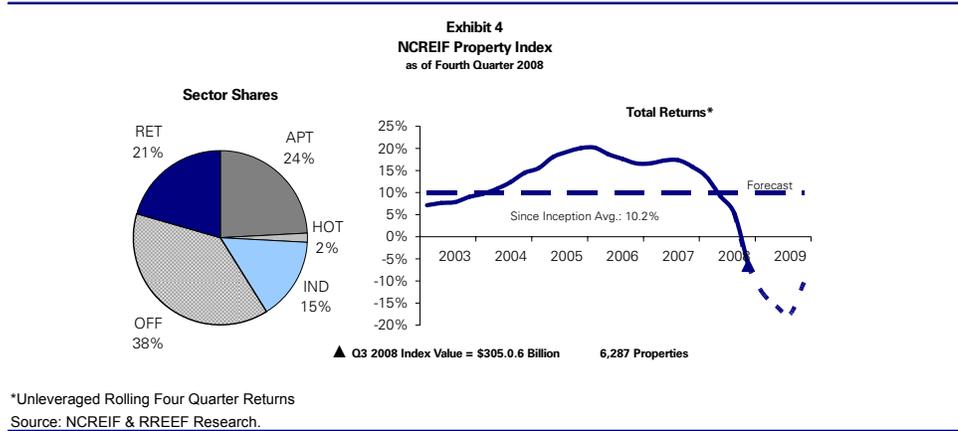
The implosion of the CMBS finance structure placed a significant strain on borrowers needing to refinance in the coming year. The only lenders currently in the market are balance sheet lenders (commercial banks, life companies, etc.) who are focused on in place cash flow. Balance sheet lenders do not have the capacity to fill the void left by the CMBS market implosion as they are suffering the denominator effect from losses in other segments of their portfolio.

A number of new opportunity and mezzanine funds are emerging in an attempt to take advantage of distressed properties and borrowers that are unable to negotiate loan extensions or secure refinancing. A major source of distress will stem from floating rate loans maturing in 2009, as these loans are typically used to finance development and transitional properties which are likely to be underperforming expectations due to the global recession.

## NPI returns

The NCREIF Property Index (NPI) began a significant correction in 2008. Quarterly returns for all property types turned negative in the third quarter, with office returns experiencing the most drastic deceleration. NPI returns for the year were negative 6.8 percent, with the apartment and office sectors experiencing the strongest decline. Total returns for the NPI will remain negative for all of 2009 as commercial real estate traverses through the worst market conditions since the early-1990s. Total return in 2009 will likely be between negative 11 and negative 9 percent. As stated above, income return will likely return as the major driver of sector. Historically, income return made up the majority of NPI total return and only during the past few years has appreciation greatly overshadowed income return.

The NPI index level traditionally lags the market place and this trend will likely continue in the near-term. While historically around 30 percent of all properties are appraised in any given quarter, over 60 percent of properties were appraised each quarter of 2008, while 85 percent were appraised in the fourth quarter. This has facilitated the sharpest recorded decline of the index, but lag remains within the index. Low transaction volume is decreasing market clarity and increasing the difficulty of the appraisal process as appraisers are unlikely to force property values to fall too precipitously without hard evidence.



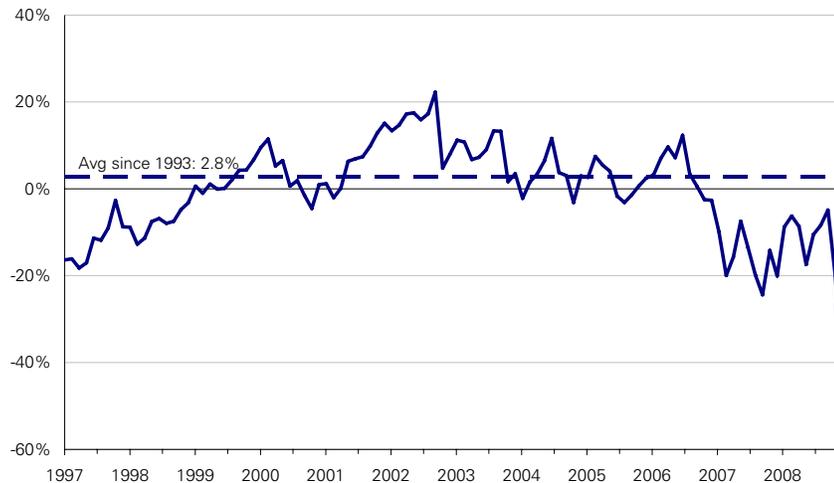
## Publicly Traded REITs

**Performance Review:** From the beginning of the first quarter to the end of the third in 2008, real estate investment trusts, or REITs, were relative outperformers compared to other equities, posting a slightly positive return on the year compared to a decline of 19.3 percent for the S&P500 through September 30. The trend of outperformance changed abruptly in October and REIT returns declined over 60 percent over the next month and a half. The bottom was reached in late November and REITs rebounded over 55 percent to the end of the year. Even with this late rebound, the full year returns were down approximately 40 percent, recording by far the worst year ever for REITs, and reflecting extreme volatility.

A change in market perception was a primary driver in the dramatic slide early in the fourth quarter. Up until recently, it was widely assumed that a REIT with substantial equity beyond its outstanding debt would never declare bankruptcy. The widening of spreads in the CMBS market in November, as AAA spreads over treasuries topped 600 basis points, increased the risk profiles of even core REITs and the market responded with a correction. Federal Reserve actions and increased risk appetite late in the year propelled a rebound for the remaining month of the year.

**Outlook:** Many of the headwinds described above will likely continue to affect the REIT sector in 2009, but the market enters the year with many factors already accounted for by price. A closed CMBS market and pending bank failures (and mergers), are reducing the capacity of

**Exhibit 5**  
**Share Price Premium to NAV**



Source: Green Street Advisors

the debt market. Some debt held by REITs will mature into a market with few refinancing options. Rising credit costs and stricter loan underwriting makes dividend cuts likely at well functioning REITs in the near and medium-term.

Several companies will likely receive negative press coverage highlighting write-downs on institutionally owned real estate portfolios. On a price basis, the REIT sector declined 60 percent from its high in February 2007, which effectively 'writes down' the underlying real estate held by sector companies by 35 percent, with adjustments for leverage. Direct real estate experienced only a fraction of what the public market experienced in 2008. The correct values of direct real estate are currently somewhere between the current valuations of the direct market and the pricing in the public market. The disconnect between the direct side and the securitized side will create opportunity in the REIT market in the coming year.

Opportunities for market participants will emerge over the next 18 months as the correction which already occurred in the REIT sector occurs on the direct side. High quality REITs with strong capital positions will have enormous potential as weaker, overleveraged investors exit the market. Although REIT valuations are compelling, alternative investments in real estate, specifically CMBS debt, suggest equity real estate valuations may remain depressed until the debt market recovers. Actions by the Federal Reserve, such as the use of non-agency mortgages and AAA CMBS paper as collateral in for ABS Term Auction Lending Facility, could stabilize the market quickly. Presently, NAREIT and industry participants are lobbying in Washington DC to provide a Treasury-sponsored source of financing for newly issued CMBS.

The REIT market experienced a large correction in 2007 and 2008, placing implied values of direct real estate well below current direct values. This sets several opportunities in the REIT markets in the coming year but, as in direct real estate, a recovery depends on a stabilization of the debt market.

## The Economy

The US economy entered 2009 in the middle of the deepest recession since post World War II and job losses are mounting from nearly every industrial sector. The status of the housing market remains obscure and the financial system is unstable. Recovery in the broader economy depends on the expansion of the credit markets and accordingly, the economic outlook is sour. The US economy will likely remain in recession through the first half of the year, making this period the longest post-war economic contraction, and recovery will likely be moderate. Nearly six million jobs will be lost from the December 2007 to the end of the recession and unemployment will creep past 9 percent in 2010. The current unemployment rate is 7.6 percent as non-farm employment has already contracted by 3.6 million jobs.

**Exhibit 6**  
**Forecast Highlights: U.S. Economy 2008-2010**  
(annual percent change)

	2008	2009	2010		2008	2009	2010
Real GDP	1.3	-2.7	2.0	Consumer Price Inflation	3.8	-1.9	1.7
Consumption	0.3	-1.0	2.5	Payroll Employment Growth	-0.4	-3.1	-0.1
Business Fixed Investment	1.8	-15.2	-1.3	Unemployment Rate (%)	5.8	8.7	9.4
Equipment & Software	-2.9	-14.4	6.4	Federal Funds (%)	1.93	0.13	0.40
Exports	6.5	-9.4	-1.1	10-Year Treasury (%)	3.67	2.65	3.10
Imports	-3.3	-11.8	7.0	30-Year Fixed Mortgage (%)	6.04	5.21	5.11

Source: Global Insight and RREEF Research

Recovery will likely be muted compared to previous cycles. The second half of 2009 will experience minimal growth and 2010 will likely exhibit growth that is below the long-run GDP trend, unlike the more robust recoveries of previous cycles. Trend-like growth is then forecast for 2011 and 2012, reflecting continued growth that is likely to underperform past recoveries. Employment growth will likely turn positive in 2010, but the unemployment rate will not peak until early-2010. The government stimulus package will allow for economic growth directly with new employment and indirectly through demand for servicing companies. This will only be a beginning of economic growth, as full recovery relies heavily on the stabilization of the housing market and a recapitalization of the financial sector, both of which are unlikely to occur before late 2009.

Although much of the economic news is negative, there are reasons to be hopeful for the future. The simultaneous decline of home prices and mortgage rates is increasing home affordability. Current refinancing is slowly giving transparency to the market, and transactions will become more frequent. Credit spreads are tightening, and although lending remains stringent, it will begin to loosen in the coming months allowing consumers and businesses to expand spending. Additional good news is coming from the government from the economic stimulus package. Expansion of government spending and a boost to consumers through a tax holiday will add to the economy directly and will hopefully indirectly pump prime the greater economy.

Substantial risk remains in the forecast. Negative shocks, poor government policy and an inability to reestablish confidence in the financial markets could easily delay stabilization of the housing and credit markets, preventing the broader economy from entering recovery. A further delay in recovery could result in peak to trough job losses between 6.5 and 7.5 million workers and unemployment peaking at above 10 percent. This scenario would have a significant negative impact on real estate markets, having the strongest effect on office and retail properties. Recovery in vacancy rates and positive rent growth would be postponed until 2011.

The continuous bombardment of bad news makes it easy to forget the long-term strength and resilience of the US economy. The US is still by far the largest economy in the world and, as evident in the long-term government bond market; it remains the safe haven for global assets. Although the workforce is aging, it continues to be among the most productive. Consumers and businesses are currently in shock, but as they regain confidence, demand and supply will both grow. The near-term weakness in the economy is not a permanent fixture and the long-term fundamentals will return to the surface.

## Regional Economic Outlook

The economic slowdown is affecting every part of the nation. Areas with large exposures to the housing and financial service industries are those leading the downturn but even areas with high concentrations in technology and energy sectors are beginning to falter.

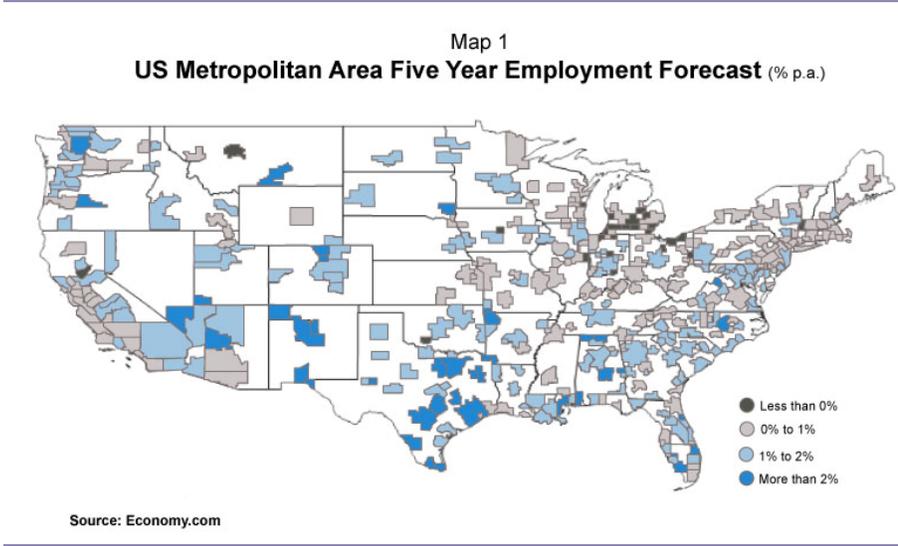
The near-term economic outlook is sour but long-term, employment growth will rebound for most sectors and most regions of the country. The outlook for job growth continues to be strongest for the South (1.5 percent p.a.) and the West (1.3 percent p.a.), then the Northeast (0.7 percent p.a.), and the Midwest (0.6 percent p.a.).

**South:** The near-term outlook for this region is weak, but it still remains the best performer over the next five years. The housing market in Southeast is significantly overbuilt and will remain weak, but the South-Central does not suffer from this problem. Overall, the South benefits from continually strong population growth and lower business costs compared to other parts of the US. In addition to modest manufacturing gains, the region is successfully increasing its exposure to business and financial services, leisure and travel services, and international trade. Although energy prices are off their peaks, large deposits of natural gas and oil will continue to be a resource for the South-Central in the long run. The Defense Department's BRAC movements will negatively affect some metros within the forecast period but will benefit others.

**West:** The Northwest and Mountain states remained some of the last strongholds of economic growth in 2008 while the Southwest took the brunt of the downturn in housing. The coming year will be more of the same for the Southwest, but unlike last year, the Northwest and Mountain states will feel the recession. But long-term, fundamentals remain strong for the region as a whole. Strong population trends should continue after the housing market enters recovery and local industries, such as high-end technology, biotechnology, aerospace and financial services, continue to be in high demand. Softer global demand will result in softer international trade in the near-term, but economic recovery will bring renewed demand for port industries later in the forecast.

**Northeast:** The Northeast is suffering from financial market turmoil and housing problems in certain metros, but growth over the next five years will be strong in certain parts of the region. In the near-term, stable metros, such as Baltimore and Philadelphia, should outperform as their core industries continue drive. These metros should be outpaced by other growth engines later in the forecast as the economy recovers. Many Northeast metros contain highly educated work forces, which encourages growth in long-term, high demand service sectors such as research operations, and business and financial services.

**Midwest:** The Midwest is expected to perform below the national average over the next five years but certain metros will outperform the nation. The dependency on older order manufacturing and the general downturn in the economy is greatly affecting the Midwest industrial centers. Higher end manufacturing will be in demand as the global economy recovers and this will bring some growth to the region. Commodities, which also depend on global growth, will remain soft in the near-term but should begin to rebound later in the forecast. Overall, the near-term outlook for the Midwest is the weakest for all the regions, but growth should return.



The benefits and risks of each of these regional economies highlight the factors that will support certain metros over others during the forecast period. Metros particularly exposed to information, professional and business services, education and health services, and the tourist industry are positioned to perform well. Those with highest exposure to global linkages and international trade will benefit from the ongoing trend of globalization. Structurally, metro areas that possess low business costs and population growth will outperform over the longer run. Exhibit 7 summarizes the drivers shaping superior regional performance in the US in the age of globalization.

**Exhibit 7**  
**Key Drivers of Regional Performance**

**Industrial Linkages**

- High-tech
- Global Trade
- Leisure & Hospitality
- Health & Education

**Structural Characteristics**

- Strong Demographic Flows
- Low Business Costs
- Availability of Skilled Labor
- Warm Climate
- Pro-business Regulatory Environment

Source: RREEF Research

## Property Markets

Continuous downgrades in the economic forecast, particularly in late 2008, dramatically lowered our expectations of performance for all property types. The next four sections highlight current market conditions and our outlook for the next couple years.

**Exhibit 8**  
**U.S. Vacancy Rate Trends**

	Actual		Projected			
	2006	2007	2008	2009	2010	2011
Apartment	5.8%	5.7%	6.6%	7.4%	7.0%	5.9%
Industrial	9.7%	9.6%	11.1%	11.8%	11.5%	10.9%
Office	12.7%	12.6%	13.9%	17.8%	18.3%	16.5%
Retail	6.9%	7.3%	9.0%	10.5%	9.5%	8.0%

Source: REIS Reports, CB Richard Ellis/Torco Wheaton, & RREEF Research

### Apartments: Batten Down the Hatches

**The Issues:** The US apartment market faces one of the most challenging and complex environments in modern history, but also enjoys the brightest recovery prospects. The apartment sector peaked during the 2005 through 2007 period, following several years of poor performance prompted by the 2001 recession and followed by a historically frothy for-sale housing market. Apartments seem to have benefited from the turmoil in the for-sale market as foreclosures began to mount, gaining traction through mid-2008. The collapse of confidence that impacted all markets in fall 2008, and which led to dramatic job losses, impacted the apartment market. As a result, vacancy rates spiked 90 basis points in 2008 to 6.6 percent. With a forecast recession for much of 2009 that will produce sustained job losses, new supply deliveries in 2008 and 2009 are creating *temporary* disequilibrium in the apartment sector across most markets through 2009 and, in some markets, 2010. Vacancy rates are forecast to peak at 7.4 percent in 2009, another 80 point increase over the prior year.

**Market Highlights:** Through third quarter of last year, the sector was on track with RREEF Research's forecast for positive net absorption of nearly 27,000 units. Preliminary estimates suggest that fourth quarter net absorption turned negative by 13,000 units, much higher than a typical seasonal effect, and reduces overall annual absorption to an anemic, albeit positive, 15,000 units. This is particularly concerning because deliveries approached 100,000 units in 2008 and another estimated 86,000 units of new supply are underway and projected for 2009. Bleak employment forecasts for 2009 and the first half of 2010 imply continued short-term weakness in demand and a further rise in vacancy rates.

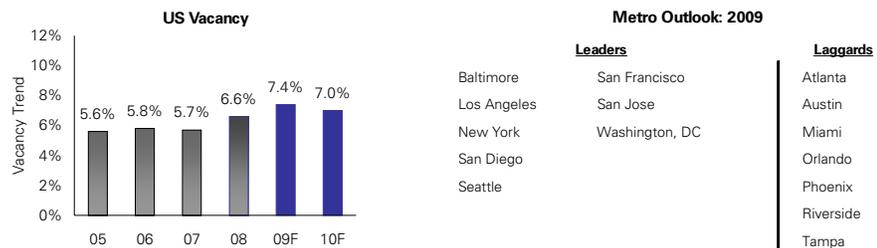
Relentless foreclosures in the for-sale sector further compound shadow supply concerns; the vacancy rate for single-family homes available for rent has ballooned to 9.5 percent, well above its long-term average of 4.5 percent, providing the growing number of renter household's abundant housing options. In addition, Fannie Mae recently announced a new policy under which renters living in homes in which the landlords have been foreclosed upon will not be evicted, thereby becoming the biggest landlord of single-family rentals in the US.

The recent decline in the US homeownership rate benefited the rental market in 2006 and 2008. Home ownership peaked at 69.1 percent in first quarter 2005 but now stands at 67.5 percent, reflecting an increase of 2.2 million renter households. Owners occupy approximately 75.9 million housing units; however, the homeowner vacancy rate is rising quickly and stood at 2.8 percent, or 2.1 million homes, as of third quarter 2008, significantly above the long-term average of 1.4 percent. The homeowner vacancy rate is the proportion of the homeowner inventory that is vacant for sale, and should be distinguished from the measure of single-family rental vacancy noted above.

To summarize the trends influencing apartment fundamentals, weakness pervades both demand and supply fundamentals for the next 18 months. The metro areas at greatest risk are those with a severe housing imbalance in both for sale and rental product in tandem with the sharpest employment declines. These include Atlanta, Phoenix, Riverside, Jacksonville, Orlando and Tampa.

Markets with the strongest prospects, in spite of some near-term pain, are **Washington DC, Baltimore, San Francisco, Seattle, San Jose, New York, San Diego and Los Angeles**. In general, these markets were not excessively impacted by housing oversupply, but they will nonetheless experience some weakness due to continued expected job losses. In the longer-term, they should rebound with relative strength.

**Exhibit 9  
Apartment Snapshot**



Source: REIS and RREEF Research

**The Outlook:** Apartment owners in 2009 should brace for rent rollbacks, higher concessions, and fewer residents available and qualified to backfill vacancies as a result of job losses, reduced income, residents doubling up and, to a lesser degree, home purchases made possible by greatly improved affordability. Owners and managers should minimize turnover by focusing on resident retention, intensifying marketing efforts and providing well-trained staff on site to manage pro-actively through the downturn. The US apartment vacancy rate may approach early 1990s levels, rising in a band of 7.1 percent to 7.4 percent by year end 2009 before recovering along with the economy mid-2010. Fortunately, apartment deliveries are forecast to drop below 1993-1994 levels, into the mid 40,000 units annual range, which will stabilize vacancy. New development will not make sense given the higher cost of debt, higher return requirements, declining-to-flat rents and weak employment. By 2010, government stimuli, past and pending, will take hold and stimulate economic activity. The sector will be poised for a solid recovery and the short-term nature of leases will allow owners to raise rents quickly as demand snaps back by late 2010.

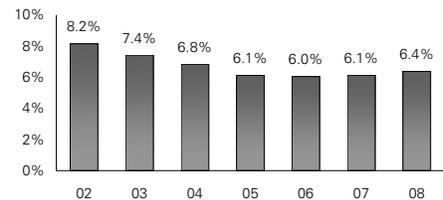
RREEF Research projects a remarkably strong recovery for apartments between 2011 and 2015, possibly with the strongest effective rent gains in history for the following reasons:

- Job growth was relatively low during the last economic expansion and growth resumes, companies may need to staff up quickly;
- Employment growth will enable huge pent up demand for apartments by echo boomers<sup>1</sup> and residents who doubled up in recession. This is comprised of 75 million people, approximately 25 percent of the US population;
- Immigration will continue to play a pivotal role in multi-family demand, forecast to continue at an average rate of 1.8 million annually; however, as highlighted in The State of the Nation's Housing 2008<sup>2</sup>, even if a 30 percent decline in expected immigration levels were to occur, household growth would still total 1.15 million per year;
- The shut down in financing and plummeting construction permits and starts implies sub-trend apartment deliveries in 2010 and 2011, which will facilitate quicker stabilization of occupancies; and
- Home financing will remain much more constrained and, home ownership may be perceived as far less desirable as workers want and need to remain mobile for job opportunities.

Nevertheless, recovery will be much quicker and stronger in those supply constrained markets that did not experience excessive for-sale housing over-building.

**Transaction Market:** Transaction volume will remain low as long as debt is scarce, which has triggered a rise in cap rates and subsequently lower asset prices. In the near-term, negative NOI growth will compound the upward shift in cap rates, producing declining values. Property owners will be forced to recapitalize with more equity or new bridge financing from sources open to commercial real estate exposure. Anecdotal evidence suggests buyers are waiting on the sidelines; however, most admit waiting for distressed opportunities as concerns over falling values persist and investors fear buying too early into the down cycle.

**Exhibit 10**  
**Average Apartment Cap Rates**  
**2002-2008**



Source: Real Capital Analytics

Looking at the multifamily sales market, the number and volume of apartment transactions dropped precipitously in 2008, to \$41 billion in about 5,000 transactions from \$103 billion in over 10,000 transactions two years ago. According to Real Capital Analytics, median cap rates have increased to 6.4 percent, up at over 100 basis points, and should trend upward further. Availability of financing from Fannie Mae and Freddie Mac remains the biggest positive for apartments compared to other sectors of commercial real estate. Still, transaction volumes are low as sellers and buyers re-evaluate the higher cost of capital and its impact on asset values as well as confront the psychology of a broad, yet narrowing, bid-ask spread. While Fannie and Freddie have continued to provide relatively attractive debt to the multifamily market,

<sup>1</sup> Echo Boomers are generally defined as people born from 1977 to 1994 by demographers.

<sup>2</sup> The State of the Nation's Housing 2008, Joint Center for Housing Studies at Harvard University, July 2008.

expectations are that, with more government oversight, they will likely move closer to the metrics of other commercial lenders. This has already begun with their recent moves toward higher debt-service coverage ratios and higher loan-to-values. The result could be more downward pressure on pricing.

Many sellers recognize the new investment realities and may be flexible with pricing; more challenging these days is finding the buyer who can close the transaction. The strategy for owners and portfolio managers to prune their portfolios during this period has not been well-received by buyers. High risk conditions have driven a flight to quality. Most brokers report only the best-of-the-best properties will receive multiple offers, get financed and closed in this environment. They expect that most properties will be purchased by private equity groups in the short-term as pension funds are generally over allocated to real estate and apartment REIT stock prices have suffered, making raising capital difficult.

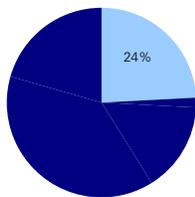
Pricing has been rapidly altered by changing market conditions. In terms of buyer metrics, the consensus is that IRRs are secondary to a focus on cap rates that reflect positive leverage and strong cash-on-cash returns. The cap rate compression that occurred in apartment properties over the past six years did not properly adjust for risk between markets and product type. Investors will refine risk profiles and differentiate more diligently in the coming year.

With transaction volume reduced, pricing is difficult to determine. For those transactions we have witnessed, buyers report requirements in the low to high 6 percent cap rate range for well located, core product, increasing to the mid 7 percent range for older Class B product in Class A locations. Third tier product and markets command higher returns. While current buyer parameters may or may not be supported as more deals close, the consensus is that cap rates are trending back towards historical norms and will better reflect the array of risks ignored in the recent years of capital abundance.

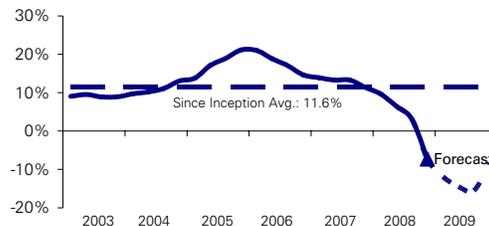
**Performance:** The NCREIF Apartment Index finished the year ending fourth quarter 2008 with a total return negative 7.3 percent matching office properties and trailing the industrial and retail sector. Declines in appreciation returns and weaker income returns contributed to a lower total return for the sector. The income return notably was the weakest of all the property types. High rise and garden properties posted total returns of negative 9.8 percent and negative 5.7 percent, respectively. Regionally, the East was the biggest drag on the NPI with returns of negative 9.1 percent, while properties in the Midwest and South led total returns, posting negative 3.7 percent and negative 5.3 percent, respectively. We expect total returns for apartment properties as measured by the NPI to range between negative 9 percent and negative 7 percent in 2009.

**Exhibit 11**  
**NCREIF Apartment Index**  
 as of Fourth Quarter 2008

**Apartment Share of NPI**



**Total Returns\***



▲ Q3 2008 Index Value = \$73.4 Billion      1,560 Properties

\*Unleveraged Rolling Four Quarter Returns  
 Source: NCREIF & RREEF Research.

## Industrial: Journey to the Bottom

**The Issues:** US Industrial market fundamentals have entered a period of profound weakness. The national availability rate jumped 180 basis points in 2008 and is forecast to reach record levels approaching 13 percent in 2009. Except for population growth and potential governmental stimulus action, all traditional demand-side drivers are faltering. The short-lived expansion of the past few years tempered the amount of new speculative supply added this cycle. This should help some metro markets establish a bottom sooner than in the early 1990s, but negative demand in 2009 will be pervasive and soften all markets considerably. Nevertheless, compared with office, the industrial sector is forecast to bounce back quicker.

The near-term outlook for US and global drivers of industrial space demand are bleak. US employment is forecast to decline by 2.6 percent in 2009. Import of goods fell by 3.8 percent in 2008 and is forecast to fall another 11.0 percent in the coming year. While export of goods remained resilient in 2008, growing by 6.5 percent, the sector is expected to contract by 7.7 percent this year. Equipment and software, and industrial equipment investments are forecast to contract of 14.6 percent and 21.8 percent, respectively in 2009. GDP among US trading partners in Europe, Canada and Mexico is expected to contract and Asia is facing a sharp deceleration in 2009 as well.

National industrial demand trends responded quickly to heightened risks and recent economic deceleration and contraction. New space demand weakened significantly in 2008 due to slower retail sales and tenant response to a slowing economy. Delayed leasing decisions turned into soft leasing demand in the first half of 2008 and then into significant space givebacks in the second half. Final net absorption recorded a loss of 92.7 million square feet for the year the worst loss since 2001 and second worst on record.

**Market Highlights:** The availability rate for industrial properties jumped 180 basis points during 2008, ending the year at 11.3 percent. A combination of speculative construction deliveries and negative absorption caused the sharp move into the double-digits. As expected, the smaller multi-tenant segment performed better than mid- and large-bay than segments which tend to cater to retail-dependant warehouse users. The base of industrial buildings smaller than 100,000 square feet carried an availability rate of 10.8 percent at year-end, while the large buildings had an availability rate of 12.4 percent.

The development pipeline totaled 175 million square feet in 2008 and widely outpaced new demand. This was below peak levels of the prior few years and well below the average annual 250 million square feet totals leading up to the dot-com bust in 2001. The recent development cycle is enough, however, to disrupt market balance, particularly at the nation's warehousing hubs. This cycle brought a disproportionately large supply of 'big box' warehouse product. Nearly 49 percent of all new industrial stock built since 2000 was larger than 200,000 square feet, compared to about 36 percent in the 1990's. All segments are weak now, but from an occupancy standpoint large bulk warehouse space is proving to be the most challenging.

From a supply-side standpoint, regional and metro differences in 2008 may allow some markets to perform better than others, as traditionally the hottest sectors during expansion are subject to the steepest declines. The West and Southwest regions comprise about 39 percent of total US stock, but were responsible for nearly 51 percent of total new supply in 2008. In the West, Riverside/Inland Empire, Las Vegas and Phoenix had tremendous development pipelines (39.8 million square feet) and are now severely oversupplied. Seattle and Portland produced moderate amounts of new construction, totaling only about 1.2 percent and 1.3 percent of their respective bases. Other areas in the West, San Jose, Oakland/East Bay, San

Diego and Orange County had only modest amounts of new construction in 2008. Dallas/Ft. Worth, with nearly 21 million square feet of deliveries, dominated the Southwest development pipeline, but Houston and Austin added 2.1 percent and 3.1 percent to their respective bases. The national average was 1.3 percent in 2008. Nearly half (16.7 million square feet), of new supply in the Midwest is attributable to Chicago, but Columbus and Indianapolis delivered 5.0 and 4.5 million square feet, respectively in 2008. New supply in the Southeast was more evenly distributed among metro markets and overall was not a large percentage boost to existing inventories, but Atlanta is at risk because the metro availability rate, at 14.6 percent, is already very high. The Northeast was more constrained contributing only 12 percent to the national development figure for 2008, but Central New Jersey had 5.0 million square feet and Washington D C had about 3.0 million square feet of new supply.

Market rents were slow to change through third quarter 2008, as anxiety over the economy did not materialize into significant action until about October. We estimate that market rents declined about 3 percent on average through the third quarter, but there was greater downward pressure in Southern California, Phoenix and South Florida, where market rents were off peak levels by as much as 10 percent to 15 percent. By year-end it is likely that effective rents fell further as competition increased and a deep US recession materialized.



**Outlook:** Economic and property market fundamentals will erode sharply in 2009, characterized by broadly rising vacancy extended lease-up times, increased free rent concessions and falling market rents. Competitive conditions will continue in 2010, as the national market struggles to find a bottom.

The industrial market will become highly competitive in the near-term. The US vacancy rate is forecasted to rise to 12.8 percent in 2009 and peak at 12.9 percent in 2010. Net absorption is expected to reach negative 143.6 million square feet in 2009, on par with the level seen in 2001. We expect that by 2010 the industrial sector will post only a modest new demand, leading to about 16 million square feet of positive net absorption. The development pipeline, shocked by poor leasing fundamentals and a highly restrictive capital market, will shrink to record low levels over the next three years, averaging less than 50 million square feet per year. Market rental rates are poised to recede back to recession levels, falling by as much as 18 percent to 24 percent over the next two years in the most troubled markets, but on average we expect market rents will decline by about 12 to 14 percent over the next two years.

The steepness of retrenchment on a regional basis will vary, depending supply-side and rent characteristics of the past few years. Unlike the late 1980s and 1990s, many metros experienced only average levels of new development this cycle. Market rents did not spike or broadly reach replacement levels due to increased land and construction costs. The previous cycle netted less high-finish industrial space from which to shrink. The East and West Coast markets led by Southern California and Florida, will prove to be the most volatile on the downside and rebound the strongest in terms of occupancy and rent movements. Absolute changes in the Midwest and South will be less volatile, but recovery momentum will lag the coasts except potentially in Texas and selected submarkets of Chicago.

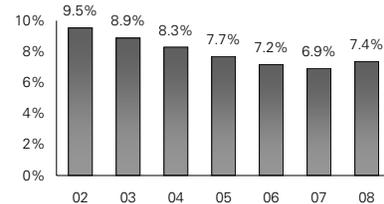
No market will be insulated from the negative impacts of recession, but industrial product in core stabilized markets and submarkets should find a bottom first. Supply-side constraints pushed new development, particularly for the warehouse segment, to outlying areas. This segment will experience the most severe supply/demand imbalances. Core coastal markets, with a few exceptions, should outperform.

There is considerable near-term downside risk in markets focused on business and technology equipment as well as trade, but when recovery does take hold, these markets will benefit the most. Current and future stimulus efforts should help business spending lead recovery. The resumption of global growth and trade is also expected to benefit coastal and port markets in the future. In the meantime, however, finding a bottom will be a painful journey.

In spite of near-term declines, markets with the most favorable outlook include **Los Angeles, San Jose, Seattle, Austin, Miami, Portland, New York and Orange County.**

**Transaction Market:** Industrial investment transaction volume reflected a growing level of uncertainty among buyers and sellers and growing distress in the financial markets during the year. Sales volumes slowed dramatically in fourth quarter 2007, as buyers and sellers failed to close or withdrew offerings in the pipeline. The volume of closed transactions eroded in each subsequent quarter of 2008. The year was characterized by low volume of sales and unmet pricing expectations, increased buyer selectivity, and increased cap rates and healthier cash returns.

**Exhibit 13**  
**Average Industrial Cap Rates**  
**2002-2008**



Source: Real Capital Analytics

Transaction volume for industrial properties plummeted to \$21.3 billion in 2008 or 58 percent below the record investment level in 2007. Flex properties in 2008 comprised only 32 percent of total volume, or \$6.8 billion. Warehouse properties comprised 68 percent of total volume, or \$14.6 billion in 2008. Los Angeles, Chicago and Riverside/Inland Empire were the only regions to crest above the \$1 billion mark in 2008. On average, cap rates increased about 80 basis points in 2008, reflected in all product types and regions, except for warehouse properties in the West, which still experienced only a modest increase. The composition of buyers and sellers changed in 2008. Institutions as a group comprised only about 13 percent of the market compared to nearly 20 percent in 2007. Users nearly doubled their prominence in the market, accounting for 14.4 percent of all buyers.

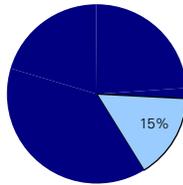
Our expectations for the transaction market in 2009:

- Reduced investor demand, eroding occupancy and declining rents will continue to put upward pressure on cap rates and a premium on long-term credit leases
- Investors will price weakness in a property or market on an opportunistic basis. Absent a significant return premium, few investors will undertake value-added acquisitions particularly where there is short-term leasing risk.
- Quality assets in good core markets will be readily available for the first time in about a decade.
- The flow of capital into speculative new development will cease. Markets with the greatest development pipelines over the past several years will achieve opportunistic pricing metrics.

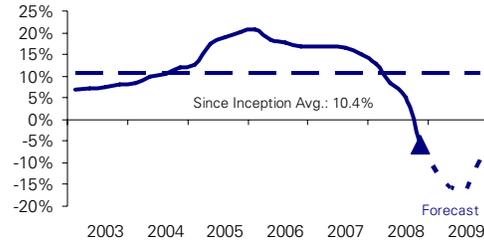
- Risk premiums will return to low-barrier, land rich markets. Historically more constrained markets will also encounter more realistic pricing, but on average outperform.

**Exhibit 14**  
**NCREIF Industrial Index**  
 as of Fourth Quarter 2008

**Industrial Share of NPI**



**Total Returns\***



▲ Q3 2008 Index Value = \$46.3 Billion      2,150 Properties

\*Unleveraged Rolling Four Quarter Returns  
 Source: NCREIF & RREEF Research.

**Performance:** The industrial sector bested the NPI composite return and outperformed the apartment and office sectors in 2008. The industrial index posted a total one-year return of negative 5.8 percent in 2008, on income return of 5.8 percent and appreciation of negative 11.9 percent. On a regional basis the Midwest and South one-year returns held up better, at negative 5.3 percent and negative 3.8 percent, respectively, compared to the East and West at negative 7.9 percent and negative 6.9 percent, respectively. Greater clarity via a higher volume of market transaction may have helped values on the coasts mirror market movements more closely. Since-inception industrial returns average 10.4 percent. Deteriorating market and leasing fundamentals as well as rising cap rates are expected to keep the industrial index in negative territory in 2009, producing a total return between negative 9 and negative 7 percent.

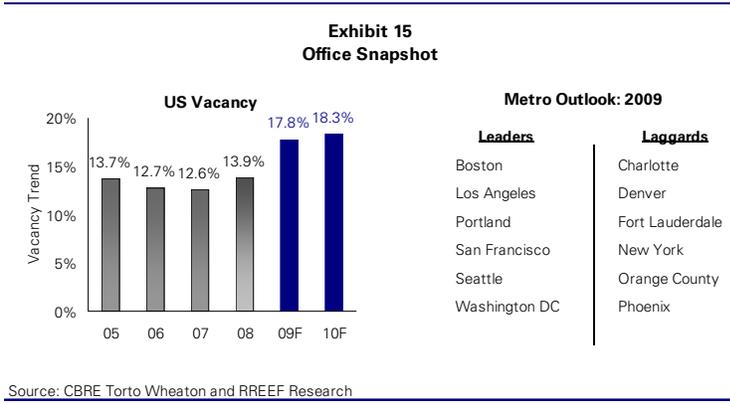
## Office: Falling the Farthest

**The Issues:** Office employment is falling, starting in the home mortgage and homebuilding-related industries, spreading to the general financial community and expanding into the business and service sectors. Additionally, office-using segments within the technology sector are also suffering, affecting metros rich in this demand component. The downturn is now affecting all metros, and those being hit hardest are the familiar weak performing markets and those markets that experienced the strongest rent upswings during the last recovery cycle. Although new supply is not inordinate, retreating demand is causing landlords to scramble for new tenants and offer incentives to preserve cash flow from existing ones. With the bottom of the market still one to two years out, the sector will remain extremely weak until job growth signals a turnaround in the sector.

**Market Highlights:** As expected, faltering demand was the story of 2008, but its rapidly deteriorating prognosis late in the year catapulted it to headline news as office demand growth declined 0.6 percent during the year. New supply of around 80 million square feet in 2008 was not expected to create alarming conditions because, although it was above the long-term historical average, it was still more than 20 percent below the last two prior peak levels in 1999 and 1989. Indeed, early in 2008, the scenario played out as expected, as new deliveries simply met with slowing demand growth, and a slowing but positive rent momentum carried through from 2007. Some rent declines were felt in the weakest markets.

But, demand cascaded rapidly from ‘wait-and-see’ to decidedly negative later in the year, and the anemic positive net absorption for 2008 obscured the strong negative undertow late in the year, which left new product out in the cold. By mid-year, with pressure on landlords mounting, effective rents in all metros deteriorated as concessions rose and face rates eroded, with rates down by 5 percent during the last half of the year, and double digit declines in the most severely affected submarkets.

The greatest rent declines generally occurred in the weakest markets and those that had the highest rent run-ups at the top of the cycle. Properties located in CBDs are generally holding up well with respect to retaining tighter vacancies, as downtown vacancy stepped up only 60 basis point from 2007 to 10.2 percent, while suburban vacancy rose 180 basis points to 16.0 percent. But, where supply issues loom or recent rent increases were high, CBDs have not been immune to large retrenchments in rents.



**Outlook:** The office market will likely continue a down-cycle during the year ahead. The major risk facing the sector continues to rest on the demand side, but each metro and submarket has its own story in this regard. The immediate outlook for office job growth is, nonetheless, poor and the gulf between new supply and demand continues to expand.

New deliveries will fall by a quarter in 2009, a level well below trend, and recede more sharply thereafter as construction comes to a virtual halt. While this will mitigate the impact of near-term demand erosion, the top supply growth metros in 2009 – in terms of percentage of existing inventory added – will face near-term challenges. San Jose, Seattle, Miami, Sacramento and Phoenix are among those metros with the highest 2009 supply risk. However, longer-term, the first two of the listed metros have more resilient demand prospects, and in the first three, supply exposure is mostly concentrated in single submarkets.

As office jobs decline by 4 percent during the coming year, all of the top 26 metros will experience negative net absorption, with at least two-thirds losing 1.0 million square feet or more. The net outflow of around 90 million square feet will be severe and nearly as high as the previous downturn. Metros with the greatest demand retractions as a percentage of existing supply are those succumbing to financial sector and/or housing impacts, led by New York, Miami, Riverside and Fort Lauderdale. Of the four metros having the least percentage declines – Houston, Dallas, Washington DC and Seattle – three will, nonetheless, face above-trend supply deliveries.

Availabilities will increase by nearly 400 basis points, reaching almost 18 percent in 2009. Only one metro ended 2008 with sub-10 percent vacancy – New York – but that will change quickly to double digits in 2009. Among the five metros hit with the highest vacancy increases in 2009, reasons vary, with the trend mostly to demand losses in New York and Riverside, supply additions in San Jose and Seattle, and a combination of the two in Miami.

Gone are the days of preserving face rates by adding concessions in many metros. Average Class A rents will tumble by 10 percent or more during the next two years, for a total decrease of 15 percent or more since peaking around mid-2008. Most of this will occur in 2009, although the swiftness of decline could be more rapid. The sharpest short-term declines will generally be in markets already sustaining severe supply and demand imbalances – Orange County, Phoenix and Fort Lauderdale. Sharp declines are also expected in several historically strong markets with below-average vacancy, but which experienced large recent rent increases, such as San Francisco, New York and Boston. Metros expected to hold rates more firmly will be in markets that tend to be less volatile over the long-term.

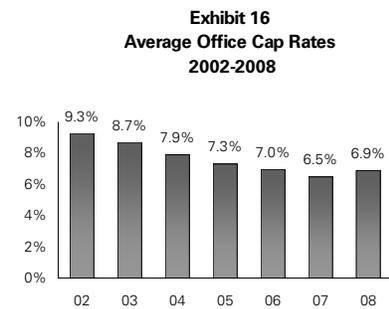
Tenant improvement concessions have ballooned to the point where in many cases “today’s \$60 is yesterday’s \$40”, but this trend should eventually settle down as dwindling rents make higher tenant improvement costs uneconomic to cash flows. As face rates erode, landlords may also become more selective about the amount of up-front concessions provided to non-credit tenants

The bottom of the cycle is not expected until late 2010, and the national office vacancy is expected to require until 2012 to dip to 14 percent. In spite of near-term declines in virtually all markets, those with the most favorable prospects include **Washington DC, Seattle, San Francisco, Los Angeles, Boston and Portland.**

**Transaction Market:** Repricing became a common component of transactions in 2008, as prices were routinely negotiated downward with buyers citing financing restrictions, deteriorating market conditions and inflated capital costs. As sales prices ratcheted down, bid prices no longer became acceptable to sellers, and they began routinely pulling properties off the market. Eventually the transaction market froze as an impasse developed between sellers and buyers. Cap rates took an upward trajectory and the sharpness of the upturn is likely greater than limited transaction data would suggest. Value-add properties became the least desirable, as buyers struggled to forecast the bottom of the market, priced risk higher, and were unable to attain financing at terms that made economic sense.

Four themes are expected in the transaction market in 2009:

- Reduced investor demand and downward rental growth will see office cap rates continue trending upward.
- Investors have little appetite for properties other than core assets. Absent a significant return premium, few investors will undertake value-added acquisitions particularly where there is short-term leasing risk.

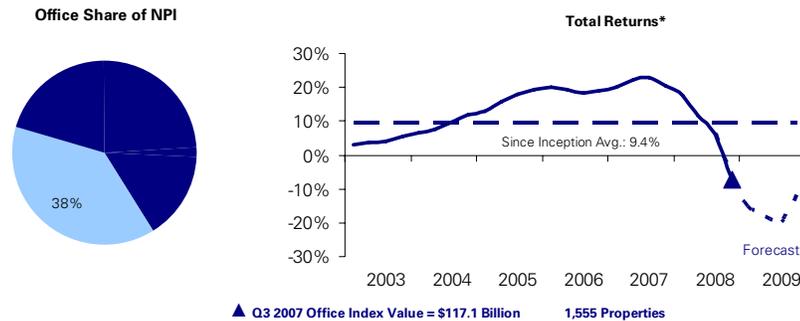


Source: Real Capital Analytics

- The flow of capital into speculative new development will cease.
- As overall market fundamentals continue to decline, and underwriting criteria remain tight, cap rates will increase by 50 or more basis points by the end of the year.

**Performance:** The NCREIF Office Index returned negative 7.3 percent in 2008, a striking difference from the record 20.5 percent total return in 2007. The Office Index lagged the total NPI by 80 basis points with both suburban and CBD properties contributing to the decline. Properties located in CBDs lagged suburban properties, returning negative 8.4 percent and negative 6.6 percent, respectively. Properties in the West and East, which returned negative 9.6 percent and negative 7.9 percent, respectively, lagged those in the Midwest, which returned negative 5.2 percent and South, which returned a marginally positive return, at 0.1 percent. We expect the NCREIF Office Index to return between negative 12 percent and negative 10 percent in 2009.

**Exhibit 17**  
**NCREIF Office Index**  
 as of Fourth Quarter 2008



\*Unleveraged Rolling Four Quarter Returns  
 Source: NCREIF & RREEF Research.

## Retail Properties: A Very Bad Hangover

**The Issues:** Consumers are now in full retreat when compared to their extravagant spending levels earlier in the decade, and this effect has cascading impacts for retail properties.

After several years of retail sales growth (nominal) averaging more than 7 percent annually, from the end of 2003 through 2006, sales growth began to decelerate in 2007, plateauing in early 2008, before finally turning negative in late 2008. The impact on retailers was almost immediate. Through 2008, bankruptcies and store closings slowly began to mount and stronger retailers retracted store openings. The downstream impact on shopping centers took some time to manifest, but now are reflected in escalating vacancies and, most recently, falling rents.

The short explanation for this turnaround has been the quick onset of recession. But retail spending actually is being brought down by four related but distinct consumer trends:

- *Wealth effect* – plummeting home values are lowering or eliminating home equity, the primary source of wealth for most households, while slumping equity markets reduced stock portfolio values;
- *Income effect* – unemployment, underemployment and reduced bonuses are eroding household incomes;
- *Reduced credit for purchases* – fewer households can tap into home equity loans, and banks are severely reducing access to credit cards and reducing credit lines;

- *Increased saving* – consumers are converting lower gas prices into savings accounts instead of spending.

Consumers are in no mood and no position to continue spending as they previously did. Last year we reported that Christmas 2007 sales were disappointing and a sharp contrast to sales during recent Christmas seasons. Sales shrunk by 0.4 percent for the month of December, yielding a year-end sales growth of 4.1 percent for all of 2007. Christmas 2008 proved to be much worse and capped the doourest year for retailing in a generation. Retail sales for the two-month holiday season, which typically account for 20 percent to 25 percent of annual retail sales, fell 2.5 percent (excluding motor vehicles, gasoline, and food and beverage) and for the year rose by only 1.1 percent, below the core inflation rate of 1.7 percent, and well below the 3 to 4 percent RREEF projected for 2008.

Looking forward, there is little reason to expect much of an improvement this year, though RREEF expects retail sales declines to ease by mid-year and perhaps *start* a modest recovery by year-end. However, more solid gains will not likely occur until 2010 and a vigorous rebound will wait until 2011. Until then, the discounters and wholesale clubs should continue to outperform the sector. We also anticipate relatively early recovery from the luxury sector. Next to strengthen will be the middle and lower-middle market discretionary retailers – apparel, electronics and mid-market department stores. Home-related retailers should be the last to recover and are likely to have the flattest bounce.

**Market Highlights:** Retail markets peaked early in this economic cycle, fueled by strong, and ultimately unsustainable, growth in consumer spending. Fortunately, supply growth was relatively tame during the cycle and new supply will be reduced even further in the next couple of years, thereby lessening the market fallout for shopping centers. Nonetheless, the impact of the consumer retrenchment is unmistakable, and conditions are certain to worsen further before they improve.

Good news does exist for the retail sector. During the retail sales surge years from 2003 through 2007, completions of neighborhood and community shopping centers averages just over 25 million square feet annually – well below the 31.5 million average since 1981 – and most of which was absorbed easily by the market. By contrast, supply swelled by almost 54 million square feet annually from 1985 through 1990, the last period of exceptional shopping center expansion in the US.

US retail property markets were relatively well prepared for the downturn, which took hold in late 2007 and gained momentum during the summer of 2008. However, even with retailers taking precautions over the last couple of years – reducing store openings and inventories, preemptively closing underperforming stores – the recession started to overwhelm retailers and shopping centers alike. In addition to aggressive store closures, many retailers who were weak going into this downturn started to liquidate in 2008 and, following the disastrous holiday sales season, more such bankruptcies can be expected in 2009. Vacancies at open-air centers reached a cyclical low of 6.5 percent in 2005, rising modestly to 6.9 percent one year later and to 7.2 percent at year-end 2007. Availabilities surged to 7.9 percent by mid-2008, and rose by another full 100 basis points by the end of 2008 to 8.9 percent. The 2008 jump in vacancy resulted in the sharpest one-year rise since REIS began tracking industry performance in 1981, and the highest vacancy rate since the early 1990s at end of the last retail building boom when vacancies peaked at just over 11 percent.



Source: REIS and RREEF Research

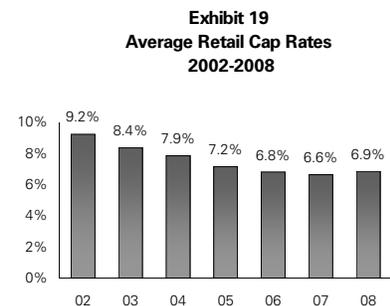
**Outlook:** Looking forward, most retailers continue to place greater focus on profitability over growth. Bankruptcies and store closures will continue this year, though, probably at a slower rate in the second half. Few store openings should occur as the economy enters recovery as even the healthiest retailers remain cautious in 2009 and 2010. Our near-term expectation calls for further market deterioration, but not quite as severe as in 1990, with vacancies peaking at 10.5 percent this year, before the market tightens in 2010 and vacancy declines to 9.5 percent.

The decline in market conditions are not confined to neighborhood and community centers. Looking at the broader market, including all types of retail space, total vacancies rose 60 basis points during the year to end at 6.7 percent. The specialty centers category – which includes airport retail, outlet centers and theme/festival centers – showed the greatest percentage rise in availability, rising from 4.5 percent to 6.4 percent. At the same time, vacancies at the nation’s malls rose from 3.2 percent to 4.0 percent, while at power centers the increase was from 4.8 percent to 6.4 percent. Only freestanding retail boxes have remained relatively untainted by the downturn, with a year-over-year increase of only 10 basis points to end the year at 5.0 percent.

Significant losses in rents are forecast for the next two years, with weak growth thereafter, reflecting retail’s status as the hardest hit sector. While current rent levels are difficult to determine in a market where few retailers are signing new leases, these rent declines could exceed 15 percent, though in most markets the drop should be more in the range of 5 percent to 10 percent.

Though we anticipate construction will moderate in the near-term, retail conditions will continue to weaken in virtually all markets, but most in low barrier-to-entry markets having low land costs. These tend to be focused in Southeastern (excluding Southern Florida) and Southwestern metros. Higher-density infill markets, with strong incomes, high land costs, and restrictive planning controls, will generally be insulated from excess supply. Northeastern and West Coast metros provide the greatest concentration of favorable markets. Metro markets that are forecast to perform best include **Seattle, Washington DC, San Francisco, Oakland, San Jose, Los Angeles, San Diego, Orange County, New York and Miami.**

**Transaction Market:** Retail properties continued to appreciate in 2006 and into 2007, as cap rates continued to decline. Although the retail sector had experienced healthy income growth over the past five years, most price



Source: Real Capital Analytics

appreciation has come from a fall in cap rates from 9.2 percent in 2001 to 6.6 percent in 2007 (see Exhibit 19). But with the downturn in retail market conditions, cap rates have started to rise again, ending 2008 at 6.9 percent.

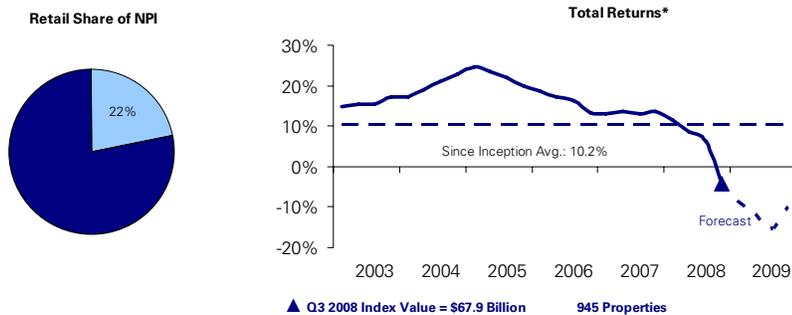
The sales volume of retail properties fell abruptly last year, slowing from approximately \$68 billion in 2007 to only \$19 billion for all of 2008. Transaction volume fell through the year, with \$7.1 billion in the first quarter and ending with only \$2.7 billion in retail property sales. As yet, there is little indication that the market for retail properties will thaw soon.

Fewer transactions make cap market movements more difficult to predict. Nonetheless, further increases in cap rates are likely over the next year. Sales will evidence an increasing divergence between commodity or second-tier shopping centers and those that are market dominant. Class A malls, centers anchored by dominant grocers in affluent markets, power centers in strategic locations with strong anchors and well-conceived lifestyle centers should continue to perform best, but most centers will experience some value loss. Lesser quality assets could experience greater cap rate increases.

**Performance:** The NCREIF Retail Index produced a total return of negative 4.1 percent in 2008 (see Exhibit 20), leading the composite index by 240 basis points. Between 2002 and 2004, the retail index beat the composite by a substantial margin. In 2005, the two indices approximated each other and during the past three years, retail lagged the composite. Regional and super-regional malls led the sector in 2008, substantially outperforming the total index. Community centers and neighborhood properties lagged the retail index, while power centers and fashion/specialty centers lagged substantially.

We expect total returns for retail properties as measured by the NPI to turn sharply negative this year with performance ranging between negative 11 percent to negative 9 percent, thereby lagging the apartment and industrial sector, and barely outperforming the office sector. This reflects our expectation that retail sales growth will continue declining over the coming year and that market conditions in the retail property sector will similarly decline.

**Exhibit 20**  
NCREIF Retail Index  
as of Fourth Quarter 2008



\*Unleveraged Rolling Four Quarter Returns  
Source: NCREIF & RREEF Research.

## Implications for Investors

The investment market in commercial real estate is quickly transitioning from its recent roll as a liquid, appreciative asset back to its historic role as an income producing investment that provides some inflation hedge. Equity buyers, using low levels of leverage of 60 percent or less, will be the main source of capital for the market in the next one to two years. There will be significantly less debt and equity in the market, transactions volume will be greatly subdued and buyers will have more control over transactions.

The economy and real estate markets should begin a stronger recovery in late-2010 or 2011 and at the same time demand for commercial real estate investment should resume. Supply is not overrunning most markets and, as demand for space returns, rent levels will stabilize and then begin to rise.

Market repricing is well underway and core opportunities are becoming attractively valued, relative to historical pricing. Deals underwritten at significantly higher cap rates than were used in 2007, and recognize poor market fundamentals in 2009 and 2010 could prove to be excellent long-term investments. In general, we are expecting an overall increase in cap rates of 200 basis points from the peak and an average decline in value of 30 to 35 percent. However, office properties will perform worse than this, while apartments will likely decline less. Over the course of the next two years, we expect an increasing number of motivated sellers, while a limited number of buyers will begin to recognize historically attractive opportunities.

Strategies to consider across regions and product types are as follows:

- **Geographies:** RREEF Research believes this is a time to focus on only the best product in the leading markets, as economic distress continues and only a limited pool of buyers is expected. These include the globally-linked metro markets that will continue to generate jobs and attract population. These metros provide above average activity in international financial and professional services, defense, trade, medical, and high-tech. In particular, focus should be given to infill locations within these and other strong metro markets. The top markets for real estate investment that minimize near-term down-side risk will be **Washington DC, Baltimore, Boston, Seattle and San Francisco**. In the longer-term, we also believe that San Jose, Austin, New York, Miami, Fort Lauderdale, Los Angeles, San Diego, Orange County, Denver and Portland should outperform. Some of these latter markets will experience greater down-side risk in the near-term, but should be strong performers longer-term.
- **Apartments:** Core multifamily investors should stick to supply-constrained markets. Infill locations, including CBDs and higher income inner suburbs, should be the focus; apartments in mixed-use or multi-use employment centers preferred. High-barrier-to-entry markets with high housing costs and the least near-term downside risk include **New York, Washington DC, Baltimore, Seattle and coastal California**. Acquisition of unsuccessful condominium projects and leasing as apartments is also an emerging opportunity in some markets.
- **Industrial:** Industrial remains a popular core asset due to its low rental volatility and modest NOI leakage from turnover. Although industrial markets are deteriorating significantly, the decline is less serious than in office and retail markets. Infill locations in port markets and locations of mid-size entrepreneurial businesses should weather the downturn better than average. Peripheral urban locations and big box distribution centers should generally be avoided. Tech markets should recover faster than others once economic recovery resumes. Favored markets include **Los Angeles, San Jose, Seattle, Austin, Miami, Portland, New York and Orange County**.

- **Office:** As is normal in a downturn, office is suffering the most in this recession in terms of rents, occupancy and valuations. As a result, it should not be considered a favored property sector for the next two years. However, some attractive opportunities will emerge for the best properties in the best submarkets. Focus should only be on Class A product in the nation's strongest CBD and inner suburban employment centers to take advantage of the long-term expanding business and professional services industry in the US. In many markets, "green" product will fare the best. Buy the best office product in recovering tech markets to take advantage of strong business spending, both domestically and globally. The list of top markets is relatively short: **Washington DC, Seattle, San Francisco, Los Angeles, Boston and Portland.** Within even this short list of superior metros, only a few submarkets should be considered investable in the near-term.
- **Retail:** The retail sector peaked early in terms of valuations, but values have remained relatively steady thus far. This trend should change drastically over the coming year and valuations will likely take a hit in the next couple quarters. RREEF Research believes the retail sector will be relatively slow to recover, even once economic activity resumes, given consumers' needs to boost their balance sheets. Also because retail fell out of favor relatively early, new supply additions are quite restrained, so that once demand resumes, the sector should recover rapidly. Also, many of the nation's strongest retailers have focused on their balance sheets, rather than market share, and are positioned to weather a difficult period. Nonetheless, given the stresses within the sector, only the best located and tenanted retail centers should be considered for acquisition in the next couple years. Metros expected to outperform include **Seattle, Washington DC, San Francisco, San Jose, Los Angeles, San Diego, New York and Miami.**
- **Mixed-use:** Mixed-use properties in dense infill settings are becoming popular with consumers, and evidence suggests that they can produce superior income returns over comparable single-use properties. Typically, mixed-use combines retail with apartment or office uses, which provide synergistic benefits. For new development, or existing product for a long-term hold, mixed-use investments have the potential to generate superior returns.
- **Value-Added Strategies:** In general, as we continue into a severe recession, value-added investments should generally be discouraged. However, emerging evidence indicates that some troubled properties in top markets could achieve pricing based upon market cap rates applied only to existing income, with little to no value given for vacant space. If properties can be acquired at healthy cash flows, needing low levels of leverage and underwritten for little leasing during the next two years at declining rents, such opportunities might be pursued by investors desiring higher long-term returns at greater risk.
- **Development:** Investment in development projects at this stage of a recession should not be considered.
- **Publicly-Traded REIT:** The REIT market has experienced a dramatic fall over the past two years. For better positioned REIT, with properties in the best markets and with reasonable leverage and minimal development pipeline, pricing is beginning to look attractive. During the coming year, buying opportunities should become available. Although they underperformed equities and bonds, the deep NAV discount on REITs brings a positive outlook for the new year. Expectations are that the Wilshire REIT should deliver a total return of between 5 percent to 10 percent this year. Although we are cautious near-term, we believe that REITs will to enjoy healthy demand given the lack of

compelling alternatives. With that backdrop, we continue to view the relative returns of real estate securities attractive in 2008.

- **Debt:** With high quality CMBS debt producing attractive yields, opportunities should be available, even in the near-term, for carefully underwritten and scrutinized high quality tranches of debt.

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