Equity Research

Real Estate Market Cycle Monitor

Second Quarter 2005 Analysis
August 2005

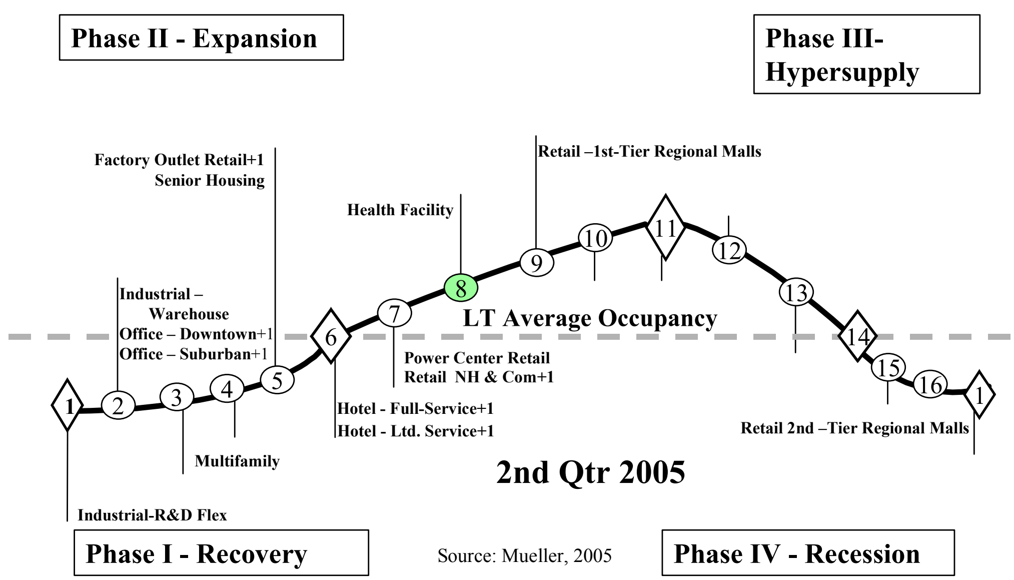
Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.

Real estate occupancies continue to improve in all property sectors and supply is still well behaved. Investors continue to flock to real estate investments as a safer alternative to a riskier stock market and a low interest rate bond market where interest rates are expected to rise soon. Everyone is wondering whether prices are too rich, but that same question was being asked four years ago.

- Office finally moved off the bottom of the occupancy cycle to position #2 in the second quarter.
- Industrial occupancies improved 20 to 30 basis points, providing expected 1% occupancy growth and 1% rent growth in 2005.
- Multifamily spring and summer leasing was positive and we expect more improvement in the second half of 2005.
- Retail occupancies were stable even with higher gas prices and less mortgage refinancing.
- Hotel prices are still below replacement cost, holding new construction in check and allowing for strong RevPAR growth.

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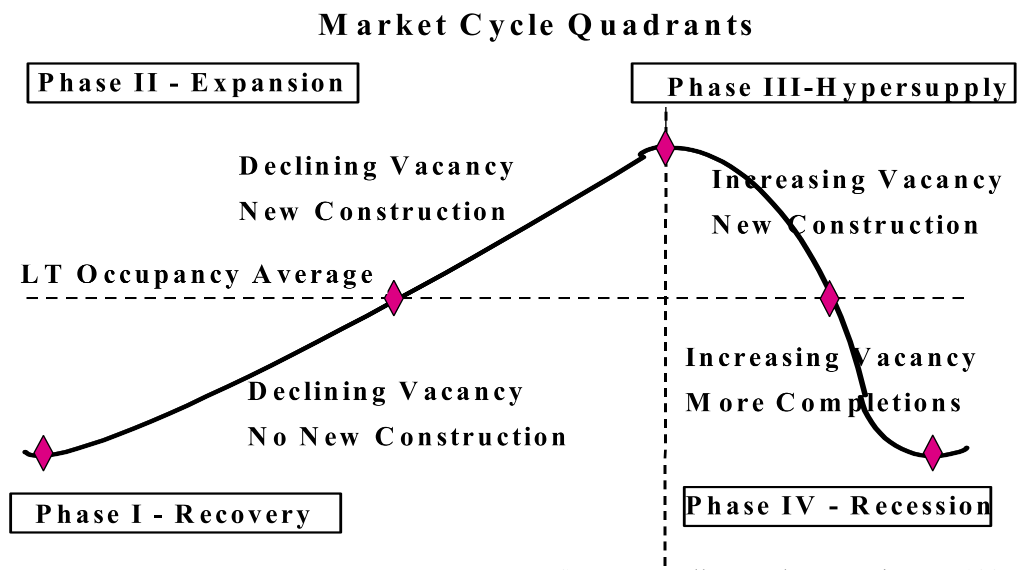
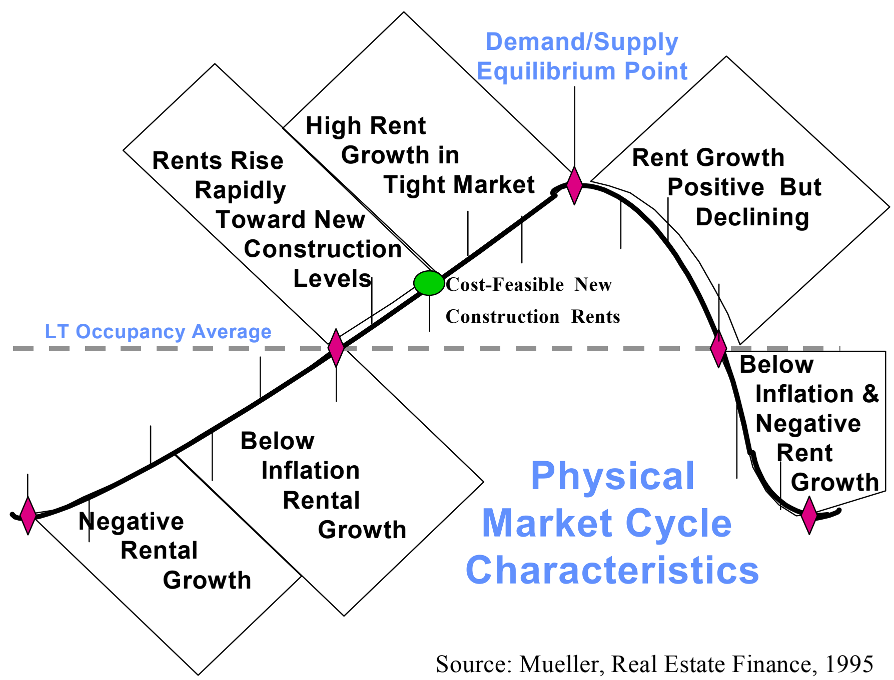
All relevant disclosures and certifications appear on page 9 of this report.

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.

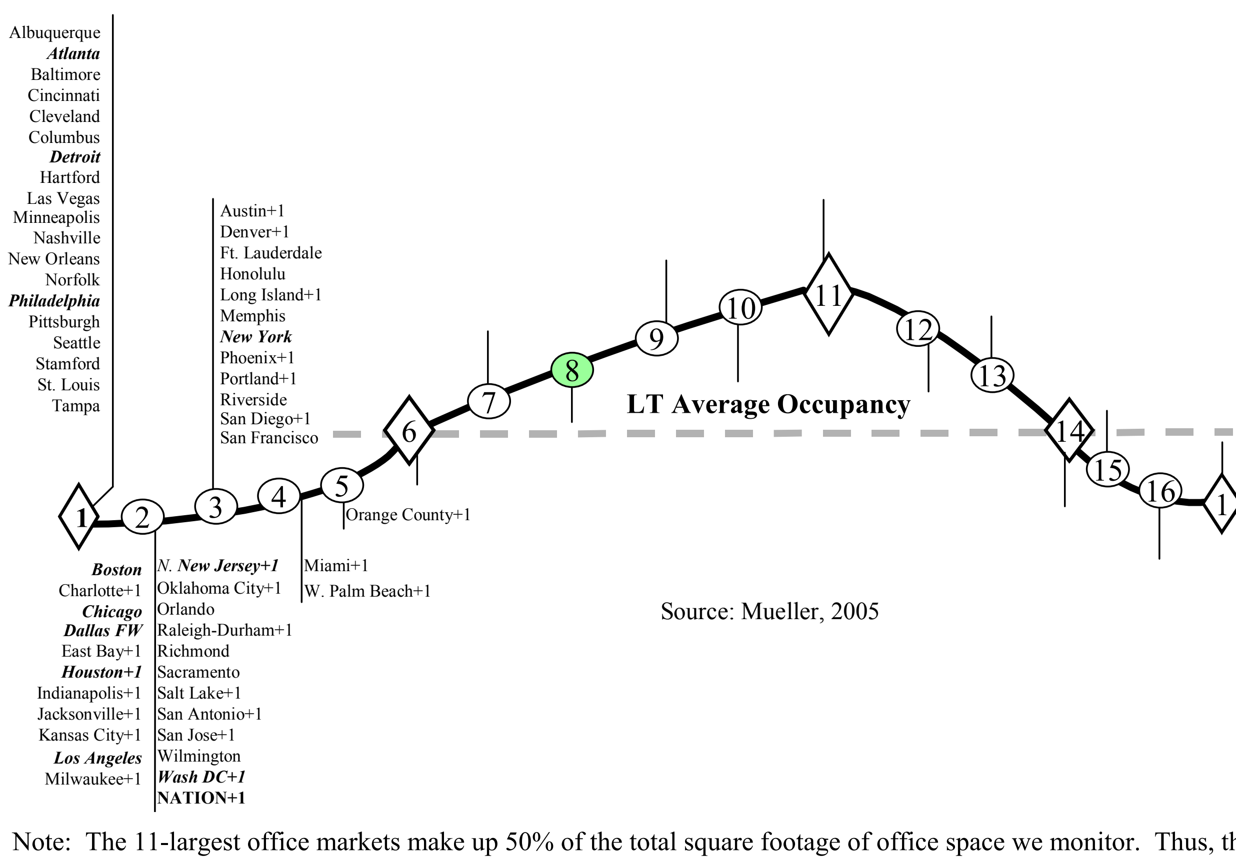


Source: Mueller, Real Estate Finance, 1995

OFFICE

The U.S. office market occupancy improved by 30 to 80 basis points from the prior quarter and 90 to 200 basis points over the year-ago quarter, depending upon the source. This is finally enough improvement to move the office national average off the bottom cycle position to spot #2 on the cycle chart. Sublease space has declined continuously for almost three years now. Suburban office still has lower occupancies but appears to be tightening faster than CBD occupancies. This may be due to continued layoffs at headquarters' operations, most of which are in the CBDs. Major occupancy improvements seem to be concentrated in western and southern markets. We continue to see the recovery and new construction as very uneven. While the traditional 24-hour CBDs are very tight, the non-24-hour CBDs are struggling. In the suburban markets, Sunbelt job growth dominates and smaller Midwest cities struggle. If a merchant builder/developer thinks he can drag a tenant into the space and sell to an institution, he will build. Where there is not an institutional exit, markets are not seeing much new product. Office demand continues to improve with the economic expansion, but at a very slow pace. Construction starts continue to behave, with just over 40 million square feet of speculative and build-to-suit space underway in 2Q05. The fastest-growing market is Washington, D.C. and its suburbs, followed San Diego, Philadelphia, and New York City. The average national rental rate continued to increase in 2Q05. We continue to expect occupancy to improve about 1% in 2005 and rental rates to remain relatively flat to slightly up for 2005. Results in 2006 should be similar.

Office Market Cycle Analysis
2nd Quarter, 2005



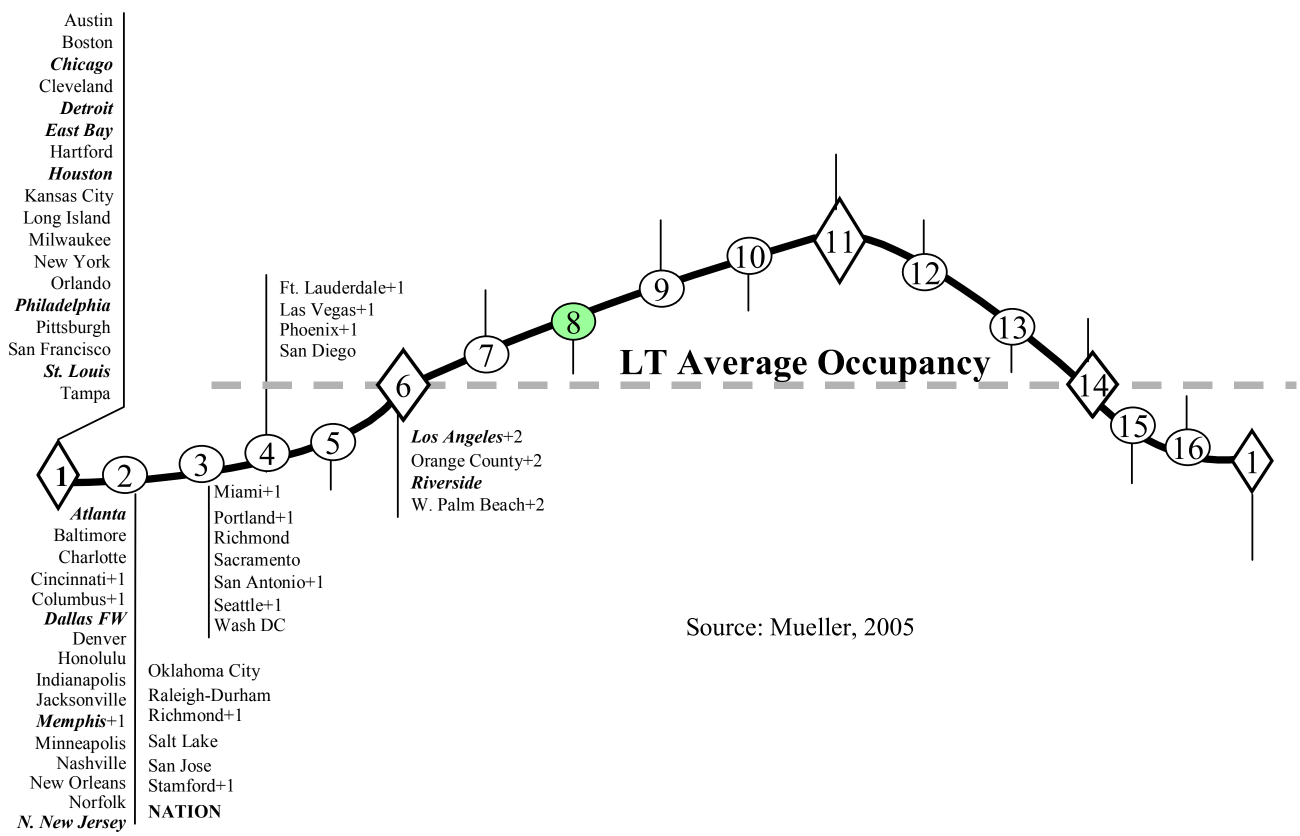
Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor. Thus, the 11-largest office markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

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

U.S. industrial occupancy improved by 20 to 30 basis points in 2Q05, which provides an almost 1% increase year-over-year. Net absorption was strong at almost 50 million square feet with most markets positive other than New Jersey, where tenant consolidations are still taking place. Southern California markets are performing the best as new supply is restricted and demand continues to be strong from the large international cargo that passes through. As long as increasing gas prices do not depress the U.S. economy, we expect industrial demand to continue at a realistic pace. Supply continues to increase as well, but is still half the peak rates of 2000. Much of the new supply is being created outside metro areas, where land is cheaper and congestion is less of a problem for truck traffic. The current national vacancy rate is approximately 9.5%, which is only 1% away from the industrial long-term average of 8.5% and we expect industrial to move forward to cycle position #3 next quarter. While markets vary dramatically, we still expect close to 1% occupancy improvement in 2005 and close to 1% national average rental growth for the year.

Industrial Market Cycle Analysis
2nd Quarter, 2005



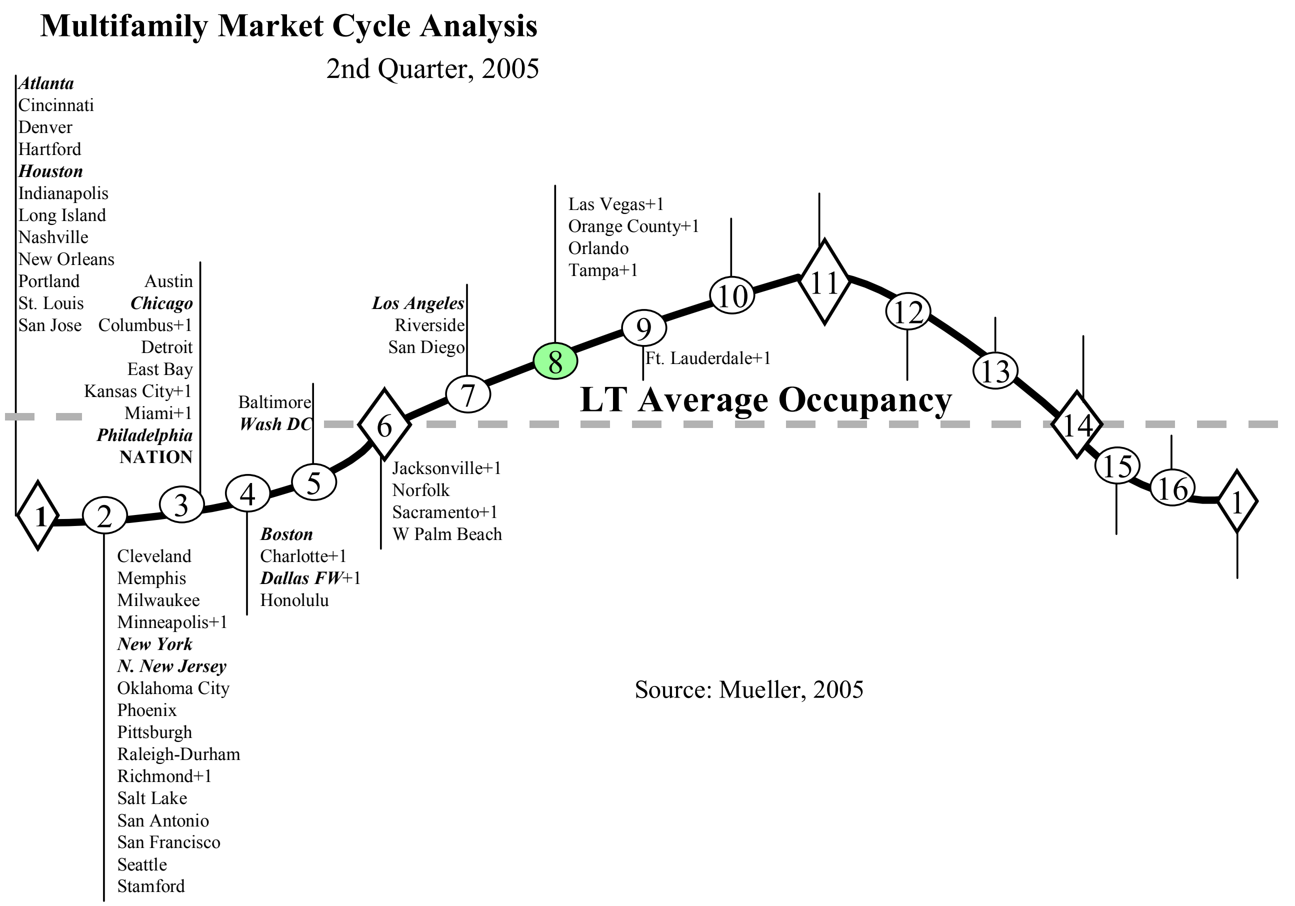
Source: Mueller, 2005

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 10 basis points in 2Q05. Employment growth continues to be the main driver for increased demand, but the number of people purchasing homes has been a drag on apartment demand for almost five years. The conversion of apartments to condominiums transforms them into non-competitive rental stock. Many units also have gone into the seniors housing or affordable housing category. In some cities, the warehousing of condominiums by speculators has created fear of a housing bubble, but this is likely only in a handful of markets (most notably, Miami). The primary spring/summer leasing season for apartments is showing positive signs, as occupancy continues to trend up, even while owners push rents modestly or reduce concessions across most markets. Landlord rental power finally is firming up for many apartment owners across the country, and concessions are declining across most markets, but weaker markets in the Midwest, Atlanta, Houston, and Dallas continue to struggle with concessions. We estimate a 60-basis-point occupancy improvement by year-end 2005. We estimate rent growth of 1%–2% in 2005 and expect more improvement in 2006.



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.

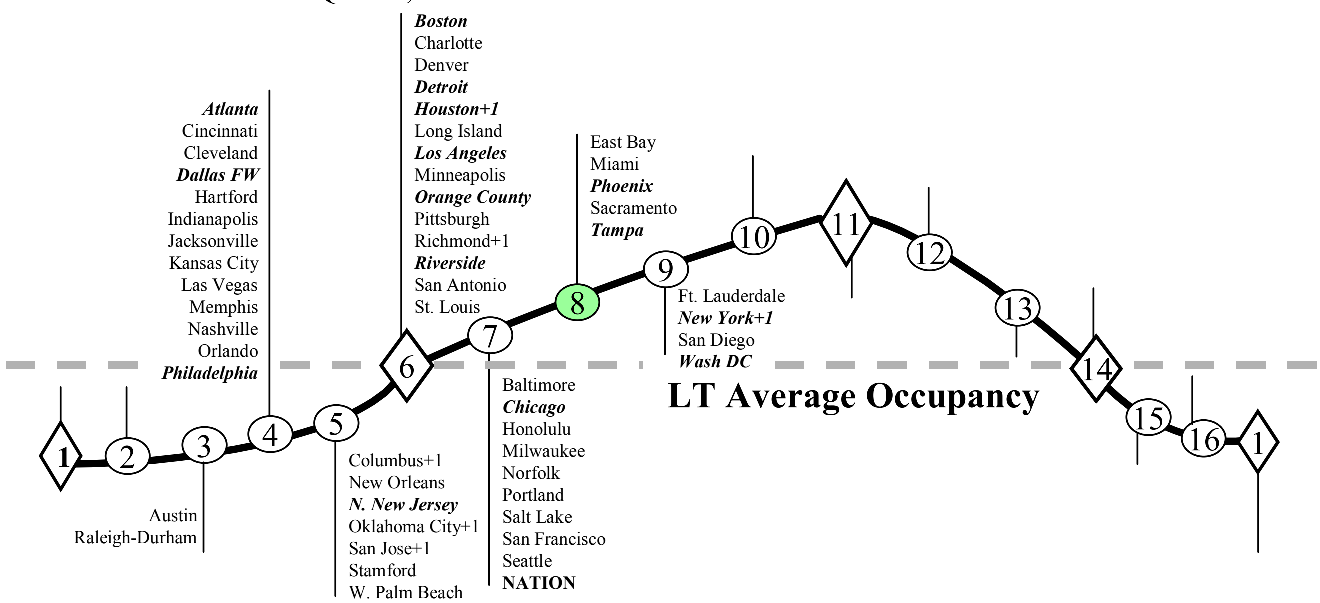
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 held at current levels, even in the face of rising gas prices. It is the first quarter in 10 in which occupancy did not improve. However, higher-quality properties did improve as most retail REITs reported occupancy improvements. Even though credit card debt is rising and the auto industry is pushing new car sales with "employee discount pricing," people continue to spend well in stores, except for low income households for which gas prices are a major concern. Residential mortgage cash-out refinancing has also slowed, from 118 billion last year to an expected 80 billion this year, providing less dollars for consumers to spend. The retail sector remains the first property type to hit the growth phase, point #7 on the cycle and we expect positive forces to continue. We project occupancies to improve by 0.5% in 2005, which should drive rental growth at the 3%–4% level for the year.

Retail Market Cycle Analysis

2nd 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.

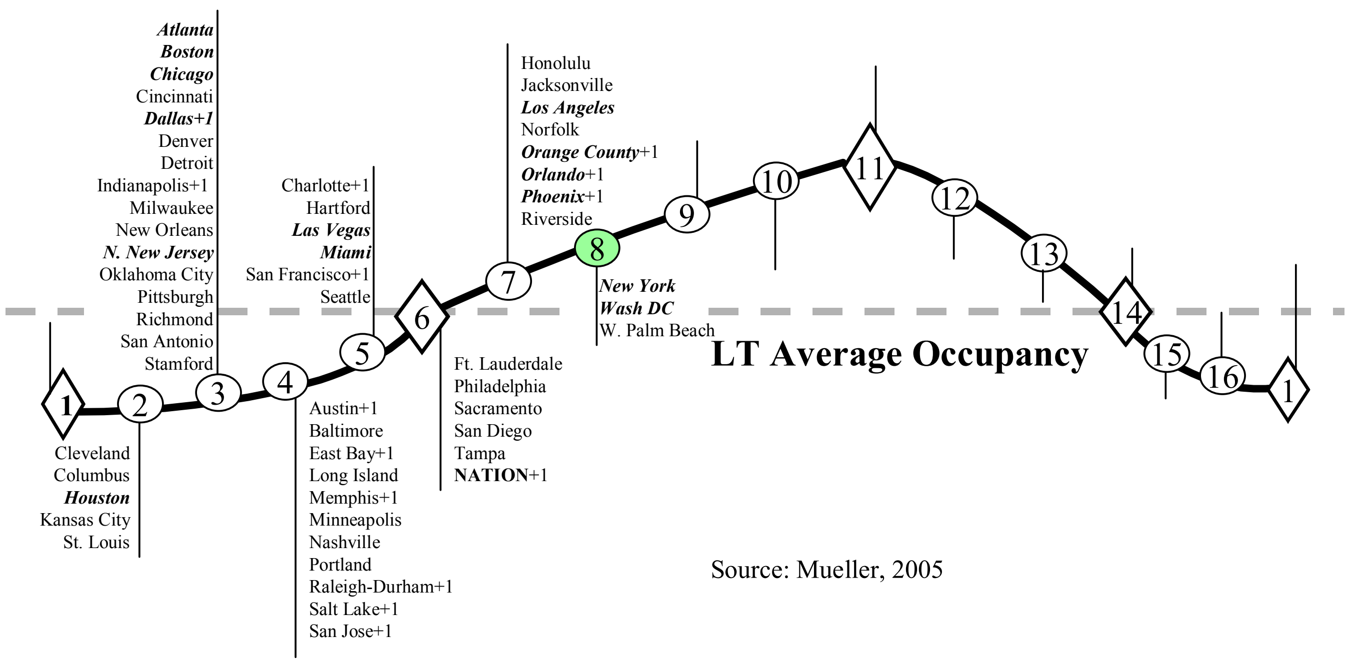
Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their 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 another 0.4% in 2Q05 after the 0.6% increase in 1Q05. This was enough to move the hotel occupancy rate to the long-term national average position #6 on the cycle chart. Fourteen markets improved occupancy rates at levels higher than the national average and thus moved forward in their cycle positions as well. Business travel continues to be strong and summer travel improved resort occupancy as well, with the best results in Orlando, Phoenix and Orange County. The U.S. is vacationing domestically and the cheap dollar brought in more foreign travelers. Supply forecasts continue to result in a favorable outlook for the industry. While supply is expected to rise over the next couple years, land and construction costs are keeping the increase at a modest pace. Additionally, the consensus view is that replacement costs are still below the cost of construction. As a result, investors will look toward acquiring hotels rather than development in the near term. We estimate that 2005 occupancies will improve by another 0.7% in the second half of 2005, bringing the full year to 1.7%. This should improve RevPAR by 7% to 8%.

Hotel Market Cycle Analysis

2nd Quarter, 2005



Source: Mueller, 2005

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.

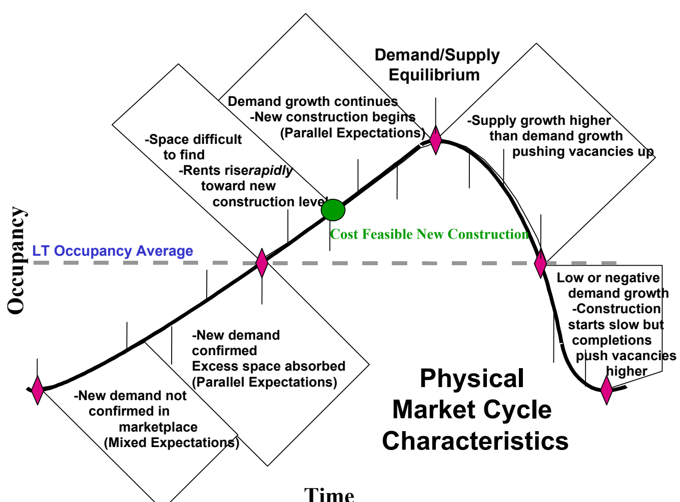
MARKET CYCLE ANALYSIS — Explanation

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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