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U.S. Outlook

Winter 2014

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Table of Contents

U.S. Outlook	Page
Executive Summary	i
The National Economic Outlook	1
The Real Estate Capital Markets	9
Real Estate Markets	
The National Single Family Housing Market	17
The National Apartment Market	25
The National Office Market	34
The National Industrial Market	42
The National Retail Market	50
The National Hotel Market	59
Summary Tables	66

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Executive Summary

National Economy

The Great Recession of 2008-2009 is still casting a long shadow over the US economy. That recession was first and foremost a balance sheet recession, or more descriptively, a recession caused by a collapsing debt and equity bubble. Returning to normalcy after those types of events historically has taken a long time, and this time is no different. RCG's outlook is little changed from three months ago, but we now have more certainty in the monetary policy area, even if some questions remain unanswered. The new chairwoman of the Fed has gone out of her way to emphasize continuity. Risks to the US economy are still primarily external and fiscal. External geopolitical events (such as the Ukraine situation) could undermine the expansion in the US and the more fragile recovery in Europe through a variety of mechanisms, including oil prices. The fiscal risk is still that the Congress may impose yet another round of austerity in the near-term without treating the real problems of the longer run—like tax reform and entitlements reform. We decry the inability of Washington promote policies that are clearly good for the US economy, like comprehensive immigration reform and ability to do trade legislation on the fast-track. These failures will weaken the US economically. Despite Washington's failures, the private sector in the US is making good progress in the four and one-half years since the end of the Great Recession, and absent major unexpected events, it should continue to gain momentum this year.

Capital Markets

While the recovery in demand is only moderate, commercial real estate is benefiting from a 50-year low in new construction in all property types except for apartments, where demand is strongest. Improving job growth and rising economic activity will boost absorption going forward, well ahead of any increase in the construction pipeline. There is strong investment demand for stabilized properties, particularly for trophy assets. At the same time, as pricing pushes near or, in some cases, above 2007s peak, investors are considering secondary markets. There is less demand for broken deals. While many problems have been worked out, there remain deleveraging and mortgage-restricting opportunities. Low construction will allow performance to improve steadily with rising economic growth and demand. From a valuation standpoint, cash flow is still highly discounted relative to long-term risk-free interest rates. U.S. real estate assets are attracting debt and equity capital, and many domestic and international institutional players like sovereign wealth and pension funds are increasing allocations to real estate. Normalizing long-term interest rates will be a major driving factor going forward. Rising rates will be met with compacting spreads on cap rates.

Single Family Housing Market

The housing market is doing as well as can be expected with limited credit availability. Even if the mortgage market remains entrenched, we expect a healthy pace of sales and normalizing, but positive home-price appreciation. We are hopeful that regulators and lenders alike are motivated to expand credit. Indeed, as time goes on, we believe the disruption of housing's virtuous cycle from first-time buyers through to move-up buyers and downsizing sellers will be clear to all. A fully productive mortgage system must bring first- time buyers and low- and moderate-income households into homeownership. More private capital will have to be attracted to the mortgage market for credit to expand. A key element necessary to attract the level of private investment that the mortgage market enjoyed during the previous three decades is to restore investor confidence. This will require restoring the sanctity of contracts and limiting put-back risk to egregious errors. Both borrowers and lenders must be prepared to stand by their words and signatures going forward if the mortgage market is to normalize. We are hopeful that such terms will be reached and that both government and private lenders will welcome back borrowers with FICO scores between 620 and 760.

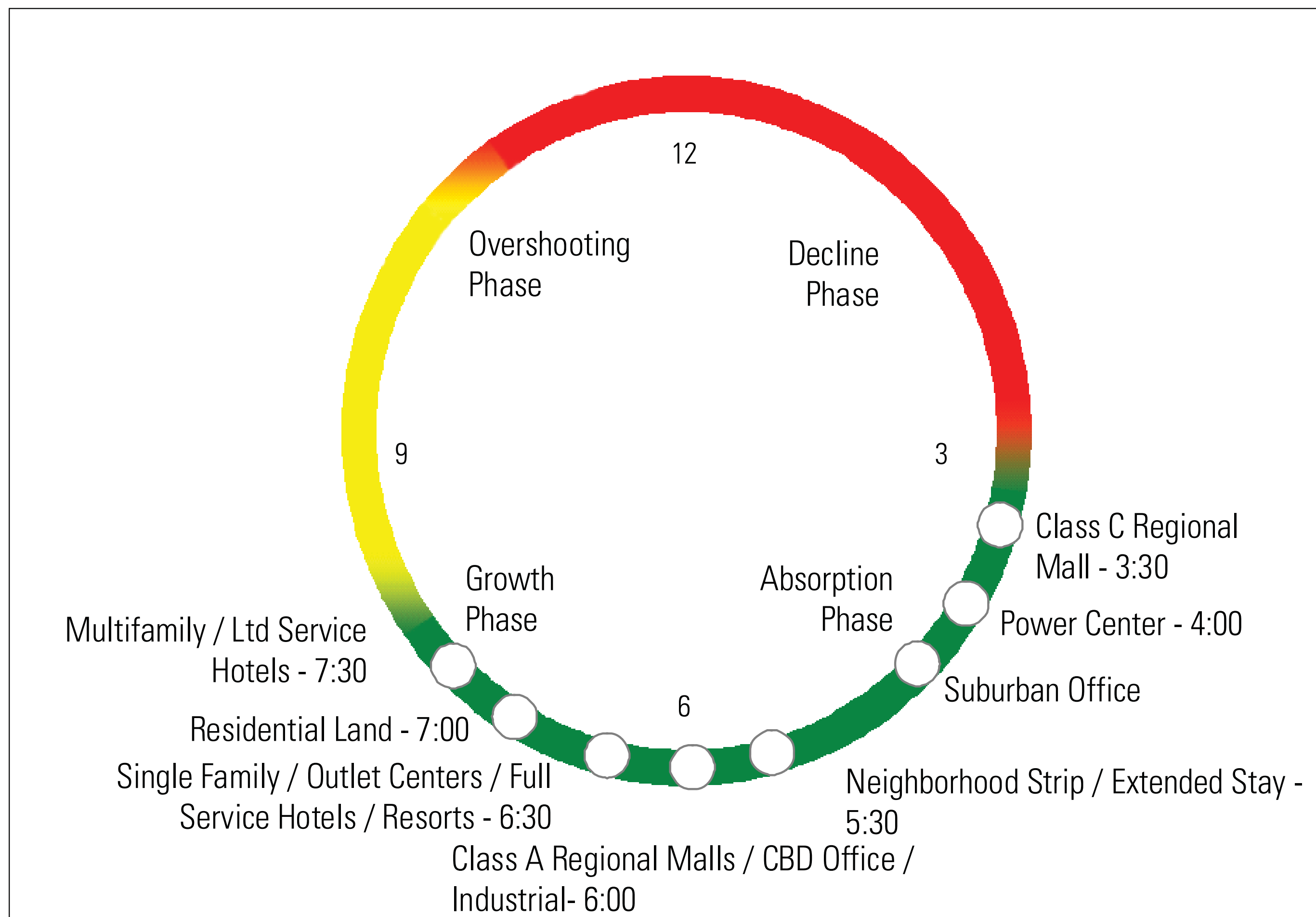
Apartment Market

Apartment market conditions are expected to continue to improve going forward, though at a more modest pace compared with recent years, as new construction starts and deliveries rise in response to elevated rental demand. Renter household formation will likely continue to growth at a healthy pace, consistent with the rate of job creation, particularly among young, renter-age workers. With the exception of select markets where oversupply will be a concern, growth in renter demand should offset the amount of new supply, maintaining relatively tight national apartment market conditions throughout the forecast period. Vacancy rates should continue to compress slightly before stabilizing, while rent growth will increase, though at a more sustainable pace compared with recent years. As the current cycle progresses, slower rent growth and rising cap rates will likely result in decreased investment volume as total multifamily returns moderate through the latter part of the forecast period.

Office Market

The office market recovery will continue and improving operating conditions should be evident in nearly all markets this year. Tenant demand already began to accelerate in early 2014, and leasing volume should be greater this year than the previous year. Additionally, a wider array of industries will increase leasing activity and small and mid-sized tenants should comprise a larger portion of leasing

Real Estate Cycle – Winter 2014



volume going forward. The increased tenant demand will lead to moderate rent growth for at least the next several years. Despite the improving operating conditions, new construction will remain conservative in the near term and the risk of oversupply outside of a handful of markets will be minimal. Investment activity should accelerate, with acquisitions increasing throughout the full range of cities. While investment returns will stabilize and cap rates may increase due in part to rising interest rates, our outlook for office market investment remains positive.

Industrial Market

Accelerating business and consumer spending will drive strengthening industrial market conditions during the next several years. Recovery will continue to spread into smaller markets, leading to a more broad-based rebound. Additionally, while tenant demand will remain elevated for large-scale distribution space, leasing activity should diversify into the smaller unit sizes as demand from mid-sized tenants increases. Forecasts for a national economic slowdown in 2017 will mean that market fundamentals will be stronger in the near term than in the medium term, with absorption levels and rent growth flattening in 2017 and 2018. Longer term, e-commerce activity will have an increasing influence on industrial market performance. The improving operating conditions should lead to further acceleration of investment volume and asset values during the next few years.

Retail Market

The continued recovery of the U.S. retail real estate market hinges on the further recovery of the U.S. consumer. RCG believes that retail market fundamentals will mirror national economic trends, with increasingly broad-based improvement at a moderate pace. Increased employment across income levels will lead to heightened levels of confidence and further retail sales growth. Given the still-elevated number of individuals that have been out of work for an extended period, pent-up demand for retail goods likely exists in many metro areas. Tenant demand should follow retail sales, with increasing absorption of retail space through the next few years. A tightening vacancy rate should allow landlords to raise rents, although the pace of rent appreciation should vary significantly across property type, building quality, and geographic area. Improving fundamentals and the search for yield should attract investors, although a high level of maturing debt and rising cost

of capital will likely pose headwinds to a significant acceleration in investment volume and prices. As a result, RCG expects steady NOI growth and moderate total returns for retail properties through the forecast period.

Hotel Market

Continued job creation and the resulting increase in both business and leisure travel should maintain strong hotel room demand, leading to further improvements in operating conditions in the coming periods. While transient room demand should remain robust, the gradual recovery in group travel should lead to improved ADR growth in this segment and a further widening of the spread between transient and group rates. As new units are brought to market, the growth in new supply should lead to more balanced market conditions into the latter part of the forecast period. Interest in assets located in secondary and tertiary markets are expected to attract a growing proportion of investment capital as the cycle progresses. Investment returns should remain positive but moderate as the anticipated rise in cap rates restrains price appreciation.

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National Economic Overview and Outlook

Ken Rosen and Dan Van Dyke

The Great Recession of 2008-2009 is still casting a long shadow over the US economy. That recession was first and foremost a balance sheet recession, or more descriptively, a recession caused by a collapsing debt and equity bubble. Returning to normalcy after those types of events historically has taken a long time, and this time is no different. With that in mind, current conditions economic policy are still being shaped by this massive economic and financial event, and the approach we take this quarter to focus on policy viewed in that light.

Focus on Monetary Policy

We focus on monetary policy because it was at the forefront of efforts to combat the effects of the Great Recession. With legacy policies in place that have been used to counter the economic and financial weakness in the US economy, a strengthening economy, and a changing of the guard at the Fed, it is reasonable to ask some pointed questions.

The exit from quantitative easing (QE) began with the December 16, 2013 FOMC statement at a time when the chairman of the Fed was still Ben Bernanke. For months prior to this FOMC announcement, the equity markets had speculated on when it might occur, and the "good news is bad news" market came into being. That is, if economic data supported the view that economic growth was good, then the markets sold off under the expectation that QE would end sooner than later. The implicit view was that QE caused equity prices to be higher than otherwise. Our first question, then, is "Will equity markets sell off as QE is unwound?"

Second, the recent Humphrey-Hawkins testimony of the new Fed chairman, Janet Yellen, has been thoroughly parsed. What are the main points to be taken from that testimony?

Winding down long-term asset purchases should have only a minimal effect if the economy is indeed still in a liquidity trap. Our third question, then, to what extent is the economy still in a liquidity trap, and does it matter?

Fourth, is inflation set to surge? Given the ballooning of the Fed's balance sheet, will all that money in the banking system propel an upward surge in prices? In some ways, these questions are all linked, but let's go one at a time.

National Economic Outlook
Base Case 2013-2018 (70%)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f	2017f	2018f
Real GDP Growth (Annual growth rate)	3.8%	3.4%	2.7%	1.8%	-0.3%	-2.8%	2.5%	1.8%	2.8%	1.9%	2.3%	2.5%	2.1%	0.8%	1.5%
Year-over-year rate (4Q)	3.1%	3.0%	2.4%	1.9%	-2.8%	-0.2%	2.8%	2.0%	2.0%	2.7%	2.0%	2.5%	2.1%	0.8%	1.5%
Inflation--CPI, 4Q/4Q rate	3.4%	3.7%	2.0%	4.0%	1.6%	1.5%	1.2%	3.3%	1.9%	1.2%	2.5%	3.0%	3.5%	3.5%	3.0%
Interest Rates															
3-month T-Bill (average)	1.4%	3.2%	4.8%	4.5%	1.4%	0.2%	0.1%	0.1%	0.1%	0.1%	0.3%	1.0%	3.0%	2.0%	2.0%
Year-end (final trading day)	2.2%	4.1%	5.0%	3.4%	0.1%	0.1%	0.1%	0.0%	0.1%	0.1%	0.3%	1.5%	2.8%	2.0%	2.0%
3-month LIBOR (average)	1.6%	3.6%	5.2%	5.3%	2.9%	0.7%	0.3%	0.3%	0.4%	0.3%	0.6%	1.4%	3.4%	2.5%	2.5%
Year-end (final trading day)	2.6%	4.5%	5.4%	4.7%	1.4%	0.3%	0.3%	0.6%	0.3%	0.2%	1.0%	2.5%	3.2%	2.5%	2.5%
10-year T-Bond Yield (average)	4.3%	4.3%	4.8%	4.6%	3.7%	3.3%	3.2%	2.8%	1.8%	2.4%	3.5%	4.3%	5.1%	4.7%	4.8%
Year-end (final trading day)	4.2%	4.4%	4.7%	4.0%	2.3%	3.9%	3.3%	1.9%	1.8%	3.0%	3.8%	4.6%	5.3%	4.7%	4.9%
Conv. 30-year Mortgage Rate (average)	5.8%	5.9%	6.4%	6.3%	6.0%	5.0%	4.7%	4.5%	3.7%	4.0%	4.9%	5.7%	6.5%	6.1%	6.2%
Year-end (final week)	5.8%	6.2%	6.2%	6.2%	5.1%	5.1%	4.9%	3.9%	3.4%	4.5%	5.1%	5.7%	6.5%	6.1%	6.2%
Federal Budget Surplus/Deficit (NIA Basis)															
$Billions (CY)	-399	-322	-209	-188	-680	-1,471	-1,275	-1,250	-1,061	-561	-581	-495	-552	-800	-1,000
As % of Nominal GDP	-3.2%	-2.5%	-1.5%	-1.3%	-4.6%	-10.2%	-8.5%	-7.9%	-6.4%	-3.3%	-3.2%	-2.6%	-2.8%	-3.8%	-4.6%
Employment Growth, 4Q/4Q rate	1.5%	1.8%	1.6%	0.9%	-2.0%	-4.1%	0.6%	1.5%	1.7%	1.8%	1.7%	1.6%	1.4%	0.5%	1.1%
Unemployment Rate (4Q)	5.4%	5.0%	4.4%	4.8%	6.9%	9.9%	9.6%	8.6%	7.8%	7.0%	6.1%	5.8%	5.5%	6.0%	6.2%
Housing Starts (000)	1,956	2,068	1,801	1,355	906	554	587	609	781	927	1,130	1,150	1,250	1,050	980
Single Family	1,611	1,716	1,465	1,046	622	445	471	431	535	618	750	800	900	750	700
Multifamily	345	352	336	309	284	109	116	178	245	308	380	350	350	300	280
Sales of Existing Homes (inc. condos and coops)															
Units (000)	6,727	7,076	6,516	5,041	4,106	4,329	4,183	4,277	4,659	5,073	5,300	5,500	5,500	5,400	5,500
Non-Residential Construction															
$Billions	302	346	416	497	552	438	362	381	437	457	470	500	550	550	500
Retail Sales Ex. Autos, 4Q/4Q rate	7.7%	8.0%	3.8%	5.4%	-4.5%	0.5%	5.1%	6.7%	4.3%	2.8%	3.6%	3.8%	2.8%	0.5%	1.1%
Total Car and Truck Sales															
Millions of Units	16.9	17.0	16.5	16.2	13.2	10.4	11.6	12.8	14.5	15.6	16.0	16.2	15.0	13.4	13.5
CPI - Rental Component, 4Q/4Q Rate	2.8%	3.1%	4.1%	4.0%	3.5%	0.9%	0.5%	2.4%	2.7%	2.8%	2.5%	2.1%	1.5%	1.3%	1.5%
Median House Price Gain--US, 4Q/4Q rate	8.8%	13.6%	-2.8%	-6.1%	-12.4%	-5.5%	0.2%	-4.7%	10.0%	10.1%	4.5%	3.9%	4.5%	3.5%	3.0%
Consumer Confidence Index (average)	96.1	100.3	105.9	103.4	58.0	45.2	54.5	58.1	67.1	73.2	90.0	95.0	100.0	80.0	90.0
Real Disposable Personal Income, 4Q/4Q rate	3.5%	1.2%	4.1%	1.2%	1.1%	-0.6%	2.5%	1.4%	3.6%	-0.1%	3.0%	3.0%	2.1%	0.5%	1.0%
Inflation PPI 4Q/4Q Rate	4.6%	5.3%	0.2%	7.0%	1.5%	1.4%	3.8%	5.4%	1.7%	0.7%	3.5%	3.4%	3.9%	3.5%	3.0%
Industrial Production (average)	92.5	95.5	97.6	100.0	96.6	85.7	90.6	93.6	97.1	99.6	99.8	100.5	101.4	99.1	100.4
%change	3.2%	2.3%	2.0%	2.5%	-3.4%	-11.3%	5.7%	3.3%	3.6%	2.6%	0.2%	0.7%	0.9%	-2.3%	1.3%

Note: For monthly data series, 4Q is average of months
Sources: Autodata Corporation, BEA, Bloomberg, BLS, Census, Conference Board, Department of the Treasury, Federal Reserve, Financial Times, NAR, RCG

How Will Stock Prices Behave as QE is Unwound?

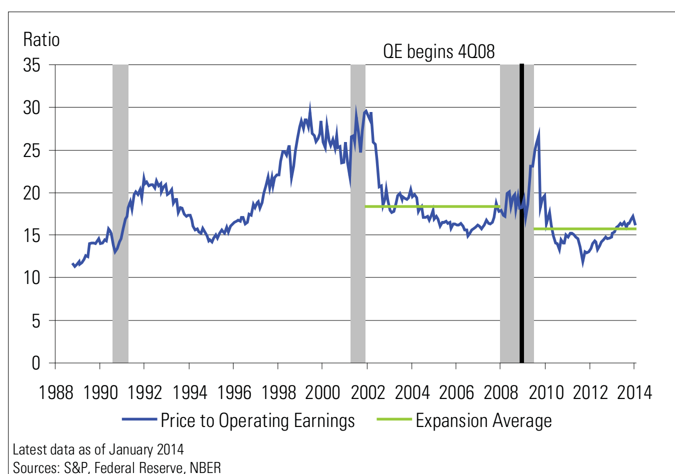
As one of the five or six main prices in the economy, stock prices carry special significance for the health of both the business and household sectors. The bizarre "good news is bad news" economy held sway over short-term stock price fluctuations for a while prior to the announcement of tapering, but our question of how stock prices will behave is one posed at the intermediate time frame. We measure stock prices not in an absolute sense, but relative to earnings. And the earnings in which we are interested are operating earnings, not reported earnings, which include all manner of one-off items that don't repeat. The price-to-operating-earnings of the S&P 500 is our measure of choice (POE ratio).

Looking at this measure, the POE ratio, averaged 18.26 during the last economic expansion from 2002Q1 to 2007Q4 (see the nearly chart). The POE ratio tends to be higher than the widely used PE ratio because of excluded one-off earnings events, such as asset sales, that are included in reported earnings. Looked at another way, the reciprocal of the multiple was 5.48% (1/18.26) during the last expansion. This is the earnings yield of the S&P 500 during that time period.

By comparison, the risk-free 10-year Treasury bond yield during the same period was 4.44%. The spread of the S&P earnings yield to the risk-free yield during the last expansion was 1.04%. This is the premium that was required, on average, to get investors to bear the addition risk of equities versus the riskless yield of Treasury bonds.

The Fed's QE programs began in November of 2008, and have continued since, being interrupted only briefly in 2010Q3. The current expansion that began in 2009Q3 can be fairly said to be a period during which quantitative easing took place. The POE ratio in the period since the expansion began in 2009Q3 has averaged 15.85, resulting in an earnings yield of 6.31%. Prices relative to underlying earnings have been lower (the yield higher) in this expansion than in the prior expansion. During this same time period, the risk-free rate on the 10-year Treasury bond has been 2.64% resulting in a spread of 3.67%. The spread ballooned to more than three and one-half times the spread in the prior expansion.

POE Ratio



Latest data as of January 2014
Sources: S&P, Federal Reserve, NBER

Stock earnings yields did not follow the Treasury bond yield down (which would have resulted in a higher stock price multiple). Rather, the spread increased for likely two reasons. First investors were fearful after the stock price collapse associated with the Great Recession, so it took a larger premium to induce investors to hold stock in the current expansion than in the prior one. Second, investors—rightly so—viewed QE as a temporary policy measure that would go away one day. That day has arrived. So did QE boost stock prices in the current expansion? By reference to operating earnings, the answer is, "No."

The expectation of stock prices (relative to earnings) nudging lower as QE is unwound is unfounded. Instead, what is likely to happen is that the earnings spread will compress. As long-term interest rates rise, reflecting more nearly the underlying financial and economic forces in the economy rather than reflecting a purposeful policy to hold them down, the spread will compress. Investors will gain confidence in the economy's ability to generate earnings without Fed support, and the premium investors demand to hold equities will fall. Already, the spread has compressed somewhat. The average spread during the expansion so far has been 3.67%, but during 2013Q4, the last full quarter for which we have data, the spread was 3.25%, 42 basis points lower than the period average.

We expect further compression the stock earnings spread as interest rates rise. To mix the metaphors, we have likened the QE tapering to releasing a beach-ball held underwater. If the 10-year Treasury bond yield rises to 4.6% by the end of 2015, as we think likely, and if the spread compresses to something like its 100 basis point level averaged in the prior expansion, then the earnings yield will be about 5.6%, which implies a price-to-operating-earnings multiple of 17.85, more than 1.2 multiple points higher than the average so far in this expansion, and still 0.41 multiple points below the average during the last expansion. With any earnings growth at all (and we expect decent earnings growth in this time frame), the prospect is for a solid stock market performance during the next two years, even with the expected rate increase. (Of course, equity prices generally don't go up or down in a smooth path; continued price volatility can be expected during this time frame.) This stock price outlook has positive implications for both business and consumer confidence, investment spending, and the wealth effect in the household sector.

Chairwoman Janet Yellen Takes Over at the Fed

There has been an extensive parsing of Chairwoman Yelen's first FOMC statement and her first Humphrey-Hawkins testimony. We

commented at the time, so we won't spend a great deal of space on this subject. The most important point to be gleaned from Chairwoman Yellen's testimony is that there will be continuity in monetary policy under her leadership. She reiterated policies that had been well formulated under Chairman Bernanke's leadership. She referenced the former chairman several times, and that alone speaks to her desire to instill a sense of continuity at the Fed.

Second, she indicated that the bar will be high to alter the Fed's calendar of tapering its long-term asset purchase program. Having begun, it will be hard to put the taper genie back into the bottle, and just garden variety volatility in the economic data is not going to be enough to do it. Our view is that parsing the strength or weakness of incoming data with an eye to calling a prospective halt or even reversal of the tapering is a mistake. Such parsing is useful to determine where the macro economy is heading, but it would take a major change in economic outlook to reverse the Fed's course of winding down asset purchases.

There are still several question marks. When tapering of QE ends, presumably by the December 16-17, 2014 FOMC meeting, then will the Fed reinvest in securities to the extent that they run off? If so, then the Fed's balance sheet would remain at the high level it attained in December. Alternatively, the Fed could let its portfolio of Treasury and residential MBS securities run-off according to their maturities. In that case, the Fed's balance sheet would slowly decline over time, thereby unwinding its large asset position. The Fed has stated formally that it will reinvest by the run-off amount. But that policy could change, and the question is, "Will it change and if so when."

Another question mark concerns the pace of rate normalization when the FOMC decides to begin lifting short-term rates. To some extent, the Fed's hand will be forced if it waits too long. Short-term market securities like bank CDs and commercial paper could begin to see rate increases ahead of Fed policy, if it waits too long. Then the Fed would be ratifying market moves rather than pro-actively pursuing policy. Answers to these questions will influence the course of capital markets and the economy in 2015 and beyond. Certainly the chairwoman has created the expectation of lower for longer, when it comes to interest rates. But again, markets may begin to force the Fed's hand by the end of 2014, and we think that is a likely course.

Is the Economy Still in a Liquidity Trap And Does It Matter?

This question has major implications for both monetary and fiscal policy. What is a liquidity trap? Essentially, it means that incremental liquidity supplied by the Fed is not being used in the economy, and therefore its shadow price is zero. Liquid, short-term assets command a near zero price, and cash and short-term debt are essentially pure substitutes.

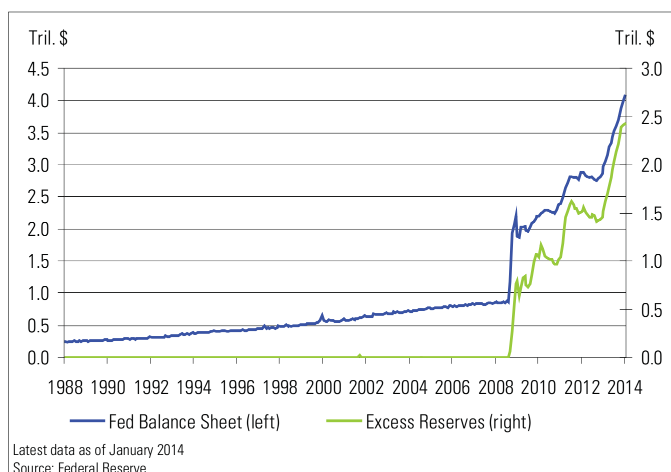
How do we know we're in a liquidity trap? The best evidence is in the behavior of excess bank reserves—those reserves held by the banking system over and above required reserves. The nearby chart shows excess reserves plotted on the same chart with the Fed's balance sheet. As the Fed's balance sheet has expanded dramatically in order to fight the Great Recession of 2008-2009 and its aftermath, excess reserves have increased in lock step. Of the more than $3 trillion expansion in the Fed's balance sheet, nearly $2.5 trillion has accumulated as excess reserves. Only a small proportion of the Fed's balance sheet expansion has made it into the lending stream. Additionally, short-term interest rates have hit the zero bound.

The excess reserves evidence indicates that the US economy is in a liquidity trap, and monetary policy can be of only limited help in providing support for economic activity as a result. This situation has been likened to "pushing on a string." Because interest rates are at zero, additional reserves supplied to the banking system through quantitative easing do not and cannot depress short-term interest rates further, so there is no interest rate impact of QE. Additionally, because the economy has all the liquidity it can use, providing additional liquidity simply ends up as excess reserves with no real-side impact.

Some secondary effects are probably being felt because of the QE program, but those impacts are relatively small. A small impact on exports through the exchange rate mechanism is likely occurring, and some impact on interest sensitive spending—for example, housing—is likely occurring as short-term interest rates at zero result in lower long-term interest rates, including mortgage rates. In fact, the primary impact of QE is likely to be in the housing market at this point.

The reason it matters whether the US economy is still in a liquidity trap is that if it is—and it does appear to be—monetary policy

Federal Assets vs. Excess Reserves



Latest data as of January 2014
Source: Federal Reserve

is relatively impotent. At the height of the recession when all manner of capital markets seized up, liquidity was in short supply. No one or no institution would lend, even overnight, for fear of not being repaid. The massive programs initiated by the Fed at that time were needed. But now, with credit markets functioning again, and an excess of liquidity in the system, the stage is set for the Fed to withdraw some monetary support with minimal consequences.

Because economic and financial activity has partially recovered, and incremental QE easing ends up largely as excess reserves with minimal real-side impact, the Fed has made the decision that there is now little cost to begin removing monetary stimulus provided by QE. Keep in mind that the Fed is not draining reserves from the banking system, it is merely adding to those reserves at a slower pace—now $20 billion per month slower than before tapering began, as this is being written.

This tapering should have virtually no first-order effects because of the liquidity trap. Secondary impacts through expectations of future interest and exchange rate movements should be minimal. We note that the Fed's broad dollar index was 101.81 in November 2013—the month before tapering was announced—and 102.99 in January, the month after the announcement. This rise was a little more than a 1%. The 10-year Treasury bond yield was 2.72% in November 2013 and 2.86% in January—14 basis points higher. Both of these moves are relatively small, and there is no question that the US economy can easily withstand the secondary fallout from those modest interest and exchange rate increases.

During the liquidity trap phase (this phase hopefully will not last forever, or even much longer), with monetary policy rendered largely ineffective, fiscal policy is the only economic policy that works. The reason that economic growth has been so slow especially in the first half of 2013 is fiscal tightening (the expiration of the Bush-era tax cuts, the expiration of the payroll tax holiday, and the implementation of the Budget Control Act, all starting in January 2013). The idea of expansionary austerity for liquidity-trapped economies—an idea prevalent in Europe and among conservatives in the US—simply does not pass empirical muster. More aggressive cuts in the deficit would result in further economic weakness until and unless the economy can escape the clutches of the liquidity trap and more nearly approach full employment. The evidence from the European periphery is abundant.

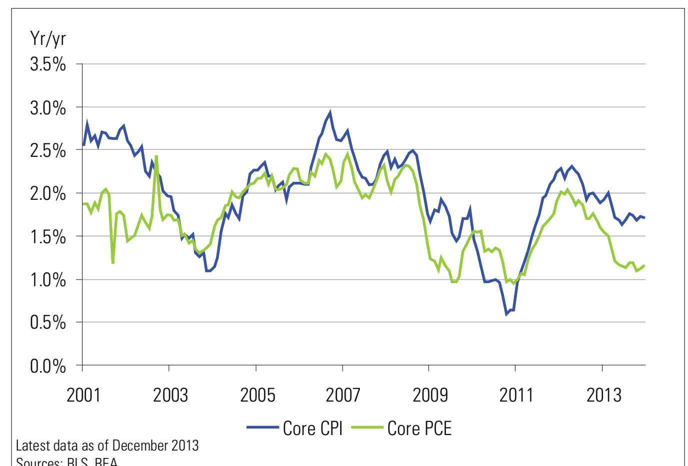
The hope for full economic recovery is that Congress can avoid a further quantum tightening of the budget at this time. The Bipartisan Budget Act of 2013 provides some underpinning for this hope, yet the opening salvos in the 2015 budget negotiations remind us of how fragile that hope is. That Bipartisan act provides for some marginal fiscal relief in the next two years in exchange for some incremental fiscal tightening in the following eight years. The markets and savvy observers cheered that agreement as taking a "fiscal policy mistake" and another government shut-down off the table. Although Congress can do anything at anytime, the difficulty of getting any budget measure passed with a divided government makes the prospect of too much fiscal tightening in the next two years unlikely.

Should Inflation Hawks Roost a Bit Longer?

Is inflation set to surge? The answer is a qualified, "No." Inflation in the US has likely reached its low point. Core inflation (excluding food and fuel prices) on both a wholesale and retail level has bottomed out. The core CPI is now about 1.7% higher than its year-ago level (see the nearby chart). The reason for the qualification is that the pace of the core CPI is likely to advance from here if for no other reason than shelter prices (rent and homeowners imputed rent) carry 32% weight in the calculation of the CPI. Housing costs, both rent and imputed rent, are rising—the former because of tenure adjustment associated with the foreclosure wave, and the latter because of the house price-undershoot associated with the housing market collapse. Both of these are changes in relative prices for reasons we know, and they are not indicative of a broader, systemic inflation of the type people generally mean when they express concern about inflation being caused by the Fed's policies. So, no, inflation is not set to surge because of monetary policy malfeasance, but there will be some upward tilt in the inflation rate for good and sufficient sector reasons.

The inflation situation is yet another example of how the Great Recession is still casting a long shadow over our current conditions. With excess capacity still in the economy (caused by the recession), weak wage growth (caused in part by the recession), and a liquidity trap (caused by the recession), inflation will still be relatively benign if accelerating. Additionally, the expected acceleration in inflation is the result of a reaction to

Core CPI vs. Core PCE



Latest data as of December 2013
Sources: BLS, BEA

events in the housing market caused by the recession. Until the economy escapes from the liquidity trap, maybe within the next two years, the economy is in very little danger from generalized inflation.

The recent release of minutes from the Fed's FOMC meeting indicates that some hawkish members suggested a rate increase at the short-end of the maturity spectrum might be needed soon. This view goes against the new Fed chairwoman's recent testimony to the effect that, ". . .a highly accommodative policy will remain appropriate for a considerable time after asset purchases end," which is likely in December 2014. If the Fed scenario plays out, that likely means that it would not begin boosting short-term interest rates until sometime in 2015. But we think that markets may force an early end to zero short-term interest rates, and some upward pressure on short rates could be felt by the end of this year.

Some Final Thoughts on Monetary Policy

Recessions are hard to see coming—note the commentary, for example, in early 2008. And inflation is hard to see coming. Additionally, monetary policy changes do take time to work—as a Nobel laureate economist once said, "Monetary policy operates with a long and variable lag." This leads us to say a word of caution about the time period perhaps three to four years hence. With the long-term asset purchases by the Fed likely to end by late 2014, the economy likely making continuing progress in the wake of the Great Recession, net credit flows, especially in the mortgage space, returning to something positive that would support a healthy housing market, and the expectation of no major fiscal policy mistakes, we think there is a risk that the Fed keeps short rates too low for too long. If so, there is a risk in the 2017 to 2018 time frame that abrupt monetary tightening would take place to tame building inflation of a general variety, including some wage inflation. That could result in a growth recession or worse in that time frame.

As we have stated before, this risk difficult to calibrate with so many unknowns—the behavior of the Fed under new leadership, the potential of Congress to do something regretful, the geopolitical situation, the weakness among some emerging nations, and the way the US economy adapts to the Affordable Care Act. Yet the Fed often in the past has moved too slowly and too belatedly.

If the Fed moves too slowly and too timidly to normalize rates after asset purchases have wound down, and the economy is no longer in a liquidity trap, then the risk exists for an unpleasant end to the current expansion when the Fed finally has to play catch up. To express this possibility, we project a growth slowdown in 2017.

The Outlook

As an organizing principle this quarter, we used the continuing adjustment to the Great Recession to focus on monetary policy, especially because its leadership has changed. What are the implications for the outlook for 2014 and 2015?

First, the most important factor, especially for the commercial real estate outlook, is what will happen to employment growth. In that regard, we expect that the current weak employment growth of the past several months will ameliorate and return to something more like the 200,000 jobs per month range. Another 2.3 million jobs should be added this year (see the nearby chart). If anything, there should be an upside risk to this expectation because of 1) payback from the horrible weather earlier in the year, 2) residential construction that is gaining traction in several parts of the country, and 3) the expected lack of fiscal drag that plagued the first half of 2013.

Second, we expect that inflation, although accelerating because of housing, will remain contained. Even if it reaches 2.5% in 2014 as we think likely, that is should not set off alarm bells at the Fed. Unless and until the economy more nearly approaches full employment and escapes the liquidity trap it is in, generalized inflation that includes wage inflation is not likely to happen. Longer term, we do think that there is a risk that the Fed waits too long to normalize interest rates, and if so, that could cause a negative growth repercussion in the 2017 time frame.

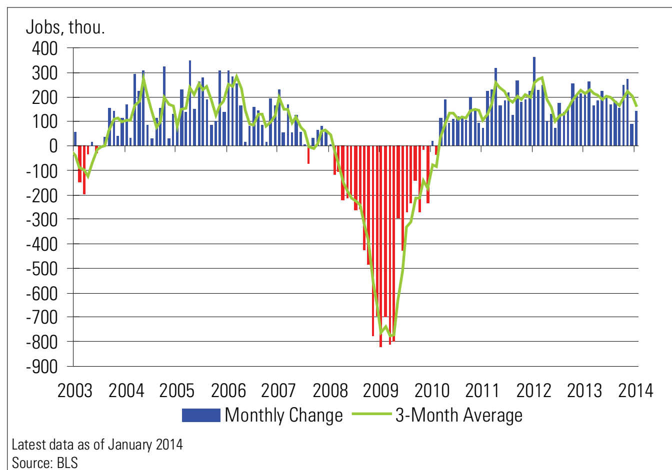
Third, housing starts have steadily risen since bottoming in 2009, but especially in 2012 and 2013 (see the nearby chart). In 2014, we expect housing starts will exceed 1 million units for the first time since 2007, and this acceleration is part of the overall growth story for this year.

Fourth, as we have been stating, capital spending will accelerate further because of 1) a high rate of return to capital, 2) accelerating economic activity, 3) diminished uncertainty regarding the Affordable Care Act, and 4) continued low interest rates and a buoyant stock market. If capital goods orders are any indication, that acceleration has already begun (see the nearby chart).

Finally, we expect the 10-year Treasury bond yield to reach 3.8% by year-end 2014, a little more than 100 basis points higher than its current yield, as this is being written. We also anticipate that market pressure by the end of the year will build at the short end of the maturity spectrum, possibly forcing the Fed's hand in setting higher short rates sooner than it may have wished.

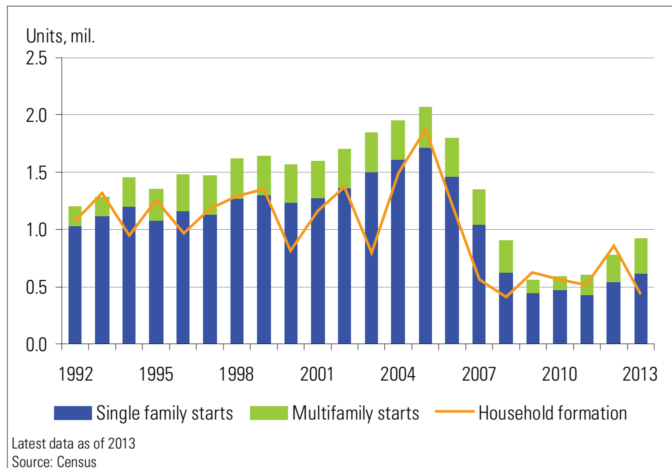
This outlook is little changed from three months ago, but we now have more certainty in the monetary policy area, even if some questions remain unanswered. The new chairwoman of the

Private Sector Job Growth



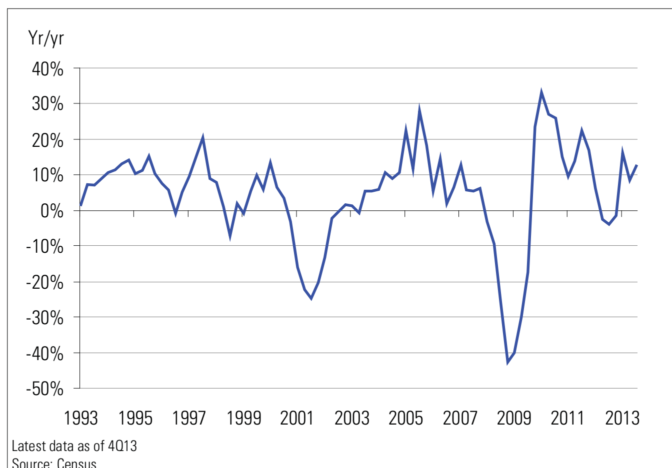
Latest data as of January 2014
Source: BLS

Household Formation vs. Housing Starts



Latest data as of 2013
Source: Census

Non-defense Capital Goods Orders



Latest data as of 4Q13
Source: Census

Fed has gone out of her way to emphasize continuity. Risks to the US economy are still primarily external and fiscal. External geopolitical events (such as the Ukraine situation) could undermine the expansion in the US and the more fragile recovery in Europe through a variety of mechanisms, including oil prices.

The fiscal risk is still that the Congress may impose yet another round of austerity in the near-term without treating the real problems of the longer run—like tax reform and entitlements reform. Increasingly, the narrow partisan lens through which economic and fiscal problems are viewed in Congress and White House distorts the real issues, and as a result, makes real solutions less likely. Nonetheless, in the near-term the federal deficit is set to decline again this year and next, giving the law-makers in Washington some breathing room. We decry the inability of Washington promote policies that are clearly good for the US economy, like comprehensive immigration reform and ability to do trade legislation on the fast-track. These failures will weaken the US economically. On a brighter note to conclude, despite Washington's failures, the private sector in the US is making good progress in the four and one-half years since the end of the Great Recession, and absent major unexpected events, it should continue to gain momentum this year.

Regional Implications

Economic growth has been uneven across the regions. The most notable employment growth in the nation has been in North Dakota, with the Bakken oil field boom. Employment is now more than 25% higher than it was at the recession trough. Other regions with strong employment growth include Texas and Northern California. In Texas, employment in its major markets is now between 7% and 13% higher than at the trough, having more than recovered all of the jobs lost during the Great Recession.

Northern California is another region experiencing high job growth. Although Oakland is lagging, San Francisco and San Jose now have employment that is between 12% and 13% higher than at the recession trough. Good tech employment boosting business and professional services employment, as well as strong education and health employment growth, are responsible for the Northern California employment growth.

In Florida, another relatively strong-growth region, markets like Miami, Fort Lauderdale, and West Palm Beach have employment that is now between 7% and 8% above their recession troughs. Even with that kind of growth, those markets have only gained between half to three-quarters of the jobs lost. Consequently, there is still excess labor market capacity in Florida.

By contrast to Northern California, Southern California has not fared as well during the current expansion. Employment growth is

between 4.9% and 6.7% higher than the recession trough, about half of the growth realized in Northern California. In Los Angeles, the aerospace industry is not growing, and some activities are shifting south to Orange County. Another stable of Los Angeles is the entertainment industry where many workers are on contract and do not show up in payroll data. Low end retail is also somewhat of a drag on employment growth. The Inland Empire is also growing slowly compared with the northern part of the state. The warehouse-distribution sector is part of its base, but not many jobs are involved.

In San Diego, with about one-quarter of the employment base tied in some way to the Department of Defense, that sector remains an important sector in San Diego. That sector was spared sequestration cuts, but it certainly is not growing. The bio-tech industry which has sprouted around UC San Diego and Scripps Research Institute is a growing, though small, sector. San Diego, although growing more slowly than its Northern California counterparts, is the best-growing area in southern California.

In broad brushstrokes, Texas, Florida, Northern California, Denver, Boston and North Dakota are the bright spots for employment growth. Georgia and Oregon are also showing good growth. Parts of New England, notably Vermont, New Hampshire, Connecticut, and Rhode Island are showing the weakest growth in the nation. Also in that group are parts of the Midwest and Mid-Atlantic—Ohio, Kentucky, West Virginia, Virginia, Pennsylvania, and New Jersey. Broadly the rest of the country is participating in the decent employment growth that we see in the national numbers.

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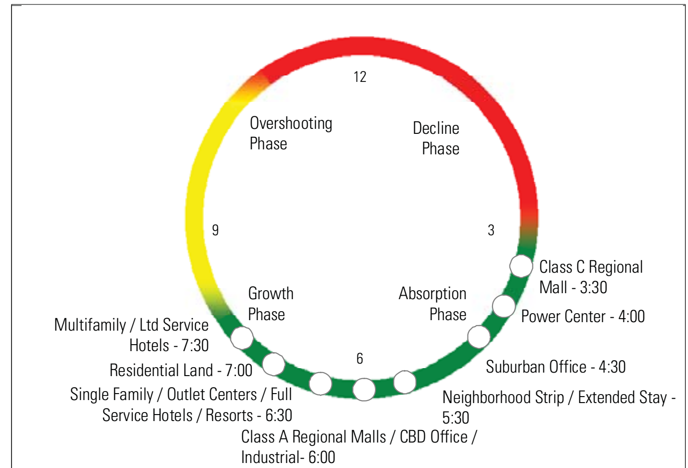
While the recovery in demand is only moderate, commercial real estate is benefiting from a 50-year low in new construction in all property types except for apartments, where demand is strongest. Improving job growth and rising economic activity will boost absorption going forward, well ahead of any increase in the construction pipeline. There is strong investment demand for stabilized properties, particularly for trophy assets. At the same time, as pricing pushes near or, in some cases, above 2007s peak, investors are considering secondary markets. There is less demand for broken deals. While many problems have been worked out, there remain deleveraging and mortgage-restricting opportunities.

- On the RCG Real Estate Cycle Clock, which tracks supply-demand fundamentals, most major property types in the United States are in the growth phase of the cycle: multifamily and limited service hotels (7:30), outlet centers, single family, full service hotels, and resorts (6:30), CBD office, industrial, and Class A Malls (6:00). With such limited construction, we expect the clock to move very slowly going forward.
- The remaining sectors are in the absorption phase and moving toward the growth phase including neighborhood strips and extended stay hotels (5:30), suburban office (4:30), power centers (4:00) and Class C malls (3:30).
- Demand growth varies across the nation with technology and energy markets ahead and markets with more diverse drivers gradually improving.
- Multifamily rental is the only property type with building activity increasing substantially in response to strong demographic drivers.

Real Estate Cycle Clock - Fundamentals
United States



- Vacancy rates are falling nearly everywhere for all property types. Upward momentum in rents for most markets will add to NOI growth during the near term.
- Mortgage rates moved up to 4.6% at the end of 2013 from 3.9% at the end of 2012. Benchmark long-term interest rates are still low by historical standards; low long-term rates are available for refinancing, workouts and new borrowing. Interest rate normalization will be a dominant theme during the next several years as ultra-accommodative monetary policy is unwound.
- We expect cap rates to move up as interest rates normalize, but given the long, artificially-low interest-rate environment, the initial 100 basis-point increase in interest rates resulted in very little movement in interest rates. RCG expects the

Real Estate Capital Market Overview

		2004	2005	2006	2007	2008	2009	2010	2011	2012	4Q12	1Q13	2Q13	3Q13	2013e	2014f	2015f
Debt Market																	
Commercial Lending Volume [1]																	
Construction Loans Outstanding	($ Bill.)	336.8	448.7	564.9	628.9	592.2	451.6	321.6	240.0	203.9	203.9	201.6	202.5	206.2	228.9	268.9	323.9
Net Dollar Growth	($ Bill.)	64.6	111.9	116.2	64.0	-36.7	-140.6	-130.0	-81.6	-36.1	-6.5	-2.3	0.9	3.7	25.0	40.0	55.0
Long Term Mtg. Loans Outstanding	($ Bill.)	2278.5	2584.7	2918.1	3270.8	3428.1	3337.9	3186.4	3106.4	3089.4	3089.4	3084.3	3108.9	3140.7	3209.4	3394.4	3594.4
Net Dollar Growth (Qtrs are SAAR)	($ Bill.)	225.8	306.2	309.8	352.7	165.7	-90.2	-166.7	-80.0	-17.0	88.4	-20.5	98.5	126.9	120.0	185.0	200.0
Domestic CMBS Issuance [2]	($ Bill.)	92.6	166.5	198.4	228.5	12.2	2.7	11.6	32.7	48.4	19.0	21.3	20.2	19.1	86.1	110.0	125.0
10-Year Treasury Rate		4.3%	4.3%	4.8%	4.6%	3.7%	3.3%	3.2%	2.8%	1.8%	1.7%	2.0%	2.0%	2.7%	2.4%	3.5%	4.3%
10-Year Commercial Mortgage Rate		5.5%	5.5%	5.9%	6.2%	6.7%	6.9%	4.7%	4.5%	3.9%	3.9%	3.8%	3.8%	4.2%	4.5%	5.3%	6.1%
Spreads vs. Treasury (bps) - Legacy																	
10-Year Commercial Mortgage		136	100	123	191	342	341	187	247	217	217	184	178	151	215	180	180
Spreads vs. Swaps (bps) - Legacy																	
Super Sr AAA		27	33	27	103	975	487	220	268	118	118	104	125	129	97	90	90
BBB CMBS		548	619	593	1168	5252	5554	4323	4561	3795	3795	3699	3411	3362	2800	650	575
Equity Market																	
Equity REIT Issuance [2]	($ Bill.)	21.5	15.4	22.2	17.9	12.8	24.2	28.2	35.9	47.6	9.3	16.1	15.8	6.2	46.2	65.0	50.0
Returns for Period																	
NCREIF - Total [3]	(yoy)	14.5%	20.1%	16.6%	15.8%	-6.5%	-16.8%	13.1%	14.3%	10.5%	10.5%	10.5%	10.7%	11.0%	11.0%	7.6%	5.3%
Wilshire REIT Index		33.2%	14.0%	36.1%	-17.6%	-39.2%	28.6%	28.6%	9.2%	17.6%	17.6%	7.4%	5.9%	2.7%	1.9%	5.8%	7.5%
REIT Yield		4.7%	4.6%	3.7%	4.9%	7.6%	3.7%	3.6%	3.8%	3.5%	3.5%	3.3%	3.5%	3.7%	3.9%	3.6%	3.5%

[1] *Includes multifamily lending*
[2] *Quarterly figures are not annualized.*
[3] *Quarterly figures are returns from the previous period*
Note: Interest rates and spreads are end of period

Sources: ACLI, Bloomberg, Commercial Mortgage Alert, FDIC, Federal Reserve, Merrill Lynch, Morgan Stanley, NAREIT, NCREIF, Real Capital Analytics, RCG, ULI, Wilshire Associates

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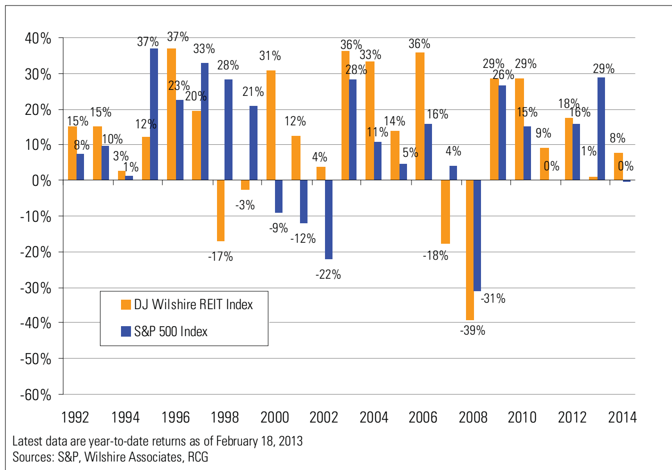
Investment Performance - REITs vs. S&P 500 Index



Latest data are year-to-date returns as of February 18, 2013
Sources: S&P, Wilshire Associates, RCG

next 100 basis-point increase in interest rates will result in a 20 to 30 basis points increase in cap rates, depending on property type.

- RCG expects the next 100 basis-point increase in interest rates will result in a 20 to 30 basis points increase in cap rates, depending on property type. From here on, we expect cap rates to increase to the historic relationship adding 60-80 basis points depending on property type. If inflation goes up at the same time, the impact on cap rates will likely be less severe.

REITs started 2014 outperforming the S&P 500. Last year, after four consecutive years of outperformance, REIT performance underwent a correction in 2013.

- The Wilshire REIT index was up by only 1.1%, compared with a 28.8% rise in the S&P 500 price index. As of March 5th, however, REITs were up 10.9% while the S&P is up 1.8%.
- In line with the correction, REIT assets are now selling at a 4.0% premium relative to private market assets. The premium reached a plateau at 21% prior to the most recent correction.
- Despite the correction, REITs are actively raising capital amid a favorable interest-rate environment and healthy premiums.
  - o In 2013, capital raised totaled $77 billion compared with $73.3 billion in all of 2012.
  - o IPOs expanded to $5.8 billion versus only $1.8 billion in 2012. In contrast, $35.8 billion has been raised in secondary offerings, surpassing the $35.1 billion raised in 2012.
  - o Unsecured debt capital raised in 2013 totaled $30.7 billion versus $25.7 billion raised in 2012. No secured debt has been issued since 2006.
  - o As of the first month of 2014, a total of $8.7 billion has been raised with $4.3 billion in IPOs, $2.5 billion in unsecured debt and $1.8 billion in secondary offerings.

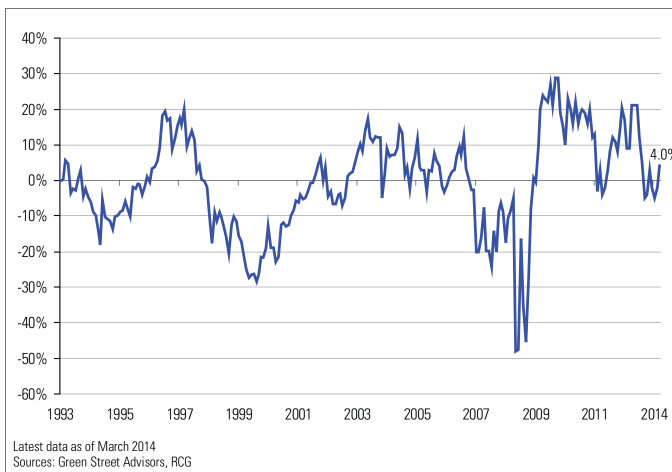
The overall transaction market appears healthy despite the increase in mortgage rates. Stronger pricing is attracting buyers and sellers to the market, and financing, albeit at a higher cost, is available. According to Real Capital Analytics, transaction volume totaled $359.4 billion in deals closed in 2013, up by 20% from 2012.

- Apartment deals exceeded all other property types with $104.5 billion closed in 2013, up by 19.4% from 2012.
- Office transaction volume in 2013 totaled $102.3 billion in closings, a 27% increase over 2012.
- Retail property transactions totaled $61.6 billion, a 9% increase over a year earlier.
- Industrial transaction volume totaled $47.4 billion, a 16% increase over 2012.
- Hotel deals in 2013 totaled $26.3 billion, 28% greater than in 2012.

According to Eastdil Secured, cap rates have compressed and internal rates of return (IRRs) slimmed, particularly in the gateway markets that are favored by foreign and domestic investors.

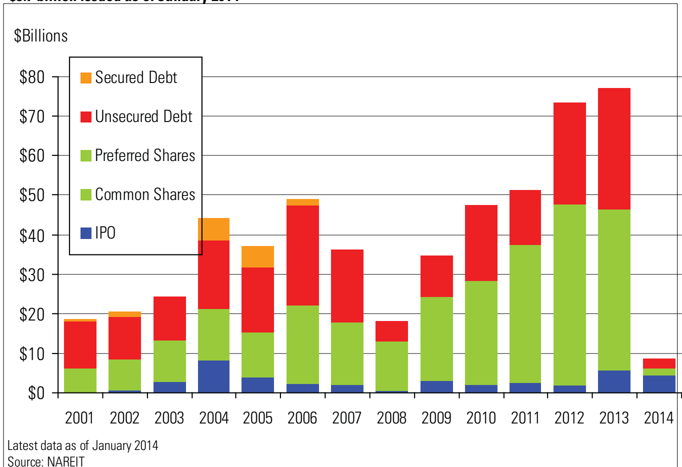
- Office cap rates are at 5.0% at the end of 2013 versus 5.25% in 2007, with IRRs down to 6.5% from 7.4%.

REIT Valuation - Premium / Discount to Underlying Asset Value



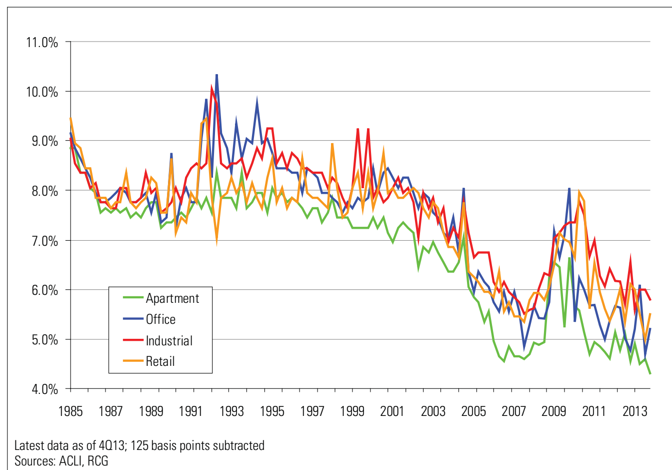
Latest data as of March 2014
Sources: Green Street Advisors, RCG

REIT Capital Offerings
$8.7 billion issued as of January 2014



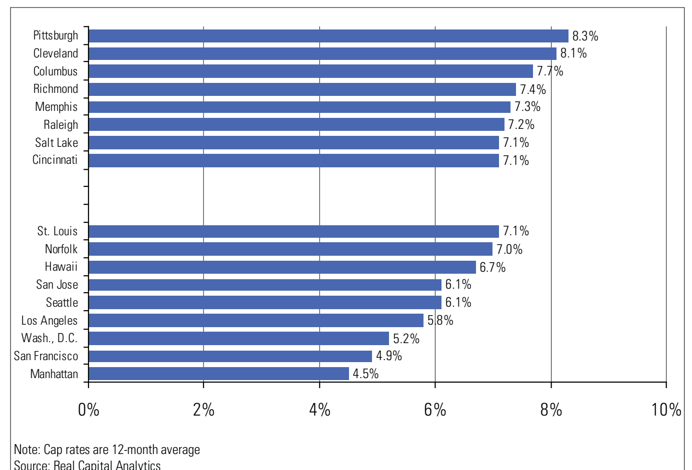
Latest data as of January 2014
Source: NAREIT

Cap Rates by Product Type



Latest data as of 4Q13; 125 basis points subtracted
Sources: ACLI, RCG

4Q13 Cap Rates – All Property Types



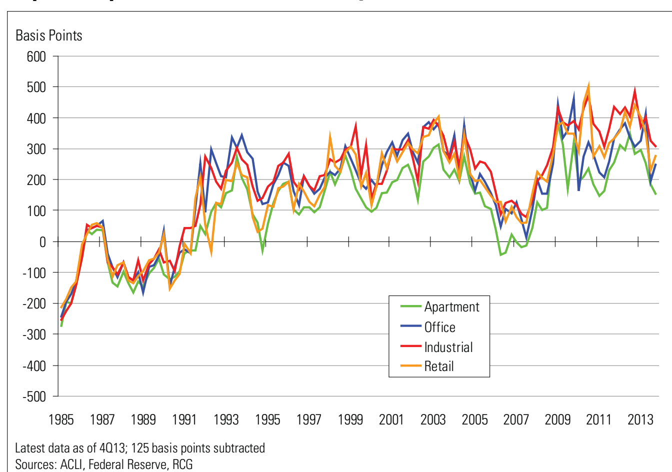
Note: Cap rates are 12-month average
Source: Real Capital Analytics

- For malls, cap rates have narrowed to 4.25% from 5.25% in 2007, with IRRs at 6.25% from 7.25%.
- Multifamily cap rates are at 4.25% from 4.4%, with IRRs at 6.0% from 7.0%.

For the overall market, cap rates have narrowed for all but office despite rising Treasury rates. RCG adjusts cap rate data from the American Council of Life Insurers (ACLI) to better reflect institutional quality market conditions.

- Apartment cap rates decreased to 4.3% in the fourth quarter from 4.6% a year earlier.
- Fourth-quarter cap rates on office properties moved up to 5.2% from 4.8% a year earlier.
- Cap rates ticked down in the industrial sector to 5.8% in the fourth quarter from 6.6% a year earlier.
- Retail cap rates decreased to 5.5% in the fourth quarter from 6.11% a year earlier.
- Relative to historical ranges, real estate assets are attractive from a value perspective compared with the risk-free rate of return and many other alternative asset classes. For all but office properties, cap rate spreads to the 10-year U.S. Treasury bond yield narrowed against the increase in Treasury rates.

Cap Rate Spreads vs. 10-Year Treasury Yield



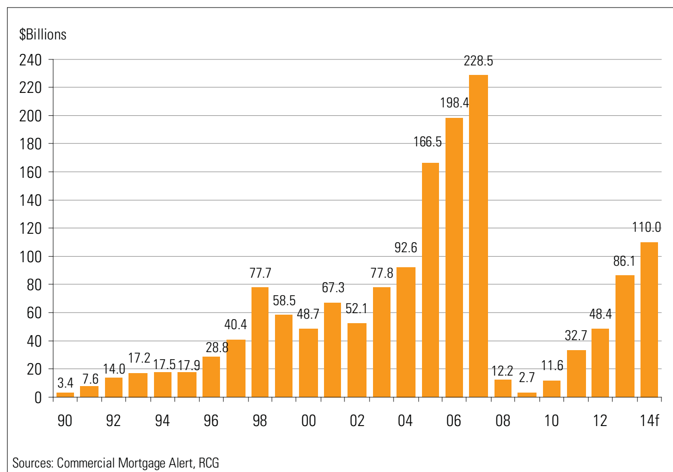
Latest data as of 4Q13; 125 basis points subtracted
Sources: ACLI, Federal Reserve, RCG

  - The apartment cap rate spread decreased to154 basis points in the fourth quarter from 185 in the third quarter and 284 a year earlier. Since 1983, the apartment cap rate spread was much tighter at 85.5 basis points.
  - The office cap rate spread widened to 248 basis points in the fourth quarter from 195 in the third quarter. The current spread is narrower than 307 basis points in the fourth quarter of 2012. The cap rate spread averaged 145 basis points since 1991.
  - The industrial cap rate spread decreased to 308 basis points in the fourth quarter from 484 in the fourth quarter of 2012. Since 1983, the industrial cap rate spread averaged 166.2 basis points.
  - The retail cap rate spread decreased to 277 basis points from 440 in the same period of 2012. The cap rate spread averaged 140.1 basis points since 1983.

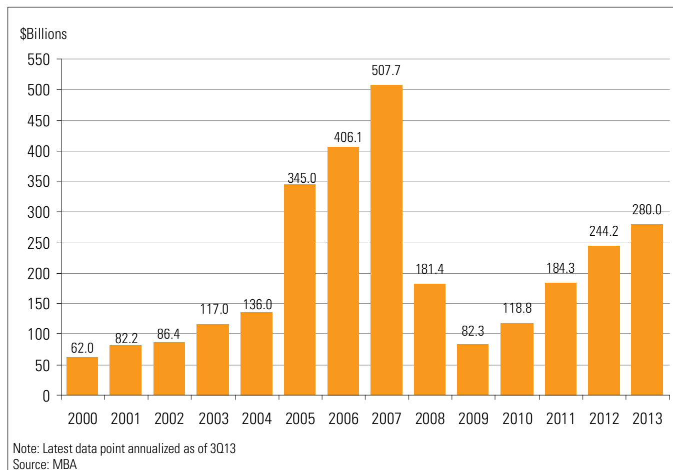
The lending environment is active as borrowers move to act ahead of mortgage rate increases. Banks, life insurance companies and CMBS issuers are active, leading to a surge of originations. There is some evidence that credit standards are again eroding given the competitive environment particularly for competitive trophy assets.

- According to the Mortgage Bankers Association, 2013 origination volume was $280 billion, up by 15% over 2012 volume. Both CMBS issuers (33%) and banks (32%) posted strong growth. Life companies increased originations by 25%, while the GSEs declined by 18% from the previous year.
- Lending was more spread out across property types with less domination by multifamily:
  - Multifamily originations are up by 13% over a year earlier;
  - Office originations are up by 22%;
  - Retail originations are up by only 4%;
  - Industrial originations are down by 11%;
  - Hotel originations are up by 10%;
  - Health-care originations are up by 35%.

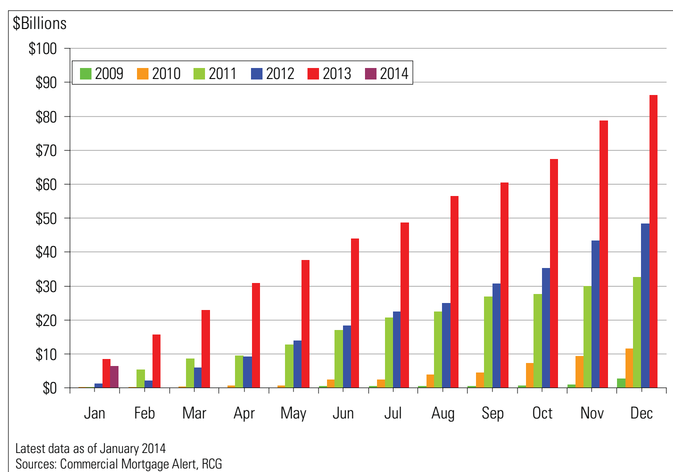
Domestic Commercial MBS Gross Amount Issued



New Domestic Commercial Real Estate Debt Originations



CMBS Issuance, Year-to-Date



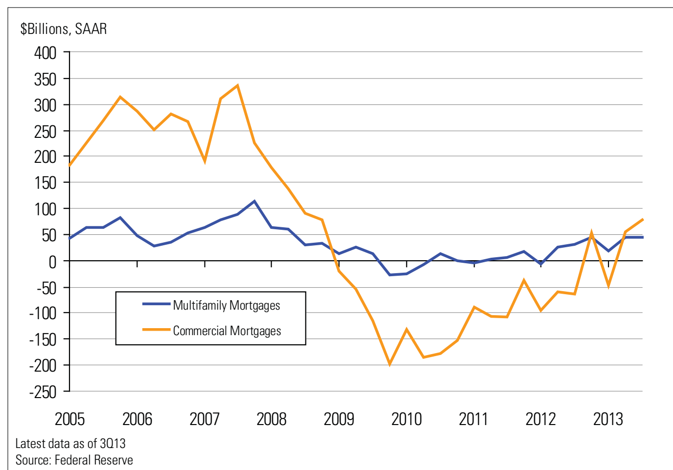
Conduits came back after being priced out when spreads widened. Since September, spreads have narrowed and investor interest has grown. There does seem to be a limit to the number of bond buyers, which may limit volume going forward. The market is better for buyers than for issuers of CMBS.

- After widening to 137 basis points in mid-June just after the Treasury rate increase, super senior AAA CMBS spreads narrowed to 104 basis points in early August. Spreads have fluctuated between 93 and 120 basis points, settling at 89 basis points as of February 21st.
- According to Commercial Mortgage Alert, spreads are narrower than the 52-week ranges for new issues.
    - As of February 27, 5-year new issues, AAA spreads narrowed to 61 basis points over swaps compared with the 52-week average of 62 basis points. For 10-year new issues, spreads were 87 basis points versus a 52-week average of 95 basis points.
    - New AA issues priced at 155 basis points versus the 52-week average of 161 basis points.
    - BBB spreads at 341 basis points over swaps were near the 52-week average of 380.
- On legacy fixed-rate CMBS loans, spreads stabilized after rising quickly since May, with lower tranches widening slightly above the 52-week range.
    - 5-year AAA spreads were at 93 basis points over swaps for the week of February 27, above the 52-week average of 88.
    - 10-year AAA spreads increased to 131 basis points over swaps, also above the 121 basis point 52-week average.
    - 10-year BBB spreads were 3,331 basis points over swaps versus the 52-week average of 3,427.
- CMBS issuance amounted to $10.3 billion year-to-date through February 27, significantly shy of the 18.9 billion issued in 2013. Issuance totaled $86.1 billion for the year versus $48.4 billion in 2012
- A total of $12.8 billion in issuance is in the works through May of 2014. Deals include 10 multi-borrower, one single borrower and one distressed.

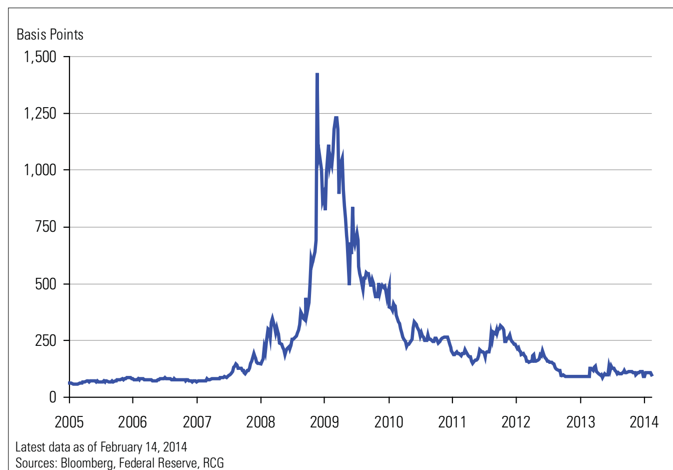
Commercial lending turned the corner and added to outstandings starting in the second quarter of 2013 after four and a half years of repayments and workouts exceeding new originations. Although there remains a stack of maturing loans, the volume has reduced ahead of scheduled maturity as borrowers prepay or use defeasance.

- In the third quarter of 2013, combined outstanding mortgages increased by $73.4 billion from one year earlier. While multifamily had consistently grown, commercial outstandings had shrunk from 2009 through the second quarter of 2013.

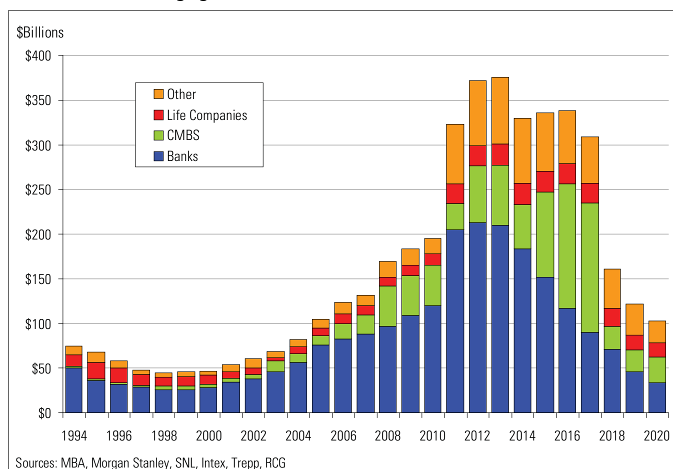
Net New Commercial and Multifamily Mortgages



Super Sr. AAA Commercial Mortgage Rate vs. 10-Year T-Bond



Commercial Mortgage Maturities



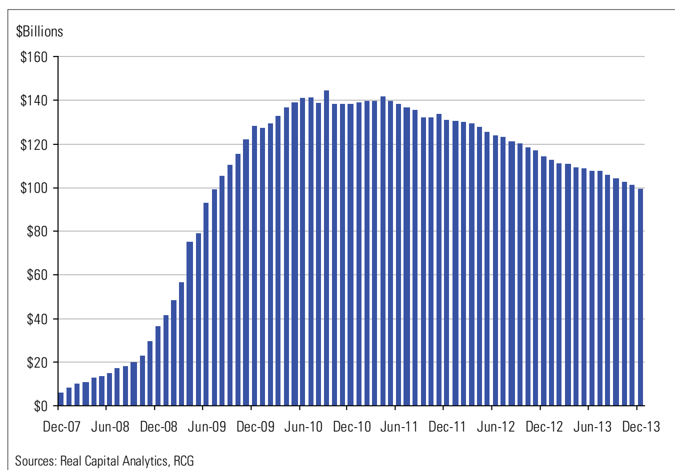
- Multifamily mortgages outstanding increased by $38.4 billion in the third quarter over a year earlier. Despite cutting back, GSEs still dominate multifamily lending with an increase of $28.0 billion. Commercial bank multifamily holdings increased by $8.5 billion over a year earlier.
- Commercial mortgage maturities peaked in 2013 with $378 billion in loans reaching maturity. Outstandings are expected to fall off to $161 billion in 2018 and to $103 billion in 2020.
  - Banks hold the largest amount of maturing loans over the medium term—$582 billion through 2017 or 41% of the total.
  - Annual CMBS maturities volume will increase substantially through 2017. We expect annual maturities to increase to $351 billion by 2017. CMBS maturities are scheduled to fall off thereafter to $29 billion by 2020.

The level of distress in commercial real estate assets is falling across the board.

- The volume of distressed commercial real estate assets remaining at the end of 2013 was $94.2 billion, according to Real Capital Analytics.
- The delinquency rate on CMBS was 5.3%, averaged over the three months through January 2014, according to Morningstar, down from a high of 8.5% in May of 2012. The total unpaid balance as of January was $39.4 billion. While there were new delinquent loans totaling $2.2 billion, an additional $2.7 billion in loans were resolved in the most recent period.
- CMBS loans in special servicing represented 9.1% of total outstandings as of January 2013 for a total of $47.7 billion, down from a peak of $89.9 billion in September 2010. By sector:
  - Office loans in special servicing total $15.7 billion;
  - Retail loans total $11.8 billion;
  - Multifamily loans total $7.5 billion;
  - Hotel loans total $6.5 billion;
  - Industrial loans total $3.1 billion.
- Delinquencies in construction and development loans improved to 4.9% in the third quarter of 2013 from a peak of 16.8% in the first quarter of 2010. The delinquency rate was a low 0.4% in 2005.

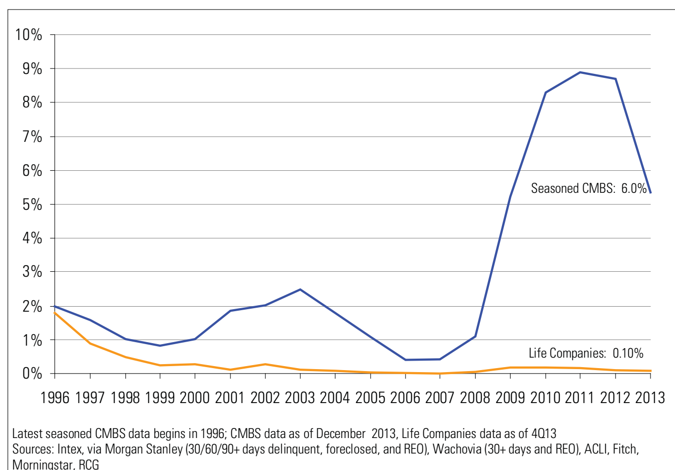
Market participants have been awaiting new capital and securitization rules. On August 28th, regulators proposed a new set of rules for risk retention according to Dodd Frank. The rules establish a Qualified Commercial Real Estate Loan (QCRE) and require that all other loans be subject to 5% risk-retention. There is concern that the new ruling will restrict the ability of B-piece buyers to purchase the risk retention piece. As currently written, monthly payments to B-piece buyers cannot exceed the amount of principal repaid to other bondholders. Many deals are interest-only with very small principal payments. Market participants are hoping this will be revised in the final ruling.

U.S. Commercial Real Estate Troubled Assets



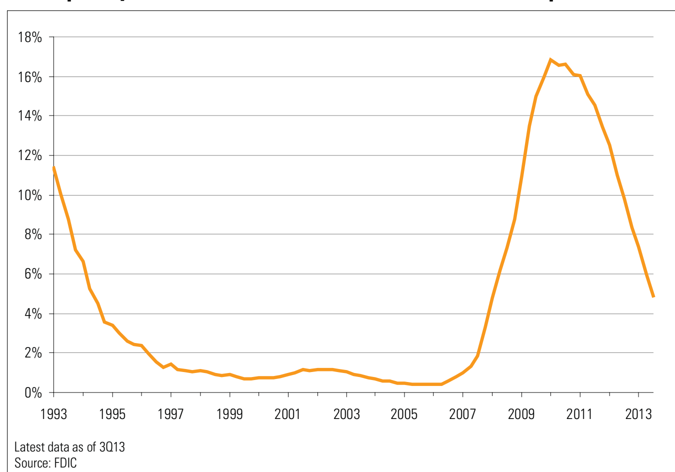
Sources: Real Capital Analytics, RCG

Delinquency Rates



Latest seasoned CMBS data begins in 1996; CMBS data as of December 2013, Life Companies data as of 4Q13
Sources: Intex, via Morgan Stanley (30/60/90+ days delinquent, foreclosed, and REO), Wachovia (30+ days and REO), ACLI, Fitch, Morningstar, RCG

Delinquency Rate on Real Estate Construction and Development Loans



Latest data as of 3Q13
Source: FDIC

Basel III rules are targeted more at larger financial institutions, particularly those deemed systemically important. High-leverage construction loans will require larger reserves. Basel III also impacts CMBS by requiring additional reserves for those bonds with a subordination level of 30% and under. Each of these impending regulatory shifts could impact materially capital availability to commercial real estate. This is particularly important when considering $496 billion in CMBS loans are maturing through 2017.

Outlook

Low construction will allow performance to improve steadily with rising economic growth and demand. From a valuation standpoint, cash flow is still highly discounted relative to long-term risk-free interest rates. U.S. real estate assets are attracting debt and equity capital, and many domestic and international institutional players like sovereign wealth and pension funds are increasing allocations to real estate. Normalizing long-term interest rates will be a major driving factor going forward. Rising rates will be met with compacting spreads on cap rates.

- Cap rates will increase as well, though not to the same degree as interest rates, indicating that near record-high spreads will tighten.
- NOI growth will offset a portion of the effect on values from rising cap rates. However, a substantial upward adjustment in long-term rates over the near to medium term will impact real estate asset values. A variety of cap rate hedging strategies are available.
- After three consecutive years of double-digit total returns, measured by the NCREIF index, cap rate compression at a national level has likely run its course. Income returns will account for the bulk of the 7.6% and 5.3% returns of the NCREIF index in 2014 and 2015, respectively.

Debt availability for commercial real estate will continue to grow going forward, particularly for term loans.

- Outstanding long-term mortgages are already increasing rapidly in the multifamily sector, with overall growth spreading to non-residential commercial real estate through 2013. We expect long-term commercial mortgages (including multifamily) to increase by $185 billion in 2014 and $200 billion in 2015.
- Though construction levels will remain low, we expect an increase in construction financing of $40 billion in 2014, the first annual increases since 2007, and $55 billion in 2015.
- The housing GSEs have played a dominant role in providing capital to multifamily investors during the last several years. The futures of Freddie and Fannie, however, are highly uncertain at this point. Under the previous director, each had lowered multifamily originations in 2013. The new director Mel Watt has yet specified volume requirements going

forward. Private capital sources, particularly portfolio lenders able to offer longer loan terms (12+ years) like banks and life insurance companies, stepped up as the agencies pulled back. CMBS conduits are not likely to offer maturities longer than 10 years.
- Spreads on 10-year commercial mortgages are expected to narrow going forward in line with rising benchmark rates. The interest rate on 10-year mortgages is forecasted to rise to 5.3% by year-end 2014 and 6.1% by year-end 2015, implying a narrowing of spreads to 180 basis points in 2014 and 2015 from 217 basis points at year-end 2012.

There will likely be future episodes of interest rate volatility, as the future of quantitative easing remains uncertain. CMBS issuance will decelerate in the second half of the year amid volatility in long-term interest rates and widening spreads on new issues.
- We expect Super Senior AAA spreads to be near 90 basis points in 2014 and 2015.
- CMBS issuance should total $110 billion in 2014 and $125 billion in 2015. We believe this is a sustainable business in the long term, with sound underwriting practices and annual issuance in the $80 billion-$150 billion range.

Barring a faster-than-expected increase in long-term rates, the REIT sector will weather the period of interest rate normalization without an extended period of weakness.
- Equity issuance should reach $65 billion in 2014 and $50 billion in 2015.
- Dividend yields have been consistent in the mid-3% range since 2009, where we expect them to stay through 2014.

Conclusion

Real estate fundamentals are improving, and opportunities for debt and equity placement are still available for most investment styles and strategies.

For core investing, we recommend:
- Buy high-quality REITs on a substantial dip (10%-20%);
- Buy office, medical office, industrial, apartments, senior housing, data centers and retail at 5%-7% or higher cap rates, at 80% replacement cost or below;
- Monetize mature core assets if cap rate is below 4% by a sale or like-kind trade or refinance;
- Lock-in low debt costs with assumable debt;
- Short China high-end residential real estate.

For value-added investing, we recommend:
- Debt for transitional assets;
- Buy vacancy in strategic markets;
- Reposition assets for upgraded use;
- Buy distressed assets from European lenders;
- Mezzanine debt to fill capital gap;
- Development deals on apartments;
- Buy hotels at 70% of replacement cost.

For opportunistic investments, we recommend:
- Single family land / housing;
- Select office and industrial development;
- Overleveraged portfolios that need equity restructuring;
- LIFO equity program.

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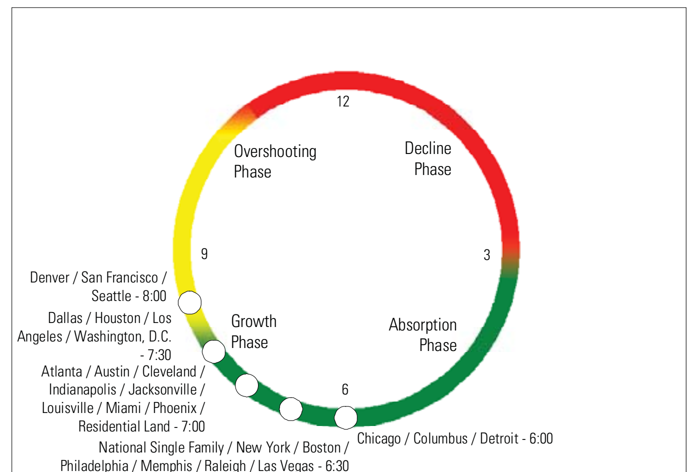
The National Single Family Housing Market

Andrea Lepcio

"Snow is cold, rain is wet" to quote Carole King and both will dampen enthusiasm for buying or building homes as seen in the most recent reports from the National Association of Realtors and the Commerce Department. We trust that warmer temperatures combined with low inventories of existing homes will encourage homebuilders to get busy. We are equally confident that prospective buyers with savings and 740 or stronger FICO scores will increase the pace of sales this spring. We remain concerned, however, that far too many potential buyers – with FICO scores below 740 – will remain out in the cold. Without these first-time and trade-up buyers in the housing market, the housing recovery will remain muted. This is particularly distressing because our demand forecast is robust. RCG expects household formation will increase as the economy continues to improve, producing strong demand for all forms of housing. Demographic factors, particularly as millennials enter their prime renting years and as baby-boomers retire and downsize, should contribute to near-term demand for rental housing. In coming years, as millennials begin to form families, we expect a gradual transition to single family housing. We hope that credit markets will open up in time to welcome them.

We are in the early days of mortgage underwriting under Consumer Finance Protection Board rules. The additional Qualified Residential Mortgage (QRM) rule is still being defined. There are also new bills under consideration in Congress aimed at winding down the GSEs and putting private capital ahead of any government guarantees. Meanwhile, the government dominates the mortgage market, guaranteeing nine out of ten loans. Government and private lenders alike, however, require the high credit scores mentioned above. With Lew Ranieri, we released a white paper in October 2013 discussing our concerns that many qualified borrowers are being left out of the market. The paper is available on the RCG website. While we applaud the restricting of option ARMS, negative amortization instruments and other toxic structures, we are concerned that current FICO-driven underwriting standards are eliminating the creation of many potentially very-good loans.

Real Estate Cycle – Single Family



We hope a solution will be found to reopen mortgage finance for worthy individuals and families.

We expect 2013 to be the last year of outsized gains before the pace of house appreciation returns to a more sustainable rate. Despite the drag of limited credit, and helped by a low inventory of existing homes and limited new housing construction, sales have been strong enough to lift prices.

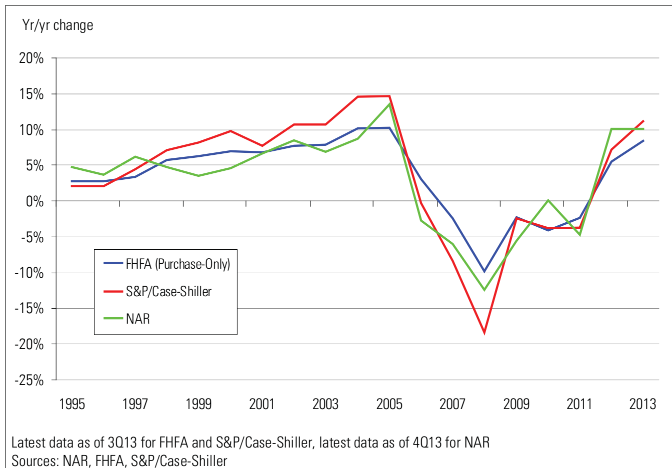
- According to the National Association of Realtors (NAR), house prices climbed by 10.1% nationally in 2013, lifting the median house price to $197,700. This is the second year of double-digit price gains.
- In January of 2014, the median existing-home price increased by 10.7% over a year earlier to $188,900 for all housing types and by 10.4% to the same price level for single-family homes.
- In January of 2014, existing home sales (including condos and coops) dropped by 5.1% to 4.62 million from 4.87 million a year ago. This volume is the slowest since July of 2012. While these statistics are seasonally adjusted, which may

Outlook for the National Single Family Home Market

	2004	2005	2006	2007	2008	2009	2010	2011	2012	3Q13	2013e	2014f	2015f	2016f	2017f	2018f
New Construction (000 Starts, Annual Rate)	1,611	1,716	1,465	1,046	622	445	471	431	535	660	618	750	800	900	750	700
Sales (000)**	6,727	7,076	6,516	5,041	4,106	4,329	4,183	4,278	4,661	5,323	5,073	5,300	5,500	5,500	5,400	5,500
Median Exist. Home Price (000)	$ 198.4	$ 225.3	$ 219.0	$ 205.7	$ 180.2	$ 170.3	$ 170.6	$ 162.6	$ 178.9	$ 207.1	$ 196.9	$ 205.8	$ 213.8	$ 223.4	$ 231.3	$ 238.2
Price Appreciation (4Q/4Q Rate)	8.8%	13.6%	-2.8%	-6.1%	-12.4%	-5.5%	0.2%	-4.7%	10.0%	12.3%	10.1%	4.5%	3.9%	4.5%	3.5%	3.0%
Affordability Index	123.4	107.6	110.5	125.7	154.1	173.7	179.5	199.2	203.7	161.3	177.6	157.1	142.4	127.8	129.4	124.0
Prime Delinquency Rate	2.2%	2.5%	2.6%	3.2%	5.1%	6.7%	5.5%	4.8%	4.4%	3.7%	3.4%	3.0%	2.5%	2.3%	2.0%	2.4%
Foreclosure Rate	1.2%	1.0%	1.2%	2.0%	3.3%	4.6%	4.6%	4.4%	3.7%	3.1%	3.3%	2.3%	1.5%	1.5%	1.7%	1.9%
Interest Rate (90-Day T-Bill)*	2.2%	4.1%	5.0%	3.4%	0.1%	0.1%	0.1%	0.0%	0.1%	0.0%	0.1%	0.3%	1.5%	2.8%	2.0%	2.0%
Conventional 30-Yr. Mort. Rate	5.8%	5.9%	6.4%	6.3%	6.0%	5.0%	4.7%	4.5%	3.7%	4.4%	4.0%	4.9%	5.7%	6.5%	6.1%	6.2%

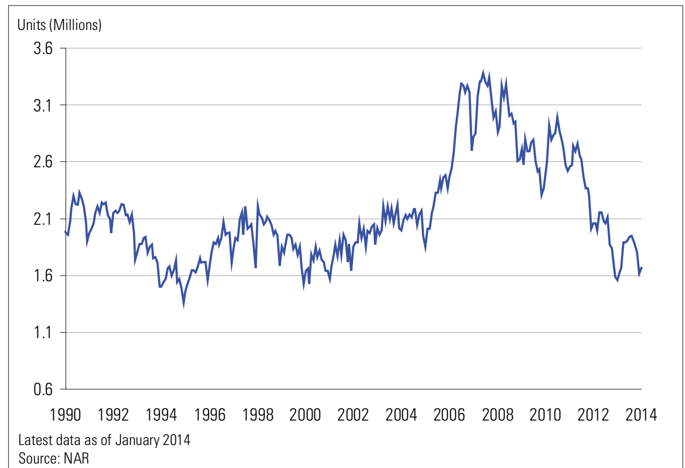
**Sales of Existing Homes (inc. condos and coops)
Sources: Census, Federal Reserve, LPS, MBA, NAR, RCG

Home Price Indices



Latest data as of 3Q13 for FHFA and S&P/Case-Shiller, latest data as of 4Q13 for NAR
Sources: NAR, FHFA, S&P/Case-Shiller

U.S. Existing Single Family Inventory

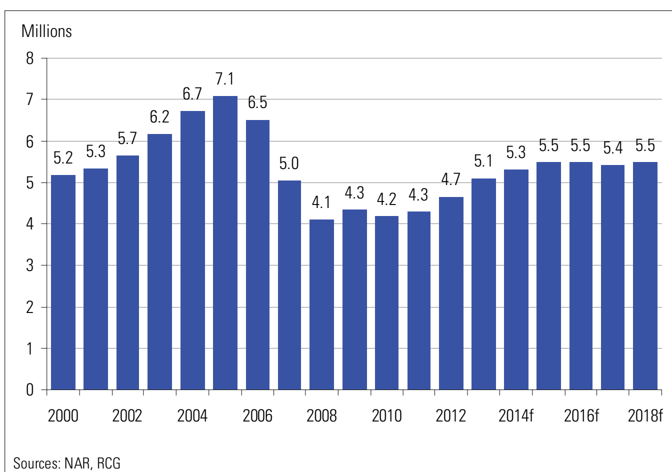


Latest data as of January 2014
Source: NAR

or may not account fully for the impact of winter on sales, overall, the housing sales market continues to be adversely affected by ongoing tight credit. Complicating matters, low inventory and rising prices will price more people out of homeownership. As a result, the percentage of first-time home buyers fell to 26% in January versus 30% a year earlier and a long-term norm of 40%.

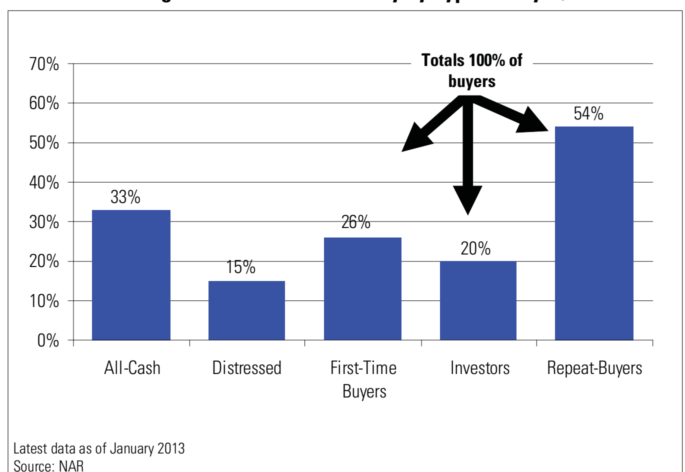
- An additional negative factor in the market is the increased cost of flood insurance. According to the NAR, sales of 40,000 homes were delayed or canceled as a result of higher rates. Currently, Congress is considering legislation to delay new flood insurance rates to allow the Federal Emergency Management Agency time to evaluate the law.
- According to NAR, the average number of days on the market narrowed to 67 days in January with 31% on the market for less than a month. The number of days on the market was 72 days in December. In January, distressed home foreclosures and sales accounted for 15% of total sales, down from 24% a year earlier. Total inventory at the end of January was 1.9 million units, a 4.9-month supply. Foreclosures accounted for 11% of sales with an average discount of 16%, and short sales accounted for 4% of sales with an average discount of 13%.
- Investors accounted for 20% of purchases in January. All-cash sales accounted for 33% of transactions; 70% of investors paid cash.
- Core Logic has been tracking house-price appreciation including and excluding distressed sales. In December, they reported that prices appreciated by 11.0% with distressed sales and 9.9% without distressed sales.
  - The Sunbelt's former boom states posted the strongest growth: Nevada (23.9%/20.0%), California (19.7%/16.2%), Arizona (12.4%/10.9%), and Florida (9.9%/11.5%). Growth was also stronger than the national pace in Michigan (14.0%/10.5%), Oregon (13.7%/11.6%), Georgia (12.8%/11.5%), Washington (10.1%/10.6%) and Utah (10.4%/11.0%).
- The S&P/Case Shiller 10-city index and 20-city index increased by 13.6% and 13.5%, respectively, year-over-year as of December 2013 on a seasonally adjusted basis. The Case Shiller index includes both distressed and non-distressed sales.
  - Year over year, Las Vegas (29.1%), San Francisco (25.7%), Los Angeles (27.3%), San Francisco (23.2%),

U.S. Total Existing Home Sales (Including Condos and Co-ops)



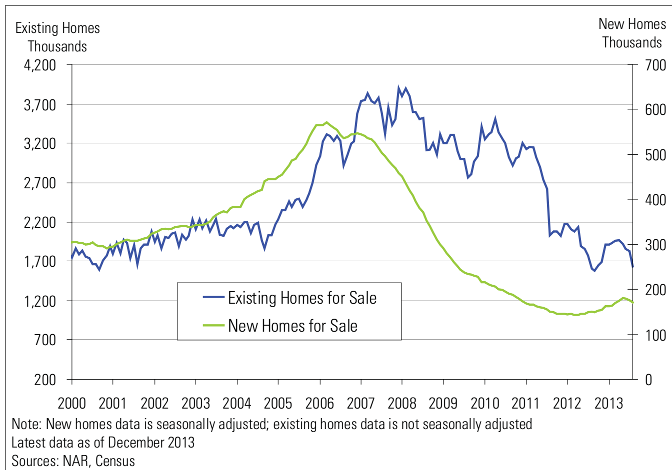
Sources: NAR, RCG

Share of Existing Home Purchase Activity by Type of Buyer, Jan. 2014



Latest data as of January 2013
Source: NAR

New & Existing Single Family Homes Available For Sale

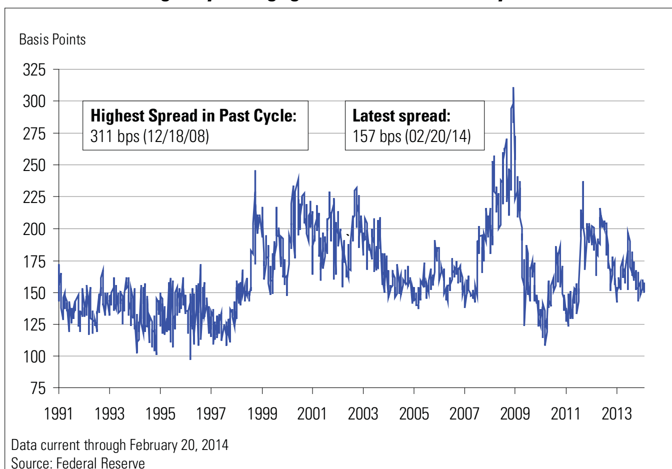


Los Angles (21.6%), San Diego (18.7%), Atlanta (18.5%), Detroit (17.3%), Denver (17.3%), Phoenix (16.7%), Miami (16.5%), and Tampa (15.7%) posted stronger gains than the 10- and 20-city indices

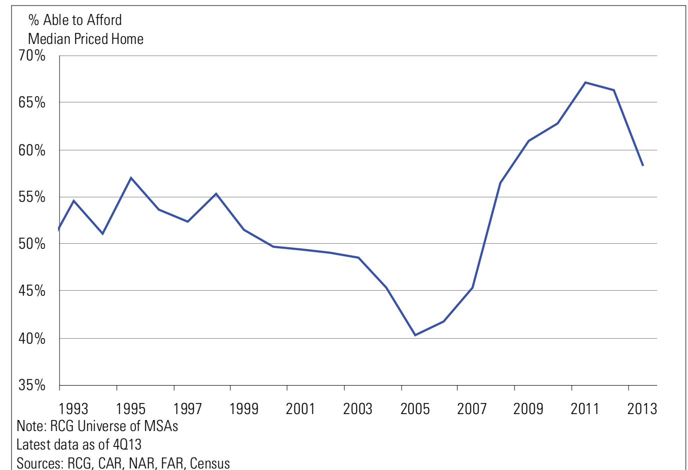
- The Federal Housing Finance Agency (FHFA) purchase-only, house-price index increased by 7.6% between December of 2012 and 2013. The FHFA index is calculated using purchase prices of houses backing mortgages sold to or guaranteed by Fannie Mae or Freddie Mac.
- Stronger economic growth is encouraging household formation as adult children move out of their parents' homes and doubling up with roommates unwinds. Household formations climbed to 1.375 million in 2013 from 1.16 million in 2012 and 861,000 in 2011. Household formations had shrunk to a low of 406,000 in 2010.
- The ten-year Treasury rate, after climbing from 1.66% in May, has been stable around 2.75%. As of February 14th, the 30-year mortgage rate was 4.28%.
- The spread between the 30-year-fixed agency mortgage rate is up by 153 basis points from a recent low of 143 basis points in November. The spread has remained under the long-run average of 164.4 basis points since September 2014. The spread had at first widened when Treasury rates rose, peaking at 197 in June.
- The push-up in mortgage rates coupled with rising house prices reduced affordability in the fourth quarter of 2013. According to RCG's calculation, 58.3% of households nationally were able to purchase a median-priced home, down from a high of 67.1% in 2011. For further perspective, however, affordability was as low as 40.2% despite low mortgage rates because of high house prices during the boom. The long-run average of 52.3% is also less than the current level.
- The affordability index produced by NAR moved down over the year as house prices and mortgages rose to 168.5 in the fourth quarter of 2013 from 203.5 a year earlier. The long-term, monthly average since 1992 is 140.5. At 100, the index shows that a family earning the median income has exactly the amount of income necessary to qualify for a conventional mortgage and purchase a median-priced home given current mortgage rates. Affordability is lowest in the West and highest in the Midwest.

Homebuilders are still gearing up after the extended pause caused by the housing downturn. From raising capital in an environment

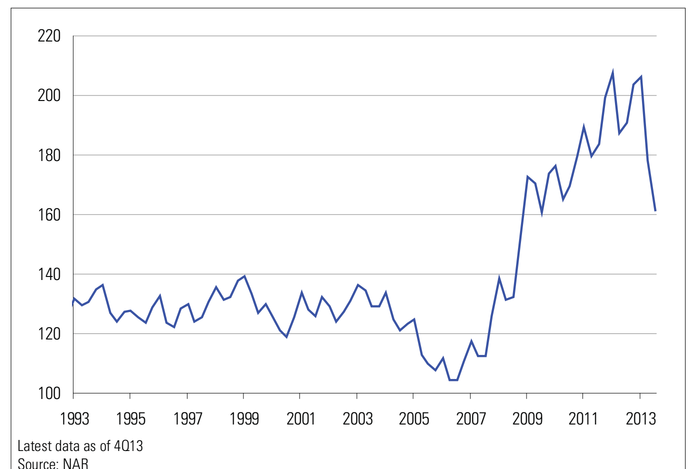
30-Year Fixed Agency Mortgage vs. 10-Year Treasury



Affordability, United States



Composite Housing Affordability Index – United States



U.S. Single Family Housing Starts

Sources: Census, RCG

Delinquencies - Total Loans Past Due By State for 4Q13

U.S. Average – 6.71%

Source: MBA

where fewer lenders are funding land purchases to rehiring skilled workers, it is taking time for housing starts to get going again despite the increase in demand.

- Single-family housing starts totaled 573,000 in January, down by 6.7% over a year earlier.
  - The most units are under construction in the South with 319,000 units started, a drop of 3.6% from a year earlier.
  - Starts in the West totaled 155,000 units, a gain of 10.7% over a year earlier.
  - The pace of starts slowed in the Midwest, down by nearly 50% from a year earlier with 48,000 units started.
  - In the smaller Northeast, starts totaled 51,000, an increase of 4.1% over a year earlier.
- New home sales totaled 468,000 units (SAAR) in January of 2014, an increase of 2.2% from a year earlier. There were 184,000 units for sale at the end of the period, which represent 4.7 median months for sale.

Foreclosure Inventory Rates by State for 4Q13

U.S. Average – 2.86%

Source: MBA

The number of delinquencies and foreclosures continues to drop as the economy and housing market improve and as problem loans are restructured, resolved and foreclosures completed. Foreclosures are more difficult to predict because the pace is influenced by a number of exogenous factors including federal and state legislation, new modification incentives and other factors.

- The overall delinquency rate remained at 6.4% in the fourth quarter from the third quarter, but is down by 7.1% from a year earlier. At crisis-highs early in 2010, the delinquency rate was 10.1%.
- Prime delinquencies decreased to 3.5% in the fourth quarter of 2013 from 4.4% a year earlier. The cyclical high was 7.3% in the first quarter of 2010. Many of these loans are in the jumbo category, exceeding the Federal agencies' loan size limit, and therefore dependent on private mortgage sources for relief.

Mortgage Foreclosures in Process by State

State	Peak 1980 - 2006	4Q 2013
FL (1991)	1.6%	8.6%
NJ (1992)	2.4%	7.9%
IL (1987)	2.1%	4.4%
NV (1986)	2.0%	4.0%
OH (2004)	3.4%	3.4%
US (2002)	1.5%	2.9%
MI (2006)	2.4%	1.5%
CA (1996)	1.9%	1.3%
AZ (1989)	1.9%	1.1%

Latest data as of 4Q13
Source: MBA

- o The biggest problems are in the prime adjustable–rate mortgage category, where 5.4% are past due and 3.9% in foreclosure.
  - o The prime fixed-rate category is performing better than the overall market with only 3.2% past due and 1.6% in foreclosure.
- After months of declining levels, subprime delinquencies moved up to 20.8% in the fourth quarter of 2013 from 20.1% in the third quarter and 20.3% a year earlier. The rate of delinquencies remains well above the near-15% peak rate of the 2001 recession. At best, the subprime business is never less than 10% delinquent. Subprime foreclosures ticked down to 10.4% in the fourth quarter of 2013 from 11.9% a year earlier.
- Foreclosure filings totaled nearly 1,632,000 year-to-date as of December 2013, down by 29.2% from the same period in 2012 and 7.6% higher than the previous month, according to RealtyTrac. During the same period, the number of foreclosure filings declined by 39.1% in Arizona, 49.6% in Nevada and 53.6% in California.
- According to Core Logic, the number of borrowers holding underwater mortgages improved to 6.4 million, or 13.0% of all mortgage properties, as of the third quarter of 2013. With each gain in house price appreciation, households are regaining equity: 791,000 million returned to positive equity during the third quarter There remain a number, however, particularly with tight credit, that are unable to easily refinance or move up to a different home.
  - o Nevada has the largest share with 32.2% of all loans underwater. Florida has 28.8% underwater; Arizona, 22.5%; Georgia, 17.8%; and Ohio, 18.0%. Roughly 40% of all underwater loans also have a second lien.
- The combination of limited new mortgage originations and foreclosures has reduced the proportion of owner-to-renter households and reduced the volume of mortgages outstanding to $9.8 trillion in the third quarter of 2013 from $9.9 trillion a year earlier and an $11.3 trillion high in 2008.
- The proportion of owner-households shrank to 65.2% as of the fourth quarter of 2013 from the housing-boom peak of 69.2%. As a result, multifamily properties are seeing very favorable rental-revenue growth as discussed in our Apartment Outlook. In some markets, rents have moved above comparable principal and interest payments on a median-priced home.
- The GSEs (including mortgage pools) accounted for 60% of the $9.8 trillion mortgages outstanding as of the third quarter. Banks are the other significant holder with $2.3 trillion or 24.0%.

The single-family rental market is a growing source of housing in the United States. As of 2012, it comprised approximately 10% of total housing stock nationally, amounting to more than 13 million units. By comparison, institutional-quality apartments numbered approximately 17 million units nationally. Institutional investors purchased an estimated 90,000 homes in the past two years at a cost of approximately $15 billion. The majority of these homes were located in the Southern and Western regions of the United States. Looking ahead, the future of the single-family rental sector as an institutional asset class is uncertain. Significant institutional investment in the single-family rental sector may be an artifact of historical events – made possible by the steep depreciation of for-sale housing prices during the recession. The lack of economies of scale and the high capital expenditure requirements of the sector may dissuade many institutional operators from remaining in the sector. After spending billions to acquire single-family rental properties, we expect institutional investors will use securitization to finance previous purchases and future purchases. Blackstone pursued the first securitized transaction in November with a $479.1 million dollar floating-rate deal on 3,207 houses.

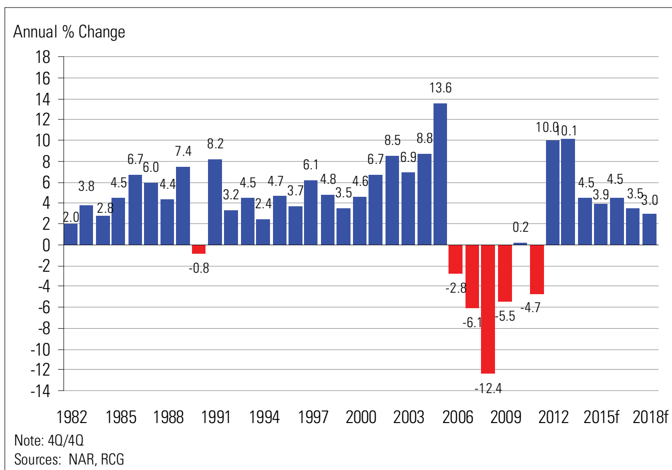
Single family is now at 6:30 on the RCG Real Estate Cycle Clock, which tracks supply-demand fundamentals. Homebuilders have increased activity and residential land is now at 7:00.

The Outlook

Under our base case, we expect job growth to support demand for housing; however, we are concerned that tight credit conditions will persist for the next 12-18 months. We expect a transition period between the current public-dominated mortgage market to one with a rising share of privately originated and held mortgages. Private volume will gradually increase as new regulations are clarified and if investor confidence is restored. It will take time for lenders to expand from wealthier buyers of high-end homes to qualifying, but lower-income buyers of lower-end to moderate homes.

- Existing home sales, including condominiums and co-ops, will improve to 5.3 million units in 2014. Sales will gradually rise to 5.5 million units by 2015 and remain there for 2016 and 2018 with a slight lull at 5.4 million in 2017. This level is near 2002s sales figure, but well below 2004-2007s boom pace.
- Single-family housing starts will increase gradually through the forecast horizon, but remain well below the long-term average of 1.1 million units. We expect starts to pick up to 750,000 units in 2014. It will take until 2016 for starts to lift to 900,000 units, before the pace of construction eases to 750,000 in 2017 and 700,000 in 2018.
- We expect the rising ten-year Treasury bond to push the 30-year mortgage interest rate to 5.7% in 2015 and a high of 6.5% in 2016. We expect rates to ease back to 6.2% at the end of the forecast horizon.
- Affordability will be strongest during the next 12 months. As house price appreciation and mortgage rates move up, affordability will decrease as home prices and mortgage rates rise.

Existing Median Home Price Appreciation - United States



Note: 4Q/4Q
Sources: NAR, RCG

- We expect new regulations will increase the cost of originating and securitizing riskier instruments. As a result, the majority of mortgages, both fixed and adjustable rate, will be conventional with fully amortized monthly principal and interest payments. All of the bad products from the bubble era were outlawed.
- The new regulations along with lenders' inclinations will exclude those households that are marginally qualified to buy and will keep the percentage of homeowners near the pre-boom average of 64%. We find the previous peak of 69% in homeownership to be unsustainable, dependent as it was on unstable aggressive loans.
- We believe the pace of improvement in delinquencies will be gradual during the next 12 to 18 months. Delinquencies and foreclosures will gradually ease to historically-normal levels by 2017. RCG believes it will take another two years for the foreclosure process to complete and for this inventory to clear.

Going forward, house price increases will be driven by rising demand and increased availability of credit. Markets with strong job growth and small inventories will increasingly experience competitive bidding, which will accelerate appreciation growth.

- We expect house price appreciation to remain healthy, albeit slower, at 4.5% in 2014, 3.9% in 2015 and 4.5% in 2016. Price growth will moderate thereafter to 3.5% in 2017 and 3.0% in 2018, bringing the median house price to $238,200 by the end of the forecast. Appreciation will remain well below the pace of the boom era and trail the long-term average of 5.1% between 1968 and 2011.
- There are wide regional differences in housing market performance. Please refer to our market spotlights for specific market details.
    - In 2013, 23 of our 75 markets will outperform our forecasted weighted-average national increase, with house price appreciation ranging from 4.6% to 15.0%. All of the top five markets are in the West with four in California:
        - Bakersfield – 15.0%;
        - Santa Barbara – 14.0%;
        - Las Vegas – 9.8%;
        - Los Angeles – 9.0%;
        - Modesto – 8.8%.
    - Additional California markets will produce healthy growth: the tech markets of San Francisco (6.2%), San Jose (7.0%) and Oakland (6.0%); Inland Empire (8.7%) and Orange County (5.0%).
    - In addition to the top growers, the following California markets will also outperform the United States as a whole: Modesto, Fresno, Salinas, Vallejo and Santa Rosa.
    - Recovering boom-markets in Florida will also outperform: Miami (6.0%), Ft. Lauderdale (5.5%), West Palm Beach (5.2%) and Orlando (4.6%).
    - We expect Phoenix to appreciate by 6.7% in 2014.
    - Four diverse markets will match the national average: Denver, Cincinnati, Raleigh-Durham and Portland.
    - All other markets will generate positive growth, but will underperform the weighted-average national gain in 2014.
    - The five slowest growth markets are spread out geographically:
        - Philadelphia – 3.0%
        - Albuquerque – 3.0%;
        - Hartford – 2.7%;
        - Milwaukee – 2.7%;
        - El Paso – 2.5%.
- The mortgage market is a work in progress. The new QM regulations took effect in January 2014. Litigation risk will be a factor for any lender considering moving outside the QM box.
- The securitization market is mired in the political process. There are a number of proposals and new pieces of legislation with alternative concepts for the wind-down of the GSEs and future securitization model.

Conclusion

The housing market is doing as well as can be expected with limited credit availability. Even if the mortgage market remains entrenched, we expect a healthy pace of sales and normalizing, but positive home-price appreciation. We are hopeful that regulators and lenders alike are motivated to expand credit. Indeed, as time goes on, we believe the disruption of housing's virtuous cycle from first-time buyers through to move-up buyers and downsizing sellers will be clear to all. A fully productive mortgage system must bring first- time buyers and low- and moderate-income households into homeownership.

Going forward, more private capital will have to be attracted to the mortgage market for credit to expand. A key element necessary to attract the level of private investment that the mortgage market enjoyed during the previous three decades is to restore investor confidence. This will require restoring the sanctity of contracts and limiting put-back risk to egregious errors. Both borrowers and lenders must be prepared to stand by their words and signatures going forward if the mortgage market is to normalize. We are hopeful that such terms will be reached and that both government and private lenders will welcome back borrowers with FICO scores between 620 and 760.

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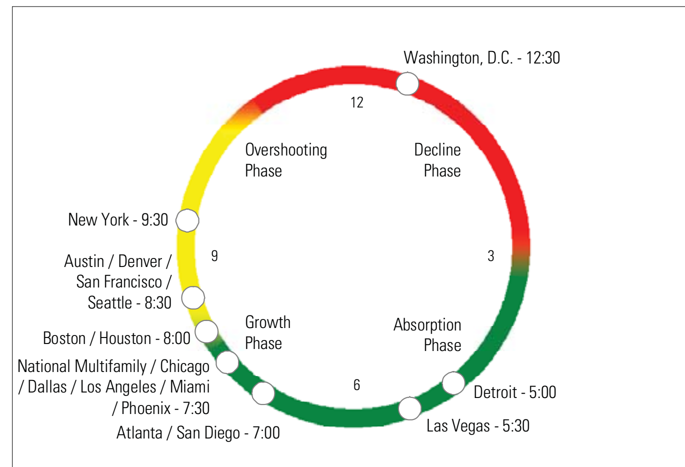
The National Apartment Market

David Bank

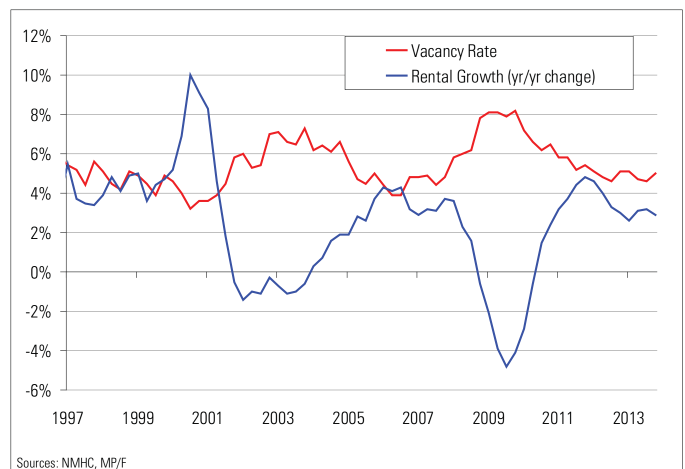
Although increasing levels of new construction and easing rent growth are concerns in select markets, national apartment market conditions remained tight through year-end 2013. Elevated levels of rental unit absorption in response to sustained employment growth and positive demographic trends continued to put downward pressure on the overall rental vacancy rate. Owing to strong rental demand and low vacancy rates, rents expanded at a healthy pace nationally. Through the fourth quarter of 2013, vacancy rates in markets nationwide were at cyclical or historical lows, with tight market conditions supporting increased rent growth in many markets. Performance in terms of rent and income growth continued to be led by markets closely linked to the high-tech and energy sectors, which generated rapid employment growth and supported elevated levels of renter household formation. Strong apartment market fundamentals led to robust investment activity during the past year, with transaction volume rising and the average apartment cap rate contracting in response to healthy investor demand and expanded access to capital. With average cap rates in core markets remaining near historical lows, transaction activity picked up in secondary and tertiary markets, particularly in the Southeast region, as investors continued to seek out opportunities for increased yields. Looking ahead, new construction activity is expected to rise in the near term, however sustained job growth and new household formation, particularly among young, renter-aged households should support tight apartment market conditions, with cyclically low vacancy rates and positive rent growth throughout the forecast period.

- The U.S. apartment vacancy rate for investment-grade properties decreased slightly to 5.0% in the fourth quarter of 2013, down from 5.1% in the fourth quarter of 2012, according to MPF Research.
    - o By region, vacancy rates trended upward during the

Real Estate Cycle – Multifamily



Professionally Managed Apartments



Sources: NMHC, MP/F

Outlook for the National Apartment Market

	2006	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f	2017f	2018f
Total Multifamily Construction (Starts, Ann., 000)*	336	309	284	109	116	178	245	307	380	350	350	300	280
Rental Apartment Const. (Starts, Ann., 000)*	185	189	217	91	99	159	222	282	340	300	295	247	224
Condominium Const. (Starts, Ann., 000)*	151	120	67	18	17	19	23	25	40	50	55	53	56
Overall Vacancy Rate	9.7%	9.8%	10.0%	10.6%	10.2%	9.5%	8.7%	8.2%	8.1%	8.0%	7.9%	8.0%	8.1%
Vacancy Rate, 5+ Units	9.9%	10.3%	11.2%	12.3%	11.7%	10.4%	9.7%	8.8%	8.6%	8.5%	8.3%	8.4%	8.3%
Vacancy Rate - Professionally Managed Properties	4.3%	4.7%	6.5%	8.1%	6.6%	5.6%	4.9%	4.9%	5.1%	5.2%	5.2%	5.4%	5.3%
Gross Rent (SF/Yr.)	$ 15.24	$ 15.85	$ 16.41	$ 16.57	$ 16.66	$ 17.06	$ 17.53	$ 18.02	$ 18.47	$ 18.85	$ 19.14	$ 19.39	$ 19.68
Rent Growth - CPI Component	4.1%	4.0%	3.5%	0.9%	0.5%	2.4%	2.7%	2.8%	2.5%	2.1%	1.5%	1.3%	1.5%
Rent Growth- Professionally Managed Properties	3.2%	3.5%	-1.7%	-4.1%	2.3%	4.8%	3.0%	2.9%	2.6%	2.4%	2.2%	2.0%	2.3%
Cap Rate	4.8%	4.7%	5.3%	6.2%	5.3%	4.8%	4.9%	4.6%	4.8%	5.2%	5.5%	5.4%	5.5%
NCREIF Return	14.6%	11.4%	-7.3%	-17.5%	18.2%	15.5%	11.2%	10.4%	7.6%	6.1%	7.6%	4.3%	4.6%
Capital Return	8.9%	6.4%	-11.4%	-21.9%	11.8%	9.6%	5.6%	5.1%	2.8%	1.2%	2.7%	-0.7%	-0.5%
Income Return	5.4%	4.7%	4.5%	5.3%	5.9%	5.5%	5.4%	5.2%	4.8%	4.9%	4.9%	5.0%	5.2%
Delinquency Rate	0.02%	0.05%	0.04%	0.17%	0.19%	0.07%	0.10%	0.00%	0.02%	0.02%	0.03%	0.04%	0.03%

* Numbers in quarterly columns are annualized.

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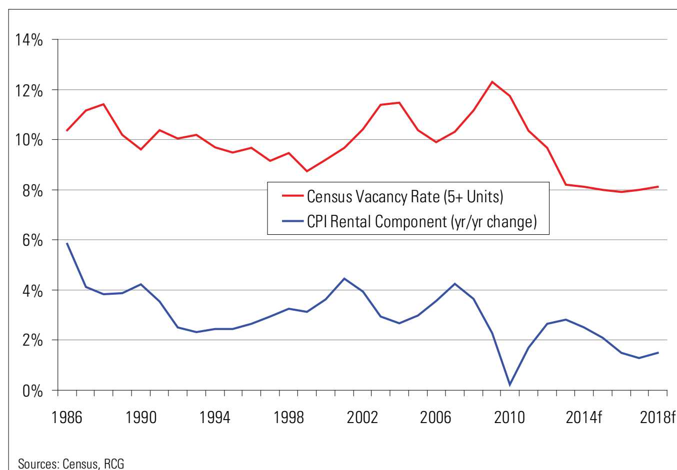
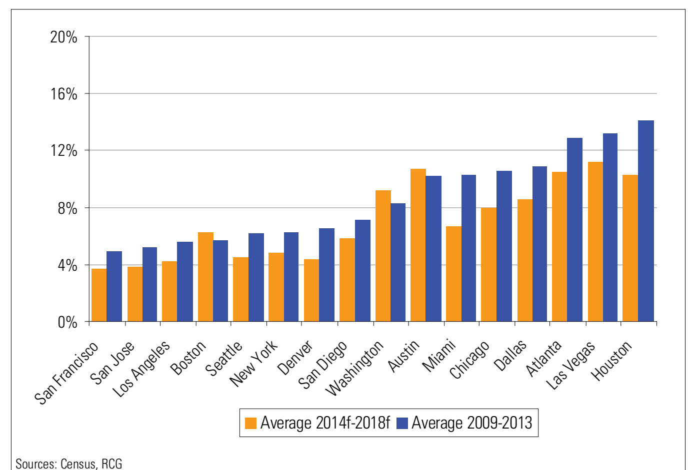
Overall Rental Market



Sources: Census, RCG

Average Forecasted Vacancy Rate vs. 2009-2013 Average



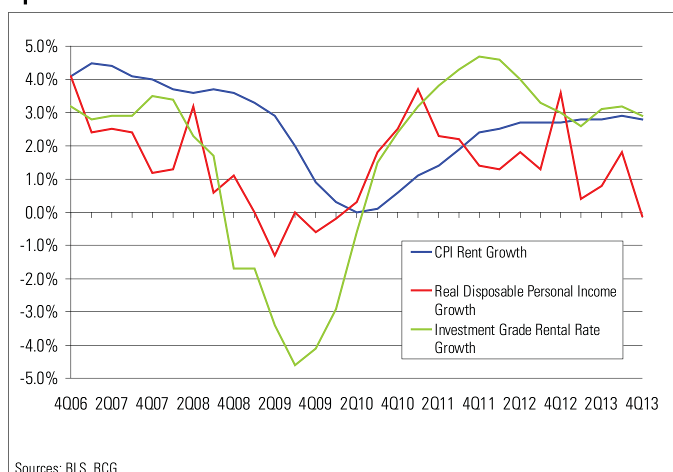
Sources: Census, RCG

past year in the Northeast and Midwest, as additional new supply came on the market, while vacancy rates contracted in the South and West because of sustained high levels of renter household formation.

- The vacancy rate in the West contracted to 4.3%, decreasing from 4.6% in the fourth quarter of 2012.
- The vacancy rate in the South fell to 5.8%, from 6.1% in the fourth quarter of 2012.
- The vacancy rate increased in the Midwest, reaching 5.0% in the fourth quarter of 2012, up from 4.7% during same time last year.
- The vacancy rate in the Northeast edged upward to 4.1%, compared with 3.8% in the fourth quarter of 2012.

o Nationally, the overall Census rental vacancy rate decreased to 8.2% through year-end 2013, from 8.7% at year-end 2012. The vacancy rate for properties with five or more units contracted to 8.8% in the fourth quarter of 2013, from 9.2% during the previous quarter and a 9.7% vacancy rate during the same time last year.

Apartment Rent Growth v. Income Growth



Sources: BLS, RCG

- With healthy rental unit absorption and a slight decline in the vacancy rate through year-end 2013, the average apartment rent continued to rise at a modest pace. Average effective rent for institutional-grade properties grew by 2.9% year-over-year in the fourth quarter of 2013, moderating somewhat from the 3.2% growth rate in the previous quarter, according to MPF Research. The broader measure of CPI rent appreciation rose by 2.8% during the same period.
  - o The West region led all regions with average same-store rent increasing by 4.1% in the fourth quarter of 2013, with effective rent reaching $1,377.
  - o Same-store rents in the South region rose by 2.6% year-over-year to $964 per month.
  - o Average effect rents in the Midwest increased by 2.3% year-over-year to $919 per month.
  - o Same-store rents in the Northeast appreciated by 1.3% year-over-year to $1,296 per month, down from 2.2% rent growth in the previous quarter and a 2.8% growth in the fourth quarter of 2012.
- Rental affordability continues to be a significant concern, particularly in core markets, as rents appreciate, while incomes have remained relatively stagnant nationally. As of the fourth quarter of 2013, real disposable incomes contracted by 0.1% year-over-year, while CPI and investment-grade rents appreciated by 2.8% and 2.9%, respectively, compared with the fourth quarter of 2012.
- Despite increased construction activity, elevated levels of rental demand should continue to outpace supply, pushing vacancy rates downward at least through the near term. The overall Census vacancy rate should contract to 7.9% by 2016, before rising slightly during the latter part of the forecast period, while the 5+ unit Census vacancy rate is expected to decrease to 8.3% by the end of 2018, down from 8.8% in 2013.

Year-over-year Change in Apartment Fundamentals, December 2013

	Year-over-year Change in Revenue per Available Unit	Year-over-year Change in Occupancy	Year-over-year Change in Effective Rent
San Francisco	7.9%	0.8%	7.1%
Denver	7.6%	0.4%	7.2%
Atlanta	6.5%	1.0%	5.3%
Houston	5.9%	0.9%	5.0%
Seattle	5.4%	0.0%	5.4%
Austin	5.2%	0.0%	5.2%
San Diego	4.4%	0.2%	4.3%
Dallas/Ft. Worth	3.7%	0.2%	3.5%
Riverside	3.7%	0.4%	3.3%
Phoenix	3.6%	0.3%	3.3%
Orange County	3.4%	0.1%	3.4%
Orlando	3.3%	0.1%	3.2%
Los Angeles	2.8%	-0.2%	3.0%
Las Vegas	2.5%	0.8%	1.6%
Tampa	2.4%	0.3%	2.1%
Charlotte	2.2%	-0.2%	2.4%
Boston	2.0%	-0.1%	2.1%
Chicago	1.2%	-0.2%	1.4%
NYC Metro	-0.4%	-0.3%	-0.2%
Washington, D.C.	-1.8%	-0.4%	-1.4%

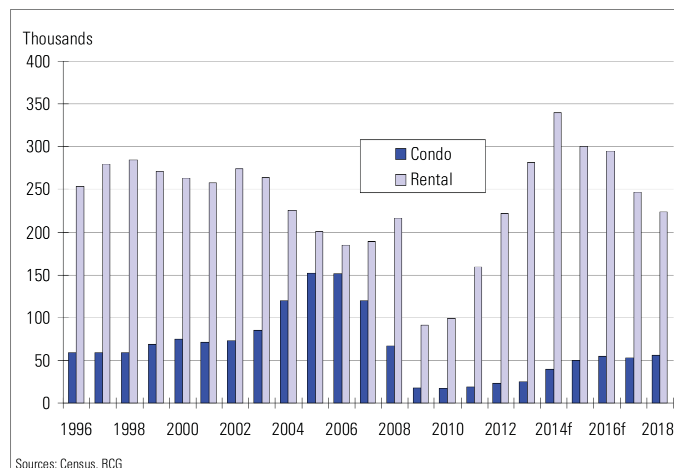
Sources: Axiometrics and Bank of America Merrill Lynch

- Energy and technology-driven markets continued to lead all major metropolitan areas in terms of effective rent growth through December 2013, according to data from Axiometrics and Bank of America Merrill Lynch.
  - Denver : 7.2%;
  - San Francisco: 7.1%;
  - Seattle: 5.4%;
  - Atlanta: 5.3%;
  - Austin: 5.2%; and
  - Houston: 5.0%.
- In terms of year-over-year growth in revenue per available unit, a rough analog to NOI, through December 2013, the following markets demonstrated strong income growth:
  - San Francisco: 7.9%;
  - Denver: 7.6%;
  - Atlanta: 6.5%;
  - Houston: 5.9%;
  - Seattle: 5.4%; and
  - Austin: 5.2%.

With healthy demand fundamentals, cyclically low vacancy rates, and strong rental absorption, the development pipeline of apartment properties planned and under construction continues to expand. New development will likely be constrained by the rising cost of construction and the availability of equity capital, curtailing the rise in new supply through this stretch of the current growth cycle.

- Through year-end 2013, multifamily starts (buildings with 2 or more units) reached the highest year-end level of new starts activity since 2007, at 308,000 units, significantly exceeding the 245,000 multifamily starts in 2012. Multifamily starts, however, were short of the most recent peak of 352,000 in 2005 at the height of the condo construction boom.

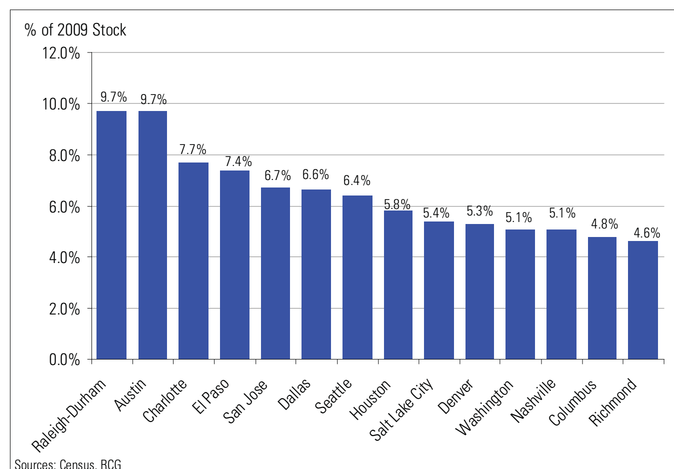
Multifamily Starts



Sources: Census, RCG

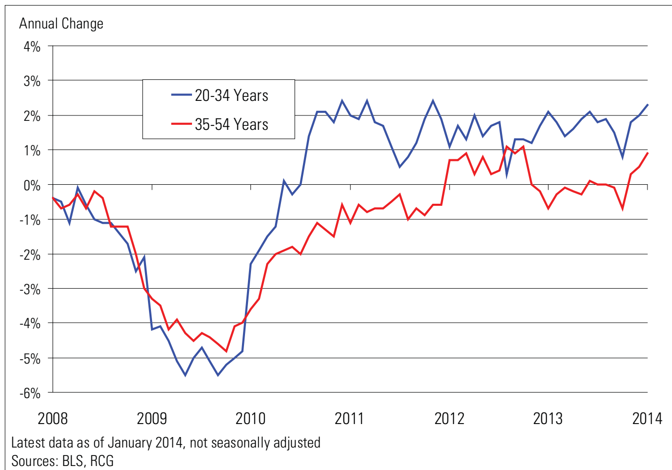
  - In 2013, multifamily starts in the South region increased to 139,000 units started, up nearly 20% from 2012. Rental properties accounted for 94% of the annualized units started.
  - In the West region, multifamily starts increased to 82,000 units in 2013, representing a 32% increase in units started compared with 2012. New condominium development is beginning to increase, particularly in strong for-sale housing markets such as San Francisco.
  - The Northeast started 41,000 multifamily housing units in 2013, up by approximately 28% from 2012, with rental units representing 78% of all multifamily starts during the year.
  - Multifamily housing starts in the Midwest region reached 48,000 units in 2013, up by nearly 30% from 2012. Rental units accounted for approximately 96% of starts in 2013.
- At the market level, new construction activity, as measured by permitting activity continues to rise in response to strong rental absorption, healthy operating conditions and robust household formation. New development in recent years has been particularly active in both core and secondary markets

Permit Activity (2010-2013) As a % of Existing Multifamily Stock



Sources: Census, RCG

Employment Growth by Age Group



Latest data as of January 2014, not seasonally adjusted
Sources: BLS, RCG

throughout the South and West regions.

- The number of permits issued since 2010 represents 9.7% of the existing multifamily housing stock as of 2009 in both the Raleigh-Durham and Austin markets.
- New multifamily permits issued in Charlotte from 2010 through 2013 represent 7.7% of the overall multifamily stock in 2009.
- Permitting activity during the past four years in El Paso represents 7.4% of the 2009 existing multifamily housing stock.

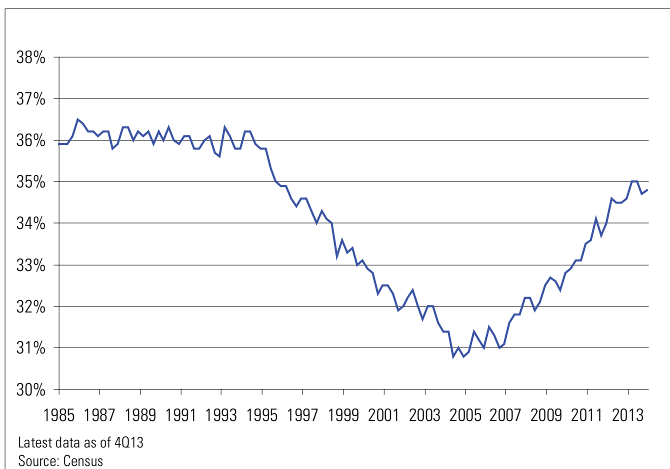
- Multifamily completions grew steadily in 2013 increasing to 195,000 units, up from 163,000 units in 2012 and the most recent annual trough of 138,000 units in 2011.
- Demand fundamentals continue to benefit from a number of favorable economic and demographic trends.
  - Healthy employment growth in the renter-aged population continues to benefit rental unit absorption. Through December 2013, job creation among 20-34 year-olds, the prime renter-age cohort, increased by 2.0% year-over-year, up from 1.7% growth during 2012. In comparison, employment growth among the 35-54 year-old cohort increased by 0.5% through December year-over-year.
  - New household formation among 25-34 year-old households increased for the third consecutive year, with 172,000 additional households, or an increase of 0.9% compared with 2012. Growth in the 65+ year-old households is also supporting increased rental unit demand, with 1,081,000 new households formed in this age cohort during 2013.
  - The rentership rate continues to rise steadily with renter households representing 34.8% of total households in the fourth quarter of 2013, up from 34.6% during the fourth quarter of 2012, and far exceeding the year-end low point of 30.8% in 2004 during the for-sale housing boom.

While the development pipeline continues to lengthen, owing to the extended construction timeline, the current level of apartment completions remains modest. Vacancy rates continue to trend downward, while average rents rise at a healthy pace in response to sustained rental demand. With increasing rental income and strong investor demand for multifamily assets, cap rates remain low despite the rise in interest rates during the past year. With favorable demand-side fundamentals and a modest level of new apartment completions nationally, RCG places the multifamily property market at 7:30 in the growth phase of the RCG Real Estate Cycle Clock, leading all real estate property types through this point in the cycle.

Condominium Market

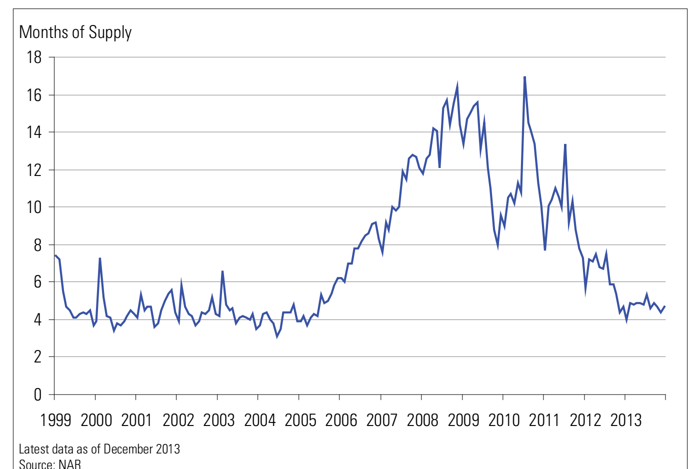
Declining rental affordability and improving for-sale housing markets, combined with extremely limited new supply in recent years, caused the inventory of available condominium units to decline substantially and condominium pricing to rise throughout much of the nation. Price gains were most prominent in markets such as Las Vegas and South Florida, which had previously

Renter Households Proportion of Total Households



Latest data as of 4Q13
Source: Census

U.S. Condos and Co-ops Housing Inventory

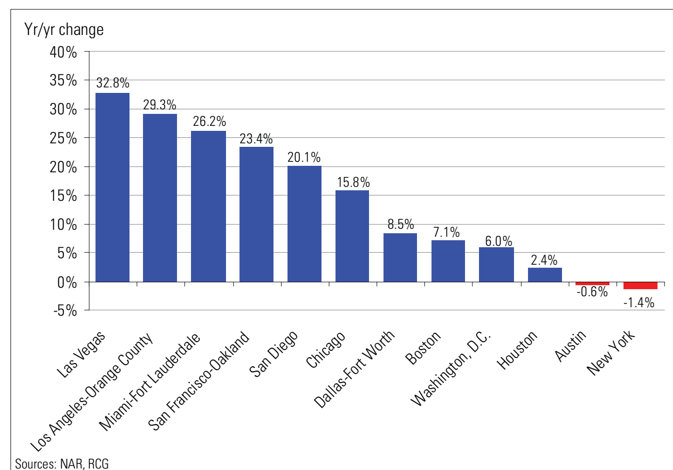


Latest data as of December 2013
Source: NAR

experienced the largest excess of newly constructed condominium units during the recession. Although condominium demand remains tepid nationally, improved pricing and the limited inventory led a modest amount of new for-sale construction and planned condo-conversion activity in select markets. Condominium starts are expected to rise steadily in the coming years; however the number of deliveries should remain well below the levels during the previous cycle, allowing for ongoing price appreciation.

- Existing condominium sales through December 2013 totaled 570,000 sales at a seasonally adjusted annual rate, unchanged from the number of sales in December 2012.
- In December, on a seasonally adjusted, annualized basis, condo sales increased by 14.3% in the Midwest region year-over-year. Condominium sales activity was flat in the Northeast and South regions, remaining unchanged compared with December 2012. Sales activity slowed considerably, falling by 7.1% in the West region year-over-year.
- With a modest increase in condominium construction, the level of inventory was essentially unchanged year-over-year, dipping by just 0.4% from December 2012 to 223,000 condo units in December 2013. Similarly, the months of supply inventory ended the year at 4.7 months, equivalent to the inventory level one year earlier.
- With limited of inventory, increased competition for available condominium units led to significant price appreciation across a number of major markets through 2013. As of December, the median condominium sales price rose by 10.9% year-over-year to $198,600.
- The rapid growth in condo sales in the West led to a 21.9% year-over-year increase in the median sales price to $264,700 in the fourth quarter of 2013.
    - The median condo sales price in Sacramento surged by 46.9% year-over-year to $126,800 in the fourth quarter.
    - Las Vegas values increased by 32.8% year-over-year to $93,100 in the fourth quarter.
    - Condominium prices in Los Angeles increased by 29.3% to $362,900.
    - San Francisco metropolitan-area (which includes the East Bay) prices rose by 23.4%, reaching $534,800.
    - Phoenix price appreciation increased by 22.7%.
    - Condominium prices jumped 20.1% year-over-year in San Diego.
    - Portland values rose by 19.2%
- The median condominium sales price in the South region increased by 15.0% year-over-year, rising to $150,400.
    - The median price in Atlanta rose by 46.4% year-over-year in the fourth quarter to $125,300.
    - Median pricing in Jacksonville gained 41.5% to $110,100.

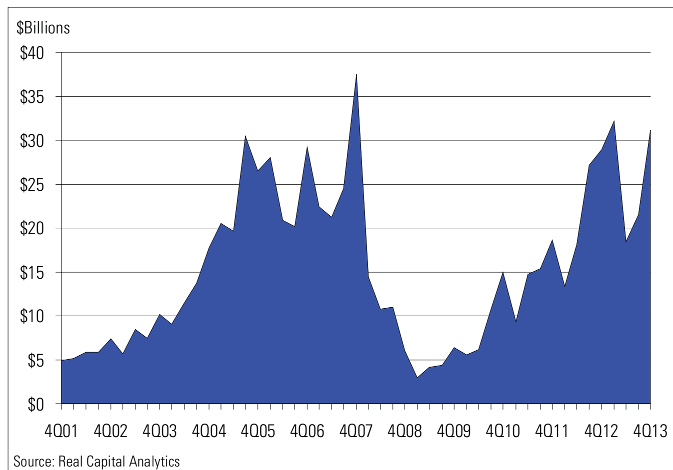
Condo-Coop Median Home Price Appreciation for Select MSAs, 4Q 2013



Sources: NAR, RCG

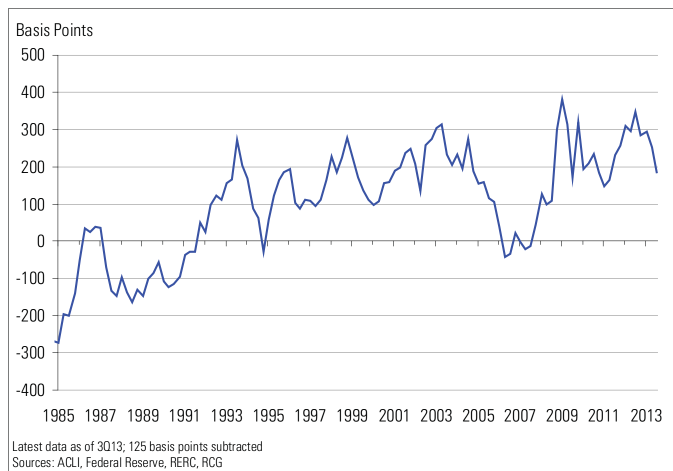
    - Miami values surged by 26.2% year-over-year to $136,900.
    - Dallas prices increased by 8.5% year-over-year.
    - Median prices in Tampa rose by 6.3%.
    - Norfolk condominium pricing increased by 3.0%
    - The median price in Houston rose by 2.4% to $145,800.
    - Austin prices contracted by less than 1% year-over-year.
- Median sales prices in the Northeast region increased by 3.0% year-over-year to $246,900.
    - Condo prices in Newark increased by 7.5% year-over-year in the fourth quarter.
    - Boston prices increased by 7.1% to $325,800.
    - Median pricing in Central New Jersey rose by 6.1%.
    - Condo prices in Washington, D.C. increased by 6.0% year-over-year.
    - Baltimore prices rose by 4.1% year-over-year.
    - Prices in New York fell by 1.4% year-over-year.
- Median sale prices in the Midwest region increased by 10.3% in the third quarter of 2013 to $138,200.
    - The median sale price in Chicago increased by 15.8% year-over-year to $143,200.
    - Median sales prices in Indianapolis rose by 5.7% year-over-year.
    - Columbus values increased by 4.8% year-over-year.
    - Milwaukee prices rose by 3.4% year-over-year.
- Condominium demand is expected to rise steadily going forward, generating increased pressure on prices and providing support for greater condominium construction activity going forward. Through the near term, condominium starts should increase gradually, before stabilizing in the medium term near 55,000 units per year from 2016 through 2018. In total, condominium construction should account for 15.3% of all multifamily starts in the United States during the forecast period.

Total Multifamily Sales - Apartment



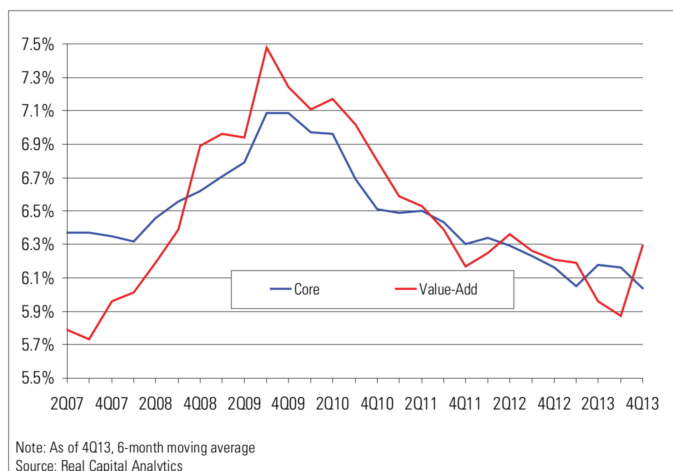
Source: Real Capital Analytics

Apartment Cap Rate vs. 10-Year Treasury Yield



Latest data as of 3Q13; 125 basis points subtracted
Sources: ACLI, Federal Reserve, RERC, RCG

U.S. Apartment Transaction Cap Rates by Investment Type



Note: As of 4Q13, 6-month moving average
Source: Real Capital Analytics

Investment Market

Ongoing income growth and a healthy market outlook continued to draw investors into the apartment market. As a result, the sustained flow of investment capital has provided the liquidity for acquisitions and new developments in apartment markets across the country. As investors compete over opportunities particularly in core markets, cap rates have contracted to historical lows. At the same time, rent levels in primary apartment markets continue to reach new highs, testing affordability constraints that may limit rental appreciation and income growth going forward. Looking ahead, investors are expected to turn to secondary and tertiary markets as well as value-add investments in order to achieve higher returns. Even as interest rates increase, elevated investment activity, particularly in core, multifamily assets, will likely limit the rise in cap rates through the near term.

- U.S. apartment transactions volume during 2013 totaled $103.5 billion– an 18.2% increase compared with total apartment sales activity during 2012, according to Real Capital Analytics. Apartment prices increased by 12% in 2013, with an average price per unit of $111,800.
  - Apartment sales in the combined Northeast and Mid-Atlantic region increased by 18.5% during 2013, accounting for $30.7 billion in property sales.
  - Multifamily sales in the Southeast region rose by 27.4% compared with 2012, to $19.9 billion in multifamily property sales.
  - Total apartment transaction volume fell by 5.3% to $6.3 billion in the Midwest region during 2013.
  - Multifamily transaction volume expanded by 17% year-over-year in the Southwest region, reaching $20.5 billion in property sales.
  - Sales activity in the West region increased by 10.3%, with total sales volume rising to $23.7 billion.
- In the fourth quarter of 2013, the average cap rate fell to 4.3%, down from 4.6% in the third quarter of 2013 and from 4.9% in 2012, according to ACLI. While the average cap rate is expected to rise through the near term, it remains well short of the long-term historical average of 7.1%.
- Demand for core investment opportunities remains very strong, with transaction-based cap rates for core deals contracting, while cap rates for value-add deals increased slightly through the year-end. The average six-month cap rate for core property transactions contracted to 6.0% through the fourth quarter of 2013, down from 6.2% the previous quarter, according to Real Capital Analytics. In comparison, the average six-month cap rate for value-add transactions rose to 6.3% through the fourth quarter, up from 5.9% last quarter and little changed from 6.2% in the fourth quarter of 2012. By market type, transaction-based cap rates for core

markets compressed to 5.5% in the fourth quarter of 2013, down from 5.7% during the same period a year earlier. Cap rates for secondary and tertiary markets rose to 6.6% and 7.3% respectively during the same period.

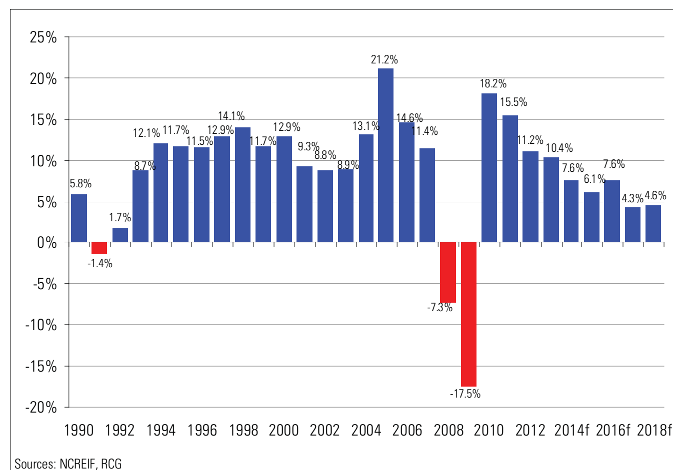
- Following several years of limited activity, portfolio transactions accounted for much of the growth in investment volume during 2013, fueled by strong investor demand and expanded access to capital. Sales of individual properties actually declined compared with 2012. Major mergers and acquisitions during the past year included the $16 billion purchase of Archstone by Equity Residential and AvalonBay and the merger of Essex and BRE properties.
- In the third quarter of 2013, the most recent data point available, the agency and GSE-backed mortgage pools expanded to $138 billion, increasing approximately 32% from the third quarter of 2012. Although, agency programs continue to be a major source of multifamily mortgage capital, potential changes to mortgage finance industry would likely promote a greater share of private-sector multifamily financing going forward.
- During the fourth quarter, life insurance companies made nearly $6.3 billion in apartment mortgage commitments, representing 43.4% of total commercial mortgage commitments in the quarter, up significantly from the approximately $2.2 billion in apartment mortgage commitments in the fourth quarter of 2012, according to ACLI.
- Through 2013, the NCREIF total return index rose by 10.4% year-over-year compared with 2012, with capital returns increasing by 5.1%. Income returns expanded by 5.2% year-over-year.

The Outlook

Apartment market conditions are expected to continue to improve going forward, though at a more modest pace compared with recent years, as new construction starts and deliveries rise in response to elevated rental demand. Renter household formation will likely continue to growth at a healthy pace, consistent with the rate of job creation, particularly among young, renter-age workers. With the exception of select markets where oversupply will be a concern, growth in renter demand should offset the amount of new supply, maintaining relatively tight national apartment market conditions throughout the forecast period. Vacancy rates should continue to compress slightly before stabilizing, while rent growth will increase, though at a more sustainable pace compared with recent years. As the current cycle progresses, slower rent growth and rising cap rates will likely result in decreased investment volume as total multifamily returns moderate through the latter part of the forecast period.

- Following the 308,000 multifamily starts in 2013, starts should peak during 2014 at 380,000 units and slowly taper through the duration of the forecast period, decreasing to 280,000 units started in 2018.

Private Market Total Return (NCREIF) Multifamily



Sources: NCREIF, RCG

- Despite the rise in multifamily starts and construction completions in the coming years, renter household formations are expected to outpace the rate of new unit deliveries through 2016. During this time, the overall vacancy rate and the 5+ unit vacancy rate should contract to 7.9% and 8.3%, respectively. Thereafter, ongoing construction and moderating economic conditions will likely result in a slight uptick in the vacancy rate starting in 2017.
- Apartment rent growth should continue to increase though at a slower pace compared with rent growth during the past three years. Rental appreciation for professionally managed apartments is expected to increase by an average 2.3% annually through 2018, while CPI rent growth should average 1.8% per year throughout the forecast period.
- As interest rates rise, debt financing will become more costly and, combined with reduced rent growth, should constrain investment activity. At the same time, the average cap rate should rise with increased non-core asset transactions. The average cap rate is expected to increase steadily, reaching 5.5% by 2016, but remaining less than the historical average through the duration of the forecast period.
- With rent growth slowing and gradually increasing cap rates, total results are expected to decrease substantially going forward. Total NCREIF returns reached 10.4% in 2013. Returns should average 7.1% annually through the near term, decreasing to an average of 4.4% from 2016 through 2018.

Conclusion

Favorable demographic trends and sustained job creation among renter-aged households should support ongoing renter-household formation and healthy rental unit absorption through the forecast period. While multifamily starts should peak in the coming year, new construction completions remain moderate with healthy rent

growth anticipated during this time. Given the large development pipeline, the risk of oversupply will become a growing concern for a few markets going forward. Nationally, however, apartment market fundamentals remain strong. Rental unit demand will likely continue to outpace new completions at least through the near term, and apartment market conditions should remain relatively tight throughout the forecast period.

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The National Office Market

Randall Sakamoto

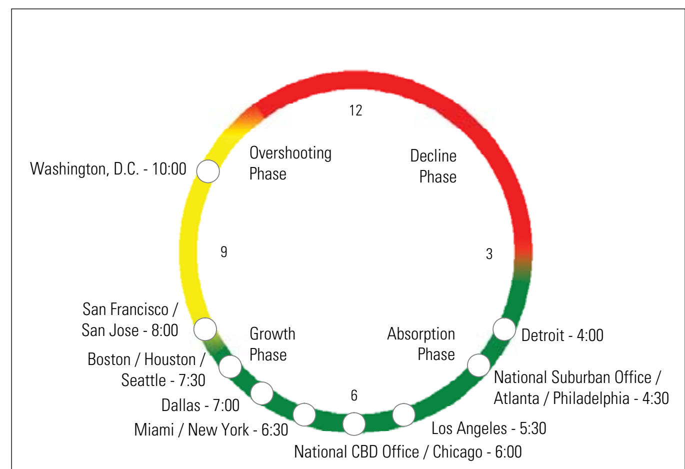
While headwinds and the choppy economic recovery helped to slow the office market rebound in the second half of 2013, the national office market is clearly in a better position than last year. Tenant demand is on the rise throughout the country and the recovery cycle is evident in secondary and tertiary cities. Even as operating conditions improved, the amount of new supply remained minimal and should continue to focus the growing tenant demand on the existing supply of available space, leading to moderate increases in rent growth and asset values.

The economic recovery progressed further, driven primarily by expansion within the technology, energy and other knowledge-intensive fields. The bulk of recent hiring was within the service-providing industries and led by the professional and business services sector. In the past year, office-using employment increased by 2.7%.

- In the past year, office-using employment increased by nearly 770,000 workers. From 2011 through 2013, nearly 2.08 million office-using jobs were created across the country.
- In 2013, office-using employment surpassed the pre-recession peak.
- By the end of 2013, office-using employment reached a record high as a share of jobs in the United States.
- The professional and business services sector continued to drive the bulk of job creation, with strong hiring throughout the past several years in knowledge-intensive industries.
- While hiring in the financial activities sector remained constrained by regulatory uncertainty, nearly 83,000 jobs were created in the past year.

Overall office demand improved; however, operating conditions were impacted by the choppy nature of the economic recovery. Additionally, tenant demand remained bifurcated, with an outright economic boom in parts of the San Francisco Bay Area and Texas leading to a high level of demand for office product. On the positive side, leasing velocity accelerated even in tertiary markets as local economies continued to recover from the recent recession.

Real Estate Cycle – Office



- The vacancy rate remained in the high-15% range throughout much of the past year. In the second half of 2013, tenant demand stabilized but remained positive. By year-end, leasing volume was 3.5% higher than in 2012, a moderate slowdown from the 7.5% growth rate at mid-year.
- Despite the decelerating leasing velocity, rent growth accelerated to 4.3% by the end of 2013. In the second half of the year, rent growth within suburban regions finally began to recover.

Improving operating conditions and greater capital availability continued to spur a modest rise in office construction. Overall, development activity remained restrained and the bulk of construction projects were concentrated in several cities.

Outlook for the National Office Market

	2005	2006	2007	2008	2009	2010	2011	2012	3Q13	2013e	2014f	2015f	2016f	2017f	2018f
New Construction* (Put-in-place, 2009 $ Bill.)	$45.6	$49.6	$55.1	$54.2	$37.3	$24.7	$23.3	$26.9	$28.6	$29.0	$31.0	$33.0	$34.0	$36.0	$37.0
Office-Using Employment Growth	2.8%	2.3%	0.7%	-3.2%	-5.0%	1.4%	2.4%	2.5%	2.7%	2.8%	1.8%	1.5%	1.3%	0.2%	1.0%
Office Vacancy Rate	15.1%	13.1%	12.6%	14.4%	17.7%	17.6%	16.7%	16.0%	15.8%	15.8%	15.0%	14.2%	13.4%	13.8%	13.8%
CBD Vacancy Rate	12.5%	10.6%	9.7%	11.2%	14.7%	14.4%	13.5%	13.1%	13.4%	13.5%	12.4%	11.2%	9.9%	10.4%	10.5%
Suburban Vacancy Rate	16.7%	14.5%	14.3%	16.2%	19.3%	19.4%	18.5%	17.6%	17.2%	17.0%	16.5%	15.9%	15.4%	15.7%	15.7%
Overall Rent Growth	2.1%	8.8%	10.9%	4.1%	-8.1%	-1.0%	0.9%	2.1%	3.4%	3.8%	2.9%	3.2%	4.2%	2.3%	2.1%
CBD Rent Growth	2.1%	13.2%	15.5%	8.5%	-11.5%	-0.6%	1.2%	3.4%	3.3%	4.3%	3.4%	3.8%	4.6%	2.4%	2.5%
Suburban Rent Growth	2.4%	7.2%	9.1%	2.2%	-7.3%	-0.5%	0.3%	1.1%	3.1%	3.6%	2.8%	2.9%	4.0%	2.2%	2.0%
Cap Rate	6.1%	5.7%	5.4%	5.6%	7.2%	5.8%	5.3%	5.3%	4.7%	5.3%	5.5%	5.8%	6.3%	6.5%	6.4%
NCREIF Total Return	19.5%	19.2%	20.5%	-7.3%	-19.1%	11.7%	13.8%	9.5%	9.7%	9.9%	6.6%	4.8%	3.6%	4.5%	6.9%
Capital Return	12.0%	12.3%	14.4%	-11.8%	-24.3%	4.6%	7.4%	3.7%	4.0%	4.4%	0.9%	-1.1%	-2.8%	-2.2%	0.0%
Income Return	6.9%	6.3%	5.5%	4.9%	6.4%	6.9%	6.0%	5.7%	5.5%	5.5%	5.6%	6.0%	6.4%	6.7%	6.8%
Delinquency Rate	0.22%	0.04%	0.01%	0.03%	0.15%	0.28%	0.19%	0.14%	0.04%	0.08%	0.13%	0.15%	0.20%	0.20%	0.20%

* Numbers in quarterly columns are annualized.
Sources: ACLI, BEA, BLS, Census, Cushman & Wakefield, NCREIF, RCG

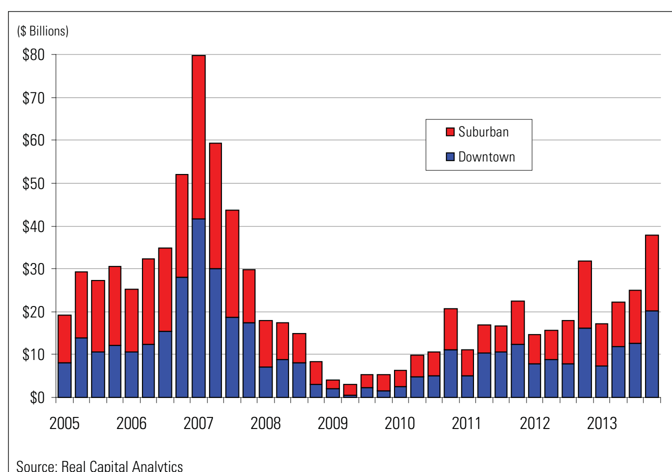
- The value of put-in-place construction reached $29 billion in 2013. With the cost of materials and labor continuing to rise, and increased leasing volume leading to more tenant improvement projects, spending on office construction increased for the 11th consecutive quarter.
- Markets with a substantial amount of completed office product in the past year included Houston, Manhattan, and Washington, D.C.
- The pipeline of under construction projects continued to build, reaching 56.7 million square feet by the end of 2013. Much of the under construction activity was concentrated in Dallas, Houston, Manhattan and the San Francisco Bay Area.

The national office market recovery progressed further, ending 2013 on a positive note following a modest slowdown in the middle of the year. Despite this temporary lull, leasing volume increased relative to the previous year and this spurred a modest amount of rent growth. The recovery cycle spread into secondary and tertiary markets as the local economies in these cities continued to recover from the recession. Even as operating conditions improved, the supply-side response was muted, with few projects under way outside of a handful of cities. With little risk of oversupply at the national level and steady improvement in leasing demand fundamentals, we maintain our view that the CBD office market is at 6:00 and the suburban office market is at 4:30 on the RCG Real Estate Cycle Clock.

Investment Market

Investment activity accelerated at the end of 2013 and into early 2014. Despite the increase in the 10-year Treasury yield and rising cost of capital, office acquisitions remained attractive for most investors. The recovery of investment activity in secondary and tertiary markets also progressed, driven by increased capital availability from the CMBS market and improving local economic conditions.

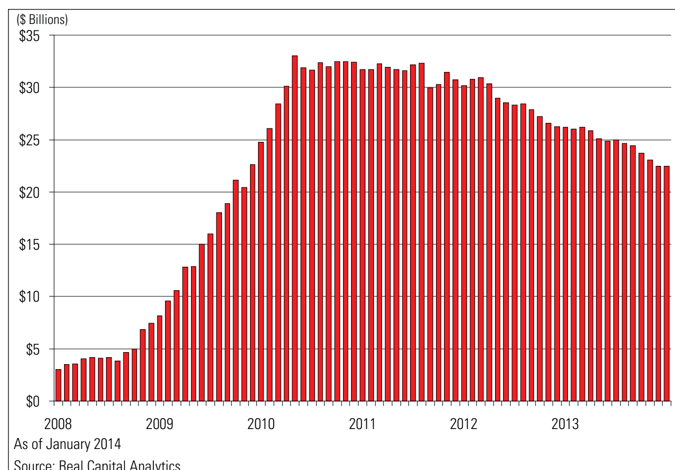
Quarterly Transaction Volume



Source: Real Capital Analytics

- Investment in office properties continued to accelerate, reaching nearly $98 billion in 2013, according to Real Capital Analytics, an increase of 27% from the previous year.
  - Acquisitions of assets within downtown cores remained elevated throughout the year, and increased by nearly 28% in 2013.
  - After lagging much of the initial stage of the recovery, investment in suburban office product accelerated in 2013 by 27%. Diminished yields in urban cores continued to shift some investors to suburban assets.
  - The average transactional cap rate remained in the high-6% range despite the rise in the 10-year Treasury bond yield in late 2013.
  - The differential between CBD and suburban cap rates remained wide at approximately 120 basis points, nearly double the average differential from 2001 to 2010.
  - The return of CMBS originations helped to provide capital for office acquisitions, particularly within secondary and tertiary markets. This helped to spur a surge in acquisitions in markets such as Atlanta and Orlando.
  - Capital remained concentrated on major office markets, but steadily shifted towards smaller markets in recent quarters. Improving asset values and operating conditions within secondary and tertiary markets helped to slightly narrow the cap rate spread to major cities.
  - The rising cost of capital continued to limit the number of bidders for some assets, but has yet to curtail the increase in asset valuations to a measurable degree.
  - Private capital sources remained significant net acquirers of office assets. In the past year, net acquisition activity totaled nearly $4.9 billion.
  - Office investment remained attractive for foreign buyers, with nearly $16.7 billion of acquisitions in 2013. Foreign investors continued to concentrate on major cities and urban cores: more than 80% of investments last year were in downtown areas.
  - As corporations continued to monetize real estate assets, user dispositions were nearly 58% greater than acquisitions.
  - Investment within the medical office segment continued to accelerate, with nearly $7.6 billion of asset acquisitions last year, an increase of 13.2% from 2012.
  - The substantial amount of capital raised in the past few years for net lease funds and REITs helped to spur a surge in single tenant office purchases. In 2013, investment volume for single tenant office product increased by more than 45%.
- Improving operating conditions and increased access to refinance capital continued to drive the volume of distressed

Total Distressed Assets - Office



As of January 2014
Source: Real Capital Analytics

assets lower. By early 2014, the volume of distressed office properties fell to $22.5 billion, a decrease of more than 14% from the previous year.

- While the majority of distressed office assets are securitized loans, financial institutions accounted for more than $4.9 billion of the distressed volume.
- As lenders are better able to dispose of repossessed assets, the volume of REO office buildings fell to $9.7 billion, the lowest amount since 2010.
- The more conservative underwriting by life companies during the past cycle continued to help loan performance, even for distressed loans. The average loss severity rate for life companies was estimated at 26%.

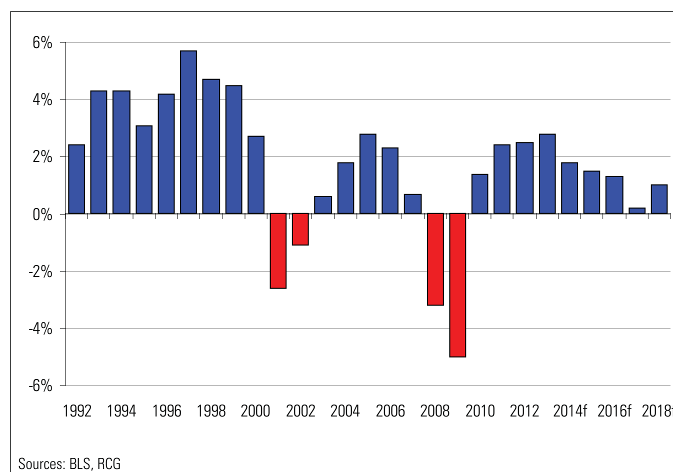
- Delinquent securitized office loans remained a significant issue, as refinance capital underwriting is generally more conservative now than during the period when most of these loans were originated. Although improved operating conditions helped some borrowers hold on to assets, the rise in asset valuations is causing some lenders and special servicers to be less flexible than in the recent past.
  - The CMBS delinquency rate fell to 7.5% in January, down from the mid-8% range only three months earlier, according to Morningstar. The unpaid principal balance on delinquent loans totaled $12.5 billion, down by more than $4.5 billion from the previous year.
  - The office sector accounted for 32% of delinquent securitized loans.
  - While still the largest share by property type, the volume of office assets in special servicing decreased to $15.8 billion from $22.1 billion the previous year.
  - In 2013, the average loss severity rate improved as operating conditions and asset values improved. Of the nearly $4.0 billion of outstanding office CMBS liquidated in 2013, the average loss rate was 44.6%, a modest improvement from the 47.4% loss rate in 2012.

The Outlook

The next several years should produce a continued recovery in leasing fundamentals throughout nearly all markets. Tenant demand should accelerate, particularly in the secondary, tertiary and inland cities that lagged much of the recovery to date. Office tenants in gateway cities and technology- and energy-centric markets will also increase absorption through the near term.

- Through the near term, office-using employment growth should continue at a moderate pace, before slowing slightly in the latter stages of the forecast horizon.
  - During the next five years, we project annual average hiring of 336,000 positions within the office-using sectors.
- Leasing volume should accelerate during the next few years as the broadening economic recovery prompts tenants of various sizes and industries to relocate or open new locations. The amount of leases rolling in the near term is sizable and will contribute to additional leasing volume in most cities.
  - The rebound in tenant demand will continue to spread throughout secondary and tertiary markets. As the local economies in these smaller cities recover, office leasing activity should follow suit.
  - Anecdotal evidence of an uptick in property tours from prospective tenants in 2013 should translate into an increase in signed leases this year.
  - The increase in demand, combined with little new construction in most cities, will make 2014 a transformative year as leverage shifts from tenants to landlords across a broad array of cities.
  - Location and access to transportation infrastructure will remain a priority for most tenants. The revitalization of urban cores will continue and high-rise office properties in many cities will benefit from increasing resident populations and amenities.

Office-Using Employment - Annual Percent Change

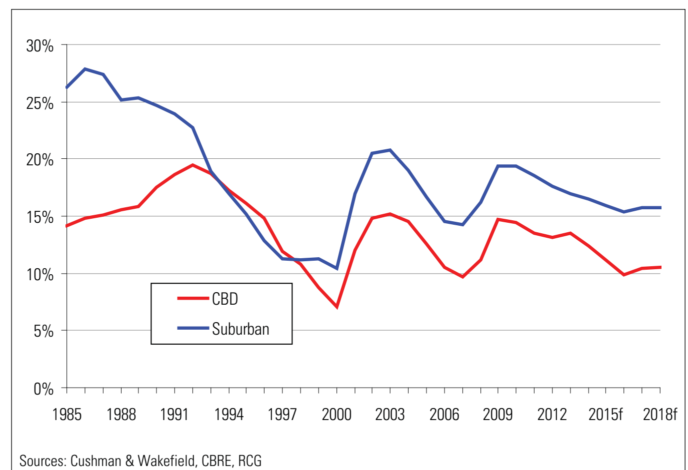


Sources: BLS, RCG

- Although the number of space options is decreasing, rents are still relatively affordable in most markets and the flight-to-quality trend should persist for the next year in many cities.
- Densification and more efficient utilization of space will continue to transform the office sector, though perhaps not to the extreme some expect. As tenants relocate, more firms will utilize open floor plans. Changes in workplace demographics and need by employers to compete for top talent should foster this trend for the long term.
- Additionally, traditional office tenants will shrink space footprints as they utilize technology to reduce the amount of space required for paper documents and storage. Some traditional office users are able to reduce leased square footage by one-third upon relocation as they adapt new floor plans to better utilize technology.
- While densification is a secular shift in office space utilization, there are limitations on density before worker productivity is negatively impacted. We also expect that firms, in particular technology companies that value collaboration and innovation, will continue to place a premium on providing multiple work areas for employees.
- In order to better position assets to take advantage of the densification trend, older office buildings may need to be renovated with building services and life safety systems to handle a higher capacity. The risk of functional obsolescence will be heightened for some older assets that are unable to offer flexible floor plans needed by tenants.
- Environmental and energy-conscious amenities will become even more important to a broad array of corporate tenants. LEED certification and socially responsible measures will become more prominent requirements as corporate ESG policies guide location decisions.

- The national vacancy rate should continue to trend lower through the near term. By 2016, we project the vacancy rate will reach the mid-13% range before stabilizing in the high-13% range for the next two years. The slowdown in leasing volume combined with construction deliveries support our expectation of a modest rise in the vacancy rate in the latter stage of the forecast period.
  - Significant decreases in the vacancy rate are projected in markets including Austin, Southern California and Seattle.
  - The vacancy rate should improve, but at a modest pace, in markets throughout the Midwest and Mid-Atlantic regions. The slower pace of economic improvement in these markets will constrain the recovery in office demand.
- Following the temporary lull in the second half of 2013, the CBD vacancy rate should resume a downward trajectory, reaching single-digit territory in 2016. Thereafter, the vacancy rate should increase modestly to the mid-10% range into 2018.

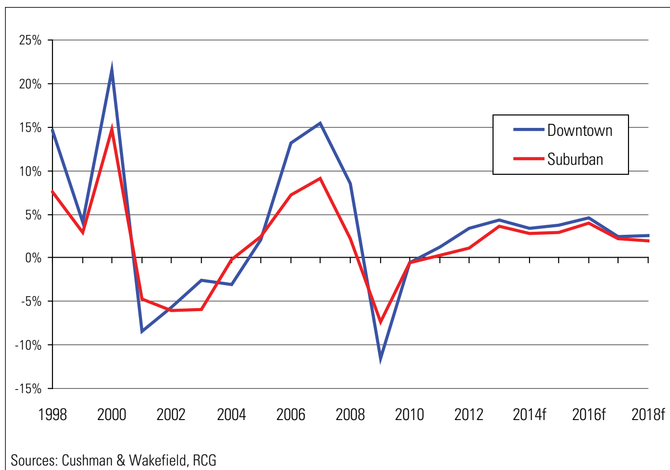
Office Vacancy Rates



Sources: Cushman & Wakefield, CBRE, RCG

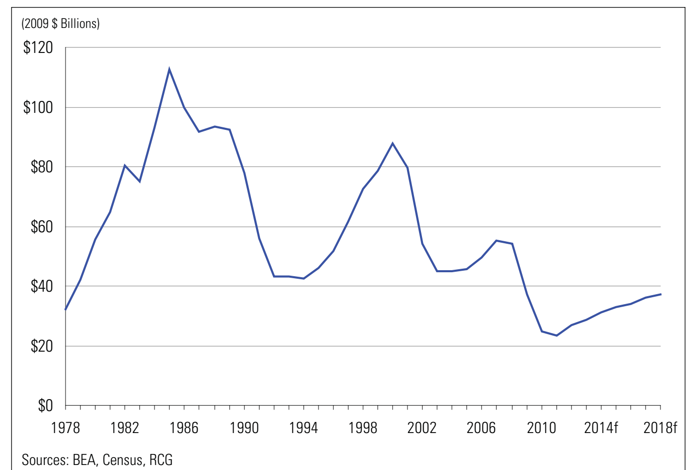
  - In gateway cities, the availability of large blocks of space will likely remain minimal through the near term. While these large economies are often more stable, the diversified clusters of industries should combine to generate a high level of growth in office space demand.
  - With space conditions already tightened in several large cities, the near-term improvement in the vacancy rate by secondary and tertiary CBDs could outpace larger markets.
  - Our forecast calls for substantial decreases in the CBD vacancy rate in Denver, Nashville, Seattle and San Jose.
- The suburban vacancy rate should improve at a modest pace through the next several years, reaching the mid-15% range by 2016. The slowdown in leasing velocity in 2017 should push the vacancy rate to 15.7% in 2017 and 2018.
  - The difference in tenant demand between well-located and desirable submarkets relative to those on the periphery will remain high in most cities. With effective rents still lower than the previous cycle in most submarkets, tenants will remain focused on higher-quality assets and submarkets in the near term. In the longer term, the availability of transportation options and amenities will continue to attract tenant demand to these better submarkets.
  - As it will take some time for tenants to absorb the large amount of vacant space in peripheral submarkets and lower-quality buildings, the broader market-level vacancy rates will remain elevated and mask the improvement of the well-positioned submarkets.
  - The technology-related office markets, including Austin, Oakland and Silicon Valley, should continue to outperform.
  - Other markets with substantially improved vacancy rates are Atlanta, Los Angeles and San Diego.

Office Rent Growth



Sources: Cushman & Wakefield, RCG

Office Construction Put-in-Place



Sources: BEA, Census, RCG

  - The weakening tenant demand and drive by the GSA to relocate federal agencies into owned properties will maintain an elevated vacancy rate in the submarkets surrounding Washington, D.C.
- The steady absorption of vacant space should lead to moderate rent growth in most markets. RCG expects annual average rent growth of 3.4% from 2014 through 2016, slowing to 2.2% per year in 2017 and 2018.
  - Downtown rent growth should outpace the suburbs through the forecast horizon. During the next several years, we project CBD rent growth averaging 3.9% per year through 2016, compared with 3.2% suburban rent growth during the same period.
  - We expect the strongest CBD rent growth in Boston, Denver, New York, San Francisco and Seattle.
  - The strongest suburban rent growth is projected in Austin, Boston, Silicon Valley and West Los Angeles. The tech-related submarkets across the country are generally expected to be at the forefront of rent growth through the next several years.
  - The availability and dollar value of concessions will continue to steadily decrease in most cities.
- Development activity will continue to recover, though new projects should remain somewhat constrained by capital availability through the near term. The moderate rent gains and rising costs will also help to reduce the potential supply-side response in most regions.
  - Spending on put-in-place construction should steadily increase from $31.0 billion in 2014 to $37.0 billion in 2018. While construction spending will rebound from the recent trough, we expect spending will remain much lower than during the first half of the last decade.
  - In the near term, a large share of construction spending will be for deferred maintenance projects and tenant improvements.
  - From 2014 through 2018, we project approximately 243.8 million square feet of new construction, less than half of the delivered square footage from 2006 through 2010.
  - Markets with a significant amount of forecasted office construction include Houston, Manhattan, San Francisco, Silicon Valley, and Washington, D.C.
  - Increasing development costs greater than the pace of inflation will constrain some new construction. The expected increase in hard and soft development costs will raise financial hurdles for new projects.

Investment activity in the office sector will accelerate further, fueled by greater capital availability and elevated investor interest in real assets. Simultaneously, lending standards remain more stringent than the pre-recession period and investors remain somewhat cautious, leading to our expectation for a moderate acceleration in acquisitions but not a surge.

- Asset values remain less than the pre-recession peak and will take some time to recover fully.
- Demand for acquisition debt is high and lenders will continue to slowly loosen underwriting standards; however, we do not expect a return to the underwriting standards of the pre-recession period.
- Interest rate normalization will place additional upward pressure on cap rates even as operating conditions improve. Going forward, the rise in interest rates will cause a corresponding but smaller rise in cap rates. As expected, the first 100 basis-point rise in the 10-year Treasury yield had little impact on office cap rates. The next 100 basis-point rise is expected to have a minor upward influence on the average office cap rate. As interest rate normalization continues, the average office cap rate should rise into the mid-6% range. The wide spread between the cap rate and Treasury yield will narrow, allowing for a modest rise in the office cap rate during the next several years.

- In markets in the initial stages of the recovery in investment activity, the cap rate may move in an opposite direction to the 10-year bond yield temporarily. As these local office markets recover and increased investment leads to price appreciation, the local cap rates are likely to move lower even with interest rates rising.

- The search for yield will continue to shift some investment activity into secondary markets and value-add opportunities. In the near term, acquisitions may accelerate in cities such as Charlotte, Miami and Phoenix.

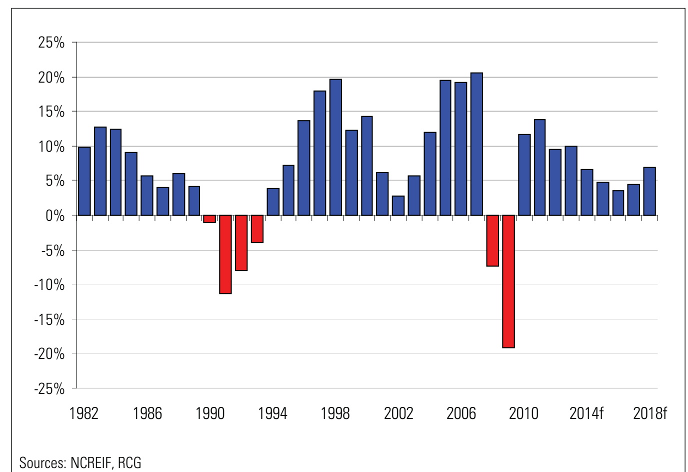
- While yields for core urban assets should remain tight, the wider availability of debt for this type of asset should support further price appreciation. As should be expected following a deep recession and disruption in capital markets, and a slow recovery period, less risky assets will remain highly desirable for the foreseeable future.
  - Globally, institutional investors will seek to increase real estate investments. Recent surveys depicted real estate portfolios for many institutions were under-weighted relative to allocation targets. Foreign capital investing in real estate typically prioritizes U.S. assets, particularly within gateway cities.

- Energy and technology markets will remain strong investment plays, with a large amount of capital focused on these types of markets.

- Despite increased asset price appreciation in smaller markets, the cap rate differential between gateway cities and secondary markets will remain wide in the near term. The differential should narrow and approach the historical average within the next several years.

- Once considered niche investment types, non-traditional office space will continue to evolve into mainstream asset categories. With many institutional investors under-invested in real estate, these property categories may be vehicles to reach allocation targets.
  - With some uncertainty regarding the Patient Protection and Affordable Care Act resolved, investment in medical office properties will accelerate. The decentralization of health care to outpatient facilities and medical offices beyond hospital campuses will spur underlying physician and patient demand for privatized medical office buildings. The strong demographics related to this segment will also drive long-term growth.
  - The net lease office segment should accelerate further. The large amount of capital raised for the sector and the continued desire by many corporations to monetize owned real estate assets will fuel further growth in the segment.

Total Rates of Return – Office Properties



Sources: NCREIF, RCG

- Even as debt and equity capital becomes more readily available at less restrictive terms, the volume of maturing debt poses a risk to the office sector. This wave of maturities will come due before market rents return to higher rates than in-place leases for many assets. With debt coverage ratios already low for many properties, the default risk remains elevated.
  - Borrower demand for bridge loans should be elevated for the foreseeable future. With many existing borrowers unable to recapitalize given current LTV requirements, mezzanine debt will remain an important component of the capital stack.
  - Although the delinquency rate should improve going forward, default by some high-value assets that are unable to recapitalize could cause temporary increases in the delinquency rate. Many assets could produce decreases in net income since landlords may be unable to replace in-place tenants with similarly valued leases because of the current level of achievable rents. The large volume of expiring leases, coupled with current rents lower than the previous cycle, could lead to additional mortgage defaults.
  - Securitized office loans accounted for 42% of new additions to the Morningstar watchlist. In early 2014, watch-listed office CMBS reached 2,350 loans with an aggregate balance of $51.4 billion. The office sector accounted for more than 37% of CMBS on the watchlist.
  - The impending maturity risk also remains elevated. In the next year, nearly $12 billion of office CMBS will mature. With refinancing options still limited, the balloon maturity default risk is high even for assets with debt-service coverage ratios greater than one. Furthermore, a large segment of loans are interest-only and will require full payment of principal at maturity. While only 1.2% of maturing office loans are delinquent, many more borrowers could default as they approach maturity because of an inability to refinance.

- Office investment returns should moderate in the near term to a sustainable rate. From 2014 through 2018, private returns should average 5.3% per year.
    - As interest rates normalize and risk is re-priced, the modest upward pressure on cap rates will offset some of the improvement in net income.

Conclusion

The office market recovery will continue and improving operating conditions should be evident in nearly all markets this year. Tenant demand already began to accelerate in early 2014, and leasing volume should be greater this year than the previous year. Additionally, a wider array of industries will increase leasing activity and small and mid-sized tenants should comprise a larger portion of leasing volume going forward. The increased tenant demand will lead to moderate rent growth for at least the next several years. Despite the improving operating conditions, new construction will remain conservative in the near term and the risk of oversupply outside of a handful of markets will be minimal. Investment activity should accelerate, with acquisitions increasing throughout the full range of cities. While investment returns will stabilize and cap rates may increase due in part to rising interest rates, our outlook for office market investment remains positive.

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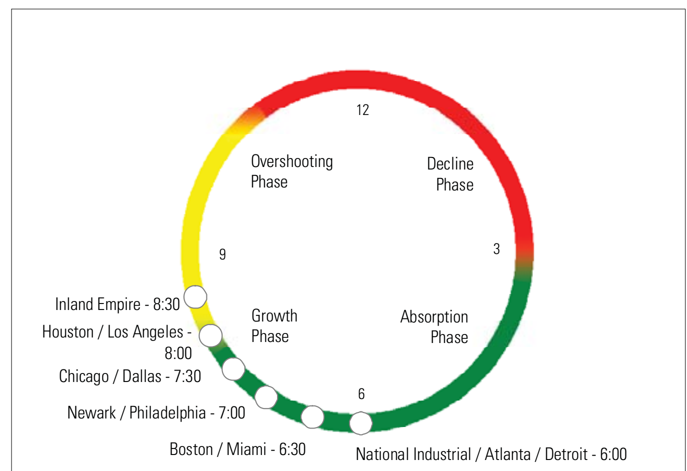
The National Industrial Market

Avani Patel

The industrial market continued to rebound in the latter part of 2013, with both domestic spending and international trade flows increasing at a healthy pace and driving growing demand for space. While the major distribution hubs remained the strongest performers, the recovery spread to secondary and tertiary markets, and most metropolitan areas across the nation experienced improving fundamentals. Strengthening operating conditions also spurred further recovery in investment activity. The winter storms that blanketed much of the country contributed to volatility in industrial activity indicators in early 2014, but prospects for growth remain positive. Accelerating economic activity should continue to move the industrial market further along the path to recovery during the next few years. Even as interest rates rise, improving operating conditions and the comparatively favorable inflating-hedging capabilities that industrial properties offer will maintain elevated investor interest in the sector.

- Pointing to favorable demand conditions, employment growth in industrial-related industries accelerated during the second half of 2013 and payroll gains for the year were moderately higher than 2012. Buoyed by a strengthening trade sector, approximately 300,000 new jobs were added within industrial-related industries in 2013.
    - The initial surge in manufacturing employment following the recession slowed further. Even with production rising, increased usage of technology and automation limited the number of new workers needed.
    - The trade sector grew at the fastest pace and accounted for 77% of industrial-related job gains in 2013.
- Business spending continued to drive activity in the economy. Industrial production increased steadily through the first nine months of 2013 and accelerated during the fourth quarter.

Real Estate Cycle – Industrial



    - The index hit a post-recession high during the fourth quarter, increasing by 3.3% from the previous year.
    - Growth in the durable goods component continued to outpace that in the non-durable goods component, led by higher output of automotive products and furniture. The motor vehicle and parts index grew by 7.4% from the previous year, while the furniture and related products index gained 8.4%
    - Bolstered by the housing market recovery, production of other home-related goods besides furniture, such as carpeting and construction supplies, also trended higher.
- Capacity utilization rose to 79.2%, the highest level since June of 2008, but still one percentage point below it's long-run average.
- Economic data released in early 2014 pointed to softening industrial activity more recently, as the harsh winter weather

Outlook for the National Industrial Market

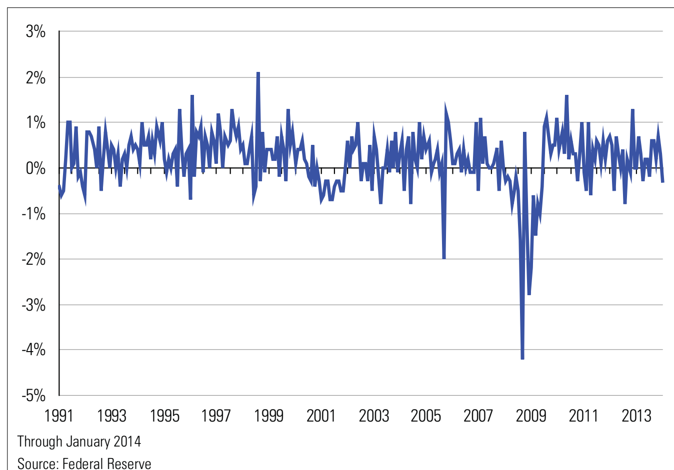
	2005	2006	2007	2008	2009	2010	2011	2012	3Q13	2013e	2014f	2015f	2016f	2017f	2018f
New Construction* (Put-in-place, 2009 $ Bill.)	$14.0	$14.6	$16.0	$15.2	$8.8	$5.3	$6.1	$6.3	$7.4	$7.8	$8.5	$9.5	$9.6	$10.0	$10.2
Manufacturing Employment Growth	-0.8%	-1.0%	-2.0%	-5.4%	-11.6%	0.6%	1.8%	1.4%	0.2%	0.7%	0.4%	0.4%	0.0%	-0.5%	0.2%
Trade Employment Growth	1.5%	0.9%	1.2%	-3.6%	-4.7%	0.6%	1.9%	1.6%	2.2%	2.0%	1.7%	1.7%	1.3%	0.5%	1.1%
Transportation & Utilities Employment Growth	2.1%	2.2%	1.0%	-2.3%	-5.2%	1.2%	2.2%	2.6%	1.1%	1.5%	1.2%	1.2%	1.3%	0.7%	0.8%
Industrial Production Index ('07=100)	95.5	97.6	100.0	96.6	85.7	90.6	93.6	97.1	99.5	99.6	99.8	100.5	101.4	99.1	100.4
Industrial Production Index Percent Change	2.3%	2.0%	2.5%	-3.4%	-11.3%	5.7%	3.3%	3.6%	2.5%	2.6%	0.2%	0.7%	0.9%	-2.3%	1.3%
Vacancy Rate	8.3%	7.3%	7.2%	8.3%	10.4%	10.3%	9.2%	8.3%	7.8%	7.5%	7.1%	6.8%	6.5%	6.6%	6.8%
Rent Growth	3.5%	10.0%	3.9%	0.8%	-21.9%	-5.5%	0.1%	3.5%	2.6%	3.9%	4.1%	4.3%	3.9%	2.0%	2.3%
Cap Rate	6.7%	6.0%	5.7%	6.1%	7.2%	7.3%	6.4%	6.1%	6.0%	5.5%	5.7%	6.3%	6.6%	6.6%	6.4%
NCREIF Total Return	20.3%	17.0%	14.9%	-5.8%	-17.9%	9.4%	14.6%	10.7%	11.7%	12.3%	9.7%	6.0%	5.3%	4.2%	5.0%
Capital Return	12.3%	9.8%	8.3%	-11.1%	-23.5%	2.0%	7.7%	4.3%	5.4%	6.3%	3.7%	-0.3%	-1.4%	-2.8%	-2.3%
Income Return	7.3%	6.6%	6.3%	5.9%	6.9%	7.3%	6.6%	6.3%	6.1%	6.0%	6.0%	6.3%	6.7%	7.0%	7.3%
Delinquency Rate	0.09%	0.01%	0.01%	0.03%	0.08%	0.21%	0.11%	0.10%	0.11%	0.10%	0.08%	0.07%	0.07%	0.10%	0.08%

* Numbers in quarterly columns are annualized.
Sources: ACLI, BEA, BLS, Census, Cushman & Wakefield, Federal Reserve, NCREIF, RCG

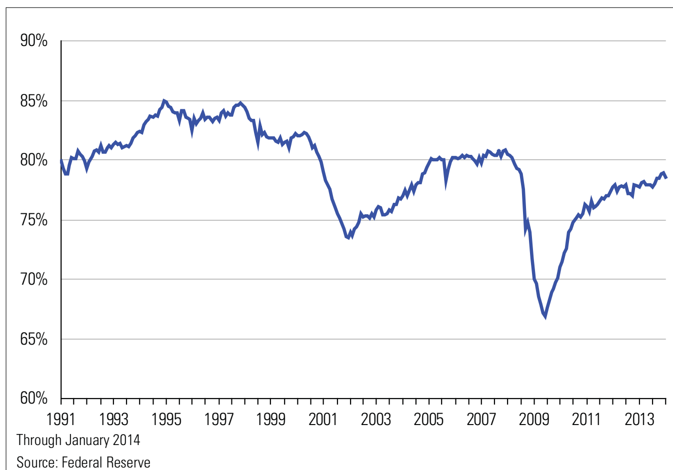
hampered supply chains and production; but, underlying growth momentum appears strong.

- Industrial production as well as new orders and shipments for manufactured goods all fell in December and January.
- However, after declining for two straight months, the Institute of Supply Management (ISM) reported that the index of national factory activity rose to 53.2 in February, up from January's 51.3 read, which was the weakest reading since May 2013. A rebound in new orders fueled the reversal.

Index of Industrial Production: Percent Change



Index of Industrial Capacity Utilization



- Consumer spending was resilient given only modest income gains, fueled by a strong recovery in the housing sector. Consumer spending rose by 2.6% in 2013 and 0.4% in January. However, spending on big-ticket items such as electronics and appliances was sluggish.
- The flow of cargo into and out of the country accelerated at a modest pace even as economic headwinds curtailed a greater improvement.
  - U.S. exports climbed by 2.1% in 2013, with broad-based gains in industrial supplies, capital goods, automotive vehicles, consumer products and food and beverages. Imports fell by 0.7% to $7.8 billion. However, while imports of industrial supplies declined during the year, imports of capital goods, consumer products, automotive vehicles and food and beverages all rose.
  - Containerized imports grew by 3.5% in 2013, while containerized exports gained 1.9%. Cargo volume along the West Coast increased in 2013, fueled by strong gains in Southern California. Container traffic through the Port of New York and New Jersey fell from the 2012 level, but contractions are subsiding.

With economic activity increasing, industrial market fundamentals continued to strengthen into late 2013. Demand for warehouse space increased further, particularly within large markets. At the same time, new construction remained very restrained, driving the national vacancy rate down to 7.5%, its lowest level since 2007. Tightening conditions supported healthy rent growth in many markets. Nationally, rents gained 4.0% during the year.

- While the inventory of high-quality space is at a low level, hindering more robust activity, leasing volume continued to accelerate. Total leased space rose by 6.0% in 2013.
  - Top-tier distribution hubs continued to generate the bulk of leasing activity. In aggregate, leasing in Atlanta, Chicago, Dallas, Houston and Southern California accounted for 48% of the national total in 2013.
  - Demand for big-box space also grew in secondary distribution and population centers. Baltimore, Cincinnati, Indianapolis, the Pennsylvania I-81/I-78 Distribution Corridor, Portland, Northern New Jersey and St. Louis each registered three million plus square-foot jumps in square footage leased in the last year.
  - Several markets lagging the recovery showed marked improvement in demand in recent months and posted significant vacancy declines. These include Northern New Jersey, Phoenix and major markets in Florida.
- Improving demand and tightening market conditions supported healthy rent growth in 2013 in many markets. Fueled by a booming technology sector, tech-driven markets including Northern California, Denver and Seattle posted the strongest rent growth during the year. Rent growth in the top-tier distribution hubs was also strong, averaging 6.0% in 2013. Several markets where rents were contracting finally experienced rent stabilization, indicating that they are entering the recovery phase of the cycle.

Improving fundamentals spurred developer interest in industrial product within select markets, particularly for high-cube ware-

house space. However, new development activity remains muted in most areas.

- The value of put-in-place construction accelerated during the fourth quarter and increased by 24% overall in 2013. Much of the increase was attributable to a rise in new construction activity, with the manufacturing segment growing at an especially rapid pace.
- Overall, development activity increased by 10 million square feet during the fourth quarter, bringing the total under-construction pipeline to 100 million square feet at the end of 2013.
- A large proportion of this activity was in the single-tenant segment, and speculative development activity is concentrated in a handful of markets. Development of specialized high-cube space for e-commerce firms and other distributors consolidating supply chains represented a large portion of projects being built.
- Areas with a substantial amount of under-construction projects at the end of 2013 included Baltimore, Central New Jersey, Chicago, Dallas, Houston, the Pennsylvania I-81/I-78 Distribution Corridor and Southern California.

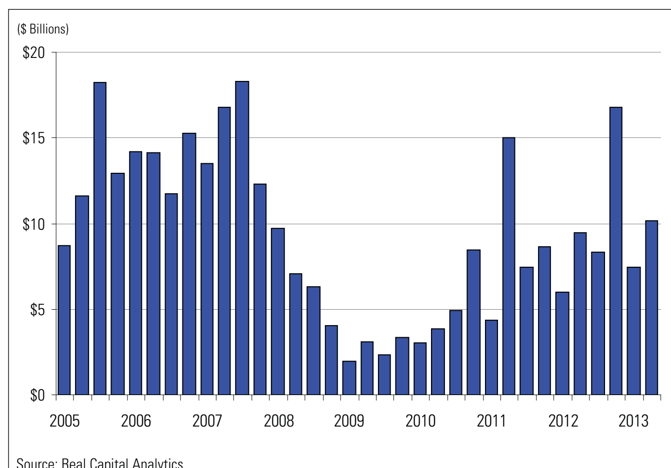
With development activity at a low level and operating conditions in several markets poised to enter a more solid recovery phase, we maintain our view that the industrial market is at 6:00 on the RCG Real Estate Cycle.

Investment Market

Strengthening operating conditions and rising capital availability continued to spur an increase in industrial investment activity. While assets tenanted by investment-grade tenants in large distribution hubs remain the primary focus of investment activity, willingness to take on more risk is growing. In anticipation of recovery, investors are increasingly entering tertiary markets with improving fundamentals.

- After falling in the last months of 2013, sales activity accelerated again into early 2014. According to Real Capital Analytics, transaction volume rose by 47% year-over-year in January. For 2013 overall, sales of industrial properties totaled $47.4 billion, a 16% increase from the previous year.
  - Warehouse properties accounted for the bulk of transactions, but the R&D segment continued to show signs of recovery. After posting negligible sales volume growth last year, R&D acquisitions spiked to $1.5 billion in January, a 70% increase from a year earlier.
  - While private investors were still the largest group of buyers, holding 40% of market share, REITS were the fastest-growing segment of industrial property investors in recent months. Total REIT acquisitions grew by 73% in 2013, increasing market share to 21% from 14% in 2012.

Quarterly Transaction Volume



Source: Real Capital Analytics

  Foreign investors also showed more interest in industrial product during the past year. In 2013, foreign investors increased industrial investments by 25%, accounting for 6% of total transactions. This is the highest share of cross-border investment in the past ten years.
  - The focus on single-tenant assets and larger metro areas continued, spurred by a large amount of capital raised for the sector and investor preference for less-risky assets. In 2013, single-tenant transactions accounted for about 35% of all industrial sales volume, up significantly from an average of 21% between 2001 and 2011. Los Angeles, Dallas, Chicago, Northern New Jersey and San Jose were the most active investment markets in 2013.
  - However, more transactions in lagging and tertiary markets also took place as improvements in operating conditions became more widespread. REITs were especially active, markedly increasing their presence in this segment in 2013. They accounted for 36% of tertiary market investments for the year, the largest share of all investor groups.
- The average transactional cap rate fell to 5.5% 2013 from 6.1% in 2012. Improved income expectations and asset values offset the interest rate rise, driving down the cap rate during the second half of the year.
  - Strong demand for core investment properties has resulted in a significant differential in cap rates in primary distribution hubs and other metro areas. High-quality assets traded with cap rates in the high-4% range in top-tier distribution markets.
  - However, the average cap rate in secondary and tertiary markets also compressed, as stronger fundamentals and accelerating investment activity in these areas boosted income returns.

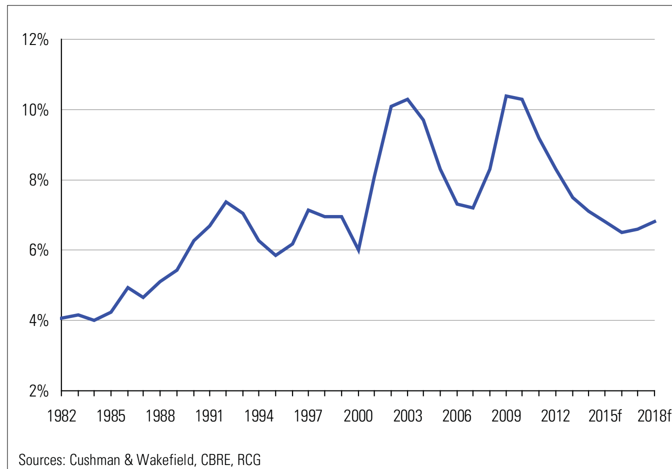
- The NCREIF total return index rose 12.3% year-over-year compared with 2102. Capital returns increased 6.4% in 2013, while income returns expanded by 6.0%.
- Improving operating conditions continued to reduce the volume of distressed industrial loans. By December, the volume of distressed industrial assets fell to $9.8 billion, a 20% improvement from one year ago.
  - Lenders remained cautious about extending terms to delinquent borrowers, and repossessed or transferred mortgages to special servicers. The volume of REO fell to $3.9 billion in 2013, down by $1 billion from one year ago.
  - Improvement in the CMBS market, where most of the defaulted loans reside, drove improvement in distress levels. The industrial CMBS delinquency rate decreased in the second half of 2013, following an uptick earlier in the year. According to Morningstar, the delinquency rate fell to 10.4% by December from 11.9% in June.
  - The principal balance of the delinquent industrial loans fell to $2.6 billion, while the number of delinquent industrial loans fell to 171 from greater than 200 earlier in the year.
  - While the industrial delinquency rate is the highest of the major property types, the industrial sector accounts for only 6.4% of all delinquent securitized loans and 6.1% of loans in special servicing, the lowest share of the major property types.
  - Improving asset values helped to drive further improvements in the loss severity rate. The average loss severity for industrial loans liquidated in 2013 was 35.5%, the second-best rate after the apartment sector.

The Outlook

Accelerating business and consumer spending will drive strengthening industrial market conditions during the next several years. Recovery will continue to spread into smaller markets, leading to a more broad-based rebound. Additionally, while tenant demand will remain elevated for large-scale distribution space, leasing activity should diversify into the smaller unit sizes as demand from mid-sized tenants increases. Forecasts for a national economic slowdown in 2017 will mean that market fundamentals will be stronger in the near term than in the medium term, with absorption levels and rent growth flattening in 2017 and 2018. Longer term, e-commerce activity will have an increasing influence on industrial market performance. The improving operating conditions should lead to further acceleration of investment volume and asset values during the next few years.

- With demand for goods from businesses and consumers expected to accelerate, industrial output will increase at a respectable pace. Growth in industrial production will slow in the medium term as it surpasses pre-recession levels and economic expansion decelerates, but it will remain at a high level.
  - The business sector will continue to fuel production, but as the housing market recovery advances and purchasing power grows, consumer spending will also pick up and make a larger contribution to market activity.
  - The on-shoring trend has slowed, but manufacturers will continue to shorten supply chains and bring production back to the United States, boosting output going forward.
- A modest rebound in global growth combined with stronger domestic consumer demand will also lead to an increase in cargo flows. Both import and export activity should accelerate.
  - The housing market rebound will create more demand for foreign-made household goods, fueling import activity. Expected gains in the U.S. dollar that result from the Federal Reserve's scaling-back of its monetary stimulus are also expected to boost imports.
  - The global economic recovery should provide better prospects for exports of agricultural products, food and raw materials. The expansion of the Panama Canal could become a major benefit to exporters able to utilize the westbound locks to more efficiently reach growing markets in Asia.
  - However, the impact of the Panama Canal expansion, delayed once again until late 2015, on U.S. ports remains uncertain. With liners focused on fuel efficiency and increasingly deploying containerships that are too large to navigate the expanded Panama Canal, it remains to be seen how much demand there will be for the Asia to East Coast route. The shift in production from East Asia to South and Southeast Asia also reduces transit times for vessels utilizing the Suez Canal. Markets poised to take advantage of the expansion include post-Panamax ready ports able to handle larger ships on the East and Gulf Coasts such as Miami and Central New Jersey.
  - Geopolitical issues in the Middle East and North and East Africa continue to pose a threat to global cargo flows. The possibility of disruptions near the Suez Canal, including political unrest and terrorism, will remain a concern for the logistics industry for the foreseeable future.
- Payrolls in industrial sectors will increase moderately. While the rise in online retailing will fuel warehousing and transport hiring, productivity gains and utilization of technology will limit manufacturing-sector job gains and temper overall industrial-related job growth.

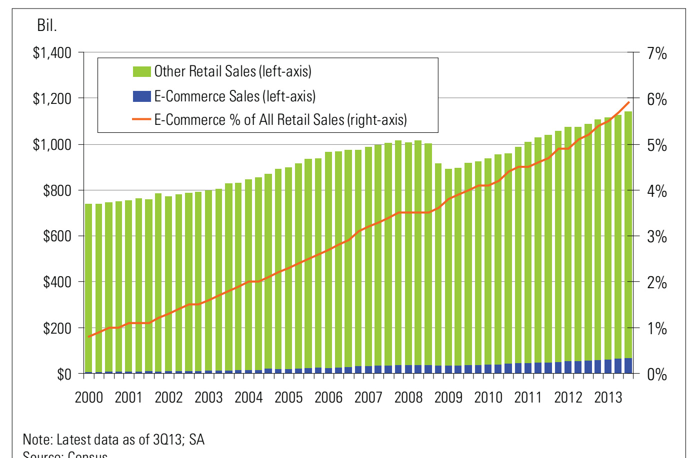
Industrial Vacancy Rate



Sources: Cushman & Wakefield, CBRE, RCG

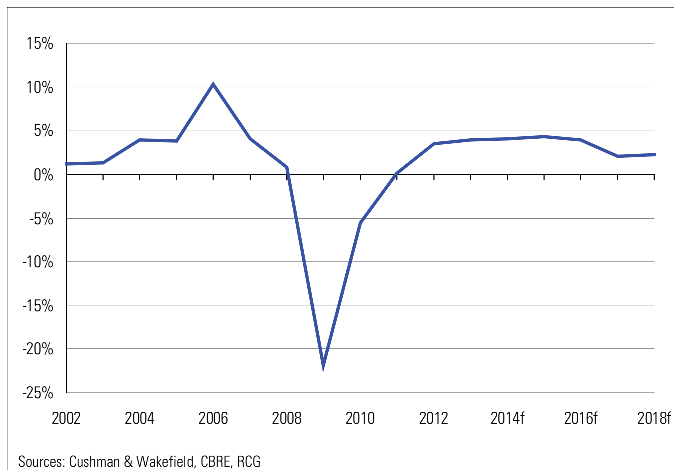
- Favorable prospects for industrial demand will generate strong leasing activity and help to drive the vacancy rate into the low-7% range next year. Availabilities will continue to fall before the vacancy rate stabilizes in the mid-6% range in 2017, when slower economic growth tempers demand. Even with the temporary slowdown, the vacancy rate is expected to remain below 7.0% through 2018.
  - Leasing activity should accelerate, particularly as the large volume of short-term renewals expires in the next several years. The vacancy rate will decrease in most markets through the next several years
  - Strong technology and distribution centers, many of which are posting cyclically low vacancy rates will tighten even further, creating significant pent-up demand by the end of the forecast period. Vacancy rates in Denver, Oakland, San Francisco and Southern California are all expected to be below 5.0% by 2018.
  - As recovery takes hold, vacancy rates will begin to markedly fall in several weak markets, finally drawing down excess inventory created during the downturn. Markets that will experience the largest vacancy rate declines through 2018 include Hartford, Phoenix, Jacksonville and Raleigh.
  - The vacancy rate for buildings of less than 50,000 square feet should improve in the near term as the recovering economy supports the expansion of smaller tenants. With many housing-related tenants such as construction materials and appliance centers occupying space in the 25,000 to 50,000 square-foot range, a full recovery in the single family sector will be a substantial positive for smaller industrial buildings and multi-tenant assets.
- The growing popularity of e-commerce and associated shifts in supply-chain distribution will be an important driver in industrial market demand in coming years. The share of the distribution market dedicated to e-commerce is growing and with online sales expected to accelerate during the next several years, this trend should deepen.
  - Online retailing will fuel demand for modern, high-cube logistics facilities, as dedicated e-commerce companies expand operations and brick-and-mortar retailers increasingly establish dual platforms backed by large distribution facilities that manage both in-store and online inventory. The elevated demand for state-of-the art facilities will also lead to further bifurcation in the market as older buildings become functionally obsolete.
  - Evolution of supply-chain management will continue to focus on leaner supply chains with fewer and larger distribution centers as more products are delivered directly to the customer. This trend will magnify tenant demand for facilities with access to multiple transportation nodes that limit the need for more costly and slower truckload transportation. In addition to the established distribution hubs, smaller markets with developable land, established rail networks and access to intermodal rail ramps and air cargo for e-commerce fulfillment could benefit from this trend.
  - The rise of same-day delivery by online retailers could also shift tenant demand towards larger population centers, as proximity to end-markets becomes more important. As this delivery model can be adapted to smaller distribution centers in closer proximity to urban populations, the trend of retailers moving away from city centers could be reversed. This would help revitalize older industrial submarkets that have been unable to compete for large-scale tenants in recent years. Additionally, the first wave of retailers moving into these underperforming submarkets or older properties should be able to take advantage of lower rents.
- As the market tightens, rent growth is expected to accelerate through the near term before slowing in the latter stages of the

E-Commerce Retail Sales

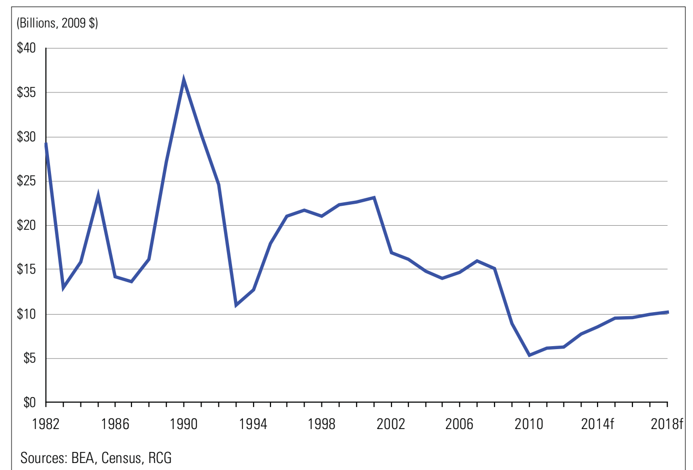


Note: Latest data as of 3Q13; SA
Source: Census

Industrial Rent Growth



Industrial Construction Put-in-Place



forecast horizon. From 2014 through 2018, we project annual average rent growth of 3.3%.

- Most regional and national distribution hubs should produce annual rent growth in excess of the national average.
- We expect the strongest rent growth in tech-driven and top-tier distribution markets such as Southern California and Central New Jersey. Other fast-growing areas including the Texas markets will also post healthy rent gains, but the availability of developable land precludes stronger rent growth in these metro areas.
- Rent growth, while positive, should lag the national average in parts of the Rust Belt and Midwest where local economic conditions are expected to also lag the national recovery.
- Despite the moderate rent growth, sufficient room remains for industrial rents to increase before reaching the peak of the previous cycle.

- As rents rise, construction activity should also continue to accelerate. The bulk of development projects will likely be in large distribution hubs and big-box warehouse product.
    - The value of put-in-place spending should steadily accelerate through the near term. However, even with the increase, development activity will remain substantially less than pre-recession levels. Put-in-place spending between 2014 and 2018 is expected to be about 40% less than total spending between 2003 and 2007.
    - Through the next several years, most new construction will be concentrated in major distribution hubs. Markets with the greatest projected deliveries through 2018 include Chicago, Dallas, Houston and Southern California.
    - Beyond technology centers such as Silicon Valley, Austin and Seattle, the majority of new construction will be distribution product.
    - Development of large, specialized logistics facilities catering to e-commerce is expected to increase. Following Amazon's lead, retailers including Wal-Mart, Target, Home Depot and Nordstrom are all building new facilities for direct-to-consumer order fulfillment. As other major retailers follow suit, a fresh wave of construction activity in this segment is expected during the next several years.
    - Development of smaller distribution product near city centers may also accelerate in major urban cities. Infill development of under-utilized industrial land should accelerate, particularly if same-day deliveries by retailers become more common.
- As interest rates rise, debt financing will become more costly and may reduce the number of bidders for some assets. However, with a continued focus on safe assets, steadily improving operating conditions and the lower volatility of returns that the industrial sector offers, should maintain elevated investor interest. Inflation-hedging capabilities should also spur additional capital allocations to the sector. Industrial real estate in particular, through the use of net leases, offers strong inflation hedging characteristics. As the industrial market recovery spreads, higher cap rates in later-to-recover markets will still provide some upside for opportunistic investors.
    - Competition for quality assets in primary distribution hubs will remain high through at least the near term in spite of rising asset values.
    - Accelerating investment volumes in secondary and tertiary markets will continue to place downward pressure on cap rates in these areas even as interest rates normalize. However, opportunities to acquire assets with limited competition and higher yields still exist in some tertiary markets.
    - The average cap rate for high-quality assets should remain in the mid-5.5% range through the next year. Thereafter, the cap rate is expected to rise moderately to the mid-

6% range.

  - The acquisition environment for net leased, mission critical facilities should remain highly competitive through the next several years. A large amount of capital has already been raised or allocated to the sector, and even with corporations monetizing real estate, the number of acquisition opportunities remains limited. Repositioning industrial assets with traditional in-place lease terms to long-term net leases could be a highly effective disposition strategy.

- Investment velocity should accelerate as operating conditions improve, but the volume of maturing industrial loans will remain an issue through the next several years. A large amount of industrial loans will mature in the near term under more conservative lending criteria than in-place mortgages. The ability of these maturities to secure adequate take-out financing under existing lending standards will have substantial implications for industrial investment activity going forward. Additionally, the in-place leases of many assets may be at higher rents than current market rents, further hampering owners from recapitalizing.
  - Throughout 2013, industrial loans watchlisted by Morningstar decreased, as delinquent situations were resolved. By December, $7.9 billion of securitized industrial loans were on the Morningstar watchlist, approximately 30% of the industrial CMBS total, and slightly down from 32% in October.
  - More than $1.4 billion, or 5.9%, of industrial CMBS loans will reach maturity in 2014. While only 1.5% of these loans are watchlisted, the lack of take-out financing options for many borrowers could lead to further default situations.
  - With cash flow insufficient to cover debt obligations for many assets, the heightened risk of default will continue for some time and lead to an extended period of delinquencies and special servicing activity. For CMBS of all property types, more than 10% of maturing loans have debt-service coverage ratios of less than one. With many loans offering interest-only payments, loans with higher debt-service coverage ratios may not be successfully recapitalized.
  - This capital gap will create opportunities for bridge lenders for the next several years.

- The industrial sector should continue to provide a stable source of investment returns even in a rising interest-rate environment. With rent growth accelerating in the near term, income gains should be sufficient to offset interest rate normalization and the impact on asset values. Returns are expected to average 7.0% through 2016. Slowing rent growth and increasing cap rates in the medium term will put some downward pressure on returns, which will average 4.6% in 2017 and 2018. However, even with this decline, the industrial market will remain one of the better performing property market sectors during the forecast period.

Conclusion

The industrial market has been one of the best-performing property market segments through the recession. Accelerating economic activity will drive further improvements in operating conditions during the forecast period, with recovery broadening to secondary and tertiary markets as well as smaller-scale product. Demand for space will remain greatest for larger distribution buildings in primary distribution centers. However, as industrial production accelerates, increasing the movement of goods in the economy, smaller markets will advance further into the absorption phase of the real estate cycle. Stronger economic growth will also create more opportunities for small and mid-sized industrial tenants, boosting demand for buildings with smaller floorplates. The construction pipeline will grow moderately as availabilities fall and rents reach a level to justify new construction; but building activity is expected to remain well below pre-recession highs. As a result, we do not believe that there is a high risk of overbuilding through the medium term. Strengthening operating conditions and an elevated acquisition environment should lead to stable investment returns even as interest rates normalize. We maintain our view that the industrial sector will improve at a healthy pace, with above-average growth during the near term giving way to moderating conditions towards the end of the forecast period. Longer term, structural shifts in supply-chain distribution and how consumers purchase products should significantly impact the industrial market. This property segment is expected to be the major beneficiary of accelerating e-commerce activity, which will have ongoing implications for location decisions, building design and the type of industrial product that distributors demand.

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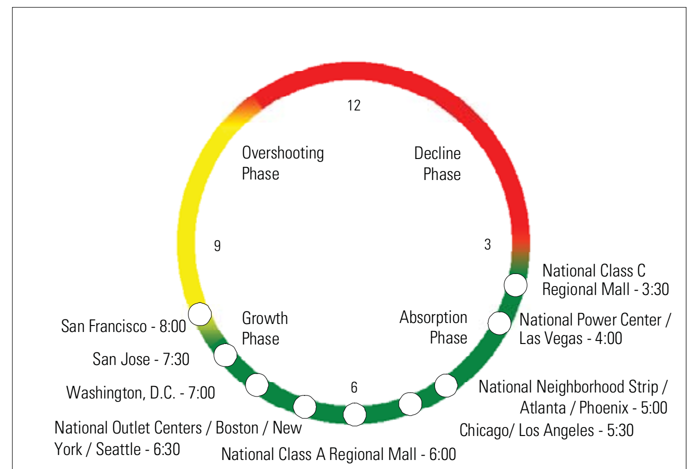
The National Retail Market

Melinda McLaughlin

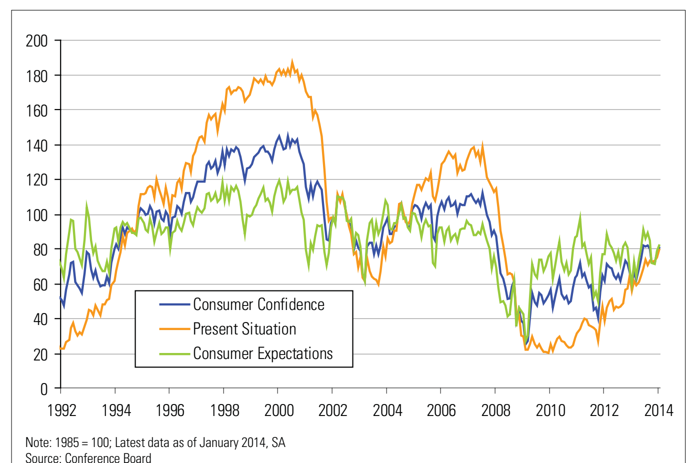
Retail market conditions steadily improved during 2013, supported by the continued economic recovery. Tenant demand increased at a measured pace, which led to increased occupancy and accelerating rent gains. Although retail market conditions in economically-strong regions outperformed, investor demand for retail assets strengthened across much of the nation.

- Private-sector job creation remained at a healthy level through 2013, in spite of a modest slowdown in the final months of the year. While knowledge and resource-based industries such as high tech, health care and energy continued to lead hiring, job creation is gradually broadening as the multiplier effect from these industries spreads throughout regional economies. As this trend continues in the coming years, we expect retail sales growth to reflect increased employment and spending power at all income levels.
- After growing early in the year, real disposable personal income fell by 0.1% year-over-year in the fourth quarter of 2013.
- Early in 2014, consumer confidence ticked up for most segments of the population, although the overall level of consumer confidence remains far below its prior peak.
  - Following a dip in late 2013, overall consumer confidence increased to 80.7 in January 2014, up 38.2% from 58.4 in January 2013.
  - Consumer confidence last peaked at approximately 111 in early 2007.
  - The gap between consumer confidence levels of the highest-income households and the lowest-income households widened further in early 2014.
- In line with the trend of broadening job creation, the rate of overall comparable same-store sales growth for national chains accelerated, surpassing the year-over-year growth in luxury chain retail sales.

Real Estate Cycle – Retail



Consumer Confidence



Note: 1985 = 100; Latest data as of January 2014, SA
Source: Conference Board

Outlook for the National Retail Market

	2005	2006	2007	2008	2009	2010	2011	2012	3Q13	2013e	2014f	2015f	2016f	2017f	2018f
New Construction (Put in Place, 2009 $ Bill.)	51.6	51.6	57.4	51.1	29.7	21.5	21.9	23.5	24.6	25.2	25.5	28.5	31.0	32.0	33.5
Retail Sales Excl. Autos ($ Bill.)	824.6	856.2	902.8	862.2	866.3	910.3	971.7	1,014.0	1,035.0	1,041.4	1,078.9	1,119.9	1,151.3	1,157.1	1,169.8
% Change (Yr./Yr.)	8.0%	3.8%	5.4%	-4.5%	0.5%	5.1%	6.7%	4.4%	3.4%	2.7%	3.6%	3.8%	2.8%	0.5%	1.1%
Real Disposable Income Growth	1.2%	4.1%	1.2%	1.1%	-0.6%	2.5%	1.4%	3.6%	1.8%	-0.2%	3.0%	3.0%	2.1%	0.5%	1.0%
Consumer Confidence	100.3	105.9	103.4	58.0	45.2	54.5	58.1	67.1	81.0	73.2	90.0	95.0	100.0	80.0	90.0
Vacancy Rate	7.2%	6.9%	7.3%	7.6%	8.7%	8.8%	8.5%	8.1%	---	7.7%	7.3%	7.1%	7.0%	7.2%	7.3%
Neighborhood Strip: Rent Growth	2.6%	2.8%	2.9%	2.3%	0.7%	0.6%	1.5%	1.8%	1.8%	1.9%	2.8%	2.9%	3.0%	1.7%	1.8%
Power Center: Rent Growth	2.6%	3.0%	2.9%	1.4%	-1.7%	-0.7%	0.8%	1.2%	1.2%	1.2%	2.2%	2.5%	2.7%	1.0%	1.3%
Regional Mall: Rent Growth	2.8%	2.9%	2.9%	1.9%	0.3%	0.7%	1.5%	2.6%	3.1%	2.8%	3.3%	3.5%	3.2%	2.0%	2.1%
Cap Rate	6.1%	5.9%	5.5%	5.9%	6.9%	7.0%	5.9%	5.8%	5.0%	5.5%	5.7%	6.0%	6.4%	6.6%	6.5%
NCREIF Return	20.0%	13.4%	13.5%	-4.1%	-10.9%	12.6%	13.8%	11.6%	13.2%	14.8%	7.8%	3.3%	3.7%	5.5%	6.9%
Capital Return	12.6%	6.8%	7.3%	-9.5%	-16.6%	5.3%	6.8%	5.2%	6.9%	6.6%	2.1%	-2.7%	-2.7%	-1.0%	0.2%
Income Return	6.8%	6.3%	5.9%	5.7%	6.5%	7.1%	6.6%	6.2%	6.0%	6.0%	5.7%	6.0%	6.4%	6.5%	6.6%
Delinquency Rate	0.07%	0.06%	0.02%	0.00%	0.25%	0.10%	0.05%	0.04%	0.07%	0.04%	0.05%	0.20%	0.10%	0.30%	0.20%

Note: Annual retail sales data series is the 3-month, 4Q average
Sources: ABA, ACLI, BEA, Census, The Conference Board, NCREIF, PwC, RCG, U.S. Commerce Dept., Viewpoint

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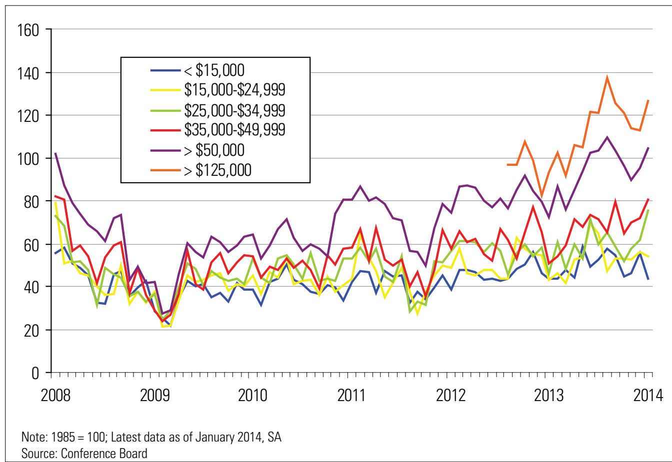
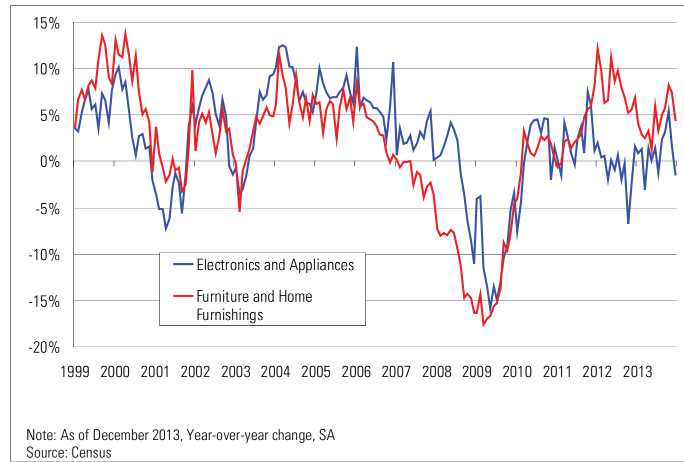
Consumer Confidence by Household Income

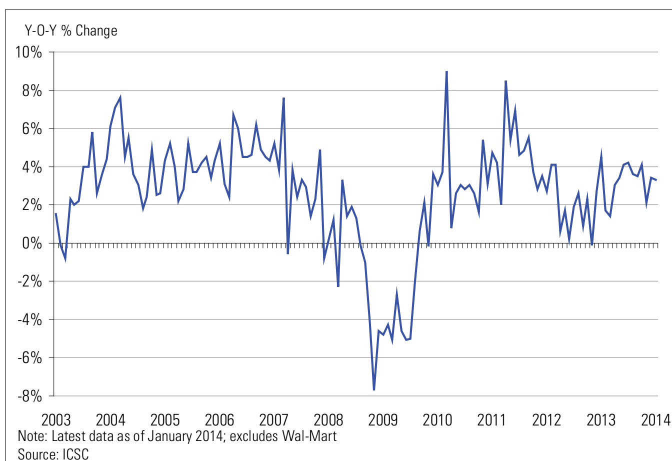


Retail Sales : Electronics, Appliances, Furniture and Home Furnishings

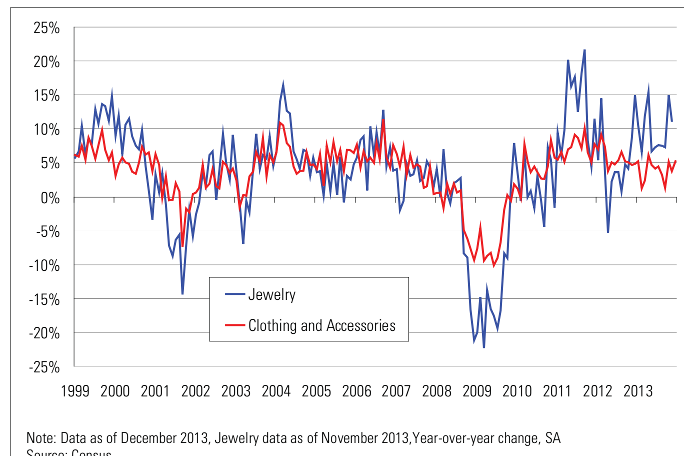


  - According to latest data from ICSC, comparable same-store sales increased by 3.1% for all chains year-over-year in the third quarter of 2013, as compared with 2.6% for luxury stores.
  - However, the luxury segment still maintained a sizeable lead in terms of the cumulative recovery: as compared with the third quarter of 2009, luxury same-store sales increased by 38.9%, while overall same-store sales increased by only 7.7%.
- Following a strong bounce-back effect in the early stages of the economic recovery, the velocity of retail sales growth moderated through 2013.
  - Retail sales excluding autos continued to grow, but at an increasingly moderate pace, following two years of strong bounce-back growth. The total volume of retail sales surpassed the prior peak that occurred in 2010, partially a product of continued population growth, an early recovery in net worth for high-income households, and the resilient nature of the U.S. consumer.
  - Motor vehicle sales continued to record brisk improvement through 2013, a function of improved consumer confidence and low interest rates.
  - The recovery of the U.S. single-family housing market spurred strong growth in sales of housing-related goods during 2012 and 2013. However, the level of sales remains below the peak of the last economic cycle, potentially indicating room for future growth. Additionally, the seasonally adjusted pace of sales growth slowed sharply at the end of 2013.
  - Although sales volume improved from its recessionary low, retail sales of electronics and appliances have been slow to rebound – a trend that extended through 2013.
  - Department store sales continued to slow through 2013, in spite of a rise in apparel and jewelry sales. Increasingly, shoppers are purchasing these items online, partially contributing to the slowdown in department store sales.
  - E-commerce sales increased further in 2013, up 7.9% year-over-year in December 2013.
- Retail construction activity remained near the cyclical bottom, with only an estimated $24.5 billion put-in-place during 2013.

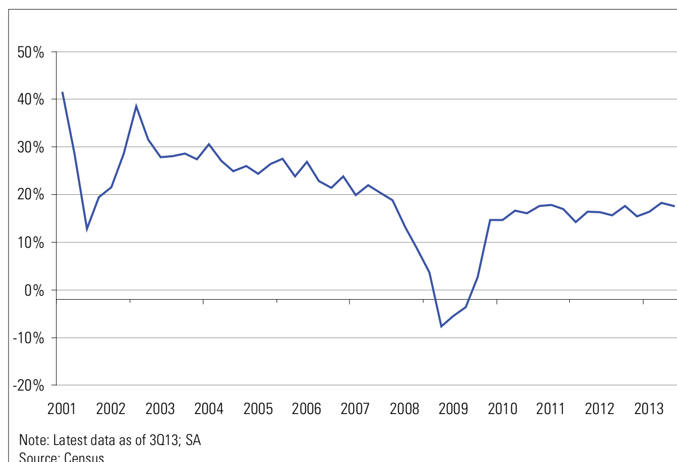
Comparable Store Sales



Retail Sales: Jewelry, Clothing and Accessories

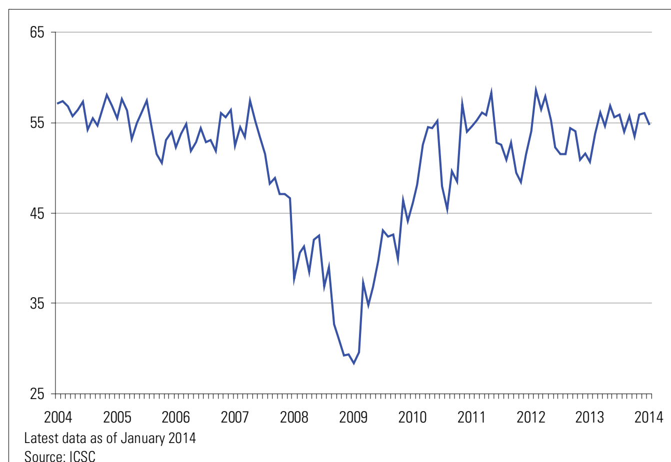


E-Commerce Retail Sales – Annual Percent Change



Note: Latest data as of 3Q13; SA
Source: Census

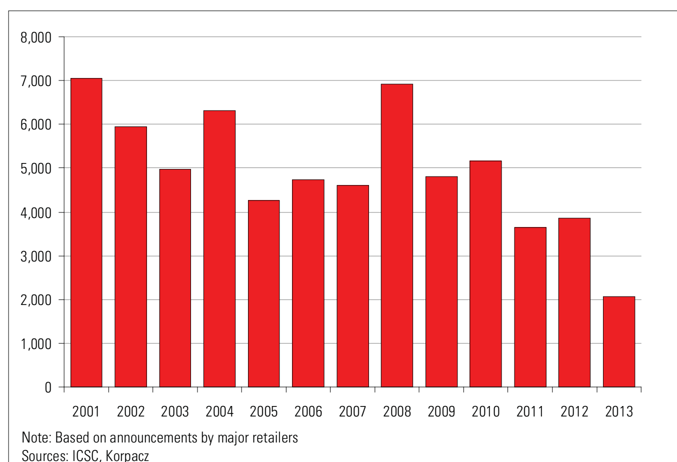
Shopping Center Executive Business Barometer



Latest data as of January 2014
Source: ICSC

- The number of announced store closings by major retailers fell to its lowest level in more than in a decade during 2013. In line with our expectations for an extended period of economic growth, RCG believes that the store closings figure should remain relatively low through at least the near term.
- The national retail vacancy rate tightened to 7.7% in 2013 from 8.1% in 2012. Strengthening tenant demand and limited new supply allowed for continued absorption of available space.
- Retail rent growth spanned all property types, with the fastest rent appreciation in the regional mall property type and the slowest appreciation for power center properties.
- Net operating income growth accelerated as a result of rising occupancy levels and moderate rent growth. According to NCREIF, net operating income increased by 7.7% in 2013 for all retail property types.
  - This increase represented the fastest annual rate of NOI growth since 2008.
  - Of retail store types, super-regional malls posted the largest increase in NOI, with 13.1% in 2013 on a per square foot basis.
  - Neighborhood center properties recorded an increase of 6.3% in NOI.
  - Community center NOI growth accelerated to 3.1% in 2013. Power centers also recorded 3.1% NOI growth during this period.
  - By region, the West recorded the strongest NOI growth with 9.3% for the total shopping center market. The South region lagged with 6.1% growth.
- The ICSC Shopping Center Executive Survey shows improving optimism on the part of retail executives. Respondents indicated that business is improving, albeit at a moderating pace. In January 2014, the current business barometer index increased by 3.7% year-over-year to 53.8 while the future business barometer index increased by 4.7% to 55.9. An index value above 50 indicates growth.
- As compared with other retail property types, outlet centers remained further along at 6:30 on the RCG Real Estate Cycle Clock. Strong sales growth, rising occupancy and rental rates, and increasing demand from investors are characteristics of property types currently within the growth phase of the cycle, including outlet centers and Class A malls.
- Neighborhood strip properties, power centers and Class C malls are still in the absorption phase of the cycle. For these property types, occupancy levels are rising but the still-high vacancy rate and slower pace of sales growth are causing limited rent growth and investor demand.

Retail Store Closings



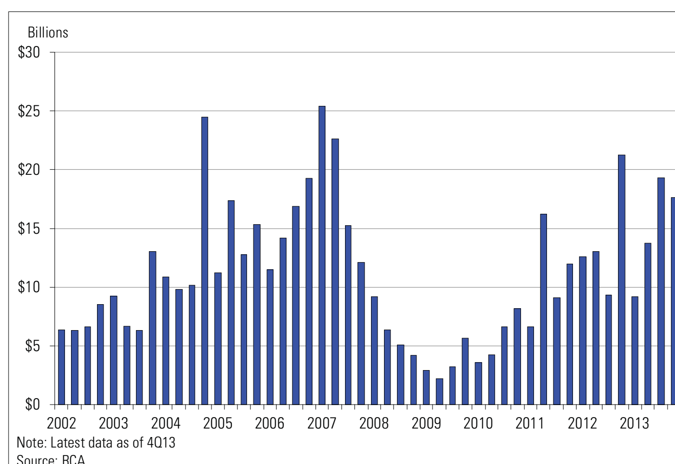
Note: Based on announcements by major retailers
Sources: ICSC, Korpacz

Investment Market

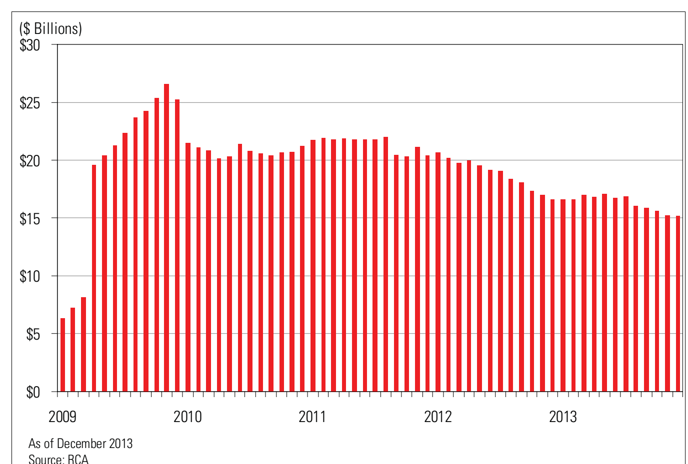
The combination of improving retail fundamentals, an increasingly solidified economic recovery, and rising capital availability drove an increase in investment volume during 2013. According to Real Capital Analytics, total retail investment volume reached $60.8 billion, an increase of 8% form 2012.

- Individual asset transaction volume contracted slightly during the year, falling to $39.8 billion from $40.2 billion the prior year. However, increased capital availability allowed for a higher level of portfolio sales, reaching $15.0 billion in 2013 from $12.2 billion in 2012.
- The combination of a limited number of acquirable assets in major gateway markets and an increased appetite for risk fueled a strong rise in transaction volume in select secondary and tertiary markets. In contrast, transaction volume decreased by 14% in the six major metro areas (New York, Boston, Washington, D.C., San Francisco, Los Angeles and Chicago) from 2012.
- Similarly, riskier asset types recorded the largest rise in transaction volume during 2013. Non-grocery-anchored strip, particularly, received a surge in investment and prices, although properties are still selling at significant discounts to the pre-recession peak level. In contrast, retail prices fully recovered for single-tenant properties and gateway-city retail.
- Increased lending activity and demand for CMBS supported increased investment volume. The volume of retail loan originations increased by 43% in the fourth quarter of 2013 from a year prior, according to the Mortgage Bankers Association.
- REITs recorded the only positive net acquisition level in 2013, with all other investor types selling more retail assets than acquiring them. Private investors were the largest sellers and buyers, but ended the year with a net disposition of nearly $3.9 billion worth of retail properties.
- In spite of a rise in interest rates, transactional cap rates declined further in 2013, falling to an average of 7.4% for all types of retail properties in the fourth quarter of 2013. During the same period in 2012, the transactional cap rate was 7.6%.
  - The gap between cap rates in gateway metros and all other metros persisted, with the average gateway retail transactional cap rate approximately 100 basis points lower than the average transactional cap rate for all other metro areas. In contrast, the gap was almost nonexistent during early 2010 as a result of very low levels of sales in both geographic groups, and before that, hardly any gap existed during the excesses of the previous economic growth period.
- Investment in mall properties declined by 36% to $7.9 billion in 2013. The average transactional cap rate contracted further to 6.0% in the fourth quarter of 2013 from 6.3% a year prior.
- Shifting acquisition patterns stabilized the average transactional cap rate for strip properties. With a higher proportion of sales occurring in secondary and tertiary locations, the average cap rate held steady at 7.4% through 2013. Transaction volume for strip properties increased by 26% to $27.3 billion in 2013.
  - Grocery-anchored centers continued to command significant price premiums and lower average cap rates than non-grocery-anchored centers.
  - Grocery-anchored properties recorded an increase of 6% in transaction volume to $9.1 billion in 2013.
  - Investment volume for non-grocery-anchored properties increased to $7.2 billion, up by 33% from 2012.
  - Lifestyle/power center transaction volume increased by 42% to $6.4 billion in 2013.
- The sales volume of single tenant properties increased by 41% during 2013 to $6.6 billion. Drugstore sales comprised nearly half of all single tenant properties sold.

Quarterly Transaction Volume



Total Distressed Assets - Retail



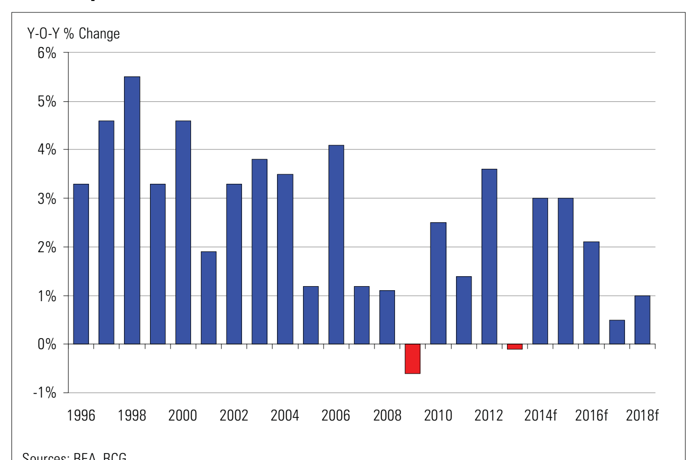
- o Within the single tenant property type, drugstore investment volume recorded the third year of double-digit growth, rising by 25% to $3.2 billion.
  - o Sales of big-box centers increased by 89% from a historically low level to reach $1.9 billion in 2013.
- Increased competition for retail assets in 2013 led to cap rate compression throughout gateway, secondary and tertiary markets, in spite of an increase in interest rates. During the fourth quarter, the average transactional cap rate fell to 6.9% from 7.2% a year prior, according to Real Capital Analytics.
- Although major markets such as Los Angeles, Chicago and New York continued to capture the bulk of retail investment, retail transaction volume and pricing in many secondary/tertiary markets increased substantially. Strong competition for relatively few assets available for sale in major markets pushed many investors to consider other metro areas. Additionally, increased investor confidence in the economic recovery in secondary/tertiary markets allowed for a rise in acquisition activity in these types of metros. One such example, Las Vegas retail recorded the strongest price and investment volume gains in 2013 of all the U.S. metro areas covered by Real Capital Analytics.
- Improving fundamentals led to the continued absorption of distressed retail properties. The combination of improving prospects for the retail sector and heightened demand for retail assets caused the cumulative retail distress volume outstanding to fall to $15.1 billion at the end of 2013, from $16.6 billion a year prior.
  - o Rising property values likely enticed many lenders to hold on to troubled assets, rather than sell at a discount. As a result the volume of distressed retail sales fell by 11.6% to less than $4 billion in 2013.
  - o Although improving investment fundamentals are increasing lenders' willingness to repossess retail assets rather than extend debt terms, the volume of REO retail properties decreased by 15.7% in 2013 to $8.3 billion outstanding as of December.
- The retail CMBS delinquency rate fell to 5.7% in January 2014 from 7.3% in January 2013. The unpaid principal balance of these delinquent loans decreased to $10.3 billion, according to Morningstar.
  - o In January 2014, delinquent retail loans accounted for 26.2% of the principal balance of all delinquent securitized loans. Retail CMBS loans in special servicing accounted for 24.4% of all loans in special servicing.
  - o The average loss severity reached 46.1% for retail loans liquidated in 2013, down slightly from 49.6% in 2012.

Outlook

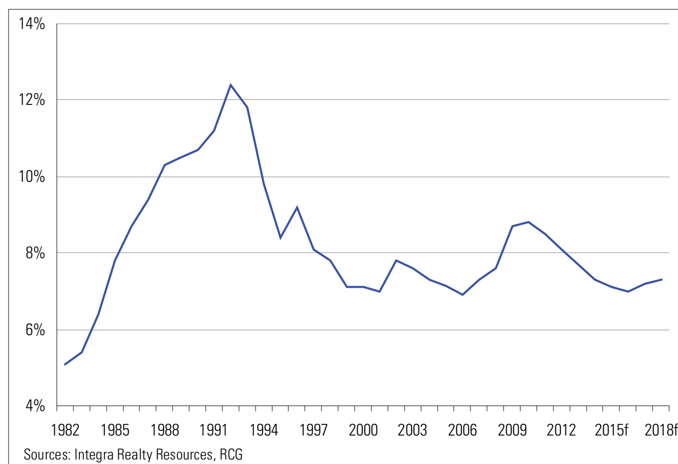
RCG expects retail market fundamentals to improve at a moderate pace going forward, driven by the extended national economic recovery. In line with increased employment among wage levels, retail sales growth and tenant demand should become increasingly broad-based by income level and product type. Although we do not expect consumer confidence to reach the highs recorded during the previous economic growth period, increased consumer spending should support strengthening tenant demand and improving operating conditions through the near term. In the medium term, RCG expects a slight rise in the national retail vacancy rate and a slowdown in rental rate appreciation caused by a slowdown in the pace of national economic growth.

- Excluding autos, retail sales should increase at an average annual pace of 3.4% from 2014 to 2016, up from 3.1% growth in 2013. This future rate reflects a more sustainable pace of growth relative to the average annual pace of 5.4% recorded in the initial years of the economic recovery.
- In the latter part of the forecast period, increased inflation and interest rates should curb the pace of retail sales growth. In 2017 and 2018, RCG forecasts an average annual increase of 0.8% in retail sales, excluding motor vehicles.
- Reflecting RCG expectations for a moderate rate of job creation in the near term, followed by a tapering in the latter part of the forecast period, real disposable income should increase by an average of 2.7% per year from 2014 to 2016, before slowing to 0.8% average annual growth in 2017 and 2018.
- Continued job creation should boost consumer confidence, even as economic and political headwinds remain. However, a still-elevated unemployment rate should keep the overall level of consumer confidence well below the peak recorded during the previous economic expansion period. RCG expects consumer confidence to reach 100 in 2016 before easing back down in 2017 and 2018.

Real Disposable Income

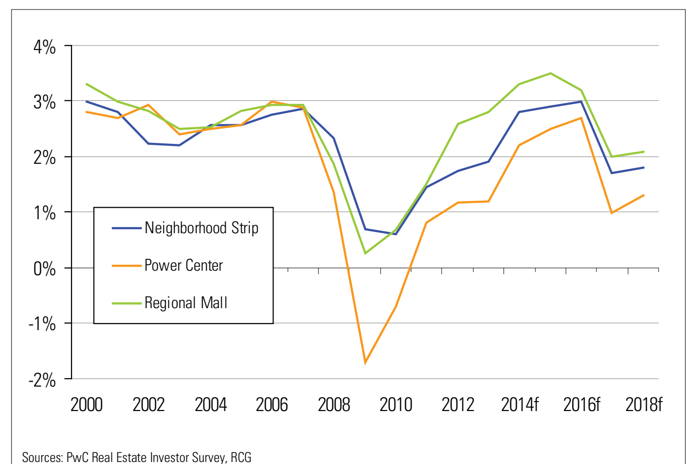


Retail Vacancy Rate



Sources: Integra Realty Resources, RCG

Retail Rent Growth

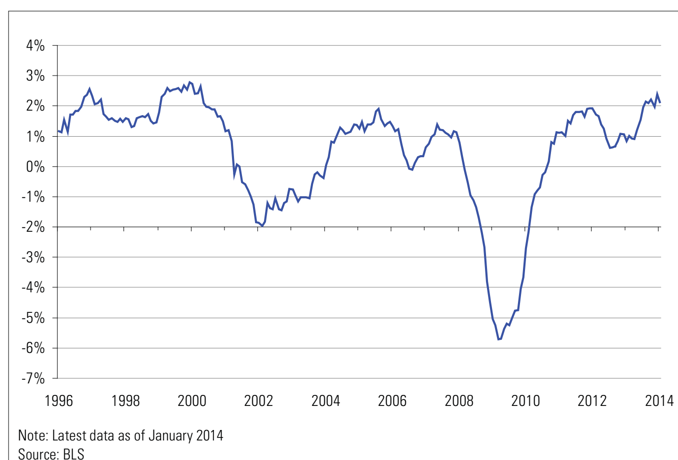


Sources: PwC Real Estate Investor Survey, RCG

- In line with the long-term trend, higher-income earners should continue to record the highest confidence levels and optimism regarding future conditions. Lower-income earners should feel less confidence by an enduring margin in the coming years.
- The extended recovery in single-family home values and sustained strength in equity markets should also support higher levels of consumer confidence in the near to medium term.

- Restaurant and retail trade hiring activity should reflect increasing sales. Aggregate employment in the retail trade subsector should reach its prior peak by mid-2015.
- Rising consumer confidence, extended population growth and increased disposable income should fuel a corresponding increase in tenant demand for retail space. As retailers increase store openings and expansions, the vacancy rate should bottom at 7% in 2016 before ticking up to 7.3% in 2018.
  - Market conditions should remain bifurcated as tenants continue to prefer high-quality space, whether in strip or lifestyle properties or Class A malls. Lower-quality retail centers will likely have difficulty attracting tenants for some time.
  - Innovative uses of vacant strip space, such as pop-up shops and temporary art exhibitions, should minimize the impact of unoccupied space on adjacent storefronts, particularly in urban areas.
  - RCG expects that the high cost of adapting underperforming retail to medical and other uses will remain a significant hurdle, leading outdated space to linger on the market and keep the overall retail vacancy rate at an elevated level.
  - Metro areas that grew at a rapid pace during the last economic expansion period, such as Phoenix and Las Vegas, contain a significant amount of vacant space, as developers built to accommodate a future population that was never realized due to the recession. With growth resuming in these metro areas alongside improving economic conditions, this excess retail space should be steadily absorbed.

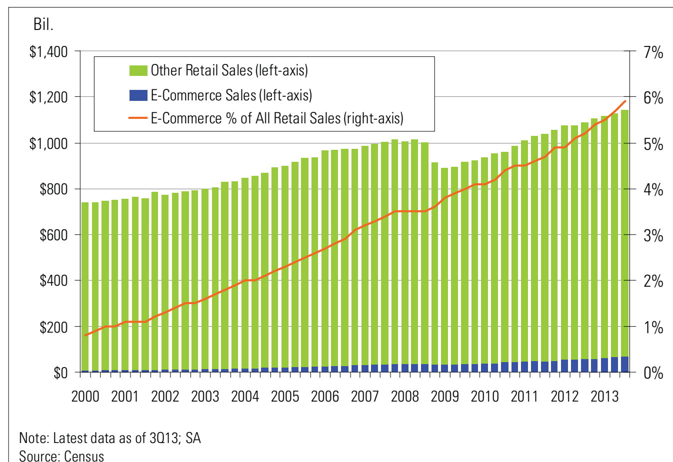
Retail Trade Employment – Annual Percent Change



Note: Latest data as of January 2014
Source: BLS

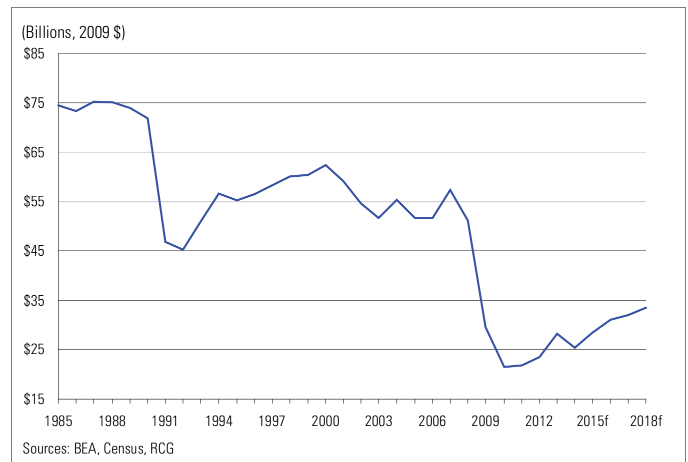
- RCG believes that online shopping will continue to cannibalize brick-and-mortar stores in the coming years, albeit at a slower pace. Additionally, increasing adoption of technology by traditional retailers should allow for effective deployment of multi-channel strategies.
  - Increased online sales should lead to further brick-and-mortar store closures as well as increasing use of smaller store footprints.
  - The industrial sector should benefit from increasing levels of e-commerce and the recovery of the U.S. consumer, as the need for efficient distribution networks increases.

E-Commerce Retail Sales



Note: Latest data as of 3Q13; SA
Source: Census

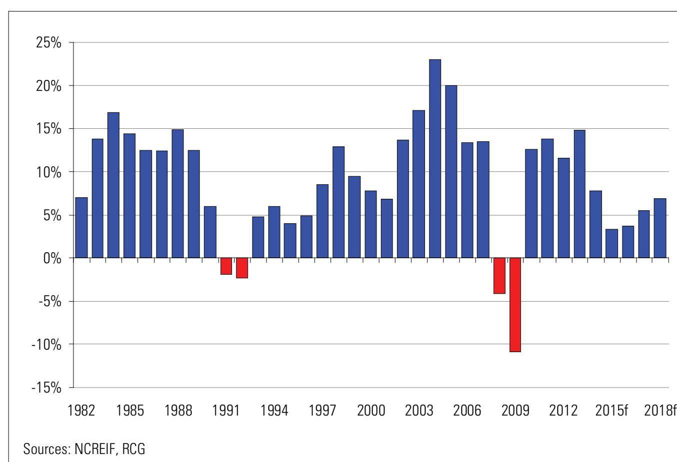
Retail Construction Put-in-Place



Sources: BEA, Census, RCG

- The combination of an elevated amount of vacant space on the market and relatively measured tenant demand should limit retail landlords' ability to raise rents.
  - Regional malls should record the fastest pace of rent appreciation, with an average of 3.3% annual growth from 2014 to 2016 and a deceleration to 2.1% growth annually in 2017 and 2018. Class A malls should record a stronger rate of rent growth than the property-type average.
  - Lingering power-center vacancies should hurt the potential for rent appreciation in the coming years. RCG projects average annual power-center rent growth of 2.5% during the next three years, with a slowdown to 1.2% in 2017 and 2018.
  - Neighborhood strip rent growth should average 2.9% from 2014 to 2016, slowing to 1.8% in the latter part of the forecast period.
- Limited rent appreciation and an elevated vacancy rate should lead to a low level of construction activity through the near term. Development should be focused on the most in-demand submarkets, which also tend to have high barriers to entry. RCG projects real put-in-place construction to increase to $33.5 billion in 2018 from a recent low of $21.5 billion in 2010. However, this level is substantially lower than the pre-recession annual high of $57.4 billion in 2007.
  - In downtown cores, ground-level retail is becoming a fixture in multifamily and office properties. Additionally, small urban infill projects, including renovations, should also comprise a significant portion of retail construction spending.
  - Construction of grocery-anchored or drugstore-anchored neighborhood centers should steadily accelerate through the forecast period, particularly in areas of strong population growth and household formation.
  - Regional mall and power center construction activity should remain minimal through much of the forecast period.
- With capital flowing to the real estate sector again, retail investment activity should increase alongside improving fundamentals and heightened investor confidence in the recovery of the U.S. consumer. Rising interest rates should temper this rise in the latter part of the forecast period, but overall, RCG expects strengthening investor interest through the near term at least.
  - The trend of rising retail investment volume in secondary/tertiary markets should extend through the near term. Increasing debt availability and accelerating local economic growth should continue to support increased investor interest in these markets.
  - Demand for retail net lease assets should remain elevated in the near term, as many investors seek out real estate assets to hedge against inflation.
  - Competition for high-quality assets should keep retail cap rates at less than 6% through the near term, in spite of interest rate normalization. In the latter part of the forecast period, higher interest rates coupled with slowing improvements in retail real estate operating conditions should fuel an increase in the average cap rate. By 2017, RCG projects that the average retail cap rate will reach 6.6% and remain nearly unmoved through 2018.
- An elevated volume of retail loan maturities during the next several years poses a risk to investment fundamentals. Given stricter lending standards in the current environment relative to when many maturing loans were underwritten, difficulty refinancing these assets could lead to a rise in the number of distressed retail properties.

Total Rates of Return - Retail Properties



- As of January 2014, 3,424 retail CMBS loans with an unpaid balance of $34.3 billion were on the Morningstar watchlist. These properties accounted for nearly 20% of securitized retail loans outstanding.
- In the 12 months between February 2014 and January 2015, more than 1,500 retail CMBS loans will reach maturity, representing nearly $13.9 billion – the highest amount of any property type. Of these maturing retail loans, approximately 1.7% were delinquent and 2.6% were with a special servicer, also the highest percentages among property types, according to Morningstar.

- Following four consecutive years of double-digit returns, private retail real estate returns should moderate in the coming years. Operating conditions should result in steady income returns, averaging 6.2% per year from 2014 to 2018. However, interest rate normalization will impact capital returns. RCG expects total retail returns for private real estate to average 5.4% through the next five years.

Conclusion

The continued recovery of the U.S. retail real estate market hinges on the further recovery of the U.S. consumer. RCG believes that retail market fundamentals will mirror national economic trends, with increasingly broad-based improvement at a moderate pace. Increased employment across income levels will lead to heightened levels of confidence and further retail sales growth. Given the still-elevated number of individuals that have been out of work for an extended period, pent-up demand for retail goods likely exists in many metro areas. Tenant demand should follow retail sales, with increasing absorption of retail space through the next few years. A tightening vacancy rate should allow landlords to raise rents, although the pace of rent appreciation should vary significantly across property type, building quality, and geographic area. Improving fundamentals and the search for yield should attract investors, although a high level of maturing debt and rising cost of capital will likely pose headwinds to a significant acceleration in investment volume and prices. As a result, RCG expects steady NOI growth and moderate total returns for retail properties through the forecast period.

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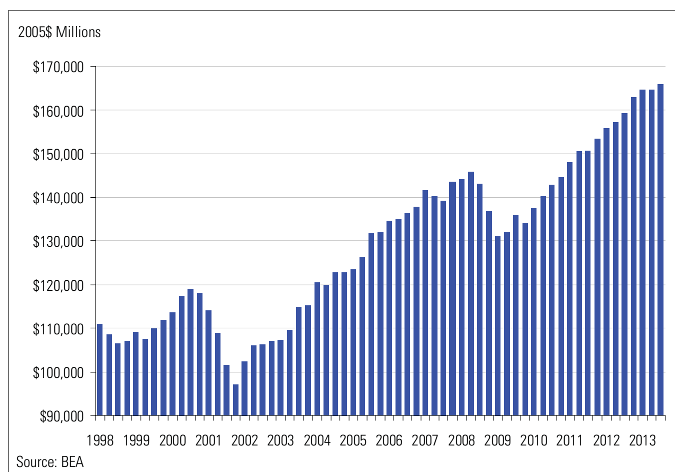
The National Hotel Market

Jeremiah Lee

Bolstered by strengthened job creation and economic growth, hotel market conditions tightened during the final months of 2013, as indicated by the rise in room demand and improved operating metrics. Increased domestic and international leisure travel contributed to greater room demand, while demand from business travelers also strengthened, driven by the continued growth in the private sector. Given the increased room demand and modest level of new construction through the near term, the favorable market conditions should lead to a continued rise in national occupancy rates and RevPAR growth during this time.

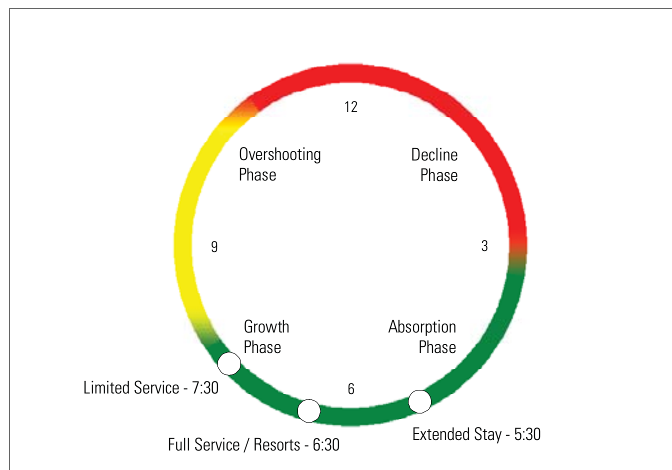
- Tourism spending continued to increase into the second half of 2013, rising by 0.6% from the previous quarter and 3.8% year-over-year to $730 billion in the third quarter of 2013, according to the BEA. The growth in tourism spending outpaced the 2.0% year-over-year increase in GDP through the third quarter.
  - Spending for accommodations stabilized at $165.8 billion, increasing by 3.3% from the previous period and 4.0% from one year ago.
  - Passenger air transportation spending decelerated from recent quarters, increasing by just 6.2% in the third quarter from the previous period after double-digit growth through the first half of 2013.
- A reflection of the continued growth across the lodging sector, hiring within the leisure and hospitality sector increased through 2013. In the fourth quarter of 2013, payroll levels increased by 3.5%, resulting in the addition of more than 480,000 net jobs to the sector.
  - Through the fourth quarter, employment trends within the arts, entertainment and recreation as well as the accommodation and food services subsectors trended upwards, rising by 4.4% and 2.9% year-over-year, respectively.
- Hotel room demand remained robust through the final months of 2013, maintaining the upward trend observed throughout much of the year. In 2013, the number of rooms sold increased by 2.2% from the previous year, with approximately 950 million room nights sold in the United States.
  - Chain segments with the greatest increase in room demand in the past year included upscale, midscale and independents.

Real Tourism Spending on Accommodations



Source: BEA

Real Estate Cycle – Hotel



Outlook for the National Hotel Market

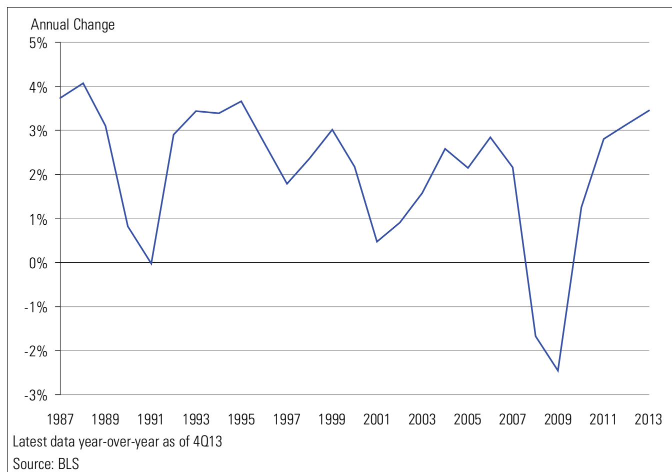
	2006	2007	2008	2009	2010	2011	2012	3Q13	2013e	2014f	2015f	2016f	2017f	2018f
Occupancy*	63.4%	63.2%	60.4%	55.1%	57.6%	60.1%	61.4%	63.9%	62.3%	63.3%	63.8%	64.0%	62.7%	63.4%
Avg. Daily Room Rate (ADR)*	$97.31	$103.64	$106.55	$97.51	$98.08	$101.64	$106.10	$110.38	$110.35	$114.77	$118.78	$122.35	$121.74	$122.22
RevPAR Growth*	7.5%	5.7%	-1.9%	-16.7%	5.5%	8.2%	6.8%	5.6%	5.5%	5.7%	4.3%	3.3%	-2.5%	1.5%
Construction** (Put-in-place, 2009 $Bill.)	$19.1	$28.1	$34.6	$25.3	$11.3	$8.2	$10.4	$13.1	$12.4	$13.2	$14.8	$15.5	$16.1	$16.8
Cap Rate	6.5%	5.9%	7.0%	9.5%	5.2%	6.5%	6.1%	5.9%	6.4%	6.7%	7.1%	7.5%	7.9%	7.9%
Delinquency Rate (ACLI)	0.00%	0.11%	0.09%	0.10%	0.66%	0.39%	0.22%	0.06%	0.70%	0.70%	0.40%	0.30%	0.70%	0.50%
NCREIF Total Return	23.6%	18.1%	-9.4%	-20.4%	9.0%	11.8%	8.2%	7.7%	7.8%	8.0%	5.7%	4.9%	3.2%	1.5%
Capital Return	14.0%	9.9%	-14.3%	-24.0%	2.2%	4.6%	0.9%	0.0%	0.3%	0.1%	-2.8%	-4.2%	-6.3%	-9.1%
Income Return	8.6%	7.6%	5.6%	4.4%	6.6%	6.9%	7.3%	7.7%	7.4%	7.9%	8.4%	9.1%	9.5%	10.6%

* Numbers in quarterly columns are year-to-date.

** Numbers in quarterly columns are annualized.

Sources: ACLI, BEA, Census, NCREIF, Smith Travel Research, RCG

Leisure & Hospitality Employment: Percent Change



Latest data year-over-year as of 4Q13
Source: BLS

- Room demand within the economy segment remained stagnant.

- The national occupancy rate for all room types increased to 62.3% in December 2013, a full percentage-point increase from 2012, according to Smith Travel Research.
  - The reduction in rooms available in the economy segment of the market accounted for the increase in the occupancy rate during this time.
- Through December, the average daily room rate (ADR) increased by 3.9% to $110.35 from the previous year, led by a 5.6% increase in the luxury segment.
- Revenue per available room (RevPAR) increased by 5.4% in December. With RevPAR growth of 7.5%, the luxury sector outpaced other chain segments during the previous 12-month period. RevPAR growth also remained strong for the upper upscale and upscale segments.
- By location, the urban and resort segments continued to lead the recovery with RevPAR up by 6.0% and 6.1%, respectively.
  - RevPAR gains in the suburban and airport location segments increased strongly during the year, rising by 5.3% and 5.6%, respectively. During the year, the airport segment had the largest occupancy gains among all location segments.

Performance by Chain Scale

	Occupancy YTD		*RevPAR YTD*		
	Dec-13	**Dec-12**	**Dec-13**	**Dec-12**	**% change**
Luxury	74.6%	73.3%	$216.47	$201.36	7.5%
Upper Upscale	71.9%	70.9%	$115.84	$109.40	5.9%
Upscale	71.7%	70.9%	$87.28	$82.85	5.3%
Upper Midscale	63.8%	63.0%	$63.99	$61.42	4.2%
Midscale	55.8%	54.8%	$42.57	$40.89	4.1%
Economy	55.0%	54.2%	$29.85	$28.46	4.9%
Independents	58.9%	58.0%	$64.11	$60.94	5.2%

Source: Smith Travel Research

Performance by Location

	Occupancy YTD		*RevPAR YTD*		
	Dec-13	**Dec-12**	**Dec-13**	**Dec-12**	**% change**
Urban	70.5%	69.4%	$113.31	$106.85	6.0%
Suburban	62.8%	61.6%	$58.26	$55.30	5.3%
Airport	69.8%	68.0%	$68.08	$64.46	5.6%
Interstate	54.8%	54.5%	$41.77	$40.49	3.1%
Resort	64.1%	63.2%	$96.36	$89.99	7.1%

Source: Smith Travel Research

- Mirroring the gains in hotel market performance nationally, market conditions continued to improve across a broader range of both traditional business travel and leisure hotel markets through 2013.
  - Bolstered by increased business travel, primary business markets outperformed other hotel location segments through 2013.
  - Rising business travel and conventioneer demand drove double-digit RevPAR increases in San Francisco, Dallas, and Houston, indicative of the heightened level of growth in the technology and energy sectors.
  - Gains in leisure travel also propelled RevPAR growth in major leisure markets. RevPAR in Oahu and Miami increased by double-digit rates, up by 12.5% and 10.1%, respectively. Nashville continued to evolve into a primary tourism destination; RevPAR increased by 13.4% while room demand grew by 7.3%.
  - Markets reliant upon significant government or military-related travelers such as Washington, D.C. and Norfolk weakened further, as both room demand and RevPAR contracted during the year.

In response to the improving market fundamentals, new hotel construction and renovation activity increased through 2013. With most chains enforcing upgrades to meet chain standards, and an increased level of re-flagging, construction spending increased in the second half of the year.

Performance by Market

	Occupancy	**ADR**	**RevPAR % Change**
Atlanta	63.2%	$87.77	6.1%
Boston	73.2%	$164.34	5.6%
Chicago	67.4%	$129.39	4.4%
Dallas	64.2%	$90.64	10.8%
Denver	70.8%	$103.18	8.6%
Detroit	62.4%	$84.20	7.0%
Houston	69.0%	$101.40	13.8%
Los Angeles	76.8%	$136.55	6.8%
Miami	77.9%	$176.66	10.1%
New York	84.6%	$258.57	4.1%
Phoenix	59.7%	$109.01	6.3%
San Diego	71.6%	$135.84	4.2%
San Francisco	83.0%	$187.79	12.9%
Washington, D.C.	66.0%	$144.58	-1.7%

Source: Smith Travel Research

- The number of hotel rooms under construction as of January 2014 rose by 33.4% year-over-year to 96,800 rooms. While construction activity is on the rise, it remained substantially less than the pre-recession peak of more than 200,000 rooms. Also, in the past five years more than 115,000 rooms were removed from service.
  - Two-thirds of new construction activity was within the upscale and upper midscale segments.
  - With 12,200 hotel rooms under construction, representing 11.1% of existing hotel inventory, New York accounts for close to 13% of total rooms under construction.
  - Construction activity is markedly robust in the Denver, Seattle, Miami and Houston hotel markets, where the combined number of hotel rooms under construction totals more than 8,100 rooms, accounting for 8.5% of total rooms under construction nationally.

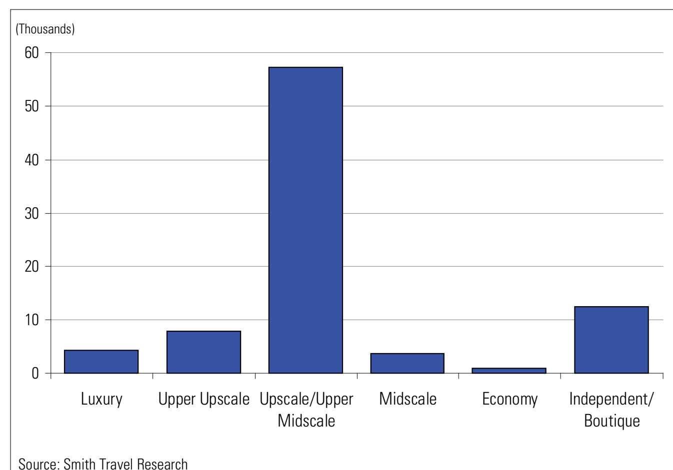
With increased leisure and business travel resulting in tighter market conditions across a broadening range of hotel types and locations, occupancy rates and RevPAR growth nationally maintained an upward through year-end 2013. While the construction pipeline widened, development activity remained well short of the peak from the previous cycle. As a result, the risk of oversupply at the national level remains low. We maintain our view that the full service hotel segment is at 6:30 and the limited service segment is at 7:30 on the RCG Real Estate Cycle Clock.

Investment Market

In response to the rising confidence among investors in the strength of the lodging sector going forward, investment activity increased through 2013, growing by 27.5% to $26.3 billion, according to Real Capital Analytics. A significant proportion of properties sold during the year were full service hotel assets located in major metropolitan areas. With few, quality assets available, asset valuations increased substantially in the past year. At the same time, investment sales for full service hotels in smaller cities, though improved as investors cast wider nets in search of higher yields, remained lackluster.

- Though a smaller proportion of total sales activity, transaction volume in the select service segment of the market also increased from the previous year, rising to $7.5 billion – a 24.6% increase from the previous year.
- With few high-quality assets available across major markets, the increased competition for quality assets led to a greater rise in valuations through 2013, particularly for trophy assets in large cities and resort locations. As a result, the average price per key increased by 9.8% year-over-year to $135,400.
- Private investors remained highly active in the lodging sector, accounting for 42% of all hotel sales in 2013, up from 34% in 2012 and just 22% in 2010, according to Real Capital Analytics. The growth in private investor activity can be partially attributed to the resurgence in CMBS lending.

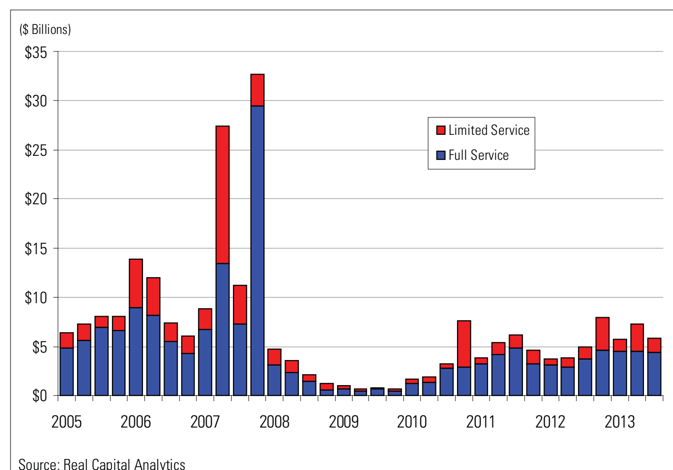
Rooms Under Construction



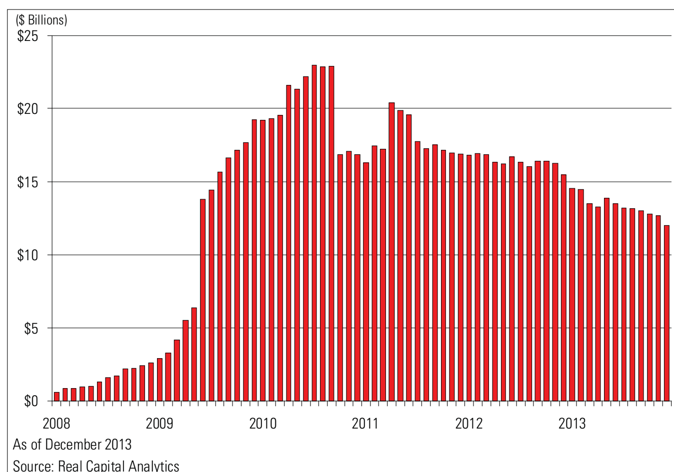
Source: Smith Travel Research

- International investors also ramped-up purchases in 2013, accounting for 14% of total sales in 2013, or $3.5 billion, concentrated in high-profile assets in prime lodging markets.
- The average transactional cap rate at year-end stood at 8.1%, matching average yields throughout much of 2013. While the 10-year Treasury yield increased more than a full percentage point through 2013, the average hotel cap rate remained relatively unchanged from the previous year. The anticipated rise in secondary and tertiary asset purchases could place upward pressure on the average cap rate going forward.
  - Despite the growing interest for assets in secondary and tertiary markets, a preference for high-quality assets in prime hotel investment markets remains, as indicated by the sizable cap-rate spread. The average cap rate held in the high-5% to 6% range through year-end 2013, while the average cap rate in secondary and tertiary markets remained within the high-7% to 8% range.

Quarterly Transaction Volume



Source: Real Capital Analytics



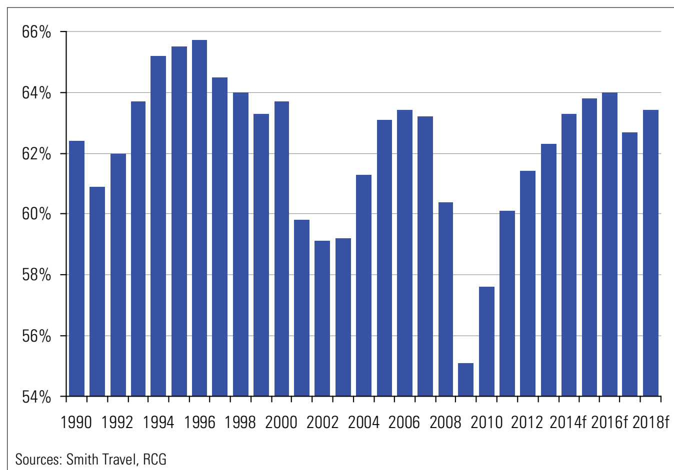
- The level of distressed assets continued to contract through 2013, as market fundamentals improved and demand for hotel assets increased during the year. As of fourth-quarter 2013, the volume of outstanding distressed hotel properties stood at $16.2 billion, a 26% decline from the fourth quarter of 2012, according to Real Capital Analytics. During the quarter, distressed sales accounted for 21% of total hotel sales nationally, up from 11% of total sales in 2012.
  - Since 2008, more than $31 billion of delinquent lodging loans were resolved.
- Rising investment activity and improving market fundamentals prompted a continued decline in the hotel CMBS delinquency rate through 2013. Trending down from the most recent cyclical peak of 15.2% in mid-2011, the CMBS delinquency rate contracted to 6.5% in December of 2013 from 10.3% the previous year, according to Morningstar.
  - The delinquent CMBS loans have an aggregate unpaid balance of nearly $4.5 billion, accounting for 196 loans.
  - The lodging sector accounted for 11.3% of all delinquent CMBS.
  - Amounting to $6.85 billion in December 2013, securitized hotel loans accounted for 13.8% of all specially-serviced assets.
  - The average loss severity for hotel loans liquidated in 2013 increased to 57.3% - the highest average loss severity among all property types.

The Outlook

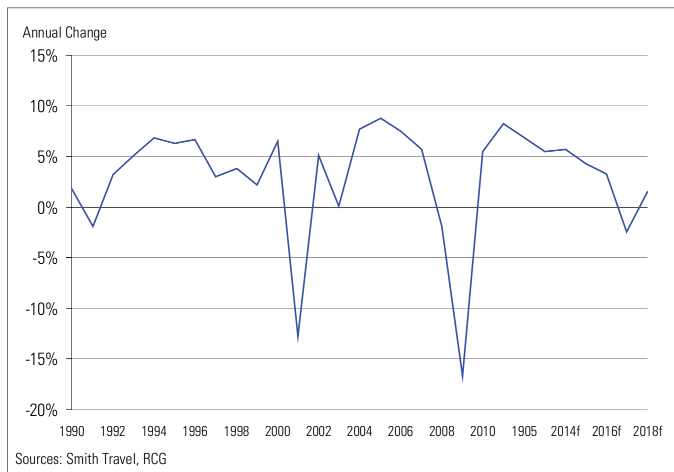
With GDP growth expected to accelerate through the near term and job creation progressing at a healthy rate, the resulting increase in hotel room demand driven by both leisure and business travelers should lead to further improvements in operating fundamentals through the near term.

- Travel volume is expected to increase further, averaging 1% growth for business travel and between 3% and 5% for vacation travel.
  - Led by healthy gains in international travel and increased travel arising from the growth of the domestic economy, spending on U.S. business travel is projected to increase by 6.6% to $289 billion, according to the Global Business Travel Association. This follows the 3.3% increase in business travel spending in 2013 and a 4.4% rise in 2012.
  - The continued growth in the technology and energy sectors should maintain a particularly high level of business travel growth to industry hubs such as San Francisco, Denver and Houston.
- Improving economic conditions should spur further demand for hotel rooms. We expect room demand will increase by at least 2% in the next year.
- In the near term with construction deliveries expected to increase at a moderate pace nationally, further increases in hotel room demand should lead to higher occupancy rates through the early part of the forecast period, with rates approaching 64% in 2015 and 2016. Through the latter part of the forecast period as more rooms come online and the pace of economic growth eases, occupancy rates are expected to decline.
  - Improvements in occupancy rates will continue to be led by urban, resort and airport locations through the near term.
- Near term, ADR is expected to grow at a healthy pace, rising at an annual average rate of 3.5% through 2016. This trend should flatten through the remainder of the forecast period in response to weaker market conditions.
- RevPAR growth should slow to a sustainable rate as well, averaging 4.4% per year from 2014 to 2016.
  - Expectations for sustained growth in the energy and technology sectors combined with modest construction pipelines could produce further double-digit RevPAR gains in areas such as Houston and San Francisco through the near term.
  - While rising visitor volumes in New York resulted in increased room demand through 2013, the extensive pipeline of units under construction will likely restrain RevPAR growth.
  - Given the dependence of the Washington D.C. market upon government and contractor travel and the number of rooms in the near-term development pipeline, RevPAR growth prospects are weak going forward.
- Driven by the growing hotel development pipeline and anticipated increase in capital improvement projects, put-in-place construction spending is expected to escalate through the duration of the forecast, increasing from $13.2 billion in 2014

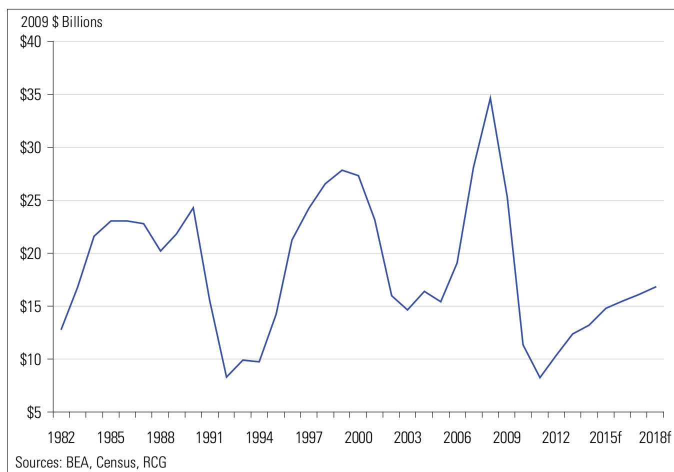
Hotel Occupancy Rate



RevPAR Growth



Hotel Construction Put-in-Place

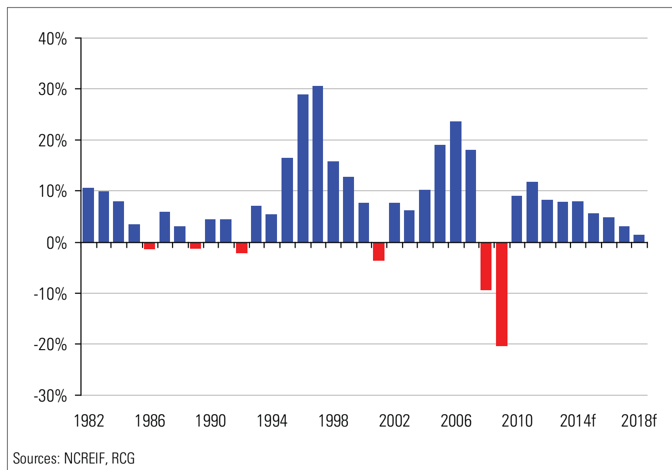


to $16.8 billion by 2018.

- With operating conditions improving and revenue rising, an increasing number of hotel operators will undertake property upgrades and previously-delayed capital improvement projects. This need for capital improvements and the improved investment environment should also lead to more re-flagging opportunities.
- Construction activity will be concentrated among limited-service brands in the upscale and upper-midscale segments of the market, prompted by strong visitor demand. The shifting traveler preferences should provide sufficient demand for these new rooms in most markets at the expense of the economy and budget categories.
- While transaction volumes surged, construction activity remained modest, with the current level of rooms under construction holding well-short of previous peaks. This moderate level of building activity should continue through the near term.
- By 2020, the echo-boomer population will become the prime workforce cohort and is expected to constitute more than 50% of business travel. With more brands instituting an increasingly millennial-focused strategy, this should drive further property renovations as operators increasingly cater to this growing hotel customer demographic.
- The likelihood of higher inflation through the next several years, and resulting increase to the cost of raw materials, should convince operators that capital improvements need to be performed in the near term.

- Strong market fundamentals and improving debt availability should drive a continued rise in transaction activity, leading to further income gains and higher valuations. While gateway cities will remain the primary target for investors, demand for higher yields should lead to greater investment activity in secondary markets, leading to a narrowing of the cap rate spread between primary markets and the national hotel market.
  - Given our expectations for interest rate normalization in the coming periods, the resulting rise in the cost of capital will likely reduce the competition for available assets, contributing to the anticipated increase in cap rates moving forward.
  - For some investors, the hotel sector can become more attractive in inflationary periods. While real assets can hedge against inflation, the ability of hotel operators to reprice every night allows for the rapid pass-through of expenses.
- Improving operating conditions, the increasing willingness among lenders to modify existing loans, and the rise in new CMBS issuance contributed to the healthy decline in the hotel CMBS delinquency rate through 2013. Despite these favorable trends, the still-elevated level of debt maturities and the in-

Total Rates of Return: Hotel Properties



Sources: NCREIF, RCG

ability of many borrowers to recapitalize could potentially lead to an uptick in defaults in the coming periods.

- As of January 2014, more than $14.6 billion of hotel CMBS loans were watchlisted by Morningstar; and though this is down from recent periods, the high volume of potentially troubled loans remains a risk to the greater property market.
- Through the 12-month period ending in January 2015, close to 150 securitized hotel loans with an aggregate balance of $5.7 billion will mature. Approximately 5% of this total volume is currently watchlisted by Morningstar.
- Through the near term, the hotel sector should continue to have among the greatest average loan loss severity percentages.

- Total returns in the lodging sector should remain strong but moderate through the forecast period, averaging 6.2% per year from 2014 to 2016 and easing substantially by 2017 and 2018. While income returns remain positive, the anticipated increase in cap rates will likely weigh on capital appreciation.

Conclusion

Continued job creation and the resulting increase in both business and leisure travel should maintain strong hotel room demand, leading to further improvements in operating conditions in the coming periods. While transient room demand should remain robust, the gradual recovery in group travel should lead to improved ADR growth in this segment and a further widening of the spread between transient and group rates. As new units are brought to market, the growth in new supply should lead to more balanced market conditions into the latter part of the forecast period. Investment activity should remain robust, with interest in assets located in secondary and tertiary market expected to attract a growing proportion of investment capital as the cycle progresses. Investment returns should remain positive but moderate as the anticipated rise in cap rates restrains price appreciation.

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Table I: Economic Growth Ranking of Selected Metropolitan Areas

	Average Employment Growth 2009-2013:	Annual Employment Growth 2014-2018(f):	Employment Growth Sep. '12 vs. Sep. '13 Percent	Absolute (000)	Unemployment Rate (%) Sep. '12	Sep. '13	Economic Risk Level 2014-2015:	Economic Risk Level 2016-2018:
WEST								
Southern California								
Bakersfield, CA	1.1%	1.9%	1.2%	2.9	12.8%	11.3%	Low-Medium	Low-Medium
Inland Empire, CA	-0.1%	1.7%	1.0%	11.4	11.6%	9.7%	Low-Medium	Medium
Los Angeles, CA	-0.2%	1.4%	1.2%	46.8	10.4%	9.3%	Low-Medium	Low-Medium
Orange County, CA	0.2%	1.5%	2.0%	27.5	7.2%	5.8%	Low	Low-Medium
San Diego, CA	0.3%	1.3%	1.8%	22.6	8.5%	7.0%	Low-Medium	Low
Santa Barbara, CA	0.3%	1.3%	2.5%	4.3	7.5%	6.2%	Low-Medium	Low-Medium
Ventura, CA	0.0%	1.0%	1.8%	5.1	8.6%	7.3%	Low-Medium	Medium
Northern California								
Fresno, CA	-0.7%	1.0%	0.7%	1.9	14.9%	12.6%	Low-Medium	Medium
Modesto, CA	-0.1%	1.0%	0.4%	0.6	14.8%	12.4%	Medium	Medium
Oakland, CA	-0.3%	1.2%	0.5%	4.9	8.6%	7.0%	Low-Medium	Medium
Sacramento, CA	-0.5%	1.4%	0.8%	6.7	10.0%	8.1%	Medium	Medium
Salinas, CA	-0.1%	0.7%	0.8%	1.0	11.1%	9.4%	Low-Medium	Medium
San Francisco, CA	1.2%	1.6%	2.2%	21.7	6.6%	5.2%	Low	Low-Medium
San Jose, CA	1.1%	1.5%	3.0%	27.1	8.2%	6.5%	Low	Low-Medium
Santa Rosa, CA	-0.2%	1.2%	1.5%	2.6	8.1%	6.3%	Low-Medium	Medium
Stockton, CA	-0.6%	1.1%	2.2%	4.1	14.7%	12.1%	Medium-High	Medium
Vallejo, CA	0.2%	1.6%	2.1%	2.5	9.7%	7.9%	Medium	Medium
Other West Markets								
Albuquerque, NM	-0.9%	0.9%	1.0%	3.8	7.1%	6.7%	Low-Medium	Medium
Boise, ID	0.6%	1.8%	2.3%	6.1	6.4%	6.1%	Low	Low
Colorado Springs, CO	0.0%	1.1%	1.1%	2.9	8.9%	8.2%	Medium	Medium
Denver, CO	0.9%	1.8%	2.7%	33.5	7.6%	6.6%	Low	Low
Honolulu, HI	0.4%	0.9%	0.9%	4.0	4.9%	4.0%	Low-Medium	Low
Las Vegas, NV	-0.5%	1.8%	2.0%	16.7	10.5%	9.3%	Medium	Medium
Phoenix, AZ	0.2%	1.7%	2.1%	36.6	6.8%	6.9%	Low-Medium	Low-Medium
Portland, OR	0.5%	1.6%	1.8%	18.7	7.9%	6.7%	Low	Low
Salt Lake City, UT	1.1%	1.9%	2.9%	18.4	5.2%	4.4%	Low	Low
Seattle, WA	0.6%	1.8%	2.8%	40.0	6.6%	5.5%	Low	Low
Spokane, WA	-0.4%	1.3%	1.8%	3.7	8.5%	7.3%	Low-Medium	Low-Medium
Tacoma, WA	-0.3%	1.3%	2.0%	5.3	8.7%	7.6%	Low-Medium	Low-Medium
Tucson, AZ	-0.6%	0.8%	0.5%	1.7	6.9%	7.1%	Low-Medium	Medium
SOUTH								
Atlanta, GA	0.6%	1.8%	3.0%	70.6	8.5%	7.4%	Medium	Low-Medium
Austin, TX	2.2%	2.9%	3.0%	24.7	5.3%	5.2%	Low	Low
Birmingham, AL	-0.7%	0.9%	-0.6%	-3.1	6.1%	5.7%	Medium	Medium
Charlotte, NC	1.0%	1.5%	3.3%	27.8	9.4%	7.8%	Medium	Medium
Dallas, TX	1.2%	1.8%	3.2%	68.5	6.3%	6.1%	Low	Low
El Paso, TX	0.6%	1.2%	0.2%	0.6	8.8%	8.8%	Low-Medium	Low-Medium
Fort Lauderdale, FL	0.5%	1.7%	3.0%	21.9	7.1%	5.5%	Low-Medium	Low
Fort Worth, TX	1.6%	1.9%	3.6%	32.0	6.1%	5.9%	Low	Low
Greensboro/Win.-Sal., NC	-0.5%	1.1%	1.2%	6.5	9.4%	7.8%	Low-Medium	Medium

Note: "--" indicates data is unavailable

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Table I: Economic Growth Ranking of Selected Metropolitan Areas

	Average Employment Growth 2009-2013:	Annual Employment Growth 2014-2018(f):	Employment Growth Sep. '12 vs. Sep. '13		Unemployment Rate (%)		Economic Risk Level 2014-2015:	Economic Risk Level 2016-2018:
			Percent	Absolute (000)	Sep. '12	Sep. '13		
SOUTH (Continued)								
Houston, TX	1.6%	2.3%	3.2%	85.9	6.2%	6.1%	Low	Low
Jacksonville, FL	0.3%	1.3%	1.8%	10.8	7.8%	6.3%	Medium	Low-Medium
Memphis, TN	-0.5%	0.9%	0.4%	2.4	8.5%	9.4%	Low-Medium	Low-Medium
Miami, FL	0.6%	1.5%	0.6%	6.4	8.9%	8.3%	Low-Medium	Low
Nashville, TN	1.8%	1.9%	3.2%	25.5	6.3%	6.6%	Low	Low
Norfolk, VA	0.2%	0.9%	2.5%	18.7	6.3%	5.7%	Medium	Medium
Orlando, FL	0.8%	1.9%	2.4%	24.8	8.0%	6.2%	Low-Medium	Low-Medium
Raleigh-Durham, NC	0.9%	1.9%	1.4%	11.7	7.4%	6.2%	Low-Medium	Low-Medium
Richmond, VA	0.3%	1.0%	0.8%	5.3	6.1%	5.7%	Medium	Low-Medium
San Antonio, TX	1.0%	1.6%	0.8%	7.3	5.9%	6.0%	Low	Low
Tampa, FL	0.8%	2.0%	3.7%	42.7	8.4%	6.6%	Low-Medium	Low-Medium
Tulsa, OK	-0.1%	1.5%	1.7%	7.0	5.4%	5.5%	Low	Low
West Palm Beach, FL	0.3%	1.7%	2.0%	10.2	8.4%	6.8%	Low-Medium	Low-Medium
NORTHEAST								
Baltimore, MD	0.8%	1.0%	1.9%	25.0	7.1%	6.7%	Medium	Medium
Boston, MA	0.8%	1.5%	2.3%	58.1	6.0%	6.2%	Low	Low-Medium
Central New Jersey	0.1%	1.1%	1.1%	11.1	8.7%	7.7%	Medium	Low-Medium
Hartford, CT	0.1%	0.8%	1.1%	6.2	8.3%	7.8%	Medium	Medium
Nassau-Suffolk, NY	0.7%	1.2%	2.1%	26.0	7.1%	6.0%	Low-Medium	Low-Medium
New York, NY	0.8%	1.6%	1.6%	84.5	8.7%	8.2%	Low-Medium	Low
Newark, NJ	-0.4%	0.8%	1.4%	13.9	9.1%	8.3%	Medium	Medium
Philadelphia, PA	-0.2%	0.8%	0.9%	24.8	8.6%	7.8%	Low-Medium	Medium
Pittsburgh, PA	0.6%	0.8%	1.8%	20.3	7.2%	6.7%	Low-Medium	Low-Medium
Rochester, NY	0.1%	0.5%	0.3%	1.5	8.0%	7.0%	Medium-High	Medium-High
Stamford, CT	0.0%	0.8%	1.0%	3.9	7.6%	7.2%	Medium	Medium
Washington, DC	0.7%	1.1%	0.9%	26.9	5.4%	5.3%	Medium-High	Medium
MIDWEST								
Louisville, KY	0.6%	1.1%	2.3%	14.2	7.8%	7.6%	Low-Medium	Low-Medium
Chicago, IL	0.1%	1.1%	1.1%	47.6	8.6%	8.7%	Low-Medium	Low
Cincinnati, OH	-0.3%	0.7%	0.7%	6.9	6.7%	7.3%	Low-Medium	Medium
Cleveland, OH	-0.5%	0.4%	-0.7%	-6.7	6.8%	6.7%	Medium	Medium-High
Columbus, OH	0.8%	0.8%	1.4%	12.9	5.7%	6.5%	Low-Medium	Medium
Detroit, MI	0.0%	0.3%	0.6%	11.5	10.3%	9.4%	Medium-High	Medium-High
Indianapolis, IN	0.7%	0.9%	1.2%	11.5	7.7%	6.8%	Low-Medium	Medium
Kansas City, MO	0.0%	0.8%	0.9%	9.2	6.2%	6.1%	Medium	Medium
Milwaukee, WI	-0.4%	0.7%	0.4%	3.3	7.1%	7.1%	Medium	Medium
Minneapolis, MN	0.6%	1.4%	2.1%	37.2	5.3%	4.6%	Low-Medium	Low-Medium
St. Louis, MO	-0.3%	0.7%	0.9%	11.6	7.3%	6.9%	Medium	Medium

Note: "--" indicates data is unavailable

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Table II: Single Family Housing Activity in Selected Metropolitan Areas

	Absolute Household Growth (000) 2009-2013:	Forecasted Absolute HH Growth (000) 2014-2018(f):	Year-to-Date Single Family Permits (000) Sep. '13	Ann Chg	Existing Median Home Price 3Q13	Annual Change in Existing Median Price 3Q13	CAGR 2014-2018(f):	Households Able to Afford Median-Priced Home, 2013	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
WEST											
Southern California											
Bakersfield, CA	14.6	16.8	1.2	0.4	$196,306	31.6%	8.1%	58.3%	7:30	Low	Low
Inland Empire, CA	76.5	162.7	4.9	1.8	$249,050	28.4%	4.8%	56.6%	7:00	Low	Low
Los Angeles, CA	89.0	132.2	2.8	0.8	$441,773	26.0%	5.6%	33.6%	7:30	Low	Low
Orange County, CA	36.2	56.3	2.9	1.3	$670,690	19.7%	4.2%	27.5%	7:30	Low	Low
San Diego, CA	55.9	67.6	1.9	0.2	$485,040	23.0%	4.2%	33.7%	7:00	Low	Low
Santa Barbara, CA	3.5	5.1	0.2	0.1	$638,870	31.6%	11.5%	21.6%	8:30	Low	Low
Ventura, CA	13.3	14.8	0.3	0.1	$550,427	27.4%	4.3%	36.1%	7:30	Low	Low
Northern California											
Fresno, CA	16.3	16.2	1.4	0.2	$184,499	20.8%	4.4%	58.9%	7:00	Low	Low
Modesto, CA	8.1	8.2	0.2	0.1	$182,564	29.0%	6.4%	63.5%	7:00	Low	Low
Oakland, CA	56.2	48.8	2.3	0.3	$707,926	23.2%	3.7%	25.9%	7:30	Low	Low
Sacramento, CA	30.5	37.9	2.8	0.8	$255,900	41.8%	3.5%	63.8%	7:30	Low	Low
Salinas, CA	-0.4	6.8	0.2	0.1	$412,767	-1.0%	4.5%	23.7%	7:30	Low	L-M
San Francisco, CA	36.9	20.5	0.4	0.1	$917,531	19.7%	3.9%	19.2%	8:00	Low	Low
San Jose, CA	35.5	28.3	1.4	0.2	$807,667	20.7%	4.1%	25.8%	8:00	Low	Low
Santa Rosa, CA	4.8	4.7	0.3	0.1	$461,376	25.0%	4.9%	33.8%	7:00	Low	Low
Stockton, CA	13.2	12.1	0.9	0.2	$218,638	33.6%	4.3%	60.8%	7:00	Low	Low
Vallejo, CA	6.5	5.8	0.4	0.1	$287,652	60.9%	4.5%	66.0%	7:30	Low	Low
Other West Markets											
Albuquerque, NM	16.9	25.9	1.1	-0.3	$180,700	4.5%	3.5%	65.3%	6:00	Low	Low
Boise, ID	15.5	28.1	2.8	0.6	$168,400	15.3%	4.2%	72.9%	7:30	Low	Low
Colorado Springs, CO	22.5	23.0	2.3	0.5	$222,100	7.8%	3.3%	65.4%	7:30	Low	Low
Denver, CO	71.9	93.8	5.1	1.0	$286,900	10.2%	4.0%	55.7%	8:00	Low	Low
Honolulu, HI	8.3	11.4	0.9	0.2	$679,800	8.4%	3.3%	19.5%	7:30	Low	Low
Las Vegas, NV	41.7	53.4	5.7	1.0	$181,900	31.9%	5.5%	71.6%	6:30	Low	Low
Phoenix, AZ	118.5	140.6	10.1	0.7	$191,700	25.0%	5.4%	70.6%	7:00	Low	Low
Portland, OR	49.6	62.3	4.4	1.0	$276,200	15.5%	4.3%	57.7%	7:00	Low	Low
Salt Lake City, UT	22.1	31.4	2.7	0.6	$243,275	12.9%	3.7%	63.8%	7:30	Low	Low
Seattle, WA	47.2	88.9	4.9	0.4	$398,327	15.1%	4.6%	48.4%	8:00	Low	Low
Spokane, WA	5.6	9.9	0.8	0.3	$181,600	3.7%	3.7%	65.8%	7:00	Low	Low
Tacoma, WA	9.6	21.4	1.9	0.4	$228,158	12.9%	4.0%	65.9%	7:00	Low	Low
Tucson, AZ	12.6	17.6	2.1	0.5	$172,400	11.0%	4.2%	62.4%	7:00	Low	Low
SOUTH											
Atlanta, GA	61.7	133.2	11.5	4.7	$152,300	41.8%	3.3%	82.4%	7:00	Low	Low
Austin, TX	82.3	104.9	5.8	0.4	$225,300	8.6%	4.3%	65.2%	7:00	Low	Low
Birmingham, AL	7.6	8.5	1.5	0.1	$173,700	10.3%	3.4%	65.1%	7:00	Low	Low
Charlotte, NC	27.6	94.4	6.9	1.8	$184,078	3.9%	3.6%	70.4%	6:30	Low	Low
Dallas, TX	131.6	155.6	11.6	2.3	$196,039	12.3%	3.8%	68.4%	7:30	Low	Low
El Paso, TX	27.2	17.5	1.9	-0.5	$143,600	1.1%	2.4%	61.3%	6:30	Low	Low
Fort Lauderdale, FL	9.0	61.5	1.1	0.4	$272,812	28.6%	4.6%	51.5%	7:00	Low	L-M
Fort Worth, TX	69.2	77.3	4.7	0.6	$136,190	11.6%	3.8%	79.8%	7:00	Low	Low
Greensboro/Win.-Sal., NC	25.7	22.2	1.8	0.4	$136,100	8.1%	3.0%	73.5%	7:00	Low	Low

Note: "--" indicates data is unavailable

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Table II: Single Family Housing Activity in Selected Metropolitan Areas

	Absolute Household Growth (000) 2009-2013:	Forecasted Absolute HH Growth (000) 2014-2018(f):	Year-to-Date Single Family Permits (000) Sep. '13	Ann Chg	Existing Median Home Price 3Q13	Annual Change in Existing Median Price 3Q13	CAGR 2014-2018(f):	Households Able to Afford Median-Priced Home, 2013	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
SOUTH (Continued)											
Houston, TX	177.1	204.3	27.0	5.1	$186,600	11.4%	3.7%	69.0%	7:30	Low	Low
Jacksonville, FL	14.7	40.0	4.9	1.6	$170,600	29.3%	3.7%	74.7%	7:00	Low	Low
Memphis, TN	7.4	12.8	2.0	0.3	$137,500	10.4%	3.4%	74.4%	6:30	Low	Low
Miami, FL	23.0	63.1	1.8	0.4	$232,483	22.2%	5.1%	52.6%	7:00	Low	Low
Nashville, TN	23.3	43.4	5.4	1.4	$197,887	11.7%	3.7%	65.0%	7:00	Low	Low
Norfolk, VA	6.2	20.1	3.4	0.7	$200,460	1.2%	3.9%	69.8%	6:30	Low	Low
Orlando, FL	45.2	58.5	7.6	2.3	$167,800	23.9%	4.2%	71.5%	7:00	Low	Low
Raleigh-Durham, NC	68.1	79.0	7.9	1.9	$208,768	2.7%	3.6%	67.3%	6:30	Low	Low
Richmond, VA	14.9	24.3	2.8	0.7	$213,421	9.7%	3.7%	68.2%	7:00	Low	Low
San Antonio, TX	93.9	76.8	4.5	0.6	$175,000	8.1%	3.9%	64.8%	7:00	Low	Low
Tampa, FL	43.0	66.2	6.0	1.7	$151,800	10.0%	4.2%	71.6%	6:00	L-M	Low
Tulsa, OK	11.8	10.3	2.4	0.3	$146,500	5.5%	3.6%	71.5%	7:00	Low	Low
West Palm Beach, FL	25.4	41.8	2.0	0.5	$249,496	13.4%	4.4%	51.6%	7:00	Low	Low
NORTHEAST											
Baltimore, MD	36.6	33.2	3.9	0.9	$266,500	4.8%	3.3%	63.7%	7:00	Low	Low
Boston, MA	63.2	45.0	3.7	0.7	$393,700	7.6%	4.3%	50.5%	6:30	Low	Low
Central New Jersey	24.7	21.6	3.1	1.1	$314,600	-0.9%	3.5%	63.4%	6:00	L-M	Low
Hartford, CT	6.9	6.2	0.6	0.1	$238,500	1.1%	2.8%	68.6%	6:00	L-M	L-M
Nassau-Suffolk, NY	30.0	13.0	1.1	0.3	$401,100	3.5%	3.8%	58.3%	6:30	Low	Low
New York, NY	88.9	98.6	1.5	0.5	$483,300	3.3%	4.8%	32.3%	6:30	Low	Low
Newark, NJ	6.3	5.2	1.4	0.3	$411,200	5.6%	3.3%	50.5%	6:30	Low	Low
Philadelphia, PA	31.2	49.1	4.9	0.9	$231,600	3.5%	3.3%	65.5%	6:30	Low	Low
Pittsburgh, PA	3.9	-0.6	2.6	0.2	$143,267	6.1%	3.8%	72.5%	6:30	Low	Low
Rochester, NY	21.5	1.8	0.6	-0.1	$132,100	1.5%	2.8%	77.0%	6:00	L-M	Low
Stamford, CT	12.4	6.6	0.4	0.1	$439,000	11.3%	3.9%	55.0%	6:30	Low	Low
Washington, DC	136.0	128.9	10.6	2.2	$392,500	8.3%	4.0%	57.2%	7:30	Low	Low
MIDWEST											
Louisville, KY	16.6	13.8	1.8	0.1	$145,100	2.8%	3.8%	72.9%	7:00	Low	Low
Chicago, IL	17.6	52.1	5.4	1.2	$209,000	13.3%	3.0%	70.5%	6:00	Low	Low
Cincinnati, OH	13.6	20.6	2.6	0.6	$142,100	5.9%	3.7%	77.1%	6:30	Low	Low
Cleveland, OH	0.7	-9.3	1.7	0.3	$127,000	6.0%	3.4%	76.0%	7:00	Low	Low
Columbus, OH	36.8	38.9	2.7	0.6	$152,100	4.2%	3.6%	76.0%	6:00	Low	Low
Detroit, MI	-8.0	-19.4	4.3	1.2	$130,169	38.6%	4.0%	78.5%	6:00	L-M	L-M
Indianapolis, IN	22.7	34.4	4.0	0.9	$143,500	7.1%	3.4%	77.9%	7:00	Low	Low
Kansas City, MO	21.6	33.6	3.2	0.8	$162,300	9.3%	3.0%	76.7%	7:00	Low	L-M
Milwaukee, WI	19.3	7.1	1.0	0.2	$211,800	6.3%	3.1%	65.4%	6:30	Low	Low
Minneapolis, MN	47.6	64.5	5.5	1.4	$208,000	14.6%	3.4%	73.7%	7:00	Low	Low
St. Louis, MO	3.1	12.2	3.6	0.5	$143,700	8.5%	3.7%	78.4%	6:30	Low	Low

Note: "--" indicates data is unavailable

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Table III: Apartment Activity in Selected Metropolitan Areas

	Absolute Household Growth (000) 2009-2013:	Forecasted Absolute HH Growth (000) 2014-2018(f):	Year-to-Date Multifamily Permits (000) Sep. '13	Ann Chg	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
WEST							
Southern California							
Bakersfield, CA	14.6	16.8	0.5	0.3	6:30	L-M	L-M
Inland Empire, CA	76.5	162.7	2.1	0.9	6:00	Med	M-H
Los Angeles, CA	89.0	132.2	6.9	0.2	7:30	L-M	L-M
Orange County, CA	36.2	56.3	4.4	1.7	7:00	Med	L-M
San Diego, CA	55.9	67.6	3.5	0.4	7:00	L-M	L-M
Santa Barbara, CA	3.5	5.1	0.0	-0.1	7:30	Low	L-M
Ventura, CA	13.3	14.8	0.3	0.0	6:30	L-M	L-M
Northern California							
Fresno, CA	16.3	16.2	0.2	0.0	6:00	L-M	L-M
Modesto, CA	8.1	8.2	0.0	-0.1	6:00	L-M	L-M
Oakland, CA	56.2	48.8	1.3	-0.6	8:30	Low	L-M
Sacramento, CA	30.5	37.9	0.6	0.3	6:30	Med	Med
Salinas, CA	-0.4	6.8	0.1	-0.1	7:00	L-M	Low
San Francisco, CA	36.9	20.5	3.7	0.7	8:30	Low	Low
San Jose, CA	35.5	28.3	3.9	1.0	8:30	Low	L-M
Santa Rosa, CA	4.8	4.7	0.1	-0.1	7:30	Low	L-M
Stockton, CA	13.2	12.1	0.1	0.1	6:00	Med	Med
Vallejo, CA	6.5	5.8	0.2	0.2	6:30	L-M	L-M
Other West Markets							
Albuquerque, NM	16.9	25.9	0.7	0.4	7:00	Med	Med
Boise, ID	15.5	28.1	0.6	0.0	7:00	L-M	L-M
Colorado Springs, CO	22.5	23.0	0.5	-0.1	7:30	L-M	L-M
Denver, CO	71.9	93.8	5.4	0.9	8:30	L-M	L-M
Honolulu, HI	8.3	11.4	1.2	0.7	7:30	Low	Low
Las Vegas, NV	41.7	53.4	1.4	0.3	5:30	Med	Med
Phoenix, AZ	118.5	140.6	3.1	1.1	7:30	Med	L-M
Portland, OR	49.6	62.3	4.7	2.3	8:30	Low	L-M
Salt Lake City, UT	22.1	31.4	1.0	0.3	8:00	L-M	Low
Seattle, WA	47.2	88.9	6.7	0.2	8:30	L-M	L-M
Spokane, WA	5.6	9.9	0.1	0.0	7:30	L-M	L-M
Tacoma, WA	9.6	21.4	0.3	0.1	8:00	L-M	L-M
Tucson, AZ	12.6	17.6	0.6	0.1	6:00	Med	Med
SOUTH							
Atlanta, GA	61.7	133.2	6.9	3.1	7:00	Med	Med
Austin, TX	82.3	104.9	7.3	1.3	8:30	L-M	L-M
Birmingham, AL	7.6	8.5	0.6	-0.3	6:30	Med	L-M
Charlotte, NC	27.6	94.4	2.9	-1.2	7:30	Med	Med
Dallas, TX	131.6	155.6	8.1	-2.6	7:30	L-M	Med
El Paso, TX	27.2	17.5	1.1	0.5	6:30	L-M	Med
Fort Lauderdale, FL	9.0	61.5	2.4	0.6	7:00	L-M	Med
Fort Worth, TX	69.2	77.3	2.5	0.4	6:30	L-M	L-M
Greensboro/Win.-Sal., NC	25.7	22.2	1.0	-0.1	7:00	L-M	L-M

Note: "--" indicates data is unavailable

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Table III: Apartment Activity in Selected Metropolitan Areas

	Absolute Household Growth (000) 2009-2013:	Forecasted Absolute HH Growth (000) 2014-2018(f):	Year-to-Date Multifamily Permits (000) Sep. '13	Ann Chg	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
SOUTH (Continued)							
Houston, TX	177.1	204.3	10.4	0.3	8:00	Med	Med
Jacksonville, FL	14.7	40.0	0.6	-1.7	6:30	Med	L-M
Memphis, TN	7.4	12.8	0.6	-0.4	6:30	Med	L-M
Miami, FL	23.0	63.1	5.9	4.1	7:30	L-M	Med
Nashville, TN	23.3	43.4	2.8	0.8	7:00	L-M	L-M
Norfolk, VA	6.2	20.1	3.0	1.3	7:00	Med	Med
Orlando, FL	45.2	58.5	4.5	1.2	7:00	Med	Med
Raleigh-Durham, NC	68.1	79.0	4.3	-0.9	7:30	L-M	L-M
Richmond, VA	14.9	24.3	1.2	0.4	7:30	Med	Med
San Antonio, TX	93.9	76.8	2.0	-0.6	7:00	L-M	Med
Tampa, FL	43.0	66.2	3.3	-0.1	7:00	Med	Med
Tulsa, OK	11.8	10.3	0.7	0.0	6:30	Med	L-M
West Palm Beach, FL	25.4	41.8	2.0	0.0	7:00	L-M	Med
NORTHEAST							
Baltimore, MD	36.6	33.2	2.2	0.1	7:00	L-M	L-M
Boston, MA	63.2	45.0	5.6	2.2	8:00	L-M	L-M
Central New Jersey	24.7	21.6	1.6	0.1	6:30	L-M	L-M
Hartford, CT	6.9	6.2	0.3	0.0	6:00	L-M	L-M
Nassau-Suffolk, NY	30.0	13.0	0.1	-0.3	6:00	L-M	L-M
New York, NY	88.9	98.6	16.9	5.8	9:30	Low	Low
Newark, NJ	6.3	5.2	2.2	0.4	6:30	L-M	L-M
Philadelphia, PA	31.2	49.1	3.5	0.6	7:00	L-M	Med
Pittsburgh, PA	3.9	-0.6	1.0	0.7	7:30	L-M	L-M
Rochester, NY	21.5	1.8	0.2	-0.1	6:30	Med	L-M
Stamford, CT	12.4	6.6	1.3	0.4	8:00	L-M	L-M
Washington, DC	136.0	128.9	7.0	-0.6	12:30	High	High
MIDWEST							
Louisville, KY	16.6	13.8	0.8	-0.3	6:00	Med	L-M
Chicago, IL	17.6	52.1	3.9	1.5	7:30	Med	Med
Cincinnati, OH	13.6	20.6	1.0	0.5	6:00	Med	Med
Cleveland, OH	0.7	-9.3	0.4	0.1	6:00	Med	Med
Columbus, OH	36.8	38.9	3.6	1.0	6:00	Med	Med
Detroit, MI	-8.0	-19.4	0.6	0.3	5:00	M-H	M-H
Indianapolis, IN	22.7	34.4	1.5	1.0	6:30	Med	Med
Kansas City, MO	21.6	33.6	2.4	1.3	6:00	Med	Med
Milwaukee, WI	19.3	7.1	0.4	-0.2	8:00	Med	L-M
Minneapolis, MN	47.6	64.5	3.4	0.2	7:30	L-M	Med
St. Louis, MO	3.1	12.2	0.5	-0.2	6:00	Med	Med

Note: "--" indicates data is unavailable

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Table IV: Office Market Statistics of Selected Metropolitan Areas

	Vacancy Rate 3Q13	Forecasted Vacancy Rate 2018(f):	Total Office Employ. Growth Sep. '12 to Sep. '13	Annual Office Employment Growth 2014-2018(f):	Average Annual New Construction (000) 2009-2013:	Average Annual New Construction (000) 2014-2018(f):	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
WEST									
Southern California									
Bakersfield, CA	--	--	-1.1%	1.8%	--	--	--	---	---
Inland Empire, CA	19.6%	12.2%	-2.0%	1.3%	128	0	4:30	M-H	Med
Los Angeles, CA	18.5%	13.7%	2.0%	1.6%	710	924	5:30	Med	Med
Orange County, CA	14.8%	13.2%	2.6%	1.5%	92	214	6:30	Med	Med
San Diego, CA	14.0%	10.7%	1.0%	1.3%	172	300	6:00	Med	Med
Santa Barbara, CA	--	--	4.1%	1.8%	--	--	--	---	---
Ventura, CA	17.1%	14.4%	-0.2%	1.1%	64	134	5:00	Med	Med
Northern California									
Fresno, CA	--	--	6.4%	0.7%	--	--	--	---	---
Modesto, CA	--	--	0.2%	0.8%	--	--	--	---	---
Oakland, CA	14.1%	10.4%	-1.2%	1.1%	146	232	6:30	Med	Med
Sacramento, CA	15.4%	14.6%	-0.1%	1.3%	570	347	4:30	M-H	M-H
Salinas, CA	--	--	1.8%	0.5%	--	--	--	---	---
San Francisco, CA	10.0%	9.3%	2.8%	1.8%	186	1,584	8:00	L-M	Med
San Jose, CA	12.1%	11.3%	5.1%	2.0%	1,097	1,831	8:00	L-M	Med
Santa Rosa, CA	--	--	4.9%	1.0%	--	--	--	---	---
Stockton, CA	--	--	2.0%	0.6%	--	--	--	---	---
Vallejo, CA	--	--	4.3%	1.4%	--	--	--	---	---
Other West Markets									
Albuquerque, NM	20.0%	18.5%	1.6%	0.8%	90	45	4:00	M-H	Med
Boise, ID	15.1%	12.3%	6.3%	2.0%	72	124	5:30	Med	Med
Colorado Springs, CO	13.2%	12.5%	-3.4%	1.3%	263	268	5:00	Med	Med
Denver, CO	13.6%	11.9%	3.7%	2.0%	568	865	6:00	Med	Med
Honolulu, HI	15.7%	13.0%	1.4%	0.9%	0	0	5:30	Med	Med
Las Vegas, NV	23.0%	19.9%	-0.2%	1.9%	280	134	4:00	M-H	M-H
Phoenix, AZ	22.7%	21.3%	2.3%	1.6%	716	214	4:30	M-H	Med
Portland, OR	12.9%	10.6%	2.6%	1.8%	381	191	6:30	L-M	Med
Salt Lake City, UT	13.6%	11.4%	4.3%	2.1%	492	705	6:00	Med	Med
Seattle, WA	14.8%	8.7%	2.0%	2.2%	1,134	883	7:30	L-M	L-M
Spokane, WA	--	--	-3.5%	1.5%	--	--	--	---	---
Tacoma, WA	15.6%	11.3%	3.0%	1.3%	14	0	6:00	Med	Med
Tucson, AZ	--	--	0.7%	1.0%	--	--	--	---	---
SOUTH									
Atlanta, GA	19.3%	16.2%	4.1%	1.7%	800	540	4:30	M-H	Med
Austin, TX	11.6%	7.5%	5.3%	3.1%	228	1,018	7:30	L-M	L-M
Birmingham, AL	13.5%	11.5%	1.0%	0.7%	20	0	4:30	Med	Med
Charlotte, NC	15.7%	13.6%	3.7%	1.8%	969	246	4:30	M-H	Med
Dallas, TX	19.6%	18.1%	6.2%	1.9%	1,201	1,478	7:00	L-M	Med
El Paso, TX	--	--	-0.5%	1.3%	--	--	--	---	---
Fort Lauderdale, FL	16.2%	14.1%	1.6%	1.6%	66	82	5:00	Med	Med
Fort Worth, TX	19.1%	19.1%	3.7%	2.3%	186	247	6:00	Med	Med
Houston, TX	12.9%	12.2%	2.7%	2.3%	2,151	1,855	7:30	L-M	Med

Note: "--" indicates data is unavailable

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Table IV: Office Market Statistics of Selected Metropolitan Areas

	Vacancy Rate 3Q13	Forecasted Vacancy Rate 2018(f):	Total Office Employ. Growth Sep. '12 to Sep. '13	Annual Office Employment Growth 2014-2018(f):	Average Annual New Construction (000) 2009-2013:	Average Annual New Construction (000) 2014-2018(f):	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
SOUTH (Continued)									
Jacksonville, FL	20.1%	17.2%	5.1%	1.6%	2	180	4:30	M-H	Med
Memphis, TN	15.7%	14.2%	0.6%	1.0%	43	0	4:30	M-H	Med
Miami, FL	16.3%	14.6%	1.8%	1.1%	752	367	6:30	Med	Med
Nashville, TN	12.1%	8.8%	5.2%	2.4%	394	506	6:30	Med	Med
New Orleans, LA	--	--	--	--	--	--	--	---	---
Orlando, FL	18.0%	15.3%	2.7%	2.5%	185	151	5:00	Med	Med
Raleigh-Durham, NC	16.0%	15.2%	2.9%	2.5%	384	574	6:00	Med	Med
Richmond, VA	16.5%	15.2%	-2.7%	0.9%	203	291	5:30	Med	Med
San Antonio, TX	15.7%	15.4%	0.5%	1.3%	314	216	5:30	Med	Med
Tampa, FL	17.0%	13.5%	4.1%	2.1%	216	22	5:00	Med	Med
Tulsa, OK	--	--	2.4%	1.9%	--	--	--	---	---
West Palm Beach, FL	19.7%	16.0%	1.9%	1.4%	53	75	5:30	M-H	Med
NORTHEAST									
Baltimore, MD	15.7%	14.4%	4.0%	1.2%	1,184	218	4:30	M-H	Med
Boston, MA	14.8%	13.2%	2.8%	1.7%	1,237	1,343	7:30	Med	Med
Central New Jersey	20.2%	19.7%	0.4%	0.9%	101	134	5:00	Med	Med
Hartford, CT	19.4%	18.7%	-0.3%	0.8%	7	53	5:00	M-H	Med
Nassau-Suffolk, NY	17.4%	16.6%	2.7%	1.5%	52	14	4:30	M-H	Med
New York, NY	11.6%	10.0%	0.5%	1.3%	1,163	1,945	6:30	Med	Med
Newark, NJ	22.3%	23.5%	1.1%	0.8%	306	294	4:00	M-H	Med
Philadelphia, PA	15.3%	13.6%	0.8%	0.8%	232	94	4:30	Med	Med
Pittsburgh, PA	14.8%	13.3%	3.8%	1.2%	673	506	5:00	Med	Med
Rochester, NY	--	--	0.9%	0.8%	--	--	--	---	---
Stamford, CT	21.2%	18.3%	0.3%	1.1%	121	0	5:00	M-H	Med
Washington, DC	17.3%	17.3%	1.4%	1.1%	3,158	1,518	10:00	High	M-H
MIDWEST									
Louisville, KY	14.7%	12.7%	2.2%	1.7%	77	80	5:00	M-H	Med
Chicago, IL	17.7%	14.7%	2.5%	1.2%	765	353	6:00	Med	Med
Cincinnati, OH	22.4%	20.8%	1.4%	0.8%	325	120	4:00	M-H	Med
Cleveland, OH	20.1%	15.9%	-2.3%	0.3%	218	0	4:30	M-H	M-H
Columbus, OH	16.9%	15.1%	2.3%	1.0%	162	175	4:30	Med	Med
Detroit, MI	25.9%	23.0%	1.2%	0.6%	52	17	4:00	High	High
Indianapolis, IN	20.1%	16.3%	-0.1%	0.8%	50	27	5:00	M-H	Med
Kansas City, MO	21.9%	18.9%	1.7%	1.0%	365	650	4:30	M-H	Med
Milwaukee, WI	--	--	-0.1%	0.5%	--	--	--	---	---
Minneapolis, MN	--	15.6%	1.3%	1.2%	105	233	6:00	Med	Med
St. Louis, MO	18.4%	16.5%	0.7%	0.7%	237	162	5:00	Med	Med

Note: "--" indicates data is unavailable

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Table V: Industrial Market Statistics of Selected Metropolitan Areas

	Vacancy Rate 3Q13	Forecasted Vacancy Rate 2018(f):	Manufacturing Employment Growth Sep. '12 to Sep. '13	Annual Manufacturing Employment Growth 2014-2018(f):	Average Annual New Construction (000) 2009-2013:	2014-2018(f):	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
WEST									
Southern California									
Bakersfield, CA	--	--	0.0%	0.8%	--	--	--	---	---
Inland Empire, CA	6.2%	4.8%	-2.4%	0.3%	4,910	14,000	8:30	Low	Med
Los Angeles, CA	4.5%	3.6%	-1.3%	-0.4%	2,068	4,750	8:00	Low	L-M
Orange County, CA	4.4%	3.8%	1.7%	0.1%	265	792	8:00	Low	L-M
San Diego, CA	8.4%	7.1%	-1.8%	-0.8%	295	960	6:30	L-M	Med
Santa Barbara, CA	--	--	0.1%	-0.2%	--	--	--	---	---
Ventura, CA	7.8%	6.8%	-2.3%	-0.1%	162	131	5:30	Med	Med
Northern California									
Fresno, CA	--	--	-1.6%	0.4%	--	--	--	---	---
Modesto, CA	--	--	-2.1%	0.1%	--	--	--	---	---
Oakland, CA	6.3%	3.6%	0.2%	-0.6%	89	550	7:30	L-M	Med
Sacramento, CA	12.9%	11.3%	4.0%	-0.2%	72	322	6:00	Med	Med
Salinas, CA	--	--	-1.8%	-0.1%	--	--	--	---	---
San Francisco, CA	5.0%	4.1%	-1.4%	-0.5%	125	36	7:00	L-M	L-M
San Jose, CA	9.0%	7.6%	0.8%	-0.6%	491	374	7:30	L-M	Med
Santa Rosa, CA	--	--	1.0%	0.9%	--	--	--	---	---
Stockton, CA	--	--	-0.5%	-0.1%	--	--	--	---	---
Vallejo, CA	--	--	0.0%	0.0%	--	--	--	---	---
Other West Markets									
Albuquerque, NM	9.9%	9.1%	-5.1%	-0.3%	161	250	5:30	Med	Med
Boise, ID	6.7%	5.4%	0.1%	1.0%	206	440	6:00	Med	L-M
Colorado Springs, CO	9.4%	8.0%	-3.1%	-1.6%	84	340	6:00	Med	Med
Denver, CO	4.9%	4.3%	-0.9%	-0.2%	761	1,832	7:00	Med	L-M
Honolulu, HI	4.0%	3.2%	1.9%	-1.0%	2	24	6:30	L-M	Low
Las Vegas, NV	10.9%	9.0%	0.6%	0.0%	273	570	5:30	Med	Med
Phoenix, AZ	9.9%	8.1%	-0.5%	-0.3%	2,200	1,950	6:30	Med	L-M
Portland, OR	7.4%	6.3%	1.2%	0.6%	416	1,076	6:30	L-M	L-M
Salt Lake City, UT	7.0%	6.1%	-0.5%	1.2%	1,359	1,320	7:00	Med	Med
Seattle, WA	8.9%	7.1%	1.1%	0.7%	935	1,950	8:00	L-M	Med
Spokane, WA	--	--	0.7%	0.5%	--	--	--	---	---
Tacoma, WA	5.9%	5.3%	0.0%	-0.3%	551	830	8:00	L-M	Med
Tucson, AZ	--	--	-0.4%	-0.4%	--	--	--	---	---
SOUTH									
Atlanta, GA	9.4%	8.4%	-0.9%	0.0%	2,135	2,290	6:00	Med	Med
Austin, TX	10.9%	9.3%	-0.3%	0.7%	360	800	6:30	L-M	Med
Birmingham, AL	17.0%	13.9%	2.5%	0.4%	317	235	5:30	Med	Med
Charlotte, NC	10.9%	10.7%	-0.9%	0.1%	135	233	5:00	Med	Med
Dallas, TX	10.0%	8.0%	-2.5%	-0.3%	3,625	6,160	7:30	L-M	Med
El Paso, TX	--	--	0.0%	-0.3%	--	--	--	---	---
Fort Lauderdale, FL	8.4%	7.7%	5.9%	0.3%	263	782	6:00	Med	L-M
Fort Worth, TX	6.1%	5.2%	6.3%	0.6%	1,238	2,140	7:30	L-M	Med
Houston, TX	7.0%	6.7%	2.3%	1.1%	3,351	6,050	8:00	L-M	Med

Note: "--" indicates data is unavailable

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Table V: Industrial Market Statistics of Selected Metropolitan Areas

	Vacancy Rate 3Q13	Forecasted Vacancy Rate 2018(f):	Manufacturing Employment Growth Sep. '12 to Sep. '13	Annual Manufacturing Employment Growth 2014-2018(f):	Average Annual New Construction (000) 2009-2013:	Average Annual New Construction (000) 2014-2018(f):	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
SOUTH (Continued)									
Jacksonville, FL	10.2%	8.4%	0.1%	-0.6%	608	710	6:30	Med	Med
Memphis, TN	16.5%	16.0%	0.8%	-0.6%	852	1,250	6:30	Med	Med
Miami, FL	7.0%	5.8%	1.1%	0.3%	459	914	6:30	L-M	L-M
Nashville, TN	9.2%	6.9%	5.9%	1.9%	1,681	790	6:30	Med	Med
New Orleans, LA	--	--	--	--	--	--	--	---	---
Orlando, FL	8.9%	7.6%	0.0%	0.5%	368	1,007	6:00	Med	Med
Raleigh-Durham, NC	16.5%	14.3%	0.9%	0.7%	60	455	6:00	Med	Med
Richmond, VA	7.5%	7.8%	-2.1%	-0.5%	685	955	6:30	Med	Med
San Antonio, TX	6.3%	6.5%	-1.7%	0.0%	571	1,160	6:30	L-M	Med
Tampa, FL	6.3%	4.9%	-0.3%	0.2%	223	660	6:30	Med	Med
Tulsa, OK	--	--	4.9%	1.0%	--	--	--	---	---
West Palm Beach, FL	7.4%	6.0%	-9.2%	-1.1%	122	529	6:00	Med	Med
NORTHEAST									
Baltimore, MD	11.1%	8.9%	-4.9%	-1.8%	260	728	6:00	L-M	L-M
Boston, MA	13.5%	11.5%	-0.6%	-0.8%	196	684	6:30	Med	Med
Central New Jersey	8.8%	7.3%	-0.1%	-1.0%	796	2,340	7:00	Med	L-M
Hartford, CT	12.3%	11.2%	-1.3%	-1.3%	148	549	5:30	M-H	Med
Nassau-Suffolk, NY	10.2%	8.6%	-3.6%	-1.5%	164	364	7:00	Med	Med
New York, NY	--	--	-1.1%	-1.0%	--	--	5:00	M-H	L-M
Newark, NJ	8.9%	7.0%	0.1%	-1.0%	270	646	7:00	Med	Med
Philadelphia, PA	6.0%	5.1%	-1.1%	-1.1%	823	1,800	7:00	Med	Med
Pittsburgh, PA	7.8%	7.6%	-0.6%	-0.3%	346	520	6:00	Med	Med
Rochester, NY	--	--	-5.7%	-2.2%	--	--	--	---	---
Washington, DC	12.8%	11.5%	-1.6%	-1.1%	551	1,020	5:30	M-H	Med
MIDWEST									
Louisville, KY	4.5%	5.1%	3.4%	0.8%	1,143	1,480	6:30	Med	Med
Chicago, IL	7.8%	6.1%	0.0%	-0.4%	5,121	6,500	7:30	L-M	L-M
Cincinnati, OH	7.1%	6.6%	-0.3%	0.1%	611	450	5:30	Med	Med
Cleveland, OH	6.5%	6.9%	-0.4%	-0.5%	196	262	5:30	M-H	Med
Columbus, OH	7.1%	5.7%	0.9%	-1.2%	1,090	675	6:30	Med	Med
Detroit, MI	10.2%	9.5%	3.7%	0.3%	14	380	6:00	M-H	M-H
Indianapolis, IN	7.0%	6.5%	-1.2%	-0.7%	2,631	2,060	7:00	Med	Med
Kansas City, MO	11.1%	9.8%	-0.1%	-0.7%	1,389	1,640	7:00	Med	Med
Milwaukee, WI	--	--	-1.2%	0.3%	--	--	--	---	---
Minneapolis, MN	--	8.0%	0.4%	0.9%	22	666	6:30	Med	Med
St. Louis, MO	8.6%	7.1%	0.8%	-0.2%	277	710	6:00	Med	Med

Note: "--" indicates data is unavailable

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Table VI: Retail Market Statistics of Selected Metropolitan Areas

	Vacancy Rate 2012	Forecasted Vacancy Rate 2018(f):	Trade Employment Growth Sep. '12 to Sep. '13	Annual Trade Employment Growth 2014-2018(f):	Average Annual New Construction (000) 2009-2013:	Average Annual New Construction (000) 2014-2018(f):	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
WEST									
Southern California									
Bakersfield, CA	--	--	3.7%	2.0%	--	--	--	---	---
Inland Empire, CA	10.7%	9.2%	2.1%	2.1%	362	1,075	4:30	M-H	Med
Los Angeles, CA	6.3%	5.1%	0.3%	1.7%	1,348	2,720	5:30	Med	L-M
Orange County, CA	6.5%	5.5%	0.0%	1.3%	10	527	6:30	Med	L-M
San Diego, CA	7.1%	6.9%	1.8%	1.5%	99	398	6:00	Med	Med
Santa Barbara, CA	--	--	0.0%	1.1%	--	--	--	---	---
Fresno, CA	--	--	-2.1%	1.0%	--	--	--	---	---
Northern California									
Modesto, CA	--	--	0.8%	1.0%	--	--	--	---	---
Oakland, CA	9.4%	7.8%	1.5%	1.4%	538	476	6:00	L-M	Med
Sacramento, CA	11.3%	10.0%	3.3%	1.5%	91	658	5:00	M-H	Med
Salinas, CA	--	--	2.5%	0.9%	--	--	--	---	---
San Francisco, CA	1.9%	1.5%	1.8%	1.4%	116	210	8:00	Low	Low
San Jose, CA	11.4%	9.0%	2.2%	1.8%	333	490	7:30	L-M	Med
Santa Rosa, CA	--	--	2.0%	1.1%	--	--	--	---	---
Stockton, CA	--	--	-1.9%	0.7%	--	--	--	---	---
Vallejo, CA	--	--	2.4%	2.1%	--	--	--	---	---
Albuquerque, NM	8.8%	7.7%	-1.8%	1.0%	207	240	5:30	Med	Med
Other West Markets									
Boise, ID	9.1%	6.6%	-0.2%	1.8%	207	400	6:00	Med	Med
Colorado Springs, CO	12.2%	9.3%	3.6%	1.4%	358	640	4:30	Med	Med
Denver, CO	9.1%	6.7%	1.7%	1.7%	364	1,670	6:00	Med	L-M
Honolulu, HI	3.3%	4.7%	-1.8%	1.1%	216	118	6:30	Low	Low
Las Vegas, NV	12.2%	10.3%	4.2%	2.3%	454	1,040	4:00	High	M-H
Phoenix, AZ	11.0%	9.7%	3.1%	1.9%	1,183	920	5:00	Med	Med
Portland, OR	7.0%	4.9%	1.6%	1.5%	337	560	5:30	L-M	Med
Salt Lake City, UT	10.6%	6.7%	2.4%	1.6%	310	860	6:00	L-M	L-M
Seattle, WA	6.7%	5.4%	4.7%	1.3%	388	871	6:30	L-M	L-M
Spokane, WA	--	--	1.8%	1.3%	--	--	--	---	---
Tacoma, WA	9.6%	7.8%	1.2%	1.3%	111	474	6:00	Med	Med
Tucson, AZ	--	--	1.5%	0.7%	--	--	--	---	---
SOUTH									
Atlanta, GA	11.9%	10.8%	2.2%	1.6%	993	1,780	5:00	Med	Med
Austin, TX	8.2%	7.3%	3.9%	3.0%	485	1,410	6:30	L-M	L-M
Birmingham, AL	11.4%	10.2%	-2.7%	0.6%	122	230	4:30	Med	Med
Charlotte, NC	8.6%	8.1%	2.4%	1.4%	617	690	5:00	Med	Med
Dallas, TX	15.3%	13.4%	4.8%	1.9%	734	1,850	6:30	Med	Med
El Paso, TX	--	--	1.6%	1.0%	--	--	--	---	---
Fort Lauderdale, FL	9.6%	8.6%	4.6%	1.9%	399	1,373	5:30	Med	Med
Fort Worth, TX	15.0%	13.0%	2.9%	1.8%	337	965	5:30	Med	Med
Houston, TX	10.3%	10.1%	4.5%	2.3%	1,463	3,480	6:30	L-M	Med
Jacksonville, FL	10.9%	9.3%	4.2%	1.3%	150	1,680	4:30	M-H	Med

Note: "--" indicates data is unavailable

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Table VI: Retail Market Statistics of Selected Metropolitan Areas

	Vacancy Rate 2012	Forecasted Vacancy Rate 2018(f):	Trade Employment Growth Sep. '12 to Sep. '13	Annual Trade Employment Growth 2014-2018(f):	Average Annual New Construction (000) 2009-2013:	Average Annual New Construction (000) 2014-2018(f):	Real Estate Cycle	Equity Risk Level 2014-2015:	Equity Risk Level 2016-2018:
SOUTH (Continued)									
Memphis, TN	13.9%	11.8%	0.4%	0.9%	140	400	5:00	Med	Med
Miami, FL	6.6%	6.3%	3.2%	1.8%	650	1,180	6:30	Med	L-M
Nashville, TN	7.8%	7.1%	3.0%	2.1%	383	770	5:00	Med	L-M
Norfolk, VA	--	--	-0.8%	0.8%	--	--	--	---	---
Orlando, FL	9.9%	8.6%	2.9%	1.7%	563	1,460	5:30	Med	Med
Richmond, VA	6.9%	7.3%	3.7%	1.1%	770	990	5:30	Med	Med
San Antonio, TX	9.5%	9.0%	1.1%	1.9%	725	1,675	5:30	Med	Med
Tampa, FL	8.4%	7.0%	4.4%	2.3%	542	1,020	6:00	Med	Med
Tulsa, OK	--	--	1.6%	1.3%	--	--	--	---	---
West Palm Beach, FL	9.4%	8.1%	6.0%	2.7%	311	925	5:30	Med	Med
NORTHEAST									
Baltimore, MD	5.3%	4.1%	3.3%	1.0%	507	745	5:30	Med	L-M
Boston, MA	5.8%	4.8%	1.6%	1.6%	1,094	1,460	6:30	L-M	L-M
Hartford, CT	9.2%	7.3%	1.9%	0.8%	212	480	5:00	Med	Med
New York, NY	7.7%	5.4%	2.1%	1.3%	992	1,180	6:30	Med	L-M
Philadelphia, PA	8.1%	6.6%	0.3%	0.6%	1,076	2,610	5:30	Med	Med
Pittsburgh, PA	5.0%	4.0%	-0.4%	0.5%	291	395	6:00	Med	Med
Rochester, NY	--	--	0.1%	0.8%	--	--	--	---	---
Washington, DC	5.8%	5.4%	1.1%	1.0%	1,834	1,380	7:00	M-H	Med
MIDWEST									
Louisville, KY	8.6%	8.4%	1.4%	0.9%	214	323	5:00	Med	Med
Chicago, IL	11.3%	10.5%	0.8%	0.8%	1,232	1,760	5:30	Med	Med
Cincinnati, OH	12.8%	11.3%	0.4%	0.7%	544	840	4:30	Med	Med
Cleveland, OH	12.4%	11.3%	1.0%	0.5%	279	670	4:30	Med	M-H
Columbus, OH	10.0%	8.3%	-1.1%	1.0%	363	410	5:30	Med	Med
Detroit, MI	11.3%	10.9%	1.2%	0.1%	473	328	3:30	High	High
Indianapolis, IN	11.6%	11.3%	3.2%	1.4%	380	635	5:00	Med	Med
Kansas City, MO	9.5%	8.3%	-1.4%	0.9%	517	1,180	5:30	Med	Med
Milwaukee, WI	--	--	2.9%	0.6%	--	--	--	---	---
Minneapolis, MN	7.8%	5.6%	1.2%	1.1%	321	1,121	6:30	Med	Med
St. Louis, MO	10.7%	9.8%	1.8%	0.6%	446	668	5:30	Med	Med

Note: "--" indicates data is unavailable

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