Equity Research

Real Estate Market Cycle Monitor

First Quarter 2005 Analysis
May 2005

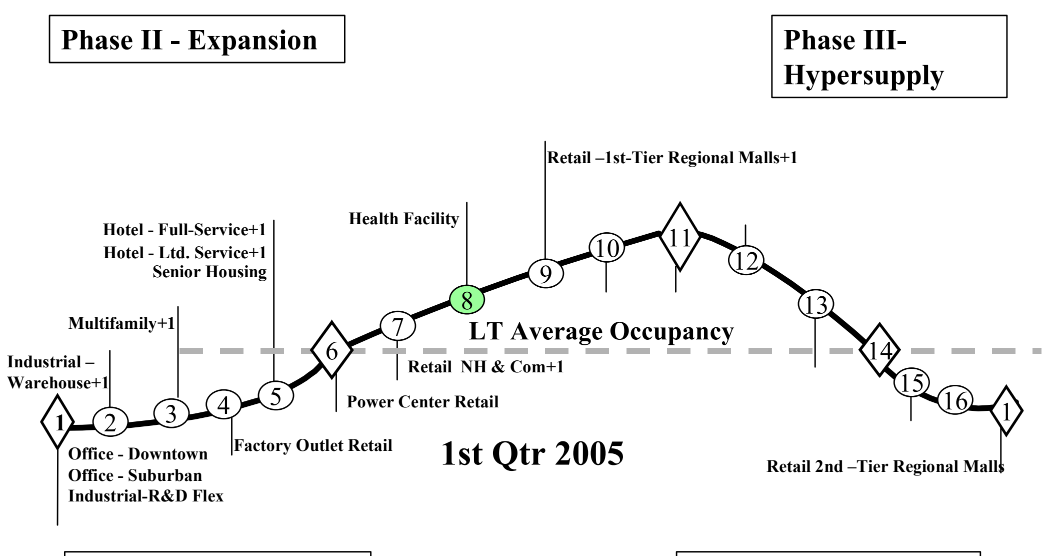
Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.

Real estate is now showing the effects of an improving economy, with positive demand in all sectors. Hotel and retail are the biggest beneficiaries of the economic expansion, with the best improvements in occupancies and rents. All sectors have supply growth due to the high prices found in real estate as capital chases the perceived cash flow safety over stocks and low interest rate bonds.

- Office occupancies improved by 0.3% in 1Q05 and we expect moderate rent growth under 1% in 2005.
- Industrial moved forward one cycle position and we expect 1% occupancy growth and 1% rent growth in 2005.
- Multifamily moved forward one cycle position and we expect a 0.6% increase in occupancy and 1% to 2% rent growth..
- Retail moved into the growth phase - cycle position #7 - which should drive rent growth at 3% to 4% in 2005.
- Hotel moved to cycle position #5 and we expect 2% occupancy growth and as much as 7% RevPAR growth in 2005.

The National Property Type Cycle Graph shows relative positions of most subproperty types — major markets are reviewed inside.

National Property Type Cycle Locations



Source: Mueller, 2005

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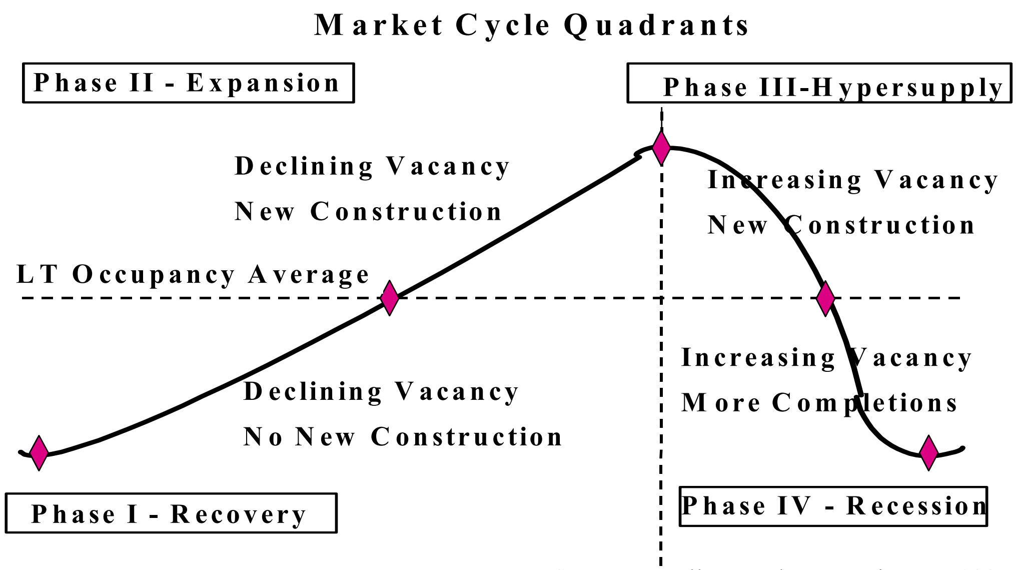
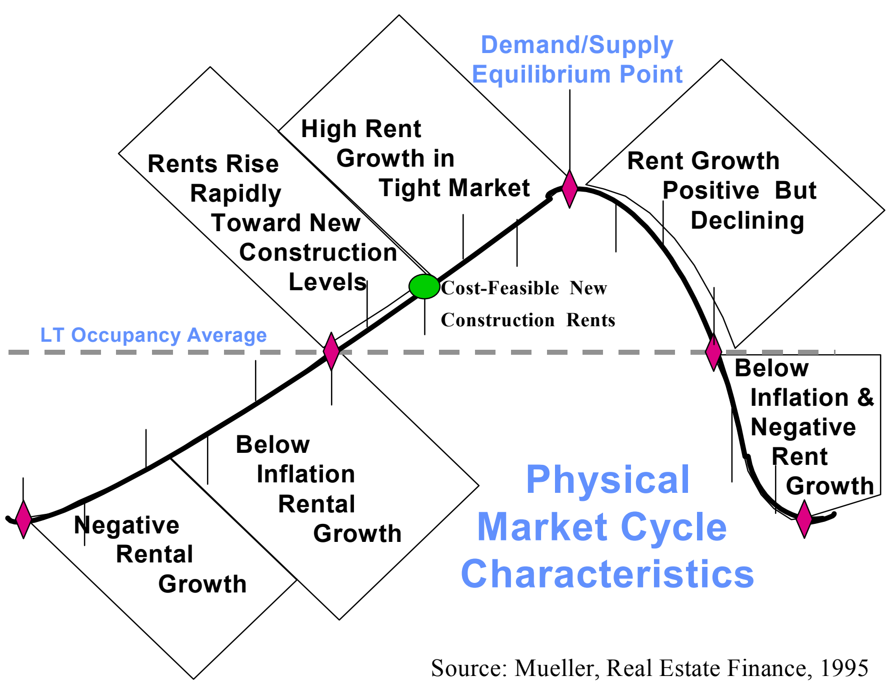
All relevant disclosures and certifications appear on page 9 of this report.

The cycle monitor analyzes occupancy movements in five property types in over 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that analyze occupancy levels and rental growth rates to provide the foundation for long-term investment success. Real estate markets are cyclical due to the lagged relationship between demand and supply for physical space. The long-term occupancy average is different for each market and each property type. ***Long-term occupancy average*** is a key factor in determining rental growth rates, a key factor that affects real estate returns.



Source: Mueller, Real Estate Finance, 1995

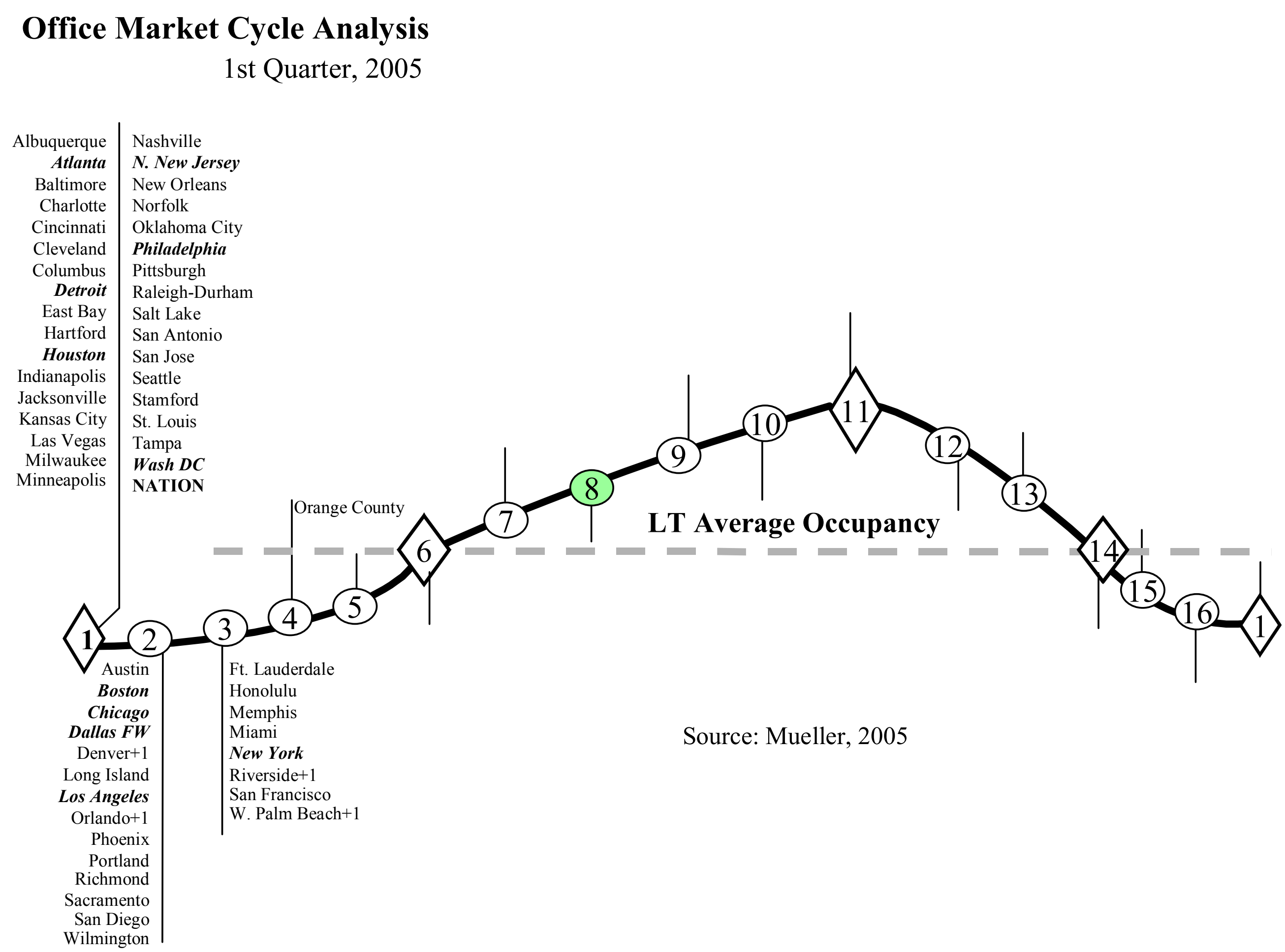
Rental growth rates can be characterized in different parts of the market cycle, as shown below.



Source: Mueller, Real Estate Finance, 1995

OFFICE

Office occupancy improved by 30 basis points in 1Q05 with suburban markets moving faster than Central Business District (CBD) markets, but CBD markets do have a 2% better occupancy rate than suburban markets. National office absorption was a positive 16 million square feet in 1Q05. The best metro occupancy rates are now in Washington, DC, New York and the Inland Empire (including Riverside, CA). Sublease space continues to burn off in most markets and is down 35% from the dot.com debacle of three years ago. Some markets, including Phoenix, Cincinnati, Columbus and Detroit, still are experiencing negative absorption. It appears that the Midwest continues to be hampered by manufacturing- and industrial-driven economies, while the coastal and climate-driven markets are relatively healthy in terms of job growth. Where new supply is developed is a function of very location-specific economics. New development is very submarket-specific and driven by rental rates returning to a level that justifies new development economics and returns. While the office market recovery has been under way for several quarters, asking rental rates have stabilized only recently. The average national rental rate rose modestly by 0.5% in both the central business districts and the suburbs in 1Q05. We expect occupancy to improve less than 1% in 2005 and rental rates to remain relatively flat in most markets in



2005.

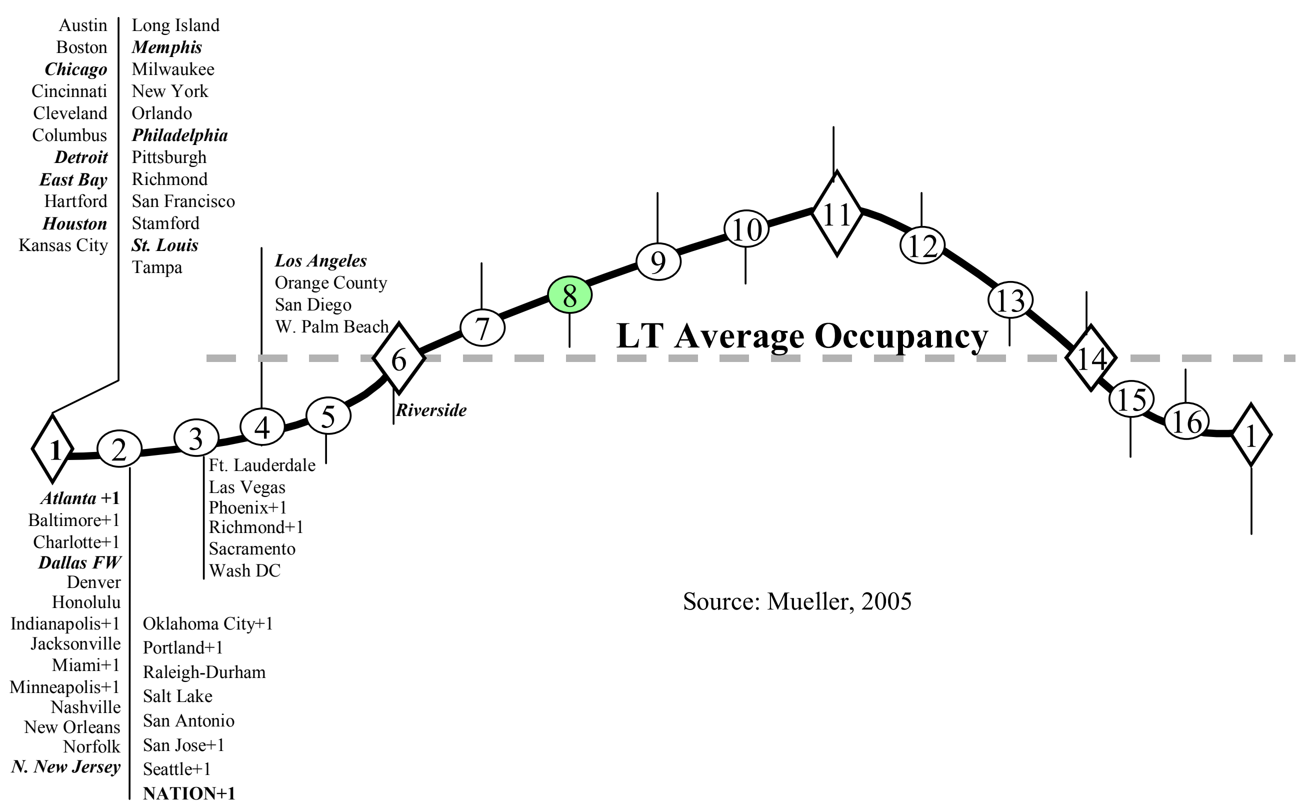
Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor. Thus, the 11-largest office markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

INDUSTRIAL

Industrial occupancy improved by 30 basis points, the strongest increase in seven years. Net absorption was almost double new construction, but still a small percentage of total space. The Southern California markets were top performers due to the booming local economy and growing trade through Southern California ports. The Midwest had strong improvements as manufacturing increased from growing exports, also helping improve warehouse distribution markets including Chicago, Indianapolis and Columbus. On the other hand, R&D-flex space continued to have declining occupancy due to poor demand from the tech sector and the developing company office market. Downward rental pressure lingers, and concessions remain in play as landlords try to improve portfolio occupancy. The current national vacancy rate is now below 10% and the national average has moved to position #2 in the cycle. We expect close to 1% occupancy improvement in 2005 and a 1% national average rental growth for the year. However, local market conditions may vary dramatically.

Industrial Market Cycle Analysis
1st Quarter, 2005



Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space we monitor. Thus, the 12-largest industrial markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

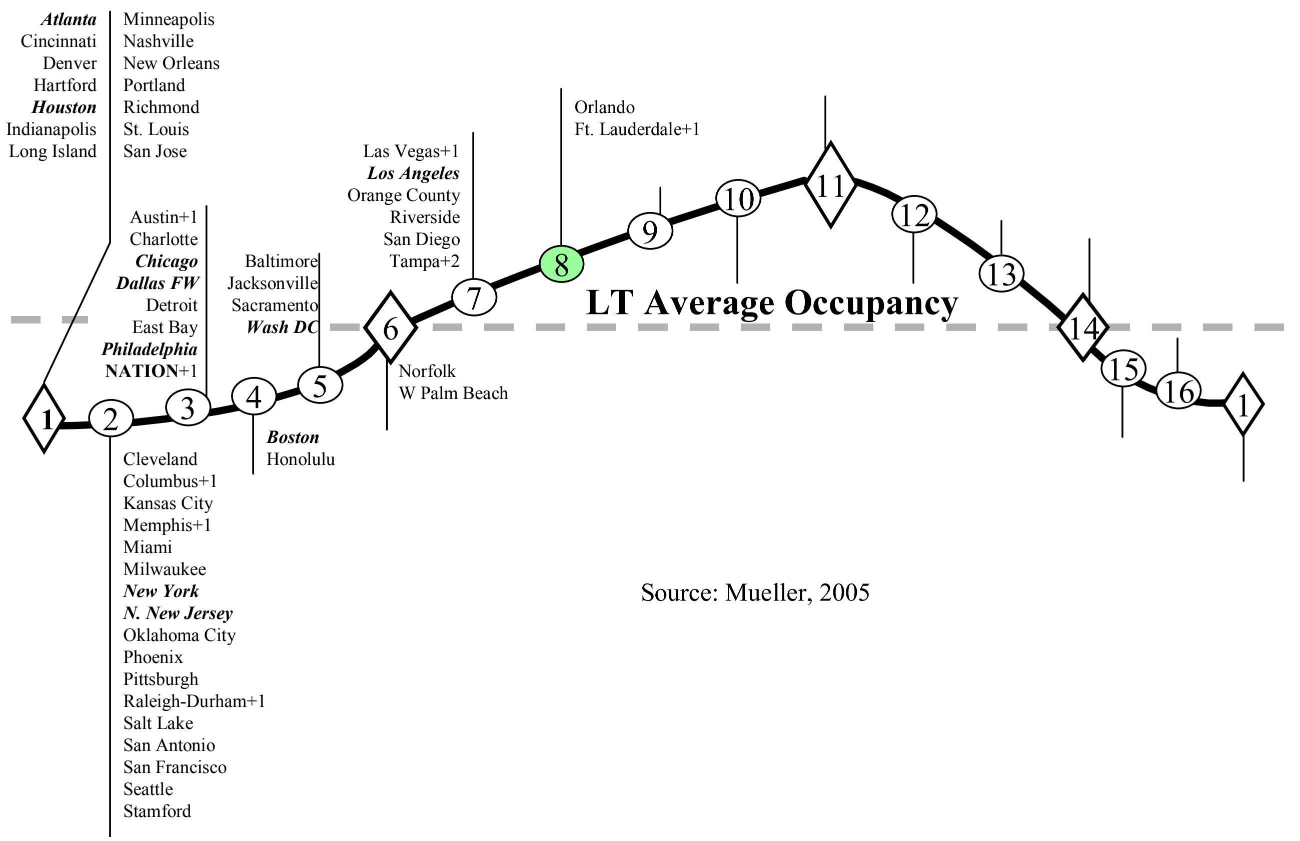
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

Multifamily

Multifamily occupancy improved 20 basis points in 1Q05. This improvement was just enough to move the national average to position #3 in the cycle. Improving employment has provided the extra demand needed in many markets in which renters have converted to homeownership. But low mortgage rates continue to be an impetus for homeownership, moderating improvements in multifamily fundamentals. While higher construction costs should be resulting in slower multifamily construction, supply is still steady, up 7.2% nationally in April 2005 compared with the year-ago level. However, some of that pickup in 5+-unit construction is condominium building, and conversions to condominiums are reducing the rental supply in some major markets. Six markets moved up in their cycle position this quarter, which may allow for some rental growth in a handful of markets, likely those with high costs of homeownership. The spring/summer leasing season will be critical in determining how much demand has been created from the higher job growth levels and college graduates. We still expect concessions to decline throughout the year and estimate a 60-basis-point occupancy improvement, which should provide rent growth of 1%–2% in 2005.

Multifamily Market Cycle Analysis

1st Quarter, 2005



Source: Mueller, 2005

Note: The 10-largest multifamily markets make up 50% of the total square footage of multifamily space we monitor. Thus, the 10-largest multifamily markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

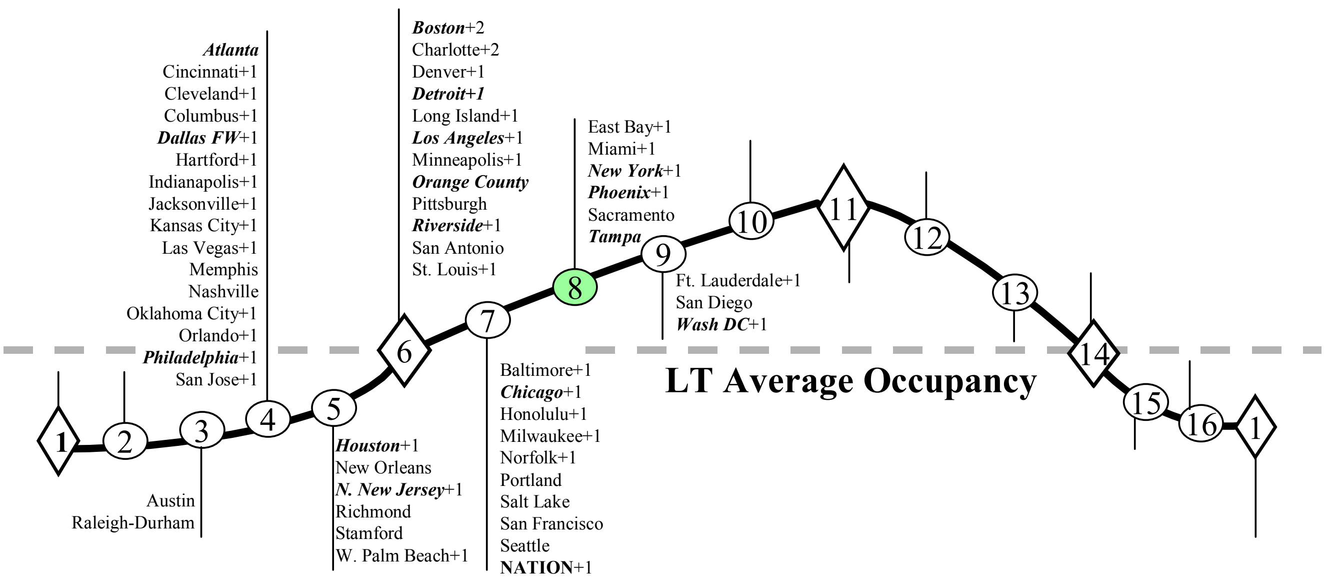
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

RETAIL

Retail occupancy improved another 0.2% in 1Q05, the ninth straight quarter of occupancy improvement for the sector. "Core" retail sales, defined as retail and food service sales excluding motor vehicles and gasoline, continue to post solid year-over-year gains, according to the Census Bureau. Continued low interest rates and rising home prices have been a major source of spending by homeowners. Higher oil prices have taken a toll on spending by lower income households, hurting sales at discount retailers. Retail sales and shopping center leasing activity should stay strong while the economy continues to create jobs. Retail occupancies are at the point that moves the entire sector into the growth phase, point #7 on the cycle. We expect occupancies to improve by only 0.5% in 2005 from their current strong levels; this should drive rental growth at the 3%–4% level in 2005.

Retail Market Cycle Analysis

1st Quarter, 2005



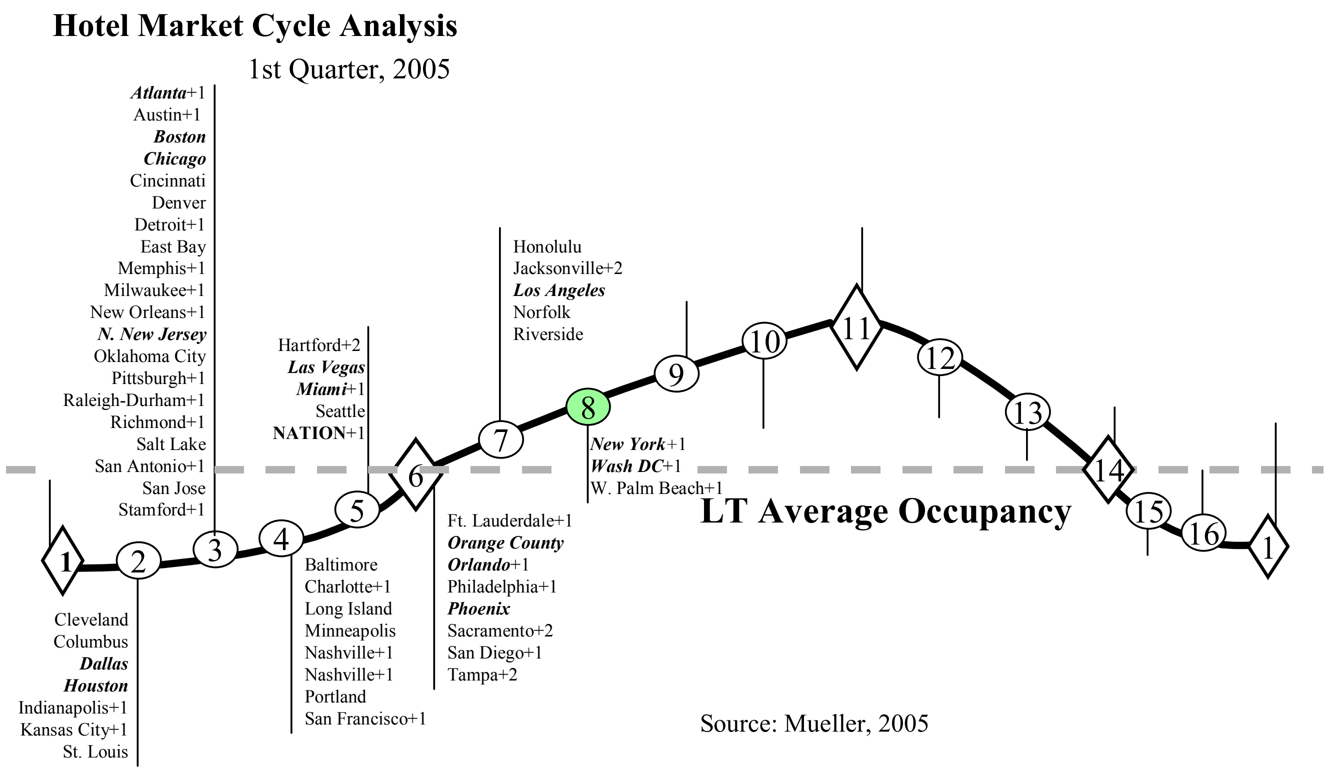
Source: Mueller, 2005

Note: The 15-largest retail markets make up 50% of the total square footage of retail space we monitor. Thus, the 15-largest retail markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

HOTEL

Hotel occupancies improved again, by 0.6% in 1Q05, providing a 3% year-over-year increase. This continues the occupancy increase of 3% for 2004. This positive movement pushed the national hotel average forward one position to #5 on the cycle chart. Many markets had enough improvement to move forward at least one position. Business travel is back and strong, with New York and Washington, DC leading the way in high occupancies at 77% and 69%, respectively. More jobs and workers, along with low interest rates, continue to foster leisure travel. Additionally, the weak U.S. dollar should keep U.S. vacationing domestically and attract leisure travelers from abroad. Japan's improved economy is viewed as a catalyst for Hawaii's strong performance, and the euro's appreciation has resulted in more Europeans traveling to Florida resort markets, like Orlando. We estimate that 2005 occupancies will improve another 1.5%, pushing RevPAR by as much as 7%.



Note: The 14-largest hotel markets make up 50% of the total square footage of hotel space we monitor. Thus, the 14-largest hotel markets are in ***bold italic*** to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

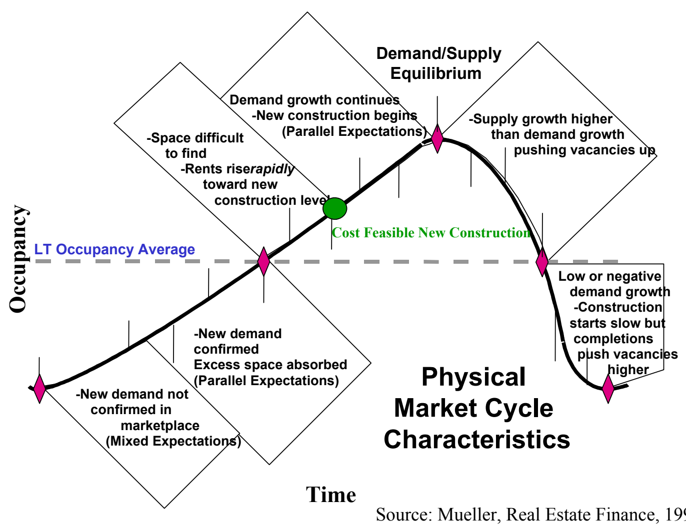
MARKET CYCLE ANALYSIS — Explanation

Supply and demand interaction is important to understand. Starting in Recovery Phase I at the bottom of a cycle (see chart below), the marketplace is in a state of oversupply from previous new construction or negative demand growth. At this bottom point, occupancy is at its trough. Typically, the market bottom occurs when the excess construction from the previous cycle stops. As the cycle bottom is passed, demand growth begins to slowly absorb the existing oversupply and supply growth is nonexistent or very low. As excess space is absorbed, vacancy rates fall, allowing rental rates in the market to stabilize and even begin to increase. As this recovery phase continues, positive expectations about the market allow landlords to increase rents at a slow pace (typically at or below inflation). Eventually, each local market reaches its ***long-term occupancy average*** whereby rental ***growth is equal to inflation***.

In Expansion Phase II, demand growth continues at increasing levels, creating a need for additional space. As vacancy rates fall below the ***long-term occupancy average***, signaling that supply is tightening in the marketplace, rents begin to rise rapidly until they reach a cost-feasible level that allows new construction to commence. In this period of tight supply, rapid rental growth can be experienced, which some observers call "rent spikes." (Some developers may also begin speculative construction in anticipation of cost-feasible rents if they are able to obtain financing.) Once cost-feasible rents are achieved in the marketplace, demand growth is still ahead of supply growth — a lag in providing new space due to the time to construct. Long expansionary periods are possible and many historical real estate cycles show that the overall up-cycle is a slow, long-term uphill climb. As long as demand growth rates are higher than supply growth rates, vacancy rates will continue to fall. The cycle peak point is where demand and supply are growing at the same rate ***or equilibrium.*** Before equilibrium, demand grows faster than supply; after equilibrium, supply grows faster than demand.

Hypersupply Phase III of the real estate cycle commences after the peak/equilibrium point #11 — where demand growth equals supply growth. Most real estate participants do not recognize this peak/equilibrium's passing, as occupancy rates are at their highest and well above long-term averages, a strong and tight market. During Phase III, supply growth is higher than demand growth (hypersupply), causing vacancy rates to rise back toward the long-term occupancy average. While there is no painful oversupply during this period, new supply completions compete for tenants in the marketplace. As more space is delivered to the market, rental growth slows. Eventually, market participants realize that the market has turned down and commitments to new construction should slow or stop. If new supply grows faster than demand once the long-term occupancy average is passed, the market falls into Phase IV.

Recession Phase IV begins as the market moves past the long-term occupancy average with high supply growth and low or negative demand growth. The extent of the market down-cycle will be determined by the difference (excess) between the market supply growth and demand growth. Massive oversupply, coupled with negative demand growth (that started when the market passed through long-term occupancy average in 1984), sent most U.S. office markets into the largest down-cycle ever experienced. During Phase IV, landlords realize that they will quickly lose market share if their rental rates are not competitive; they then lower rents to capture tenants, even if only to cover their buildings' fixed expenses. Market liquidity is also low or nonexistent in this phase, as the bid–ask spread in property prices is too wide. The cycle eventually reaches bottom as new construction and completions cease, or as demand growth turns up and begins to grow at rates higher than that of new supply added to the marketplace.



Source: Mueller, Real Estate Finance, 1995

LMWW Real Estate Research Group currently monitors five property types in more than 50 major markets. We gather data from numerous sources to evaluate and forecast market movements. The market cycle model we developed looks at the interaction of supply and demand to estimate future vacancy and rental rates. Our individual market models are combined to create a national average model for all U.S. markets. This model examines the current cycle locations for each property type and can be used for asset allocation and acquisition decisions.

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