

PRIVATE REAL ESTATE

After a challenging year in 2009, commercial real estate markets experienced stabilization in the first half of 2010, as transaction activity increased and property values showed slight gains. As measured on a total return basis by the NCREIF Property Index (NPI) private real estate values increased 0.8% in the first quarter of 2010. With the exception of hotels, all sectors showed marginal gains. Publicly-traded real estate securities (REITs) gained 5.6% in the first half of 2010, as companies benefited from investors' appetite for higher-yielding securities and significant progress by companies in recapitalizing their balance sheets over the course of the past year. In private real estate, transaction activity increased during the quarter, although ongoing distress across most sectors dominated the headlines. While debt capital is gradually returning from a variety of sources, significant debt maturities remain to be resolved over the coming two years. While distressed transaction activity continues, pricing for core, stabilized assets has strengthened. Write-downs in property values will likely continue through the year, driven by lower rents, rising vacancies, and assumptions for high exit cap rates.

Capital Markets

During the first half of 2010, U.S. Commercial Mortgaged Backed Security (CMBS) issuance totaled \$2.4 billion compared to \$3 billion for the full-year 2009.¹ The first half of 2010 saw the completion of single and multi-borrower CMBS offerings after a two year drought. Depending on rating, new CMBS deals were met with high demand from investors, in part due to strong underwriting and stability of the underlying assets. Investor's appetite for yield also contributed to demand for new issuances. Currently, JP Morgan Chase is leading a \$650 million offering backed by properties owned by Vornado Realty.² Additionally, some portion of the debt used to finance the \$3.9 billion purchase of Extended Stay out of bankruptcy is expected to be securitized as CMBS.³

Delinquencies on CMBS continued to rise through the first half of 2010, reaching 8.6% in the second quarter, the highest level in the history of CMBS.⁴ Loss severities on liquidated CMBS reached a historical high of 52.7%, and for certain property types, like hotels, were higher. By property type, the hotel/lodging and multifamily sectors have the highest delinquency rates followed by retail, office, and industrial.⁵



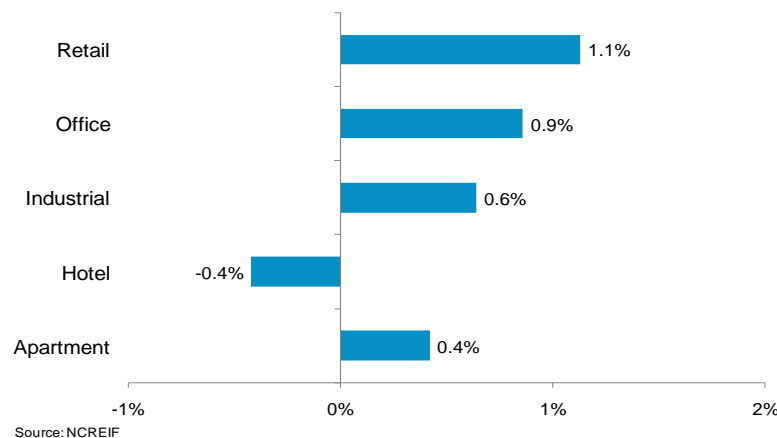
Christian Busken
Vice President

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Operating Fundamentals

Net operating income is expected to remain under pressure, particularly in the office sector due to its reliance on job growth. During the first quarter, data on rents and vacancies showed stabilization in most sectors, although vacancies remained high. As older leases expire, they will be replaced by new leases at lower market rates, which are down significantly from three years ago. The key factor in the recovery for most property types will be job growth, which remains an ongoing challenge. The returns of the NCREIF Index, however, understated actual declines in owners equity, in part, because the index includes properties without leverage. Worldwide commercial property sales volumes accelerated in the first half of 2010, but the number of properties in distress, which would include those needing to be recapitalized, or where mortgages are delinquent, was significant.

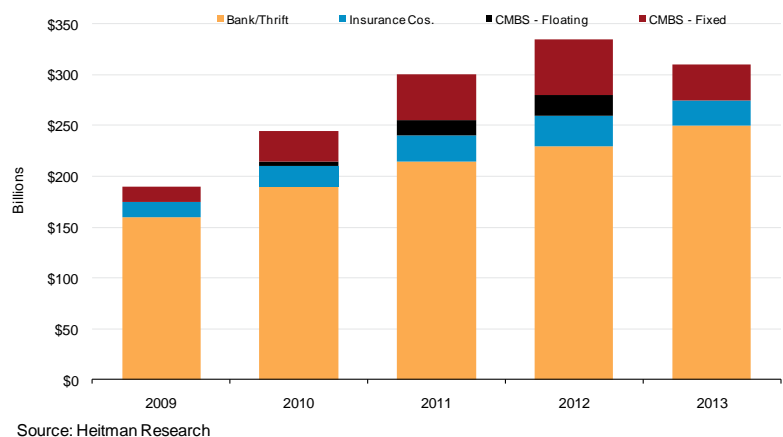
**NCREIF National Property Index Sector Returns-
First Quarter 2010**



Debt Maturities

The key issue within commercial real estate remains the large amount of debt maturing on loans taken out over the past several years when real estate values were considerably higher and financing was much easier to obtain. Over \$1 trillion in commercial mortgages are set to mature in the next four years, and how these loan maturities will be handled remains unclear. Commercial mortgage backed securities (CMBS) experienced rising delinquencies during the quarter, as property owners struggled to meet interest payments in an environment of falling rents and rising vacancies in most property sectors. Banks offered short-term extensions or loan modifications in hopes that the market improves, the “kick the can” strategy. In recent periods, bank balance sheets improved, allowing the ability to absorb losses. As such, foreclosure and workout activity increased and the opportunity set for opportunistic real estate investors is ramping up.

Commercial Real Estate Loan Maturities 2009-2013



Sectors

Apartment

The apartment vacancy rate fell to 7.8% during the second quarter, down from 8.0% at the end of the first quarter.⁶ Rents were modestly higher, showing an increase of 0.7% nationally, and net absorption was positive at 46,000 units, the strongest quarterly performance since 2005.⁷ In the best performing markets, rents increases were higher, such as in New York City, where rents rose by 1.4%.⁸ One of the key factors contributing to strong demand in the apartment sector was ongoing uncertainty in the housing market, which led many to consider renting over buying. The expiration of the first-time homebuyer credit in late April reduced incentives to move from renting to buying. Additionally, tighter lending standards for homebuyers pushed many to rental properties, further contributing to demand. Also contributing to strength in the apartments sector was the lack of available financing for new apartment construction over the past two years, which limited new supply, and should further contribute to strong pricing as demand increases. Rents declined in only 10 of 82 major markets and rent increases were strongest in major Metropolitan markets such as Boston, San Jose, and Seattle. Phoenix and Las Vegas remain among the weakest markets, with the largest year-over-year declines in rents.⁹ Going forward, the apartment sector should experience further stabilization, assuming employment improves and the economy strengthens.

Office

Office vacancies climbed in the second quarter, with the national vacancy rate reaching 17.4%, the highest level since 1993.¹⁰ Average effective rents (defined as net amount paid by tenants after landlord concessions) continued to decline in the second quarter, falling by nearly 1%, to an average of \$22/square foot.¹¹ This represented a more moderate decline than the past year and there are indications that rents and vacancies have stabilized near current levels. Weakness in the office sector was largely driven by anemic job growth, as companies were slow to hire and unemployment remained near 10%. The most distressed markets within the office sector (Las Vegas, Phoenix, and Detroit) had vacancy levels in excess of 25%, while Washington, D.C. and New York City had significantly lower vacancies, in the 10-12% range.¹² New York benefited from increased hiring in the financial services sector, while Washington D.C. saw growth in demand from expansion in the Government.¹³ Returns in the office portion of the NCREIF Property Index sector declined 0.9% in the first quarter, second only to the retail sector, which declined 1.1%. The office vacancy rate is expected to peak in 2010, but any recovery will be a function of job growth, which may not materialize until 2011. Therefore, the office sector will likely lag other property types in terms of recovery.

Industrial

Demand in the industrial sector is driven primarily by inventories, manufacturing, imports, and exports. The global recession, combined with a drop in consumer demand, negatively impacted industrial property fundamentals in the downturn. In the first half of 2010, however, signs of stabilization appeared, but fundamentals remained challenging. Net absorption was negative at 5.5 million square feet in the quarter, but this represented an improvement over prior quarters. Some major industrial markets, such as Los Angeles, Dallas, and Houston, experienced positive net absorption during the quarter. Industrial vacancy rates stood at nearly 14% nationally, a 20-year high, but certain markets (Los Angeles -10%) were significantly lower. Alternatively, Atlanta had the highest vacancy rate at 20%. On the positive side, however, conditions appear to be stabilizing and the sector should benefit from limited new supply, as new construction has been severely limited over the past two years due to a lack of available financing. New completions in 2010 are expected to be approximately 31 million square feet, down significantly from the peak when completions exceeded 100 million square feet in 2007 and 2008.

Retail

Fundamentals in the retail sector weakened during the second quarter, as vacancies rose and lease rates fell, driven by slower consumer spending that limited expansion by retailers. Vacancies at major malls in the top U.S. markets rose to 9% in the second quarter, up from 8.9% at the end of the first quarter.¹⁴ Rental rates at malls fell slightly (0.2%) to an average of \$38.75/square foot.¹⁵ Similarly, vacancies at strip centers rose to 10.9% during the quarter, up from 10.8%. Rental rates declined by 0.5%.¹⁶ Due to the longer-term nature of retail leases, the sector could lag any recovery in the broad economy and vacancy rates could remain elevated for the next several years. Same store sales rose in the first quarter, but gains were muted in the second quarter, particularly home improvement stores and discount retailers. Grocery store-anchored shopping centers remained stable and were less impacted by the downturn due their exposure to sales of consumer staples.

¹ Marcus & Milichap Research Services, July 10, 2010

²⁻³ Lingling Wei, CMBS Market Rises from the Ashes of Collapse The Wall Street Journal July 21, 2010

⁴⁻⁵ Bodamar, David, CMBS Delinquencies Rise Again, but Pace of Growth Slows. Retail Traffic Magazine, July 6, 2010

⁶⁻⁹ Timiraos, Nick Apartment Vacancies Fell in Quarter The Wall Street Journal, July 8, 2010

¹⁰⁻¹³ Troianovski, Anton, Office Vacancy Rate Keeps Climbing The Wall Street Journal, July 6, 2010

¹⁴⁻¹⁶ Hudson, Kris Shopping Centers Struggle, but Hope Seen The Wall Street Journal, July 7, 2010