

EXPECTATIONS & MARKET REALITIES IN REAL ESTATE 2015

SCALING NEW HEIGHTS

THE ECONOMY

The Economy Accelerates

THE CAPITAL MARKETS

Capital Waters Run Deep

THE PROPERTY MARKETS

Strengthening Fundamentals

SUMMARY & OUTLOOK

Looking Ahead to 2015

Deloitte.



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Expectations & Market Realities in Real Estate 2015—Scaling New Heights

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EXPECTATIONS & MARKET REALITIES IN REAL ESTATE 2015

SCALING NEW HEIGHTS

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Situs & RERC

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The NATIONAL ASSOCIATION of REALTORS®, “The Voice for Real Estate,” is America’s largest trade association, representing 1.0 million members involved in all aspects of the residential and commercial real estate industries. NAR membership includes brokers, salespeople, property managers, appraisers, counselors and others. Approximately 78,000 NAR and institute affiliate members specialize in commercial brokerage and related services, and an additional 232,000 members offer commercial real estate services as a secondary business. The term REALTOR® is a registered collective membership mark that identifies a real estate professional who is a member of the NATIONAL ASSOCIATION of REALTORS® and subscribes to its strict Code of Ethics. Working for America’s property owners, the National Association provides a facility for professional development, research and exchange of information among its members and to the public and government for the purpose of preserving the free enterprise system and the right to own real property.



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FOREWORD

January 2015

Dear Readers,

As 2015 gets underway, many investors are more optimistic than they have been in years. Economic growth has been increasing, job growth has been improving, and consumers have been given a boost as gasoline prices have dipped nationwide. Compared to the markets and financial systems in other developed countries, the U.S. economy looks generally healthy.

With respect to commercial real estate investment, interest rates are still low and fundamentals continue to improve. Volume and pricing have been increasing, especially for high-quality properties in the coastal markets, but we have also seen high values and prices in more secondary and tertiary markets. Returns in the form of both income and appreciation are expected to remain quite attractive in 2015 compared with many investment alternatives.

We—the National Association of REALTORS® (NAR), Deloitte, RERC LLC, and Situs (RERC’s parent company), which is noted hereafter as Situs RERC—expect these trends to continue. In fact, we expect commercial real estate prices and values to possibly increase even more during 2015, given the relative expected returns, the general transparency of commercial real estate in that it is relatively easy to understand, and the perceived safety of this asset class compared with many investment alternatives. As such, this issue of *Expectations & Market Realities in Real Estate* has been entitled “*Scaling New Heights.*”

Thank you to all who have contributed to our research-based annual forecast report, including our research and data providers, economists, analysts, survey respondents, reviewers, and business associates and colleagues. We appreciate your willingness to share your insights, information, and observations for *Expectations & Market Realities in Real Estate 2015—Scaling New Heights.* We also thank you—our clients, subscribers, and consultants—for your continued interest and support. We hope you find our report of value.

Sincerely,



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1

INTRODUCTION

SCALING NEW HEIGHTS

SCALING NEW HEIGHTS

In preparing the 2015 issue of *Expectations & Market Realities in Real Estate*, we—RERC and Situs (known herein as Situs RERC), Deloitte, and the National Association of REALTORS® (NAR)—looked back at 2014 to review and examine major world events as they affected the U.S. economy, capital markets, and commercial real estate markets.

The year 2014 began calmly with the smooth transition of Janet Yellen as the new chair of the Board of Governors of the Federal Reserve. She has continued to carry out the accommodative monetary policies originally enacted by former Chair Ben Bernanke. However, it was not long into 2014 before world events took center stage. Territorial disputes between Russia and its neighbors, along with threats from the newly-formed Islamic State of Iraq and Syria (ISIS) dominated newscasts. Coverage of new acts of terrorism and fears of the Ebola virus spreading to the U.S. and Europe worried investors and the general public alike. Weaknesses in most of the European economies, as well as in China and Japan, were reported, just as economic growth in the U.S. began to spike. Many investors—both foreign and domestic—became increasingly attracted to the perceived relative safety of the U.S. economy and other safe-haven investments.

As the year 2014 began to wind down, the Federal Reserve concluded its purchases of bonds and securities as planned. Employment growth increased substantially throughout the year, and the unemployment rate continued to fall, dropping to 5.6 percent in December 2014 per the Bureau of Labor Statistics (BLS). Although wages remained stagnant and inflation remained below the Federal Reserve's target range of 2 percent, the major stock market indices reached

new highs in December, with the Dow Jones Industrial Average (DJIA) topping the 18,000-point mark and the S&P 500 topping 2,000. Declining oil prices may have caused stock market returns to dip by year-end 2014, but consumers were buoyed by lower costs for fuel, as gasoline prices dropped to around \$2 per gallon in most states.

With respect to commercial real estate, interest rates remained low, and volume and prices increased in 2014 for high-quality properties. We saw new highs for many property prices, especially in the coastal markets like New York City, Boston, Washington, DC, and San Francisco. However, we have also seen high prices and strong total return performance occurring in many secondary and tertiary markets, as discussed herein. We expect these trends to continue in 2015, as

outlined in *Expectations & Market Realities in Real Estate 2015—Scaling New Heights*.

Looking Ahead to 2015

Despite being a record \$18 trillion in debt, our collective view for 2015 is that the U.S. economy is healthier than it was a year ago. However, the economies in most of the rest of the developed world and the major emerging markets have slowed significantly. Given the economic weaknesses worldwide, along with continued terrorism throughout the Middle East and recent terror campaigns in Paris and other locations in Europe, the perceived comparative safety in U.S. markets has gained additional importance. Apparent safe-haven investments like commercial real estate are increasingly attractive to many, especially when interest rates



are low (even if they increase slightly in 2015, we expect them to remain low on a historical basis). The demand for high-quality commercial real estate has caused property values and prices to climb to new heights.

As such, the 104-story One World Trade Center, an iconic symbol of American renewal and hope that is redefining Lower Manhattan's New York skyline, was selected for the front cover of *Expectations & Market Realities in Real Estate 2015—Scaling New Heights*.¹ Not only is One World Trade Center the Western Hemisphere's tallest building, it also represents:

- The world's largest economy and the improvement in the recovery that we are witnessing.
- The record-high levels of financial assets available for investing.
- The high returns we have seen in the stock market and some other asset classes.
- Still rising prices and values for commercial real estate.
- America's spirit. As the nation and New York City continue to recover from the terror attacks on Sept. 11, 2001, the spire atop this building brought the height of this skyscraper to a symbolic 1,776 feet.²

Going forward, the primary concerns of many investors include how long the short-term federal funds rate will remain in the 0 to 1/4 percent range, and when will long-term interest rates begin to increase. According to the Federal Open Market Committee's (FOMC's) minutes from their December 16-17, 2014 meeting, the FOMC "reaffirmed its view that the current 0 to 1/4 percent target range for the federal funds rate



remains appropriate. In determining how long to maintain this target range, the Committee will assess progress—both realized and expected—toward its objectives of maximum employment and 2-percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy. The Committee sees this guidance as consistent with its previous statement that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time...."

Opinions vary, but according to NAR's outlook (detailed in Chapter 2), the federal funds rate is forecasted to remain at 0.1 percent in first quarter 2015, and then begin to increase to 0.3 percent in second quarter 2015, to 0.5 percent in third quarter 2015, and to 0.8 percent

in fourth quarter 2015. Further, NAR forecasts 10-year Treasury yield rates to increase to 2.4 percent in first quarter 2015, and rise to 2.6 percent in second quarter 2015, to 3.0 percent in third quarter 2015, and to 3.5 percent in fourth quarter 2015.

The economic situation in Europe will bear watching in 2015. At present, it appears that the European Central Bank (ECB) plans to follow the quantitative easing policies implemented in the U.S., UK, and Japan, and will purchase a total of €60 billion (\$69 billion) in assets each month beginning in March 2015 and extending through September 2016, stated Mario Draghi, ECB president, in an effort to combat stagnation and ultralow inflation.

Expectations & Market Realities in Real Estate 2015—Scaling New Heights

Despite the challenges and uncertainties in the economy and capital markets, commercial real estate investments generally produced solid returns

¹ *One World Trade Center, an architectural and engineering marvel, was designed by renowned architect David Childs of Skidmore, Owings, and Merrill, LLP. Port Authority of New York and New Jersey (www.panynj.gov).*

² *Ibid.*

in 2014. Based on our collective analysis, we expect this trend to continue in 2015 and are cautiously optimistic that commercial real estate fundamentals will continue to slowly improve and that values will keep up with escalating prices, even at the new heights we are seeing. As noted in *Expectations & Market Realities in Real Estate 2015—Scaling New Heights*, total expected returns on a risk-adjusted return basis appear reasonable in the year ahead.

Chapter 2 of this report notes that as 2015 gets underway, the U.S. economy is improving and is basically “normal” in terms of growth. NAR’s economic forecast for 2015 projects gross domestic product (GDP) to approach a 3-percent real growth level in the foreseeable future and an acceleration of current favorable economic trends.

However, the chapter also notes the following risks to economic growth:

- Significant numbers of people continue to be unemployed or under-employed.
- Wage/income growth is stagnant for the majority of households.
- Housing market growth continues to be slow.
- Foreign economic slowdowns are continuing.
- Credit availability remains excessively tight.
- College student debt remains high, and household formation is low.

We examine the capital markets in **Chapter 3** of this report, noting that the investment world is flush with capital and that the U.S. commercial real estate sector continues to attract much of that capital (approximately \$5.06 trillion³), as graphed in the estimated equity and

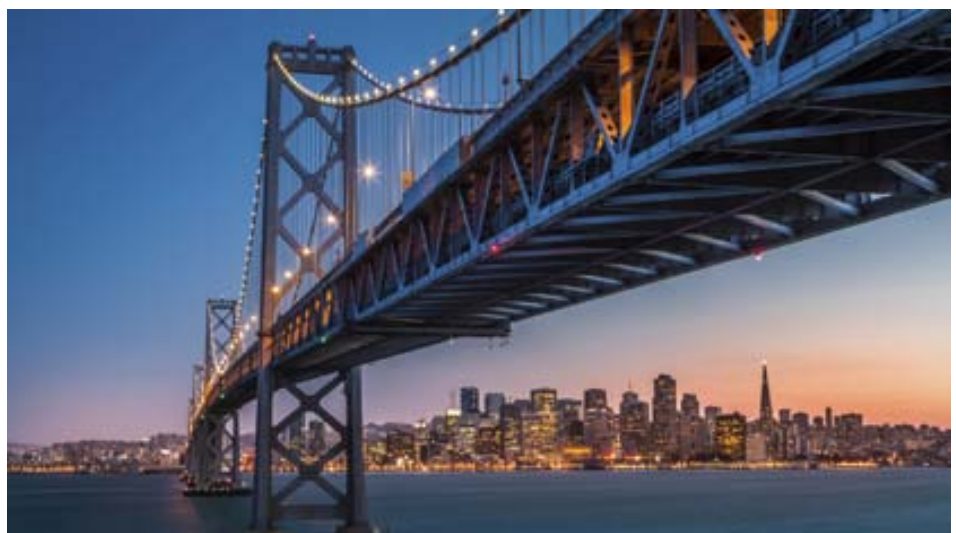
debt totals included in the report. In fact, the availability (amount) and discipline (underwriting standards) of capital resemble the trends leading up to the Great Recession, according to Situs RERC’s historical analysis. Although we do not expect a repeat of the credit crisis of 2006 and 2007, according to *Commercial Mortgage Alert*, the issuance of commercial mortgage-backed securities (CMBS) in 2014 was similar to issuance in 2004, and many investors expect issuance to increase during the next few years similarly to the pre-credit crisis era, especially if underwriting standards continue to loosen.

Further, interest rates will likely remain low through 2015. Even if the Federal Reserve begins to raise short-term rates, any increases are expected to be small and gradual. In addition, given low inflation and other economic risks, some market participants have been downgrading their expectations about risk-free rates and the timing as to when the Federal Reserve will increase the federal funds rate. Capitalization rates are expected to continue to compress on a broad market basis, as long as interest rates remain low.

In **Chapter 4**, we offer our highlights and expectations for the five major

property sectors—the office, industrial, retail, apartment, and hotel markets. Our analysis examines volume, pricing, capitalization rates, vacancy/occupancy rates, absorption and completions, and rental rates/revenues for each of the property types. On a yearly basis, commercial real estate investments rose across all property types, except for the apartment sector, reaching \$288.5 billion in transaction volume by third quarter 2014, according to Real Capital Analytics. Prices also increased. As fundamentals are expected to continue strengthening, commercial assets remain an attractive investment option for many investors.

Finally, in **Chapter 5**, we offer a summary of the highlights of the report and our collective outlook for 2015. The year 2015 will be an interesting period for investors, and we expect commercial real estate values to continue to increase slightly or to remain about the same as currently. Per Situs RERC’s analysis, it appears that broad market prices and values have room to increase for approximately 12 to 18 months, assuming that the economy and capital markets continue to function as expected, as outlined in our alternative economic scenarios for 2015.



³ Situs RERC estimate, December 2014.



2

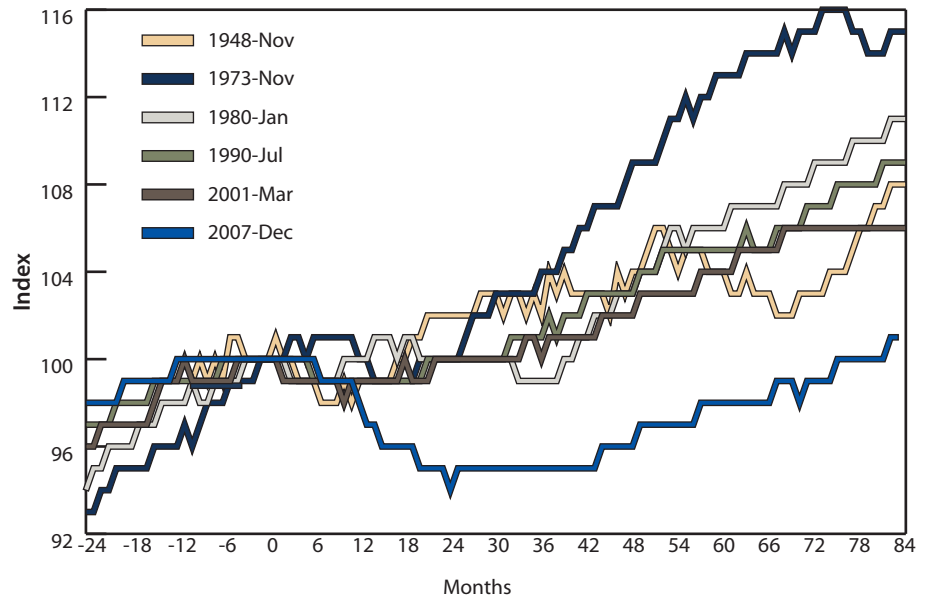
THE ECONOMY

THE ECONOMY ACCELERATES

THE ECONOMY ACCELERATES

Although the Great Recession officially ended more than 5 years ago, according to the National Bureau of Economic Research (NBER), the after-effects of the recession lingered for much longer.⁴ Until very recently, the post-recession economy experienced significant challenges, including high unemployment, slow GDP growth, declining family incomes, decreased credit availability, and high levels of risk aversion. For example, employment growth, which is a strong measure of economic wellbeing for most people, was subpar after the Great Recession compared to the employment growth after other recessions. Exhibit 2-1 compares the employment levels after the Great Recession in comparison to growth after a number of other recessions (a similar conclusion holds for GDP).

Exhibit 2-1. Comparison of Employment Growth After Recessions



Source: BLS, December 9, 2014.

However, in the second half of 2014 and thus far in 2015, there have been increasing indications that the economy is improving, and as such, NAR forecasts GDP to approach a 3 percent real growth level in the foreseeable future. This forecast is a welcome change from the “doom and gloom” outlook that has accompanied much

of the country’s economic activity during the past few years.

There are, however, two downside risks which have been factored into the short-term forecast, but which still need to be addressed in the long run. First, as the Federal Reserve ends quantitative easing, managing financial policies in order to

avoid negatively impacting economic growth will be important. Second, many families have not participated in the increased prosperity. Salaries and wages in real terms have in many cases been constant or declining. This phenomenon is not well understood, but it is important and should be addressed. Given the circular flow of the economy, some improvement in incomes, other things being equal, would likely help to spur economic growth.

Overall, NAR’s economic forecast for 2015 projects an acceleration of current favorable economic trends. All forecasts are filled with uncertainties, so the risks are highlighted herein. On balance, the uncertainties and risks appear to be on the upside—that is, the economy may actually perform better than expected as uncertainties are resolved.



⁴ The Great Recession lasted from December 2007 to June 2009, according to NBER.

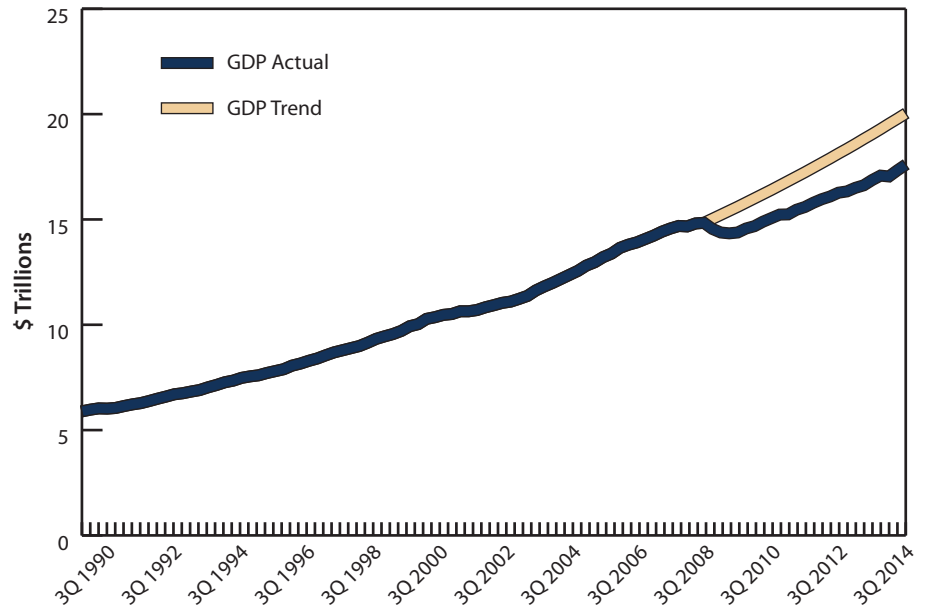
EFFECTS OF THE GREAT RECESSION

The Great Recession of December 2007 through June 2009 had a major negative impact on incomes, wealth, and confidence. A comparison of the actual GDP level as of third quarter 2014 with what it would have been if the previous GDP growth rate⁵ had continued absent a recession shows that GDP was approximately \$2.5 trillion lower than it would otherwise have been (see Exhibit 2-2), per the Bureau of Economic Analysis (BEA).

Although the Great Recession has been officially over for more than 5 years, its impact continues to be felt in a variety of ways:

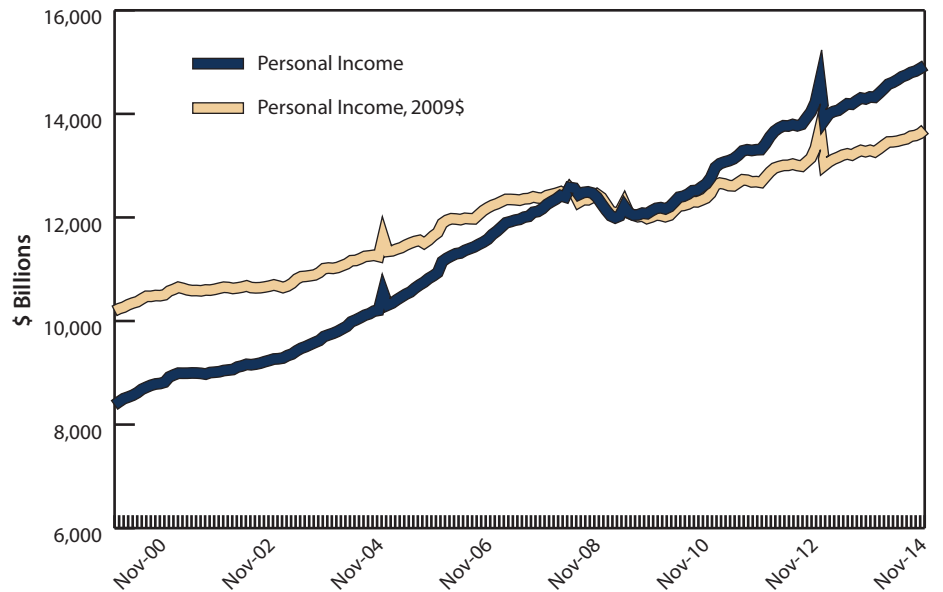
- The growth of personal income was interrupted, as depicted in Exhibit 2-3. Having risen at a 2009 constant dollar annual rate of approximately 2.5 percent in the 8 years prior to December 2007,⁶ personal income fell a total of 3 percent

Exhibit 2-2. \$2.5 Trillion Missing GDP from Great Recession



Sources: BEA, Haver Analytics, 3q 2014.

Exhibit 2-3. Personal Income: Actual and Constant Dollar



Sources: BEA, Haver Analytics, September 2014.



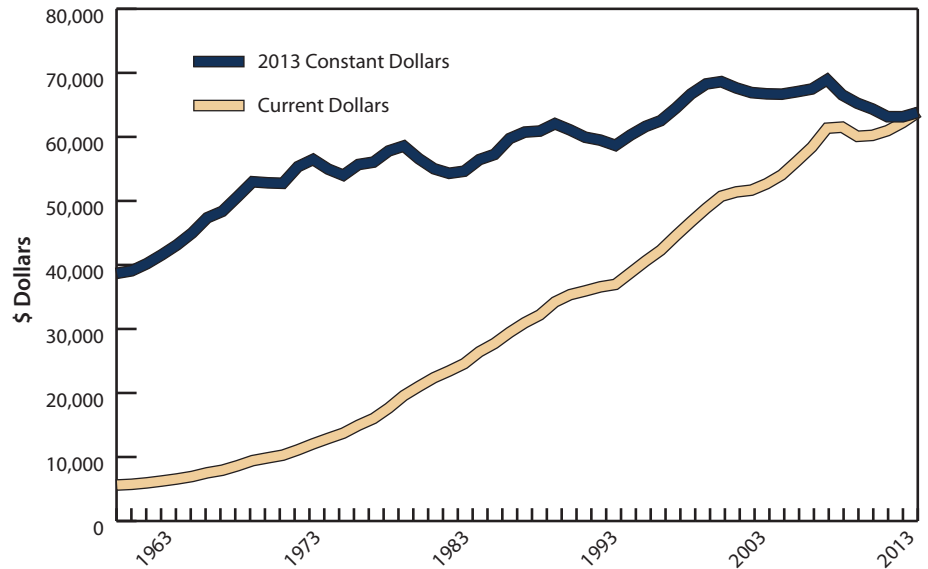
⁵ Source: U.S. Department of Commerce, Bureau of Economic Analysis, Haver Analytics. GDP growth computed as quarterly growth rate 1990 Q1 through 2008 Q3.

⁶ Source: U.S. Department of Commerce, Bureau of Economic Analysis, Haver Analytics. Constant dollar PCE computed on basis of PCE Chain Price Index, 2009 =100.

between December 2007 and June 2009, per the BEA. Growth since June 2009 has been at a rate of 2.3 percent per year from the post-recession base, lower than it would otherwise have been.

- Real median family income has been declining since 1999, according to the Census Bureau, and the decline became increasingly serious during the Great Recession, as shown in Exhibit 2-4.⁷
- Between fourth quarter 2007 and second quarter 2009, the total value of household assets measured in terms of real estate and financial assets⁸ declined by 15 percent, a total of \$10.6 trillion, per the Federal Reserve. In comparison, between 2000 and 2007, assets rose at approximately 7 percent per year, but much of the gain was in the stock market. For many families, the major asset is the value of the home, which

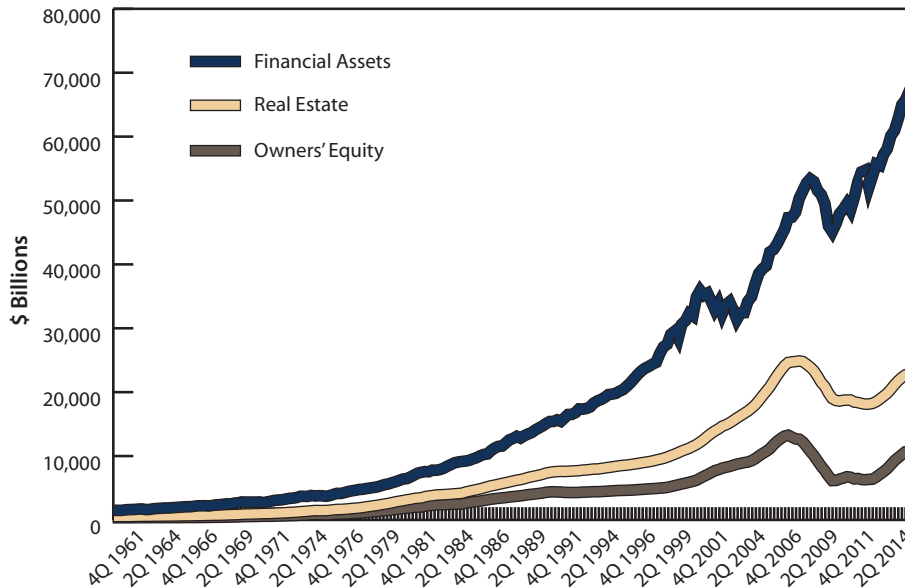
Exhibit 2-4. Median Family Income



Sources: U.S. Census Bureau, Haver Analytics, 2014.

declined during the Great Recession but has recovered to a significant degree, as demonstrated in Exhibit 2-5.

Exhibit 2-5. Household Assets



Sources: Federal Reserve System, Financial Accounts of the United States, Haver Analytics, 2q 2014.



⁷ U.S. Department of Commerce, Bureau of the Census, Current Population Reports, Series P-60. "Income, Poverty and Health Insurance in the United States," Haver Analytics.

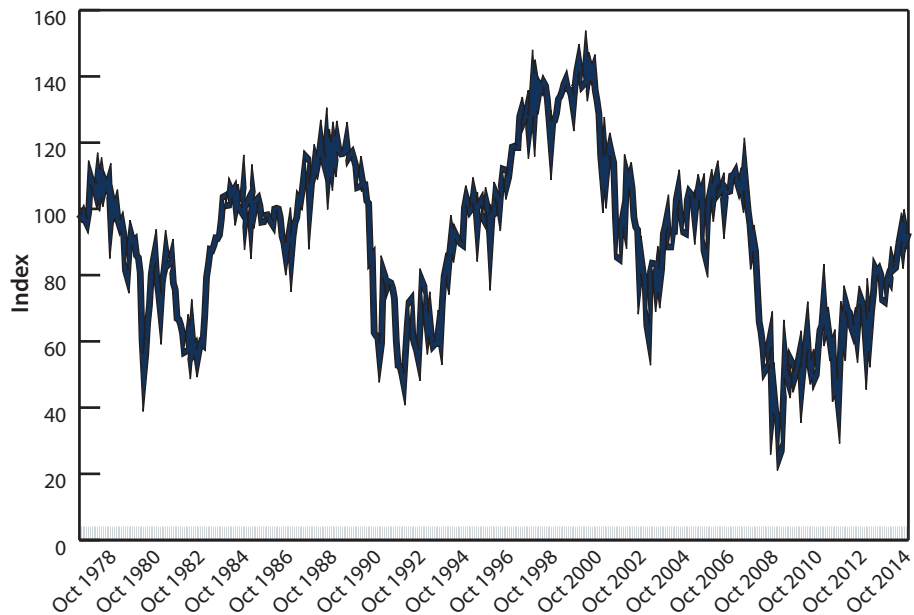
⁸ Federal Reserve System, Financial Accounts of the United States, Haver Analytics. Household data also include non-profits.

- As reflected in Exhibit 2-6, the Great Recession also negatively impacted consumer confidence, as measured by The Conference Board.⁹
- Finally, unemployment rates during the Great Recession, as shown in Exhibit 2-7, were at their highest in 25 years, per the BLS.¹⁰

In summary, the Great Recession was associated with lower incomes, higher unemployment, decreased consumer confidence, lost wealth, and slower growth. Therefore, it is not surprising that the post-recession recovery was initially weak as the nation's economic



Exhibit 2-6. Consumer Confidence

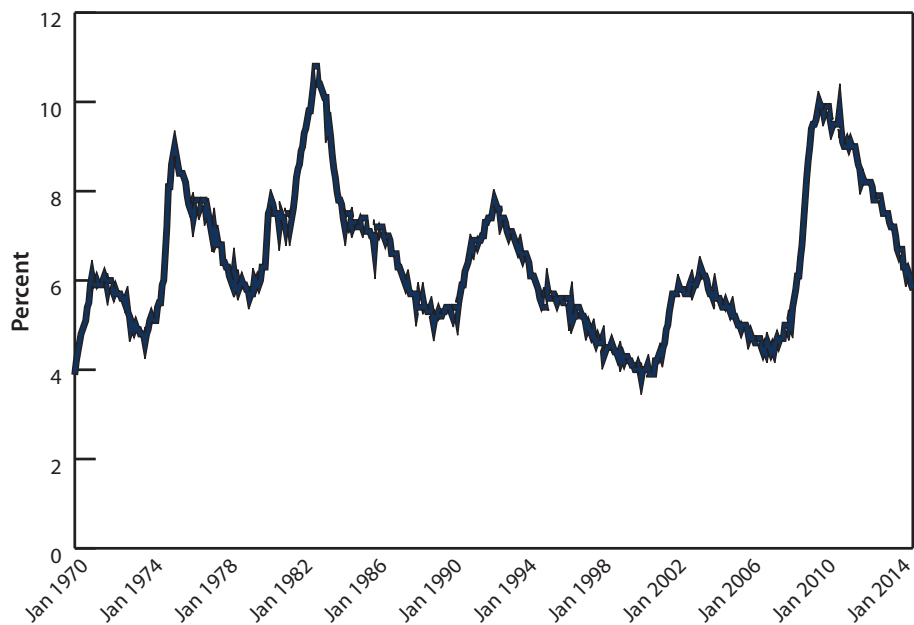


Sources: The Conference Board, Haver Analytics, October 2014.

decision makers—consumers, businesses, and investors—rebuilt their financial capabilities. In addition, the Great Recession increased the risk aversion felt by the major economic

participants. Banks, for example, decreased credit availability. Industry decreased investment expenditures. Governments decreased spending. Consumers focused on deleveraging.

Exhibit 2-7. Unemployment Rate



Sources: BLS, Haver Analytics, October 2014.

⁹ The Conference Board, 1985=100, seasonally-adjusted.

¹⁰ BLS, Household Survey Data, Haver Analytics; data current through October 2014.

THE ECONOMIC OUTLOOK—2015 AND BEYOND

The economy’s rate of expansion, initially slower than would normally have been expected after a recession, seems to have finally increased:

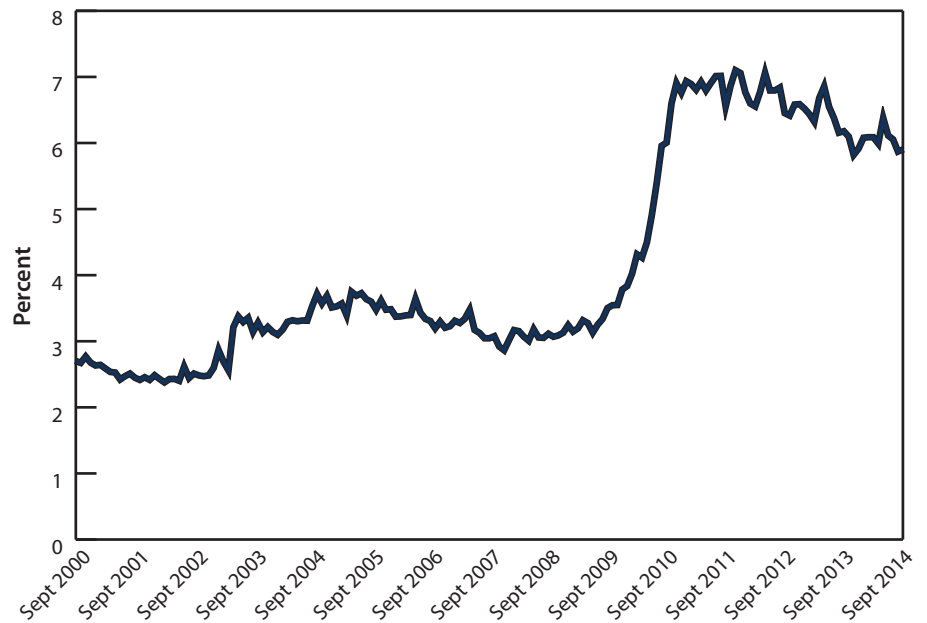
- **Consumer confidence:** Consumer confidence recovered from a low of 25 in February 2009 to 92.6 in December 2014. However, this level is still below 100, which is considered the normal level during robust expansions.
- **Unemployment rate:** The unemployment rate has declined, although the projected 5.6-percent unemployment rate for 2015 is higher than the 5-percent rate that would have been generally regarded as normal a few years ago.
- **Economic Growth:** The economy has finally started to show some signs of acceleration, although the GDP growth rate in recent years has been disappointingly low. NAR’s projected 3.1-percent growth rate for 2015 is better than experienced in the past 2 years.
- **Employment:** The level of employment is expected to improve in 2015, growing at a 2-percent rate. As of November 2014, the unemployment rate was 5.8 percent, with approximately 9.1 million workers reported as unemployed. Of the 147.3 million workers employed, 6.9 million worked part-time due to economic reasons, and labor force participation declined from almost 67 percent to slightly under 63 percent. At current job growth rates, NAR projects the economy to achieve an unemployment rate of 5.5 percent in late 2015.

- **Part-time employment:** Part-time employment for economic reasons has grown to approximately 7 million workers, which accounts for approximately 5 percent of establishment-level employees, according to the BEA. This compares to an average of approximately 3 percent of employees who worked part-time in the 1999 to 2007 time period, as shown in Exhibit 2-8.¹¹

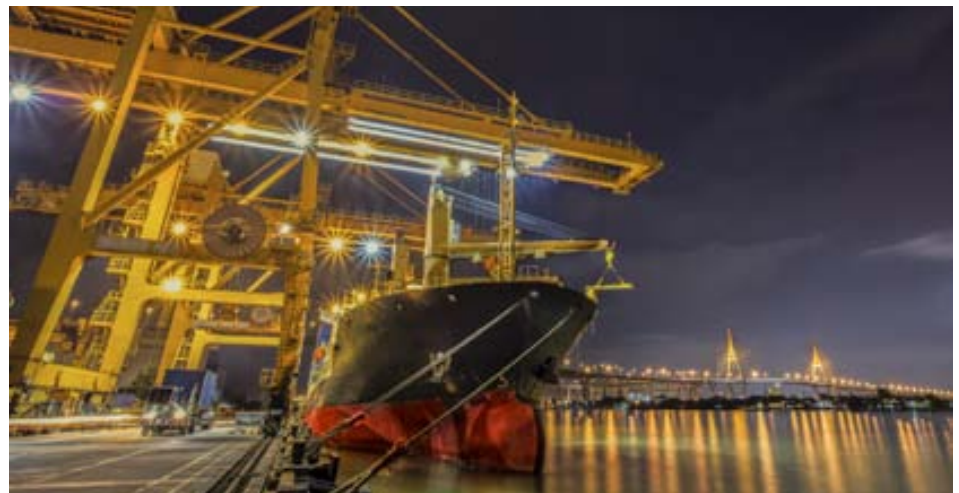
- **Inflation:** NAR projects inflation at 1.2 percent for 2014, 2.0 percent for 2015, and 3.2 percent for 2016. With substantial slack in the labor market and dormant wage growth, NAR projects inflation levels to continue to be relatively low in 2015.

The NAR forecast shows an outlook for continued economic expansion, with real economic growth expected to

Exhibit 2-8. Percent of Workers Who Are Part-Time for Economic Reasons



Sources: BEA, Haver Analytics, November 2014.



¹¹ An additional 20 million workers were part-time workers as of November 2014 for non-economic reasons, according to the BLS Household Survey.

return to approximately 3 percent in 2015, as shown in Exhibit 2-9.

GDP BY ECONOMIC SECTOR

A review of GDP by sector provides insight on the risks and uncertainties associated with the forecast. The downside risks of a no-growth economy or a recession in the near future appear to be minimal, but slower-than-normal growth appears likely.

Using the standard macroeconomic formula for GDP, analysis of the specific components provides insight on the future course of the economy:

$$GDP = \begin{matrix} \text{Consumption} \\ + \\ \text{Investment} \\ + \\ \text{Government Expenditures} \\ + \\ \text{Exports} \end{matrix} - \text{Imports}$$

Consumption

Personal consumption expenditures comprise approximately 67 percent

of GDP, according to the BEA.¹² Any change in consumption will have a substantial impact on GDP levels. Once the Great Recession began, the growth of consumption lagged relative to previous trends. If consumption had continued to increase at previous rates absent the Great Recession, personal consumption expenditures would have been \$12.3 trillion in 2009 constant dollars as of third quarter 2014 rather than the actual \$11 trillion, as depicted in Exhibit 2-10.

Exhibit 2-9. NAR Economic Outlook/Forecast

	Growth Rate Real GDP (percent)	Nonfarm Payroll Empl. (percent growth)	Consumer Prices (percent growth)	Percent Unempl.	Interest Rates (Percent)					
					Fed Funds Rate	3-mo T Bill	Prime Rate	Corp. AAA bond	10-yr Govt. Bond	30-yr Govt. Bond
1Q 2013	2.7	1.9	1.6	7.7	0.1	0.1	3.3	3.9	2.0	3.1
2Q 2013	1.8	1.8	1.4	7.5	0.1	0.1	3.3	4.0	2.0	3.1
3Q 2013	4.5	1.6	1.6	7.2	0.1	0.1	3.3	4.5	2.7	3.7
4Q 2013	3.5	1.8	1.2	7.0	0.1	0.1	3.3	4.6	2.8	3.8
1Q 2014	-2.1	1.5	1.9	6.7	0.1	0.1	3.3	4.4	2.8	3.7
2Q 2014	4.6	2.1	2.0	6.2	0.1	0.1	3.3	4.2	2.6	3.4
3Q 2014	5.0	2.4	1.1	6.1	0.1	0.1	3.3	4.1	2.5	3.3
4Q 2014F	2.8	2.2	-0.8	5.8	0.1	0.1	3.3	3.9	2.2	2.9
1Q 2015F	3.1	2.1	1.0	5.7	0.1	0.2	3.3	4.2	2.4	3.2
2Q 2015F	3.2	2.0	1.9	5.6	0.3	0.5	3.3	4.4	2.6	3.5
3Q 2015F	3.2	2.1	2.5	5.6	0.5	0.9	3.5	4.8	3.0	3.9
4Q 2015F	3.0	2.1	2.8	5.5	0.8	1.1	3.8	5.2	3.5	4.4
1Q 2016F	3.0	2.1	3.0	5.5	1.1	1.4	4.1	5.5	3.9	4.9
2Q 2016F	3.0	2.1	3.1	5.5	1.5	1.8	4.5	5.7	4.1	5.2
2011	1.6	1.2	3.1	8.9	0.1	0.1	3.3	4.7	2.8	3.9
2012	2.3	1.7	2.1	8.1	0.1	0.1	3.3	3.7	1.8	2.9
2013	2.2	1.7	1.5	7.4	0.1	0.1	3.3	4.3	2.5	3.4
2014F	2.5	2.0	1.2	6.2	0.1	0.1	3.3	4.2	2.5	3.3
2015F	3.1	2.1	2.0	5.6	0.4	0.7	3.5	4.7	2.9	3.8
2016F	3.0	2.1	3.2	5.5	1.6	1.9	4.5	5.7	4.2	5.3

Sources: GDP Growth rate: BEA/Haver Analytics, Nonfarm Payroll Employment: BLS/Haver Analytics, Consumer Prices: BLS/Haver Analytics, Federal Funds rate (effective): FRB, Table H.15/Haver Analytics, 3-month T-bill rate: FRB, Table H.15/Haver Analytics, Bank prime loan rate: FRB, Domestic Interest Rates Updated Before FRB Publication/Haver Analytics, Moody's Corporate AAA Corporate Bond Yield: FRB, Table H.15/Haver Analytics, 10-yr Treasury Note Yield at Constant Maturity: FRB, Table H.15/Haver Analytics, 30-yr Treasury Note Yield at Constant Maturity: FRB, Table H.15/Haver Analytics, January 2015.

¹² U.S. Department of Commerce, BEA, Haver Analytics.

A number of factors have been cited as contributing to the slowdown in the level of real consumption expenditures: recession, declining household incomes, increasingly unequal wealth distribution,¹³ unemployment, and decreased family formation.

However, a number of the economic negatives have turned around:

- Improved consumer confidence.
- Additional job creation.
- Recovery in the level of household assets—both in terms of the value of homes and the stock market.
- Reduced levels of consumer debt.

Accordingly, NAR’s outlook for consumption expenditures—a major GDP driver—appears to be positive in 2015.

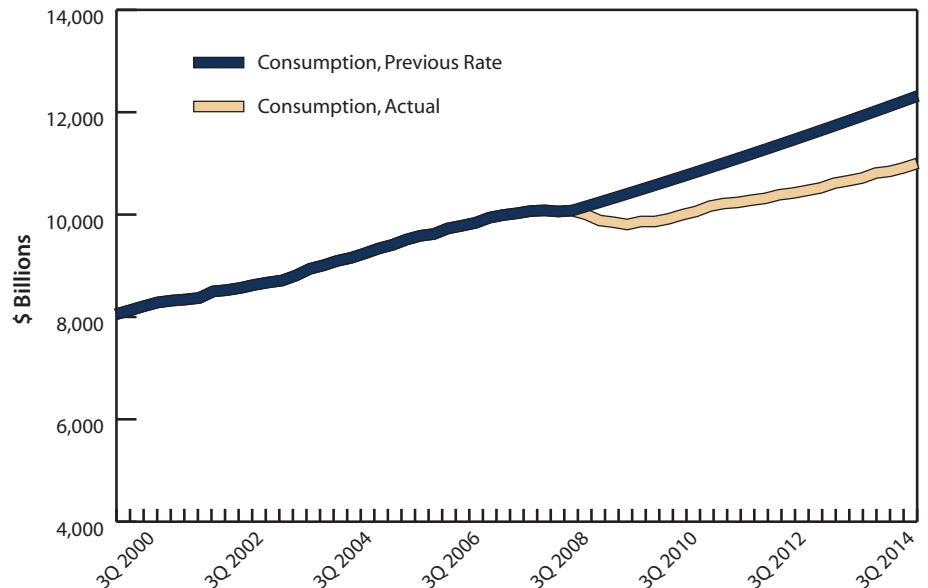
GROSS PRIVATE DOMESTIC INVESTMENT

Gross private domestic investment¹⁴ is approximately 17 percent of GDP. Residential housing investment comprises 4 percent of GDP, with non-residential and inventory investment at approximately 13 percent.

Residential Investment

Housing starts declined from 2.2 million in 2005 to under 500,000 in 2009, per the BEA.¹⁵ As indicated in Exhibit 2-11, a reasonable average expectation for housing starts is approximately 1.5 million units per year. Currently, housing starts have rebounded to approximately 1 million units per year, with a significantly larger number of multi-family units than usual.

Exhibit 2-10. Personal Consumption Expenditures

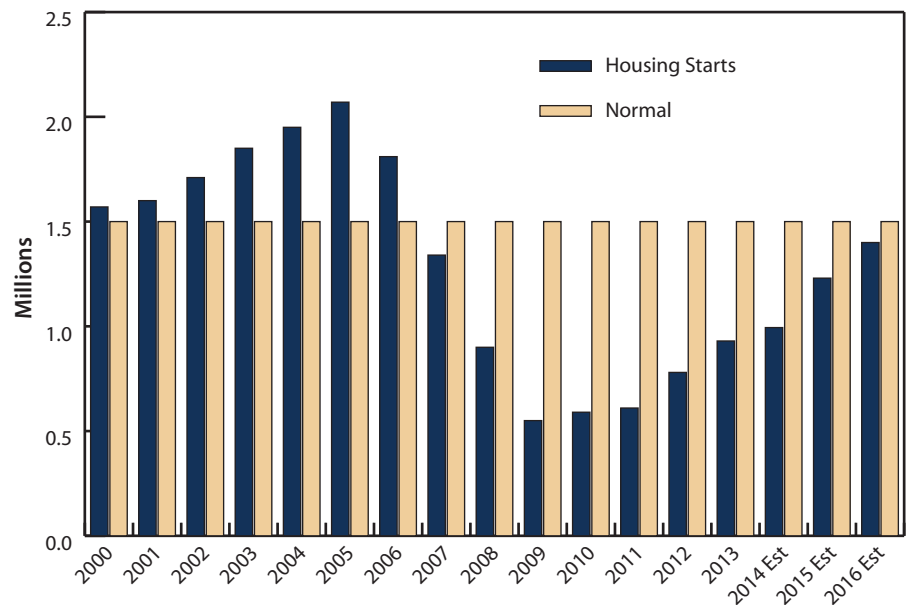


Sources: BEA, Haver Analytics, 3q 2014.

Tight credit conditions and the lingering effects of the Great Recession appear to have negatively impacted

home builders, particularly small builders, who have traditionally produced approximately half the supply

Exhibit 2-11. Historical Housing Starts



Sources: BEA, NAR, 3q 2014.

¹³ <http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf>. Survey of Consumer Finances for 2013; Over the 2010-2013 time period, the median value of real family income fell 5 percent, while mean income increased 4 percent.

¹⁴ U.S. Department of Commerce, BEA, Haver Analytics; data current through 3q 2014.

¹⁵ U.S. Department of Commerce. Bureau of the Census. "New Residential Construction."

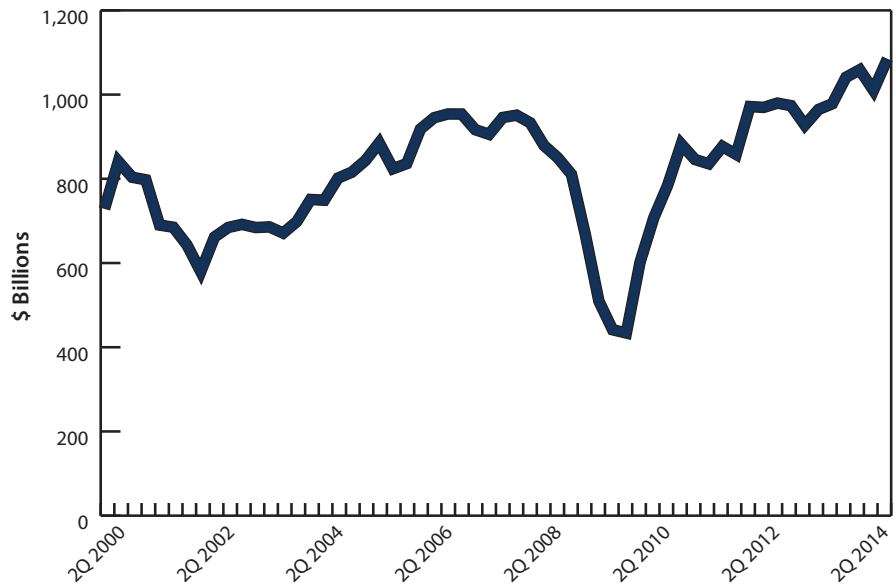
of new construction. The NAR housing starts outlook for 2014 is 994 thousand units, 1.2 million units in 2015, and 1.4 million units in 2016.

The decline of housing starts during the Great Recession created a housing deficit relative to the supply that would have been built absent the Great Recession and its lingering after-effects. From 2000 to 2014, net additions to the housing stock appear to have been deficient by 4.7 million units, based on BEA data. Over the same time period, the economy added an additional 13 million households. In view of a potential housing shortage, any risks to the housing forecast appear to be on the upside.

Investment—Business Investment, Private Non Residential Fixed Investment

Business investment, including inventory changes, typically accounts for 13 percent to 15 percent of GDP. This amount declined significantly during the Great Recession. The impact on the economy from non-residential fixed investment is now substantially above the levels experienced a few years ago, as shown in Exhibit 2-12, with the

Exhibit 2-12. Business (Non-Residential) Investment



Sources: BEA, Haver Analytics, 3q 2014.

NAR investment outlook supporting continued economic expansion.

GOVERNMENT EXPENDITURES¹⁶

With an increased focus on efficiency and constrained by revenues, government expenditures as measured in the GDP declined during the Great

Recession, according to the BEA and as reflected in Exhibit 2-13. There has been a recent modest increase in expenditures since then. Future decreases in government expenditures appear unlikely, so there does not appear to be a significant risk to the economic forecast from decreased government expenditures adversely impacting the GDP.



¹⁶ U.S. Department of Commerce, BEA, Haver Analytics.

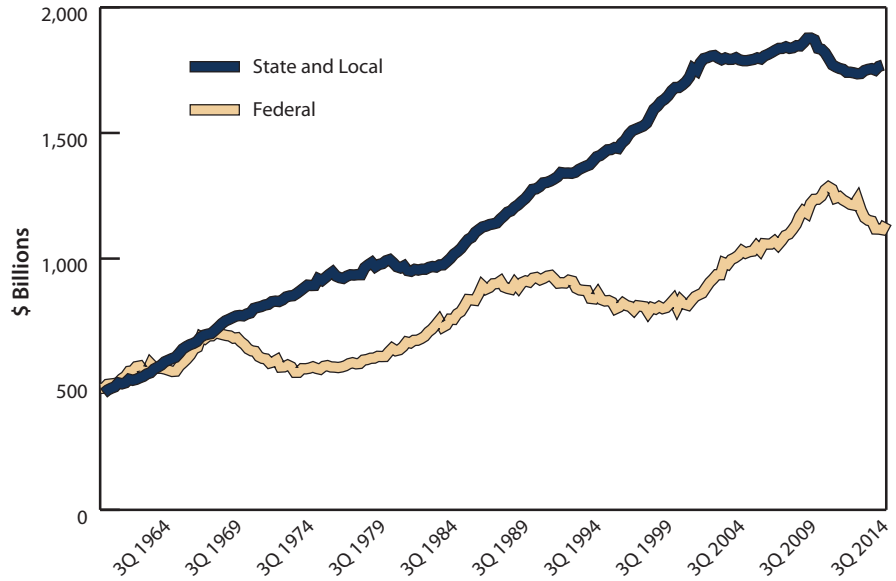
NET EXPORTS¹⁷

Net exports are the net balance of total exports compared to total imports. The impact on the GDP is the net of exports (approximately \$2.3 trillion) and imports (approximately \$2.9 trillion). Typically, there is a trade deficit, recently running in the neighborhood of \$500 billion yearly, according to the BEA. A trade deficit has a negative or downward impact on the economy.

The outlook for the trade deficit in the next year will depend largely on the strength of the economies of the U.S. trading partners. Foreign recessions can impact the U.S. economy through decreased U.S. exports. The global economic environment remains mixed, as noted by Moody’s Analytics:¹⁸

- Worldwide, the global economy is expected to experience global GDP accelerating to above 3 percent in 2015 and 2016.
- The U.S. and Canada are transitioning to a faster pace of economic growth than previously experienced.
- GDP in Asia is expected to expand by 4.5 percent.
- Europe’s economies are soft, and some economies have recently fallen into recession.
- Emerging economies appear to be in a growth mode.
- South American economies have been expanding well below their potential, as weaker global commodity prices and high interest rates have pushed Brazil, Argentina, and Venezuela into recessions.

Exhibit 2-13. Government Expenditures Declined During Great Recession



Source: BEA, 3q 2014.



¹⁷ U.S. Department of Commerce, BEA, Haver Analytics.

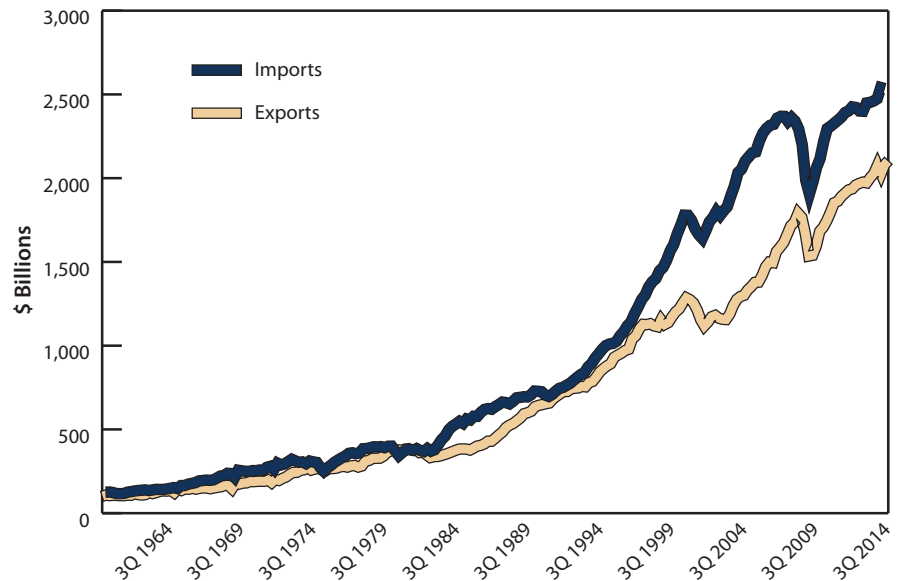
¹⁸ Ruth Stroppiana, “Global Outlook: Economic Prospects Improve,” Moody’s Analytics, Dismal Scientist.

- China is expected to remain a primary driving force in the global economy, with an economy growing in the neighborhood of 7.5 percent.

Geopolitical instability, including oil production and pricing, has been cited as a risk to global growth (probably the greatest risk in the opinion of many experts).¹⁹ In a McKinsey survey, 82 percent of senior executives polled worldwide saw geopolitical instability as a potential risk to global economic growth over the next 12 months.²⁰ The current NAR forecast assumes a continuation of foreign economic trends with no spectacular changes in the international economic environment.

Given a continuing expansion of the U.S. economy, increasing levels of imports appear likely, along with some decrease in exports to economies in slower growth modes—e.g., South America and Europe. Therefore, there could be a modest worsening of the trade deficit with a negative impact on the GDP. The total trade

Exhibit 2-14. Net Exports Were About \$430 Billion Recently



Sources: BEA, Haver Analytics, 3q 2014.

deficit is currently in the neighborhood of \$400 billion, as shown in Exhibit 2-14; a 20-percent increase in the deficit would be \$100 billion. Putting this into perspective, \$100 billion is approximately 0.6 percent of a \$17

trillion economy—a percentage generally regarded as relatively minimal. Changes in net exports and imports appear unlikely to have a major impact on GDP at this time.



¹⁹ Elliot Eisenberg gives an example of the intersection of international politics and economics. Oil prices are important economic drivers. Increased oil supply, coupled with slightly declining oil demand due to weakening global growth, led to falling oil prices during 2014. Normally, as the lead oligopolist, Saudi Arabia would cut production. They did not, and Eisenberg speculated that Saudi Arabia was squeezing other countries for political reasons (e.g., Iran, Iraq and Russia), which are all heavily-dependent on oil revenues. Elliot F. Eisenberg, Ph.D., GraphsandLaughs, LLC.

²⁰ “Economic Conditions Snapshot, September 2014,” McKinsey Global Survey, September 2014. The other top four risks were increased economic volatility (35 percent), low consumer demand (22 percent), new asset bubbles (20 percent), and sovereign-debt defaults (20 percent).

THE ECONOMIC OUTLOOK— UNCERTAINTIES AND FORECASTING

A variety of assumptions in the modeling effort, coupled with a variety of risks exogenous to the estimation process, can impact a forecast—i.e., create forecast risk that may cause the economic projections to be inaccurate—either upwards or downwards.

- **Assumptions about the underlying economic relationships driving the economy:** Differences in modeling assumptions may result in differences in conclusions. For example, the choice of potential economic drivers—e.g., GDP, household wealth, prices of various assets, etc.—can impact the estimation of economic relationships. Assumptions concerning consumer and business behavior, uncertainties, and the characteristics of economic change impact the modeling effort. The possibility of unknown unknowns enters the forecasting procedure at this

point. For example, the extent and impact of adversities in real estate markets and their impact on the overall economy during the Great Recession could have been termed one of the unknown unknowns prior to the Great Recession.

- **Assumptions about exogenous variables:** Assumptions about exogenous events—e.g., changes in Federal Reserve policies, government expenditures, the impacts of foreign affairs on economic activity, changes in government regulations, etc.—can alter a forecast. These are the unknown unknowns: economists typically have minimal, if any, expertise in predicting the occurrence of these types of events. However, these are also the types of events that can strongly impact an economic outlook.

The familiar statement “On the one hand..., but on the other hand...” frequently associated with economic commentaries highlights that

unknown unknowns and uncertainties in exogenous events can change the forecast. Therefore, any economic forecast is based on an understanding of the economy and a variety of assumptions which may or may not be accurate. The forecasting effort can produce a number of scenarios based on differing behavioral and exogenous assumptions. A major value from the forecasting scenario, as provided in Chapter 5 of this report, is the examination of the impacts of uncertainties on economic outcomes.

The Uncertainties

A variety of uncertainties are associated with the current forecast:

Foreign Economic Trends/Impacts: Approaching 2015, we find that some foreign economies are expanding and some are not. Disturbances which decrease international trade will have a negative impact on the U.S. economy. Foreign economic slowdowns are a downside risk to the forecast.

Monetary Policy—a significant risk: Through quantitative easing, the Federal Reserve has kept interest rates artificially low, with the objective being to stimulate the economy and achieve a lower unemployment rate. Interest rates impact the economy. The end of quantitative easing is likely to lead to higher interest rates, a downside risk to the forecast. The size of the risk should be relatively minimal for the next year, given that interest rate increases are likely to be orderly.

Credit Availability—a significant risk: Low interest rates are irrelevant if credit is not available to responsible, qualified borrowers. Many financial institutions have been reported as having balance sheet problems, e.g. loan portfolios that are excessively risky and have a lack of capital relative to potential risks and liabilities. As a result, it appears that overall credit availability has become excessively



tight. For example, NAR has estimated that home sales could rise by 10 percent if normal credit requirements for home purchasers were in place. A loosening of credit, based on recent comments by senior government officials, should have a positive effect on the forecast. According to a Goldman Sachs study, credit availability is more important than cyclical factors of unemployment and income in determining home sales. According to estimates in the study, the lack of credit availability contributed to about half of the housing market weakness in the past year.²¹

The Federal Housing Finance Agency, the agency that regulates the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, has initiated several measures to increase credit availability for responsible borrowers. For example, the acceptance of loans originated with a 3-percent down payment under certain qualification guidelines by the GSEs should increase credit availability to first-time buyers significantly. In the case of Freddie Mac, borrowers will be required to participate in a borrower education program. In the case of Fannie Mae, borrowers will still have to meet the standard eligibility underwriting requirements relating to income, employment, and debt, and will be required to purchase private mortgage insurance.²²

Housing and Construction Uncertainties: Following the Great Recession, housing starts have been below the normal level of 1.5 million units per year. Credit availability and increased risk aversion appear to have had a major impact on new construc-

tion. Assuming an easing of credit, this is an upside risk to the forecast.

College Student Debt: Student debt is currently in excess of \$1 trillion, according to the Federal Reserve Bank of New York:²³

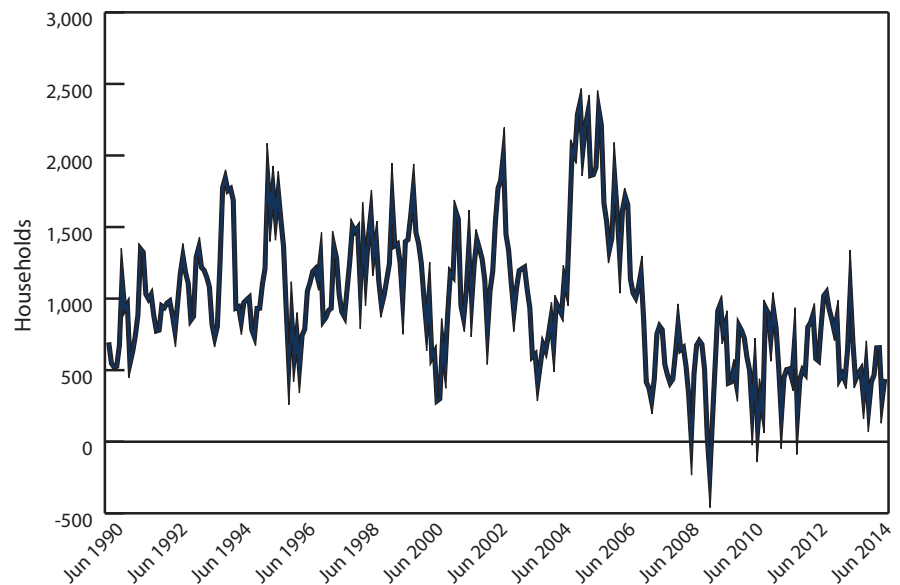
- Outstanding student loan balances reported on credit reports increased to \$1.13 trillion as of September 30, 2014, representing an increase of about \$100 billion from 1 year ago.
- About 11.1 percent of aggregate student loan debt was 90+ days delinquent or in default.

The average amount owed per borrower grew at 7 percent a year between 2004 and 2012,²⁴ and some student debt levels may be negatively impacting home ownership.²⁵ The media

have been filled with stories of college graduates working at near-minimum wage levels while owing tens of thousands of dollars. Such individuals are allegedly consigned to almost permanent indigence. However, it is important to note that student debt comes in all sizes: 12.7 percent of debtors owe more than \$50,000 according to “Student Debt Overview,” but 40 percent of debtors owe less than \$10,000. Student debt levels do not appear likely to impact the economic projections in 2015, but for the longer term, a significant number of former students owe significant amounts of money to a much higher degree than has been the case historically.

Household Formation: Household formation, as charted in Exhibit 2-15, is an important economic driver, generally creating a need for space, home furnishings, etc. To the degree that

Exhibit 2-15. Households Added (Historical Formation)



Sources: U.S. Census Bureau, Haver Analytics, October 2014.

²¹ Hui Shan, *Scotsman Guide*, July 28, 2014.

²² <http://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Director-Melvin-L-Watt-on-Release-of-Guidelines-for-Purchase-of-Low-Down-Payment-Mortgages.aspx>.

²³ *Quarterly Report on Household Debt and Credit*, November 2014, Federal Reserve Bank of New York.

²⁴ “Student Debt Overview,” *Postsecondary National Policy Institute (PNPI)* 8/14/13, Meta Brown, Federal Reserve Bank of New York.

²⁵ Meta Brown, Sydnee Caldwell, “Young Student Borrowers Retreat from Housing and Auto Markets,” April 17, 2013, *Liberty Street Economics*.

this trend changes in the next several years, the change is likely to be upwards, given the maturation of the Generation Y demographic group.

Income and Wealth Distribution:

Economic data indicate an increasing concentration in income and wealth compared to a decade ago. The Federal Reserve's *Survey of Consumer Finances for 2013* has reported that over the 2010-2013 time period, the median value of real family income fell by 5 percent, while the mean income increased by 4 percent.²⁶ Decreased purchasing power, coupled with limited income expectations by the bottom 60 percent of the population, may be holding the economy to a lower expansion path.

Job Availability and Growth: Unemployed, underemployed, and missing-from-the-labor-force workers have continued to be a problem during the recent economic expansion. Unemployment levels have been high relative to previous experience and in

comparison to the 5-percent rate frequently regarded as desirable. However, the job markets are easing, with more people finding work. If this trend accelerates, there would be additional upscale potential to the forecast.

All of the uncertainties mentioned—except for the likelihood of increased credit availability—are somewhat unpredictable. The current NAR forecast is based on the extrapolation of current trends in the risk factors. The one major uncertainty—credit availability—now seems to be much less uncertain based on comments by senior government officials; accordingly, the risk to the forecast is on the upside, and this forecast may be somewhat conservative.

Forecasting Conclusions

As 2015 continues, NAR expects a measured expansion (stronger than the past few years) of the economy. A number of negative factors holding the economy back have been

mentioned. These factors are important in terms of their negative impacts on the economy. For example, the Millennial Generation is larger than the Baby Boom Generation, which should auger well for economic growth. However, Millennials have been challenged by student loans, a difficult job market in terms of job availability and income, a slow economy, and tight monetary policies. Some of these problems are changing (e.g., credit availability, state of the economy), but the economy is unlikely to move forward at a maximum rate until issues of job markets, family formation, and household balance sheets are significantly improved for the Millennial demographic.

As economic problems are resolved, one would expect to see the economy move forward somewhat more rapidly than is currently the case. At this time, NAR's outlook is for moderate economic growth in 2015.

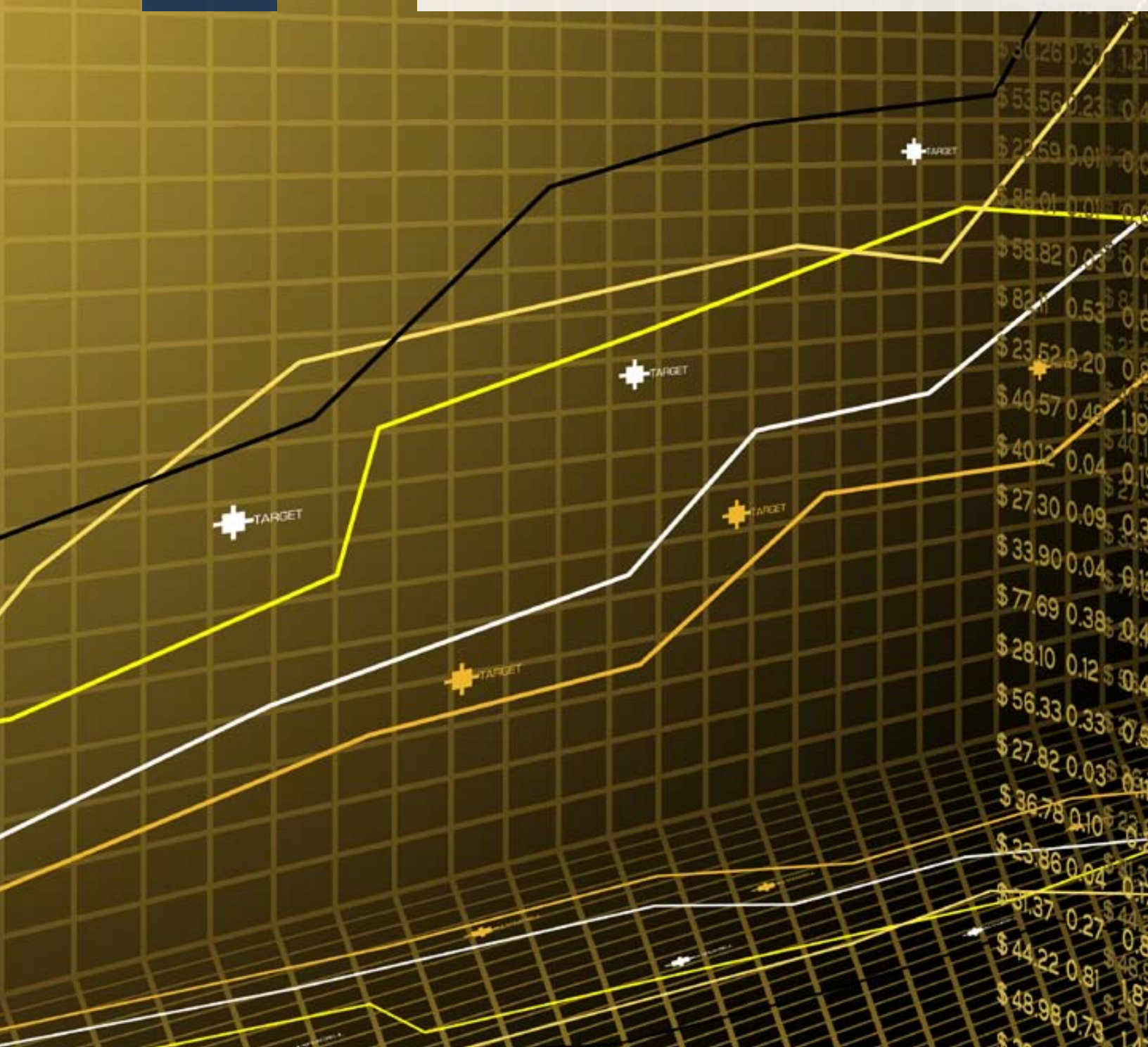


²⁶ <http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf>.

3

THE CAPITAL MARKETS

CAPITAL WATERS RUN DEEP



CAPITAL WATERS RUN DEEP

As 2015 gets underway, the investment world is flush with capital and the U.S. is generally regarded as a top destination for much of this investment capital. The U.S. stock market has recorded new all-time highs, with the Dow Jones Industrial Average (DJIA) topping 18,000 and the S&P 500 topping 2,000 as of late December 2014. U.S. Treasury yield rates have been declining due to increased demand, as have government bond rates in many other countries. As a tangible, transparent, and relatively safe investment in uncertain times, commercial real estate, especially in the U.S., also continues to attract much capital (both foreign and domestic).

In fact, according to results from the 23rd annual survey conducted by the Association of Foreign Investors in Real Estate (AFIRE), the U.S. was voted “the most stable and secure country for investment, outstripping second-place Germany by 55 percentage points and third-place UK by 60 percentage points.”²⁷ The AFIRE survey results also indicated that the U.S. offers the best opportunity for capital appreciation, “out-performing second-place Spain by 34 percentage points and third-place UK by 40 percentage points.” In addition, New York City reclaimed first place as the Number 1 global city for commercial real estate investment, per AFIRE.

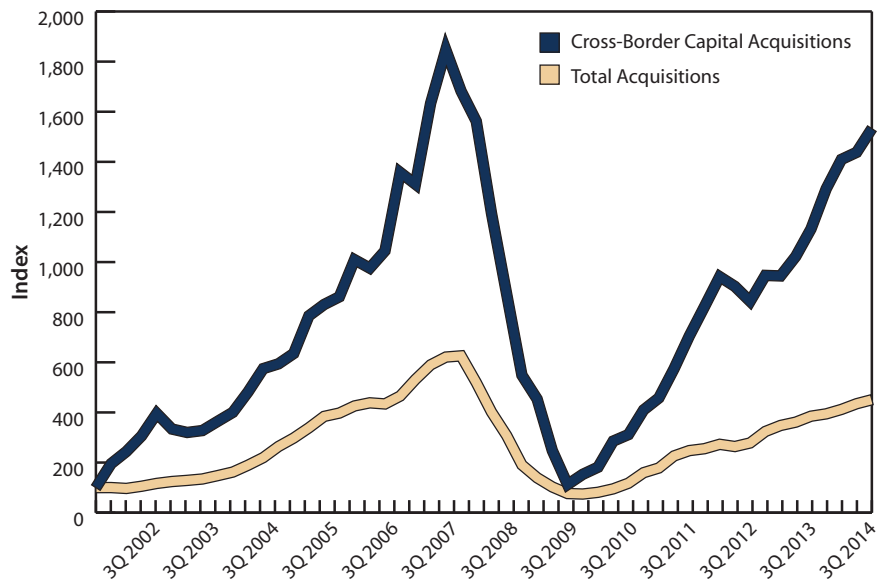
These investment attitudes for commercial real estate are reflected in Exhibit 3-1, which compares the growth of total commercial property transactions to cross-border acquisitions by indexing the percentage change in dollar acquisition volume

on a 12-month trailing basis. As shown, by the end of third quarter 2014, cross-border capital investment had reached levels seen in mid-2007, whereas total acquisition volume was closer to mid-2006 levels.

In fact, commercial real estate investment in general is more closely resembling capital investment in the pre-credit crisis years leading up to the Great Recession. According to Situs RERC’s historical analysis, the gap between the availability (or amount) and discipline (or underwriting standards) of capital is widening (see Exhibit 3-2) similar to 2007 levels, as capital floods the market and underwriting standards loosen. This is starting to raise alarm bells, and given the expected further loosening of underwriting standards and continued capital inflows, the gap

between availability and discipline will likely continue to widen throughout 2015, especially if interest rates remain low and the U.S. remains a safe haven for investment. (This graph has historically provided a good indicator when market prices were outpacing values, as capital was pushing prices, versus prices being led by the fundamentals.) Compared with the pre-credit crisis period, we note that the market is not at the point of disparity where capital availability outpaced discipline by a relatively large margin. However, the market is at an inflection point and if investors compare to historical time frames, there may be 1½ to 2 years before the next down cycle. (Yes, there will almost certainly be another down cycle—the questions are when, why, and how severe.)

Exhibit 3-1. Cross-Border Percentage Change in Acquisition Volume



NOTE: Index reflects percentage change in dollar acquisition volume on a 12-month trailing basis. Sources: Real Capital Analytics, indexed by Situs RERC, 3q 2014.

²⁷ 23rd annual survey conducted by the Association of Foreign Investors in Real Estate (AFIRE) in fourth quarter 2014 by the James A. Graaskamp Center for Real Estate, Wisconsin School of Business, and issued on Jan. 5, 2015.

KEY CAPITAL CONCERNS FOR 2015

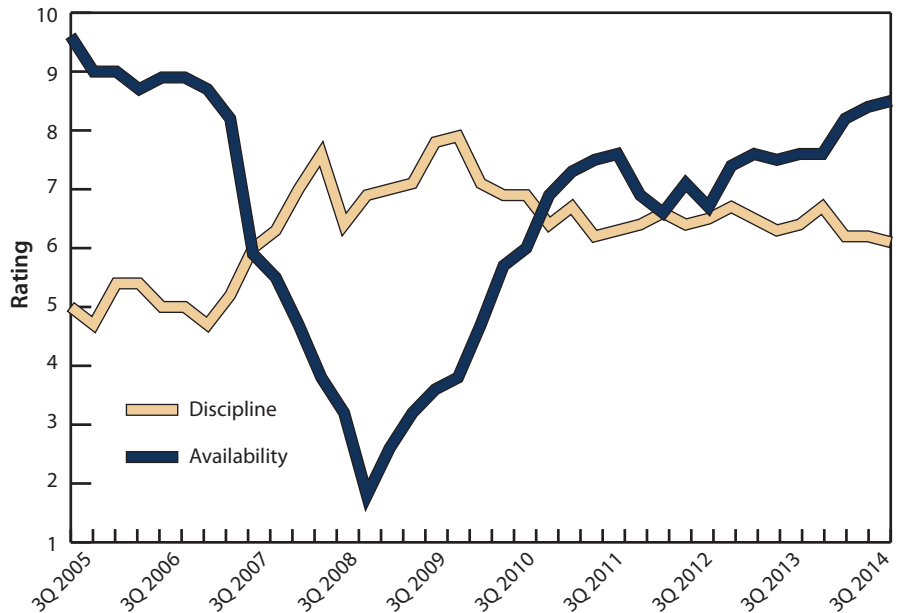
When Will Interest Rates Go Up?

Although the federal funds rate (short-term interest rate) has remained at 0 percent to 1/4 percent for much longer than most investors would have guessed, the main concerns now are the timing for when short-term and long-term interest rates begin to increase, and how will the two rates move: in tandem, lead, or lag one another?

Many forecasters believe that the Federal Reserve will start to raise short-term interest rates in mid-2015. However, according to the Federal Open Market Committee’s (FOMC’s) end-of-the-year policy statement released December 17, 2014, “...the Committee judges that it can be patient in beginning to normalize the stance of monetary policy,” and other forecasters believe the raising of short-term rates could be several years away yet because of slowing economies in the rest of the world. Further, the FOMC reiterated that it “likely will be appropriate to maintain the 0 to ¼ percent target range for the federal funds rate for a considerable time...especially if projected inflation continues to run below the Committee’s 2-percent longer-run goal, and provided that longer-term inflation expectations remain well-anchored.”

One of the clearest indications of the direction of interest rates is the direction of government bonds. Commercial real estate, as well as nearly all other investments in the U.S. and in most developed countries, uses the 10-year Treasury yield rate as a risk-free rate to compare investment yields. For the past 7 years, many investors have been hedging for the 10-year Treasury yield rate to jump back up to what is typically considered the “historical norm.” But as Exhibit 3-3 shows, risk-free rates have been consistently declining for a couple decades, and the

Exhibit 3-2. Historical Availability & Discipline (Underwriting Standards) of Capital

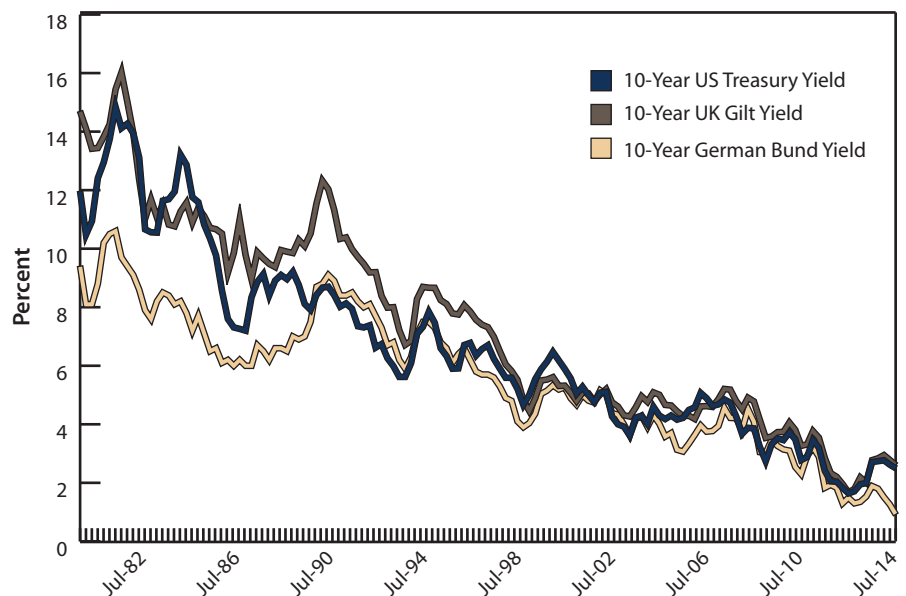


Source: Situs RERC Institutional Investment Survey, 3q 2014.

direction of change has not played out as many investors have been expecting. In addition to investors updating their definition and expectations for interest rates and their impact on investment alternations, Exhibit 3-3 shows that the downward trend could

last longer than predicted, and many market participants are downgrading their expectations on risk-free rates and the timing of the adjustment. In early 2014, most investors expected 10-year U.S. Treasuries to be 3 percent plus by now, and they based projected

Exhibit 3-3. 10-year Government Bond Yield Rates (Historical Treasury, Bund, Gilt Yields)



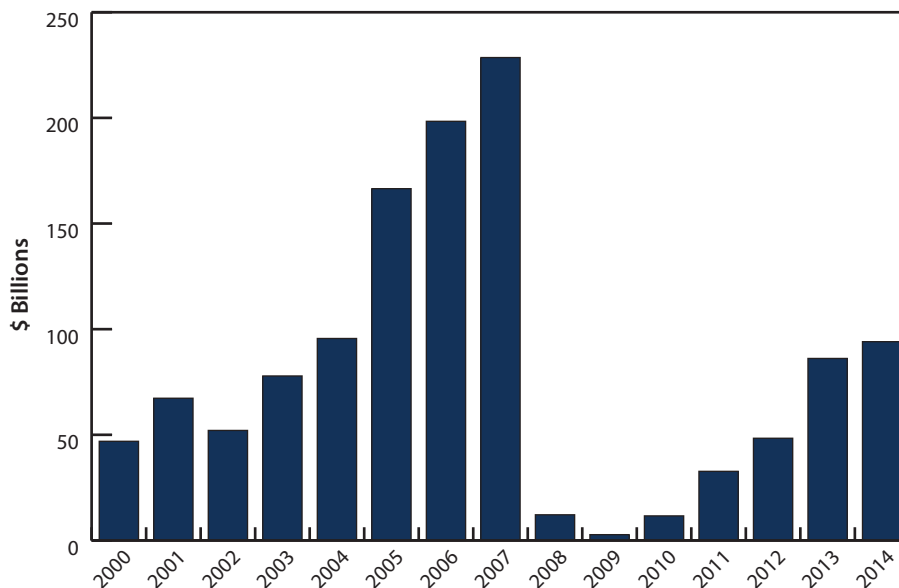
Sources: Federal Reserve, OECD, 3q2014.

relative investment performance on this forecast. Ten-year U.S. Treasuries were about 2 percent at the time of this writing, and most investors do not see a significant change over the near term as the weight of capital and the search for safety puts strong downward pressure on U.S. Treasuries, which are higher than government bond yield rates in other countries like Germany and Japan.

Credit Markets Healthy, or Déjà Vu All Over Again?

More and more, the debt market is starting to resemble 2005 and 2006, particularly as it relates to the size and quality of originations. According to *Commercial Mortgage Alert*, the issuance of CMBS in the U.S. in 2014 (\$94.1 billion) reached about the same level as in 2004 (\$95.6 billion), as shown in Exhibit 3-4, and many investors expect that this issuance will accelerate similarly to that in 2005 through 2007, especially if underwriting standards continue to loosen.

Exhibit 3-4. CMBS Issuance in U.S. (2000 through 2014)



Source: Commercial Mortgage Alert, Jan. 5, 2015.

Meanwhile, the market continues to deal with the wave of commercial real estate maturing over the next several years. Although the outlook for these maturing loans has improved greatly since 2009, as many have been resolved or restructured, there remains

well-placed concern over other maturing CMBS loans which are considered “zombie” loans because they are unable to be refinanced. In addition, according to Morningstar Credit Ratings, LLC, from November 2014 until November 2015, 5.19 percent of loans were already delinquent compared to the total CMBS delinquency rate of 4.15 percent in October 2014.

Will the next wave of CMBS maturities be as challenging as those in 2007? According to Morgan Stanley Research and Trepp, the weighted-average loan-to-value (LTV) ratio as of third quarter 2014 was 66 percent, which was significantly looser than in third quarter 2010 (approximately 53 percent). However, the current LTV ratio is still tighter than the underwriting standards prior to the LTV peak of 71 percent in second quarter 2007.

Additionally, in third quarter 2014, the Moody’s LTV ratio had one of the largest quarter-to-quarter increases in CMBS loans. The LTV increased from 108.3 percent to 112.2 percent, and signaled that leverage in the market will likely handily surpass the pre-crisis peak of 118 percent before third quarter



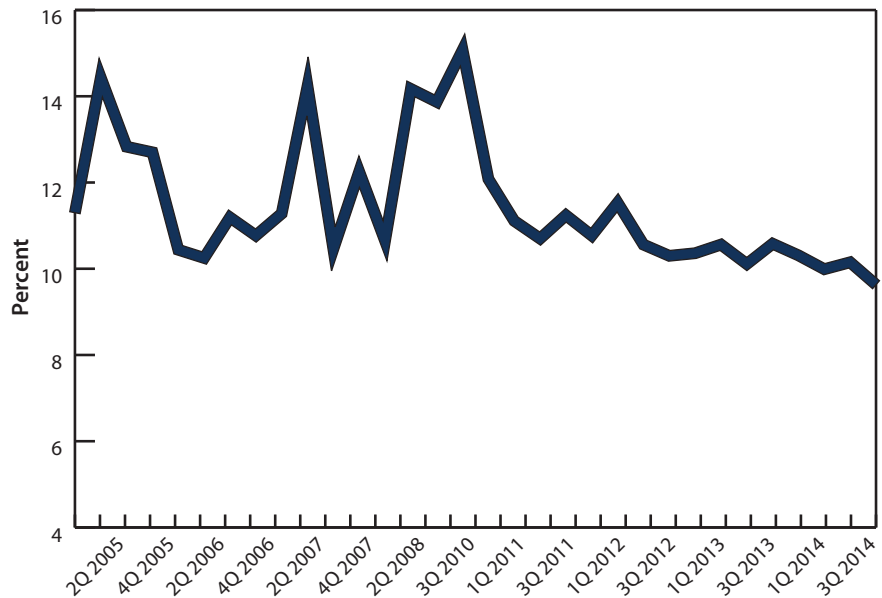
2017. On top of that, the distribution of the Moody's LTV ratio has shifted and looks eerily similar to that of 2007 but without as much risk.

Meanwhile, Morgan Stanley reported that in third quarter 2014, the weighted-average debt yield broke below the 10-percent mark for the first time ever to 9.6 percent, as shown in Exhibit 3-5. However, this is somewhat deceiving, given the difference in the 10-year U.S. Treasury rate then compared to now.

The similarities in CMBS loans today compared to those leading up to the 2006-2007 credit crisis are occurring amidst a significantly altered backdrop, and thus will likely lead to different results. Very much absent from the current CMBS outlook is an aggressive market for collateralized debt obligations (CDOs). In the few years prior to the Great Recession, the CDO market became substantially and systemically more risky when it became a major financing mechanism for the most junior CMBS bonds and more notorious subprime residential mortgage backed securities. According to *Commercial Mortgage Alert*, real estate CDO issuance peaked in 2006 at nearly \$40 billion, but through the first 9 months of 2014, totaled only \$3.4 billion.

There are other reasons why we do not generally anticipate a repeat of the credit crisis of 2006 and 2007, and key among them is improved regulations. Since then, the rating agencies have been required to become more thorough and critical in their analysis. There was also the passing of the Dodd Frank Wall Street Reform and Consumer Protection Act, as well as Basel III²⁸. These improvements increased the minimum capital requirements, and take into account risk-weighted assets for large bank holding companies. In addition, requirements have been set up to mitigate risks via minimum liquidity ratios and leverage

Exhibit 3-5. CMBS Weighted-Average Debt Yield



Source: Morgan Stanley Research, 3q 2014.

ratios, as well as capital conservation and counter-cyclical buffers. Furthermore, the largest banks must go through the Comprehensive Capital Analysis and Review (CCAR) to assess if they will have sufficient capital to withstand normal, adverse, and severely-adverse economic scenarios.

The Dodd Frank Wall Street Reform and Consumer Protection Act also specifically addressed the CMBS market. Recently finalized risk-retention rules require that CMBS sponsors retain a minimum of 5 percent of the risks on a transaction, which can be purchased by up to two different third parties on a "pari passu" basis. There is additional transparency through required financial disclosures, as well as an operating advisor, who has no conflicts of interest and reports with impunity to the investors.

Risk From Across the Pond

As 2015 gets underway, economic growth throughout Europe remains sluggish and there are deep concerns that the European Union's

(EU's) deflationary environment may push the EU economy into recession. According to most estimates, including those made by the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF), investors should expect the EU economy to continue its lethargy for the near term.

The labor situation in Europe bounced between stagnation and mild improvement in third quarter 2014. According to Eurostat, the EU's seasonally-adjusted unemployment rate decreased to 10.0 percent in October 2014, while unemployment in the euro zone remained 11.5 percent in October.

In addition, geopolitical uncertainty has increased across the globe, and the conflict in Ukraine, which has already damaged business relations between Russia and its neighbors, seems nowhere near resolution. Add to that terrorism in the Middle East, the economic challenges posed by low oil prices, and the political fracturing in the EU as the ECB begins to initiate quantitative easing, and it is

²⁸ Third document issued by the Basel Committee on Banking Supervision.

increasingly likely that many investors will continue to be attracted to safe, tangible, and transparent investments such as commercial real estate in 2015.

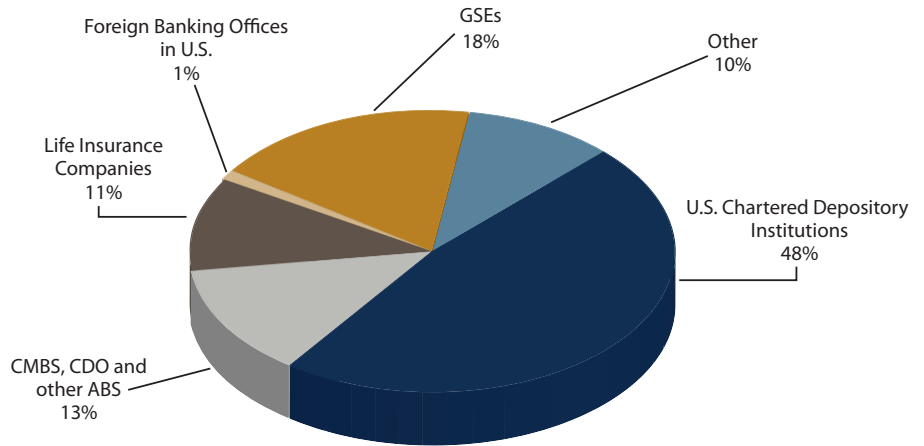
CAPITAL ORIGINATION

According to Situs RERC’s analysis, an estimated \$5.06 trillion is currently invested in commercial real estate in the U.S. Of this total, \$3.29 trillion is debt-driven, and \$1.77 trillion is equity-driven. Key investors in the debt market include U.S. chartered depository institutions (banks and savings institutions); GSEs; CMBS, CDOs, and other asset-backed securities (ABS); life insurance companies; other debt, including real estate investment trusts (REITs); and foreign banking offices. Equity investors include private investors; REITs, pension funds, foreign investors, life insurance companies, commercial banks, corporations, GSEs, and others.

Commercial Real Estate Debt Market

According to the Federal Reserve, the total outstanding debt for commercial and multifamily mortgages from

Exhibit 3-6. Commercial Real Estate Debt Universe



Fixed Income Markets - \$3.29 Trillion Lender Composition

Source: Federal Reserve Flow of Funds, 2q 2014.

second quarter 2013 to second quarter 2014 increased by 4.4 percent to approximately \$3.29 trillion (see total composition in Exhibit 3-6). Among the main lender types, debt in U.S. chartered depository institutions increased from 47 percent to 48 percent of commercial real estate loans in second quarter 2014. In addition, the total loan

holdings for REITs increased by 16.6 percent to \$194 billion, which came almost entirely during fourth quarter 2013, per the Federal Reserve. Given current market conditions and trends, growth near this level can be expected again during the next couple years, although it is unlikely to overtake as a majority lender.



Commercial Real Estate Equity Market

Situs RERC estimates that, based on its evaluation of various sources, equity investments in commercial real estate total \$1.77 trillion (see composition in Exhibit 3-7). Private investors hold the largest amount of commercial real estate equity with 43.72 percent of the total equity investment. The second largest equity group consists of REITs, with 34.40 percent of the total. Pension funds contribute 14.54 percent of the total.

According to Situs RERC’s analysis, debt originations increased for non-bank financial companies and for regional banks, but declined for national banks and insurance

companies in first half 2014. Equity investment increased among private investors, REITs, institutional and equity funds, and cross-border investors (see highlights in Exhibit 3-8 on Page 34).

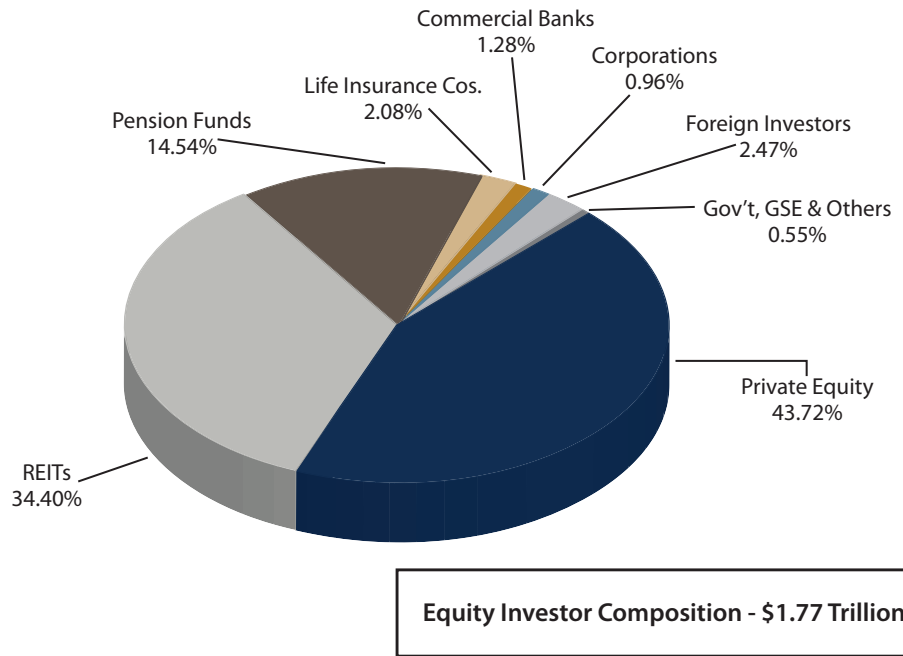
Equity to Debt

Increasingly, trusts and funds which had been aligned with equity are slowly starting to integrate debt as an essential part of their risk diversification and investment model.

For example, in December 2012, Blackstone acquired CT Investment Management Co. LLC for \$21.4 million and became Blackstone Mortgage Trust. According to their financial reports, Blackstone Mortgage Trust had a 204-percent growth in loan originations to end third quarter 2014 with \$3.9 billion in originations, compared to \$1.3 billion in third quarter 2013. The 55 different loans which make up the portfolio have a weighted-average LTV of only 64 percent, and are most heavily invested in New York, California, and the UK. Notably, all of these loans were originated based on a floating rate against the London Interbank Offered Rate (LIBOR), and as such, are positioned to deal with increases in bank lending. (All else being equal, a 100-basis point increase in the LIBOR would increase net interest income by \$15 million per year, or \$0.26 per share, as reported in Blackstone Mortgage Trust’s public financial reports.²⁹)

For this same reason, many REITs are also diversifying more into debt instruments as they focus on risk versus return and chasing market opportunities. It should be noted that offerings from all types of REITs have increased significantly over the past few years. According to data from the National Association of Real Estate Investment Trusts (NAREIT), equity capital raised by REITs peaked in 2012 (see Exhibit 3-9), while offerings of

Exhibit 3-7. Commercial Real Estate Equity Universe



Source: Situs RERC Estimate (based on NAREIT, PREA, AFIRE, Preqin, RCA, and NCREIF), 4q 2014.



²⁹ This includes the impact of LIBOR floors for loan receivable investments, per the Blackstone Mortgage Trust Report for Third Quarter 2014 Results, Oct. 28, 2014.

debt securities for REITs have continued to increase and have already surpassed last year's value with \$30.9 billion as of November 2014.

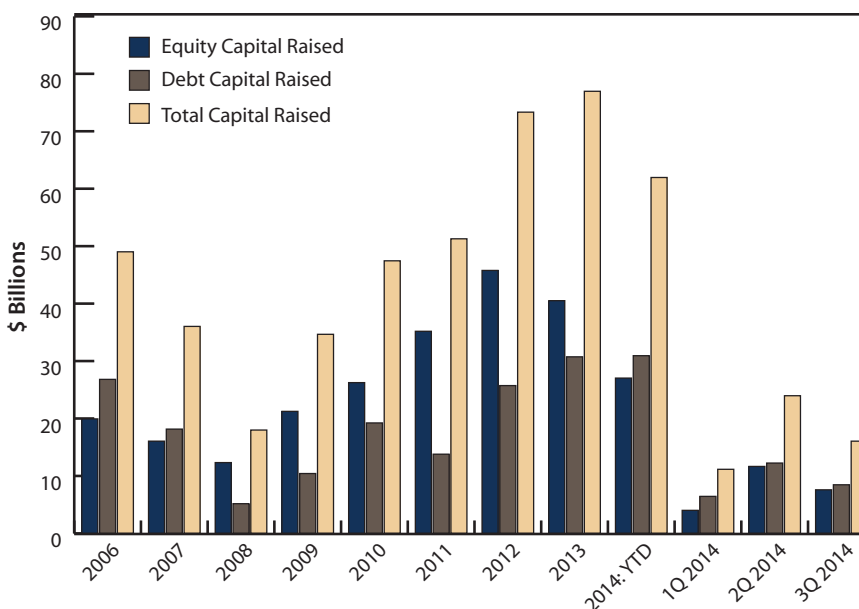
CAPITAL TO FURTHER DRIVE MARKET IN 2015

The lavish amount of capital that has been directed toward commercial real estate and other investments in 2014 shows no sign of abating in 2015. In fact, respondents to Situs RERC's quarterly institutional investment surveys have noted throughout most of the year that "capital placement defies logic" and that "there seems to be no end in sight to the amount of capital investors are willing to pay" for a quality property. The abundance of capital has helped to drive prices higher, and as we look to 2015, we recognize that we are at an inflection point where the availability of capital may be outpacing discipline (underwriting standards), and as such, property prices may also be outpacing property values.

A broader discussion of property fundamentals is presented in Chapter 4 of this report, and our overall outlook for 2015 is included in Chapter 5, but a summary of our expectations³⁰ for the capital markets as they relate to investing in commercial real estate for the year ahead is listed below:

- It is likely that huge amounts of capital will be invested in commercial real estate again in 2015. Both debt and equity investment will likely increase, and while investors will likely generally repeat the investment patterns set in 2006 (where availability pressured underwriting standards), new banking regulations and other investment requirements

Exhibit 3-9. Historical REIT Offerings



Source: NAREIT, 3q 2014.

- are expected to prevent another credit crisis from occurring.
- As the amount of capital is placing downward pressure on underwriting standards, it is also pushing property prices higher (versus property fundamentals doing so). Expectations are that property prices will continue to increase in 2015. The question is, will pricing get ahead of itself? At present, property prices remain reasonable, given the alternatives, and are not expected to get out of hand, but the risk is there.
- Pricing is expected to peak for core properties in the top coastal markets, but prices will continue to increase for good quality properties in the secondary and tertiary markets.
- Interest rates will likely remain low through 2015. The Federal Reserve may begin to raise short-term rates, but any increases will likely be small and gradual.
- Capitalization rates will likely continue to compress on a broad market basis.
- Many investors (both domestic and foreign) will likely continue to look for a relatively safe place to place investment capital, and the U.S. in general meets their requirements. Add to that their desire for reasonable returns, and it appears commercial real estate will continue to be quite attractive as the market expands in 2015.
- Expect returns on commercial real estate investment to likely be strong in 2015. The year 2015 will likely be a great year from a pricing and transaction standpoint.

³⁰ There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

Exhibit 3-8. Investor Highlights for Debt, Equity, and Cross-Border Capital Investment

Debt Highlights	
Non-Bank Financial Companies	Insurance
Originations increased to \$8.3 billion in first half 2014	Lending decreased by nearly one-fourth to \$10.9 billion in first half 2014
Lending increased for office properties, especially in Western U.S.	Originations down due to reduced lending to suburban and CBD office properties
Lending decreased for hotel properties	Lending increased for multifamily properties, especially in Mid-Atlantic region
Lending was about the same for multifamily properties, but loan size and ppu declined	Commercial mortgages in life insurance portfolios represented 94 percent (\$350 billion) of U.S. mortgages as of December 2013
National Banks	Regional Banks
Lending down in first half 2014	Originations increased to \$16.6 billion in first half 2014
Lending for hotels decreased the most, with only \$1.2 billion in originations in first half 2014	Biggest increase by total value was loans for multifamily properties (increases to \$5.7 billion)
Originations down for office properties, especially in suburban office properties in Midwest	Suburban office loans also increased, especially in secondary and tertiary markets
Equity Highlights	
Private Investors	Institutional and Equity Funds
Private investors hold the most equity in commercial real estate	\$120.3 billion total sales for the 12 months ending Sept. 30, 2014
Most active buyer (\$180.8 billion) and seller (\$182.9 billion) for the 12 months ending Sept. 30, 2014	\$50.8 billion office sales, including Blackstone's disposition of properties worth \$6.1 billion
Apartment properties comprised about one-third of acquisitions and dispositions	\$27.9 billion of office acquisitions for the 12 months ending Sept. 30, 2014, with largest purchases by JP Morgan, MetLife, Hines, and Blackstone
Public Investors	
\$23.9 billion of net capital invested during the 12 months ending Sept. 30, 2014	REITs and other listed investors netted the largest volume of capital
Stock exchange-listed U.S. REITs significantly outperformed the broader equity markets in first 3 quarters of 2014	Retail sector was most-acquired property type in 2q 2014, led by American Realty Capital Properties
Listed equity REITs delivered higher net total returns than other alternative asset classes from 1998-2011	Multifamily sector fell out of favor with REIT investors
Cross-Border Highlights	
U.S. remained most stable and secure country for investment, and provided the best opportunity for capital appreciation, per AFIRE survey results	Manhattan generated most investment with \$9.1 billion for the 12 months ending Sept. 30, 2014, followed by Los Angeles and Boston
REOCs most active type of foreign investor, w/ \$10 billion in purchases, followed by sovereign wealth funds with \$9.4 billion in acquisitions	Century Plaza suburban office in Los Angeles was sold to Hines/Hong Kong JV for \$1.8 billion at \$798 psf and 4.6-percent cap rate
\$14.5 billion net acquisitions from foreign investors for the 12 months ending Sept. 30, 2014	Foundry II, CBD office building in San Francisco was sold to Norges Bank Investment Mgmt. for \$390 million and a 2.9-percent cap rate
Canada most active foreign investor, with \$14.6 billion for the 12 months ending Sept. 30, 2014; Norway and Japan acquisitions follow, with \$3.5 billion and \$3.1 billion, respectively	Luxe City Center Hotel in Los Angeles was sold to a Chinese developer for \$104 million and \$585,112 per unit (most expensive hotel per unit)

Sources: Real Capital Analytics, 1H 2014; NAREIT, Oct. 9, 2014 and Oct. 14, 2014; AFIRE, Jan. 5, 2015; ACLI, Nov. 3, 2014.

4

THE PROPERTY MARKETS

STRENGTHENING FUNDAMENTALS



STRENGTHENING FUNDAMENTALS

Commercial real estate benefited from a favorable macroeconomic environment in 2014. Fundamentals strengthened, as demand for space advanced across all property types, driving vacancies lower and rents higher. With capital availability rising and sources broadening, investors pursued deals across markets, positioning themselves in geographies with the highest expectations for growth. The noticeable result of this shift came as a return to primary markets, where employment growth and development potential proved most promising.

Sales of major properties (priced at over \$2.5 million) totaled \$184.1 billion in the first half of 2014, a 23-percent year-over-year advance, based on data from Real Capital Analytics. Sales volume came within striking distance of the \$196.1 billion reached in the first 6 months of 2006. The third quarter 2014 saw an additional \$102.0 billion in transactions, bringing the 3-quarter total to \$288.5 billion. On a yearly basis, investments rose across all property types, except apartments, where major portfolio transactions in 2013 skewed the trend.

The office sector regained its status as the most active investment target in the first 3 quarters of 2014. With \$82.6 billion in transactions, office buildings made up 29 percent of total investments, according to Real Capital Analytics. Investors gravitated toward markets with high rent prospects, driving deal-making for central business district (CBD) office properties in top-tier markets. Apartment assets accounted for 25 percent of all deals, with \$73.1 billion in sales. Apartment deals in tertiary markets were particularly strong in 2014, with metros such as Philadelphia, Nashville, Balti-

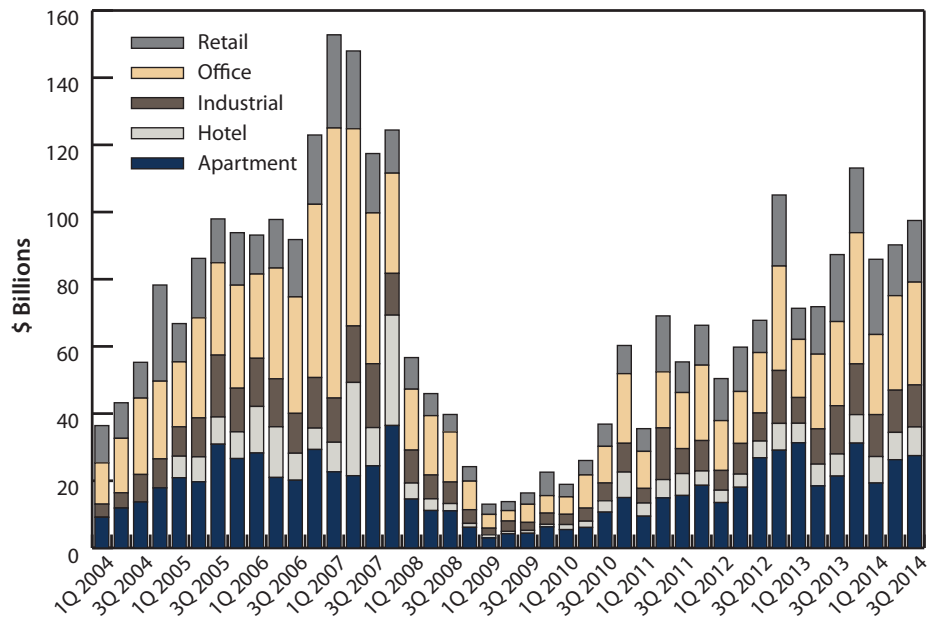
more, and Jacksonville proving highly active.

As investors sought higher yields, retail sales advanced at the fastest pace, gaining 57 percent in the first half of 2014 compared with the same period the prior year, per the Census Bureau. Aggregating data for the first 9 months of the year, Real Capital Analytics reported that retail property transactions totaled \$55.9 billion. The industrial sector also provided higher relative yields and benefited from increased investments, which totaled \$37.6 billion through the end of September, as shown in Exhibit 4-1. Over the same period, the hotel sector accounted for 9 percent of total sales transactions.

Development deals offered a particularly bright spot in the first 9 months of 2014, as developers broadened their horizons beyond apartments.



Exhibit 4-1. Commercial Property Volume

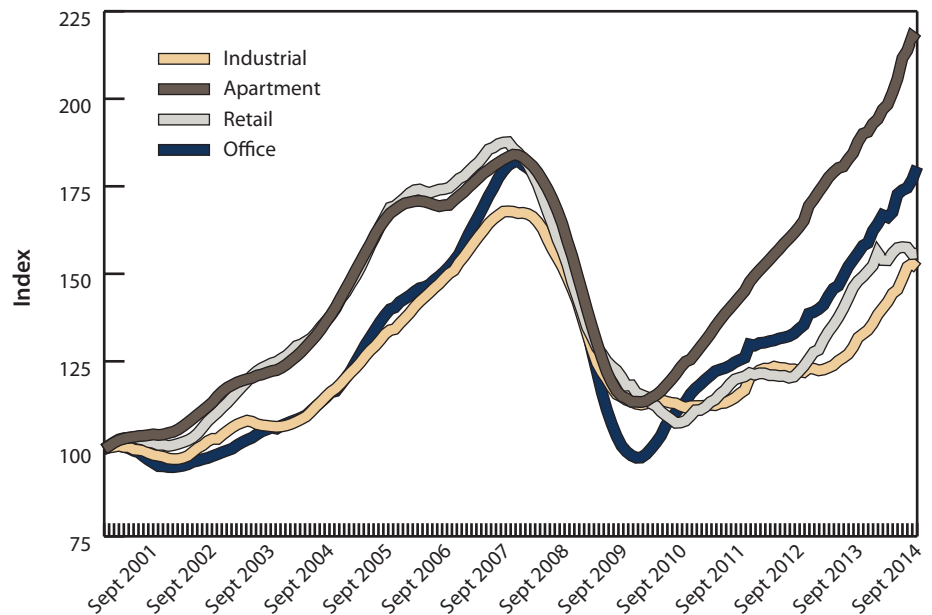


Source: Real Capital Analytics, 3q 2014.

Development land acquisitions totaled \$14.8 billion from January to September 2014. Except for multi-family, the bulk of development deals were focused in CBDs of major gateway metros, where the average price for land was about \$250 per buildable square foot, based on data from Real Capital Analytics. Entitled land in suburban locations continued to lag in pricing, with the exception of mixed-use development. At the midpoint of 2014, three fourths of the top 40 most active U.S. markets experienced gains in sales volume, per Real Capital Analytics. Manhattan continued as the top market, followed by Los Angeles. San Francisco's strong effective rent growth fueled a 125-percent increase in investments, and propelled the metro into the third spot. Dallas and Chicago rounded up the top five investment markets. With yields still at a comparative premium, secondary and tertiary markets continued to see significant inflows of capital. Stamford, Nashville, Philadelphia, and Orange County, Calif., recorded triple-digit increases in year-over-year sales volume.

Commercial property prices rose an average of 15 percent in first half 2014 compared with the prior year, according to Moody's/Real Capital Analytics Commercial Property Price Index (CPPI). CBD office properties recorded the largest gains in the first half of 2014 (above 2007 peaks), with a 19-percent

Exhibit 4-2. Property Prices Increased in 2014



Sources: Moody's Investors Service, Real Capital Analytics (Moody's/RCA CPPI), September 2014.

year-over-year increase (see Exhibit 4-2). Reflecting the rise in transactions, prices for industrial space rose 15 percent, the second strongest advance. Retail properties also experienced significant price appreciation, with an average 13-percent yearly gain. In tandem with CBD office properties, prices for apartment properties also surpassed their 2007 peaks, rising an average of 12 percent in the first 6 months of 2014 compared with the same period the prior year. Suburban office properties experienced an 11-percent yearly price appreciation,

while hotel properties posted a more modest 5-percent gain.

Cap rate compression took a more moderate line toward midyear 2014, as investors expected a rise in interest rates following the Federal Reserve's moves to curtail its quantitative easing program. According to Real Capital Analytics, the industrial property markets posted the largest decline in average cap rates between the first 6 months of 2013 and the same period in 2014, with a 34-basis point slide. As shown in Exhibit 4-3, industrial cap rates averaged 7.1 percent in the third quarter 2014. Cap rates for retail transactions averaged 6.8 percent in the first half of 2014 (24 basis points lower than the prior year). Apartment properties tied with CBD office properties for the lowest cap rates at the midpoint of 2014, both reaching 6.0 percent. Hotel sector yields rose 9 basis points, to an average 8.2 percent over the January 2014 to June 2014 period. With the monetary stimulus expected to wind down, interest rates are projected to rise into 2015



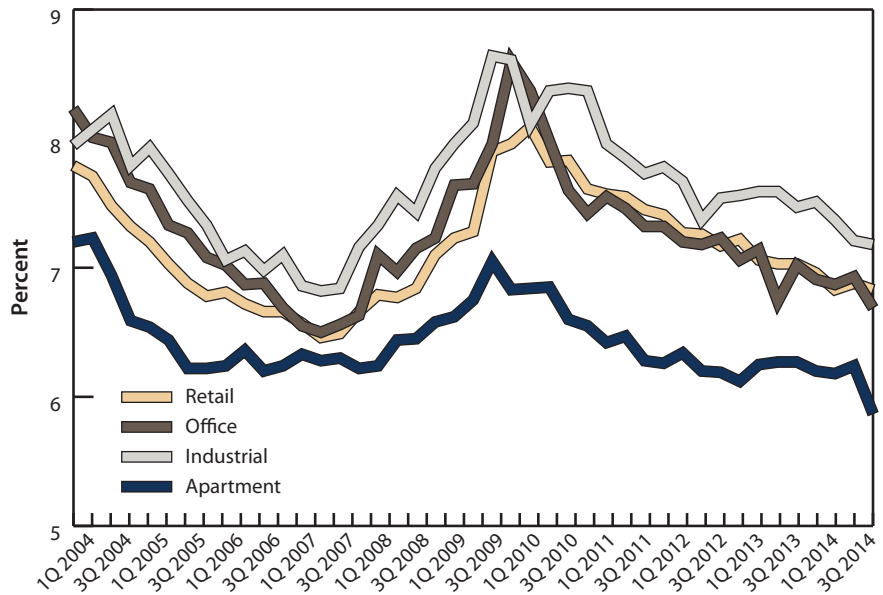
and beyond, squeezing spreads and driving cap rates upward.

As most major capital providers increased their positions in the commercial markets during 2014, some investors expressed concern about an overabundance of capital chasing too few deals in some markets. According to Real Capital Analytics, the office sector offered the most balanced capital source picture, with investor types evenly distributed between private investors, CMBS, GSEs, insurance and financial companies, as well as national, regional and international banks. The industrial sector counted on banks for over 55 percent of its funding. Financing for the apartment sector was dominated by Fannie Mae and Freddie Mac, and GSEs accounted for almost half of acquisitions. In the retail and hotel space, the CMBS market provided over 40 percent of capital.

Outstanding commercial distress volume totaled \$103 billion across all property types in the first 9 months of 2014, according to Real Capital Analytics. Continuing a positive trend, workout rates have been steadily climbing, reaching 63 percent in the first half 2014. The apartment and hotel sectors recorded the highest workout rates, at 68 percent and 67 percent, respectively. As asset values continued to appreciate, instances of distress declined (see Exhibit 4-4). Sales of distressed properties accounted for only 8 percent of total sales. At 45 percent, CMBS remained the largest holder of outstanding distress, while U.S. banks were the second largest holder of distressed properties, accounting for 25 percent.

Commercial real estate properties provided a solid investment alternative during 2014. With volatility in equity markets rising as the year progressed, commercial property returns remained attractive to

Exhibit 4-3. Cap Rates Declined

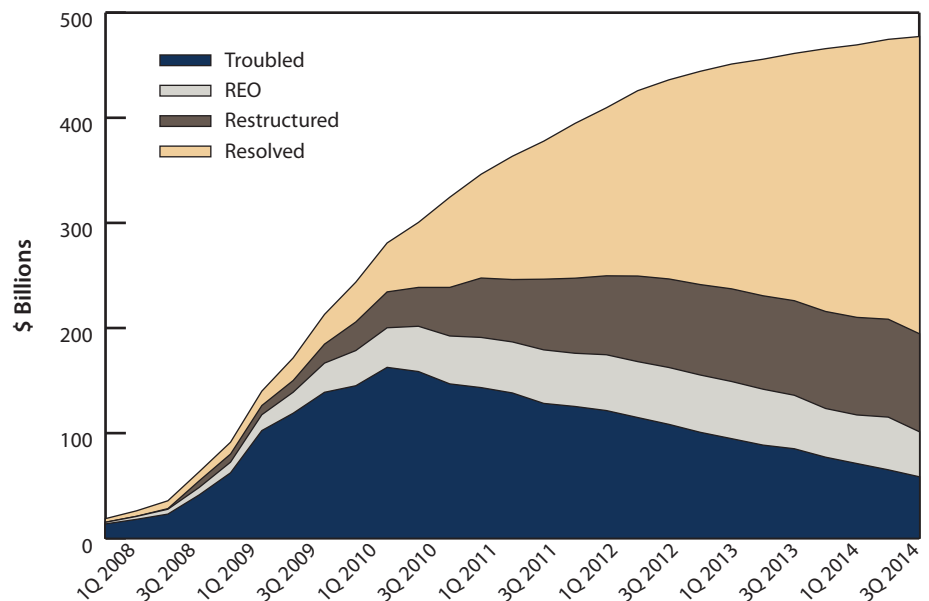


Source: Real Capital Analytics, 3q 2014.

many investors. As fundamentals are expected to continue strengthening, commercial assets remain an attractive investment option for

many investors. Property prices may hold at elevated levels, even as interest rates rise in 2015.

Exhibit 4-4. Distress Declines

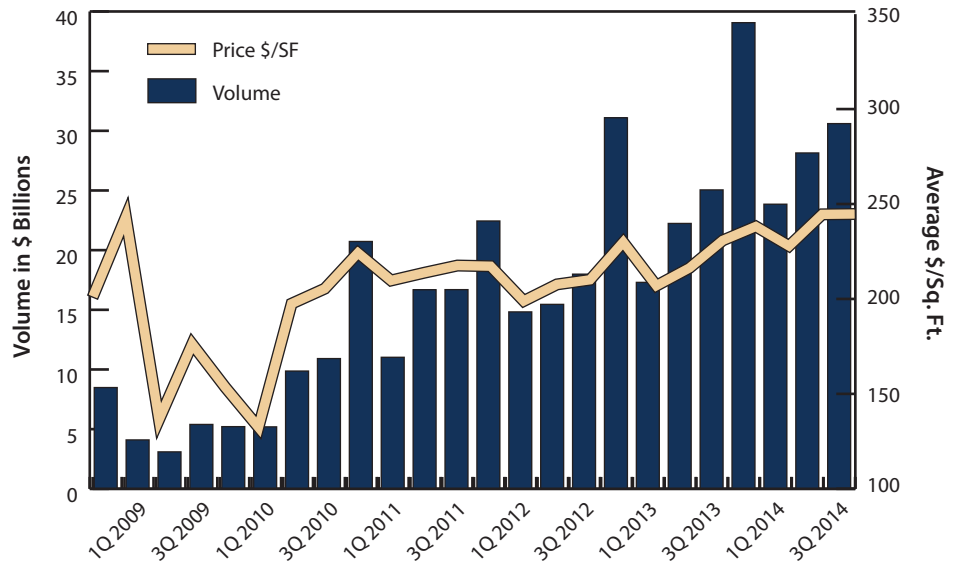


Source: Real Capital Analytics, 3q 2014.

THE OFFICE MARKET

With employment gains accruing in office-using industries and strengthening fundamentals, the office sector notched solid gains in 2014. Investment sales of office properties totaled \$51.3 billion in the first half of the year, a 30-percent year-over-year increase, according to Real Capital Analytics. As shown in Exhibit 4-A1, the third quarter 2014 added an additional \$30.6 billion in transactions, bringing the 9-month total to \$82.6 billion. Metropolitan downtown cores regained their status as preferred investment targets. Sales of CBD office buildings advanced 35 percent in 2014 compared with the first half of 2013, while sales of suburban office properties rose 25 percent on a yearly basis. In addition to their renewed interest in CBD space in 2014, investors have reversed the trend from 2013 and refocused on major metropolitan office markets. Sales volume in the six major metros covered by Real Capital Analytics increased 51 percent year-over-year during the first half of 2014, while

Exhibit 4-A1. Office Property Volume and Pricing



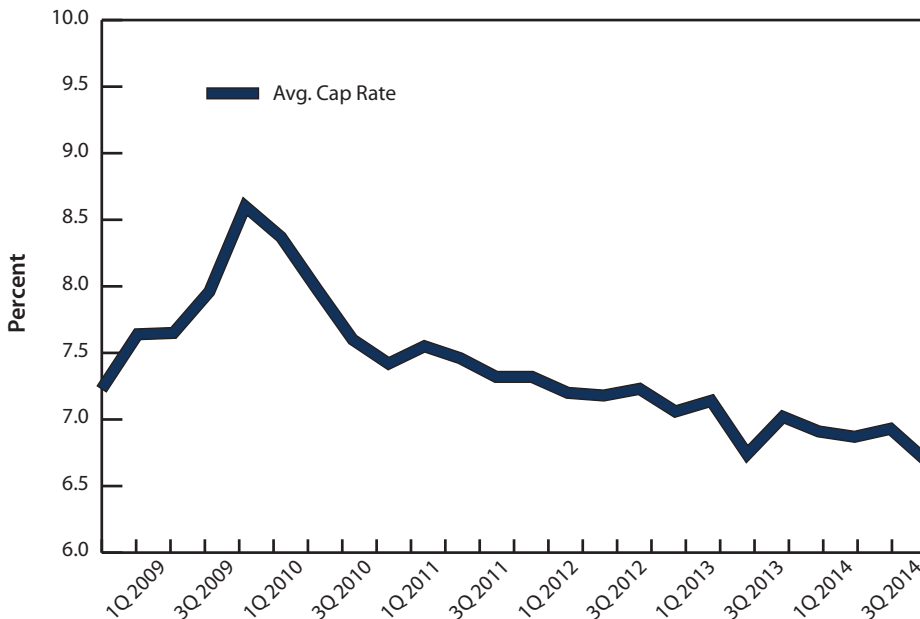
Source: Real Capital Analytics, 3q 2014.

sales in the other markets advanced a more modest 7 percent.

Investors' shift to CBD markets in major metros was driven by changes in fundamentals, with expectations for higher rent growth driving activity. Average prices for office properties

rose 10 percent on a yearly basis in the first 3 quarters of 2014, per Real Capital Analytics (see Exhibit 4-A1). CBD office properties posted a 21-percent yearly appreciation rate, averaging \$357 per square foot. Prices for suburban office buildings declined 4 percent to an average \$166 per square foot.

Exhibit 4-A2. Average Office Property Capitalization Rates



Source: Real Capital Analytics, 3q 2014.

Capitalization rate compression continued for CBD office properties, declining 29 basis points from January 2014 to September 2014, to an average of 5.8 percent. Average cap rates for suburban office transactions slid 10 basis points to 7.3 percent over the first 3 quarters of 2014. The average cap rate for the office sector overall declined to 6.7 percent in third quarter 2014, as shown in Exhibit 4-A2.

Investor Composition

The diversification of capital sources for office properties that took hold in 2013 stayed on trend in the first half of 2014. According to Real Capital Analytics, private investors and institutional/equity funds accounted for six out of 10 buyers. Meanwhile, banks increased their lending, competing

with insurance companies and a reinvigorated CMBS market. JP Morgan and Hines topped the list of buyers by volume in the first 6 months of 2014. REITs and cross-border investors increased their purchases, accounting for 19 percent and 11 percent of total acquisitions, respectively.

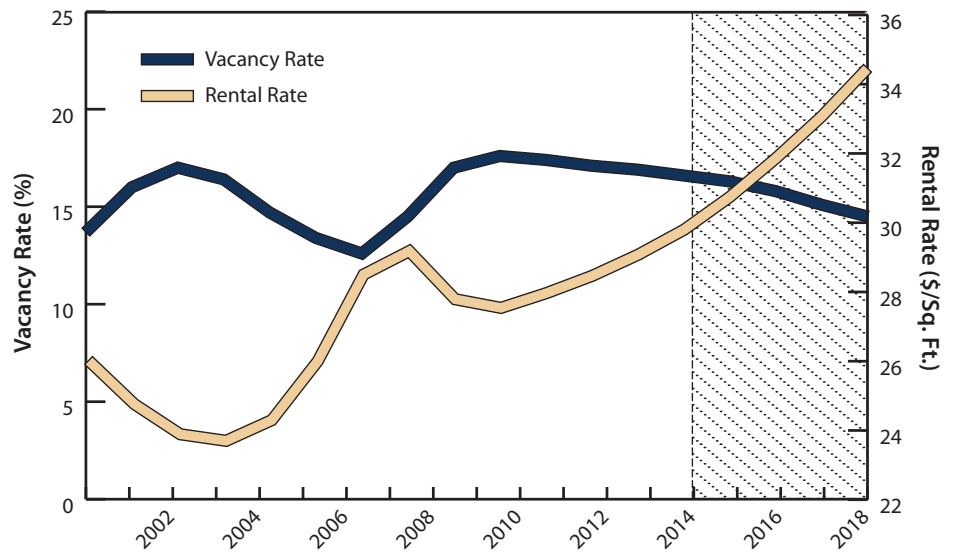
Manhattan retained the top spot for office investments, but growth was minimal. San Francisco was a clear leader, with sales volume spiking over 400 percent year-over-year during the first 6 months of 2014. Over the same period, Boston and Washington, DC, saw investments increase over 90 percent compared with 2013, while sales in Los Angeles gained 52 percent on a yearly basis. Outside the six major markets, 13 metros experienced triple-digit sales advances, signaling that investors remained interested in the higher yields of stronger secondary markets.

Market Fundamentals

As investor activity illustrated, office fundamentals marked a positive first half of 2014, characterized by rising absorption rates. However, vacancies were slow to decline as space-utilization efficiencies continued on tenants’ part. Reis, Inc. reported that national office sector vacancies declined from 16.9 percent in 2013 to 16.8 percent in the first quarter of 2014, but then stayed flat through the third quarter (see Exhibit 4-A3).

The average asking rent for the office sector rose 1.8 percent to \$29.60 per square foot by September 2014, as shown in Exhibit 4-A3, according to Reis, Inc. Effective rents increased an average 1.9 percent, reaching \$23.90 by the end of the third quarter. Over the first half of 2014, the office markets with the strongest effective rental growth were clustered around technology and energy centers. The San Jose office market experienced the fastest average effective rent gain, at 4.2 percent over the first 6 months, followed by the San

Exhibit 4-A3. Office Property Vacancy and Asking Rental Rates



Source: Reis, Inc., 3q 2014.



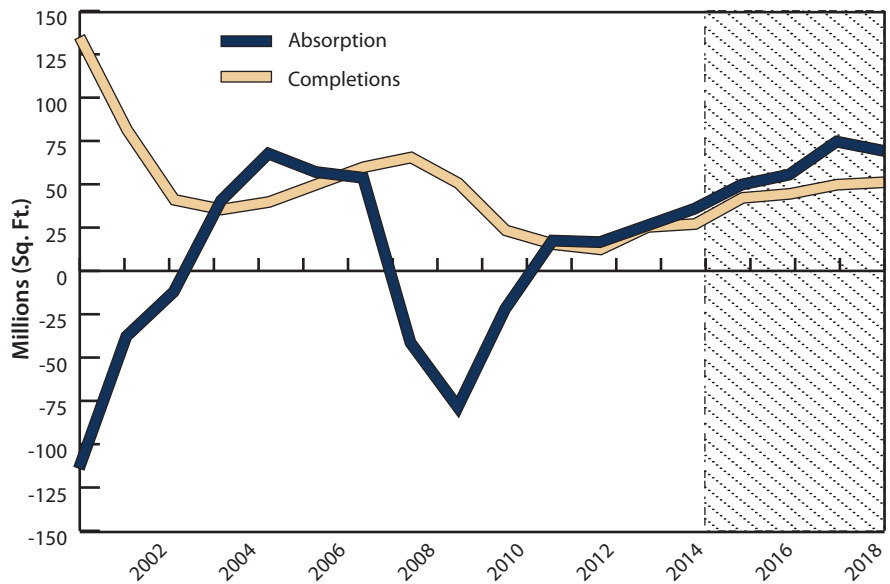
Francisco and Houston markets, which saw average effective rents increase 3.5 percent and 3.0 percent, respectively. Dallas, New York City, San Diego, and Orange County posted 2.0 percent or higher average effective rents during the first half of 2014.

Office net absorption totaled 21.7 million square feet over the first 9 months of 2014. As shown in Exhibit 4-A4, new completions added 18.4 million square feet of space to the market, mostly during the first quarter of the year.

Outlook

For 2015, the outlook for the office sector is moderately positive. With employment trending positive during the first half of 2014 (especially for professional and business services), net absorption is projected to grow. In addition to the estimated 36 million square feet absorbed in 2014, net absorption is forecasted to total 50 million square feet in 2015, per Reis, Inc. The supply of new office space is expected to rise, from an estimated 27 million square feet in 2014, to 42 million square feet in 2015, leading to declines in office sector vacancy from 16.8 percent at the end of third quarter 2014 to 16.3 percent by the end of 2015,

Exhibit 4-A4. Office Property Absorption vs. Completions

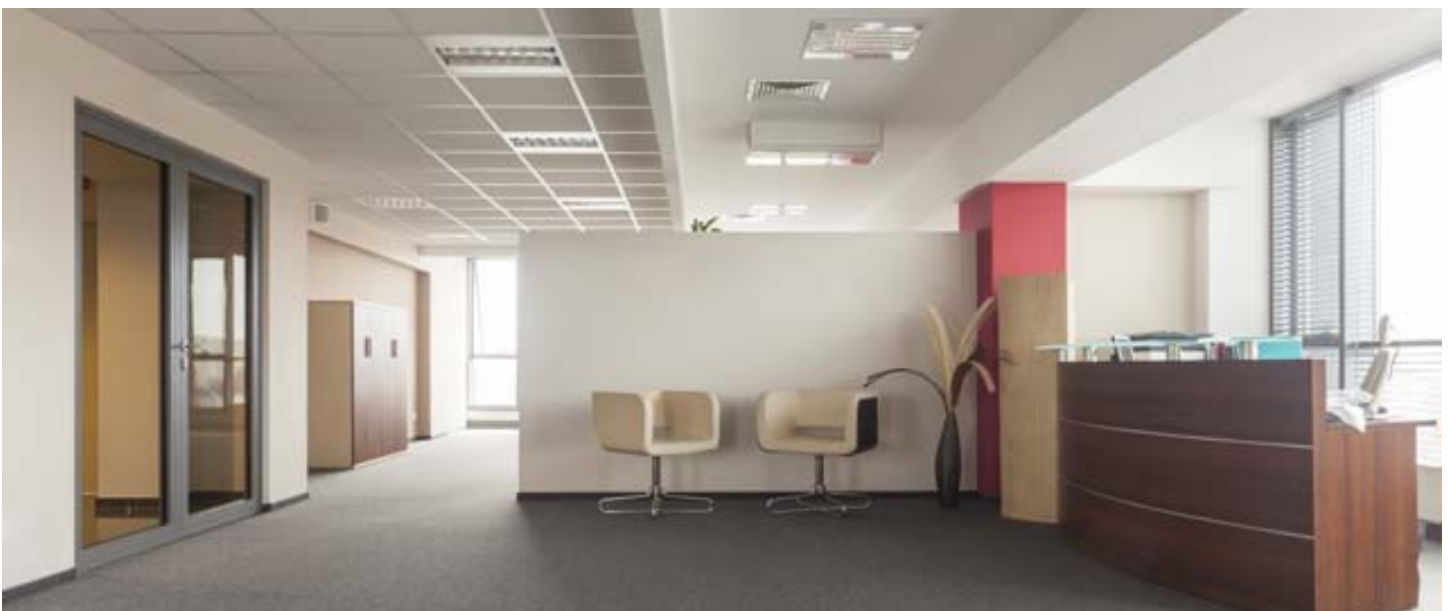


Source: Reis, Inc., 3q 2014.

according to Reis, Inc. Even though office availability rates remain high by historical standards, average asking rental rates will likely increase 2.5 percent in 2014 and 3.2 percent in 2015, from steadily rising demand, according to Reis, Inc.

On the investment front, with slowing growth in global economies, U.S.

office properties will likely remain highly attractive. Office investments are expected to grow as capital seeks growth opportunities and returns. While the spreads between cap rates and 10-year Treasuries remain high compared with historical spreads, rising interest rates are diminishing the buffer investors may have been counting on heading into 2015.

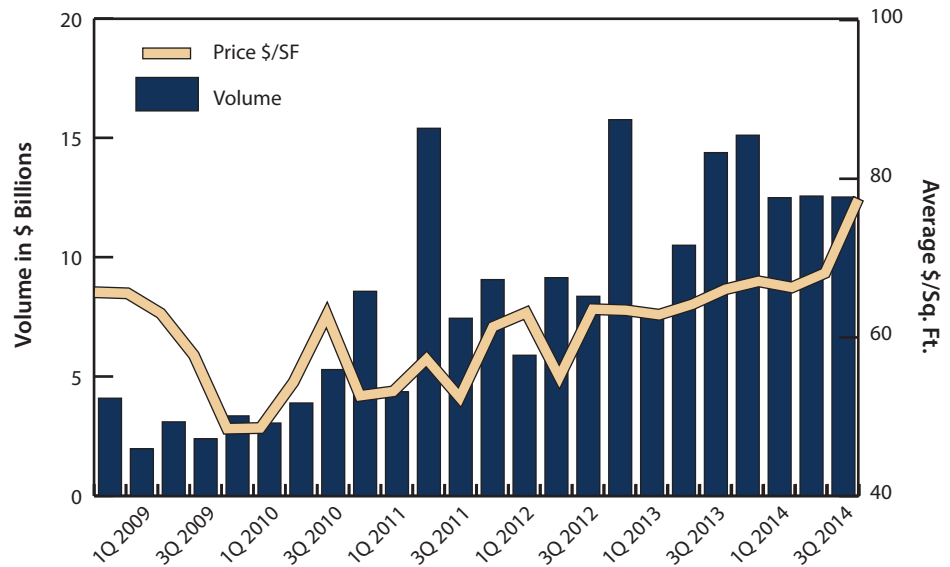


THE INDUSTRIAL MARKET

Rising consumer spending and brisk international trade in 2014 resulted in strong demand for industrial properties. Industrial sector sales volume rose 36 percent from January to June of 2014, reaching \$24.8 billion, according to Real Capital Analytics. With third quarter transaction volume of \$12.5 billion (see Exhibit 4-B1), the total volume for the first 9 months reached \$37.6 billion. Both industrial warehouse and flex properties found favorable conditions, with sales advancing in the first 3 quarters of 2014 by 13 percent and 21 percent year-over-year, respectively.

Riding the wave of rising trades, average pricing for industrial properties increased 10 percent over the first 9 months of 2014, per Real Capital Analytics. As demonstrated in Exhibit 4-B1, the national average price reached \$71 per square foot in third quarter 2014. Average prices for warehouse properties reflected stronger demand, rising 9 percent year-over-year. Flex buildings traded at an average price of \$111 per square foot

Exhibit 4-B1. Industrial Property Volume and Pricing



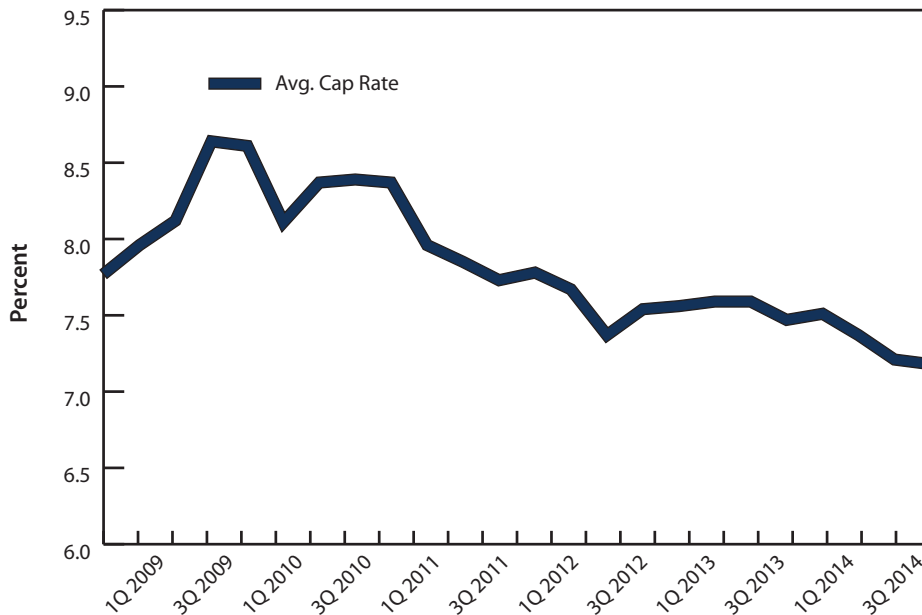
Source: Real Capital Analytics, 3q 2014.

during the first 3 quarters, a 9-percent yearly gain.

Capitalization rates for industrial properties followed positive trends, with values declining 30 basis points in the first 9 months of 2014. Over that same period, average cap rate compression

was steeper for warehouse properties than flex properties, with national averages reaching 7.0 percent and 7.4 percent, respectively, by the end of September, according to Real Capital Analytics. As shown in Exhibit 4-B2, the industrial sector overall average cap rate decreased to 7.2 percent in third quarter 2014. The six major markets tracked by Real Capital Analytics experienced an increase in yields, with average cap rates in the Inland Empire reaching a low of 5.0 percent, and Chicago seeing mid 5.0-percent rates through September 2014.

Exhibit 4-B2. Average Industrial Property Cap Rates



Source: Real Capital Analytics, 3q 2014.

Investor Composition

Individual properties made up the bulk of transactions in the first half of 2014. However, portfolio sales found an eager investment audience, surging 74 percent compared with the first half of 2013. Private investors accounted for over 40 percent of commercial transactions, according to Real Capital Analytics. REITs, along with institutional and equity funds, comprised 38 percent of deals, while cross-border investors made up about 10 percent of sales volume. Norges Bank Investment Management led

the list of buyers, with a \$750 million portfolio acquisition, followed by TPG Capital, ARCP, and CVMC REIT.

Chicago took the number-one spot in terms of investment activity, with \$1.4 billion in transaction volume during the first half of 2014, according to Real Capital Analytics. Los Angeles, Dallas, Inland Empire, and San Jose rounded out the top five. Investors seeking higher yields poured money into secondary and tertiary markets, leading to noticeable spikes in sales volume. Nashville and Wilmington experienced quadruple-digit increases in transaction volume, while 13 other metros saw triple-digit year-over-year gains.

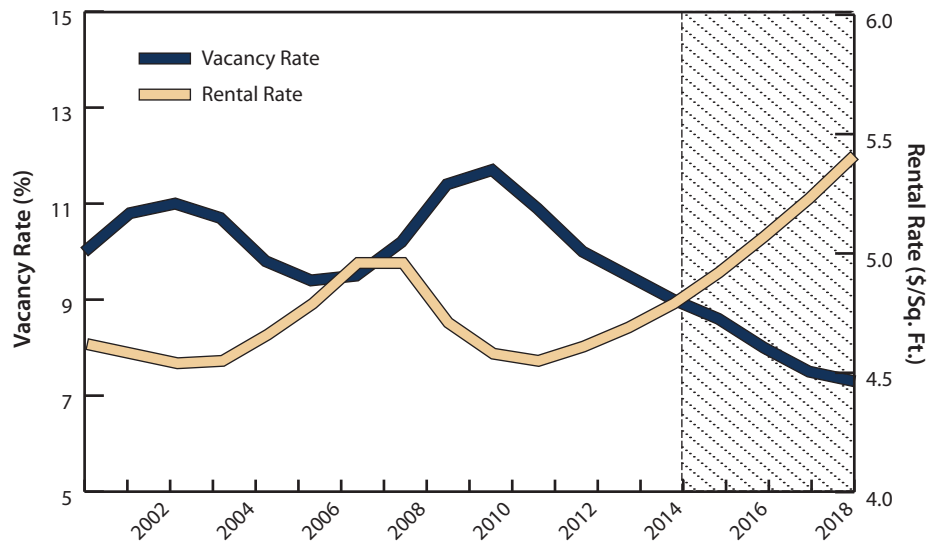
Market Fundamentals

Industrial space fundamentals echoed the favorable investment and economic environment, providing solid performance. According to Reis, Inc., at the midpoint of 2014, industrial property vacancies were 290 basis points lower than the cyclical high of 14.2 percent in third quarter 2010. By the end of September 2014, industrial vacancy dropped to 9.0 percent, the lowest level since the 2008-2009 recession (see Exhibit 4-B3).

In terms of effective rent growth on a national basis, the industrial sector average asking and effective rents rose 1.6 percent and 1.9 percent, respectively, over the January to September period as shown in Exhibit 4-B3. Among the major metros, Houston led the pack, with an effective rent increase of 4.6 percent as of second quarter 2014. Kansas City and San Bernardino/Riverside posted effective rent increases of 4.0 percent each during the same period. Chicago, Fort Worth, Atlanta, and Memphis had effective rent gains over 3.0 percent. By third quarter 2014, the group of leading metros by effective rent growth remained tightly clustered,



Exhibit 4-B3. Industrial Property Vacancy and Asking Rental Rates



Source: Reis, Inc., 3q 2014.

with Kansas City taking the lead with a 4.4-percent annual gain.

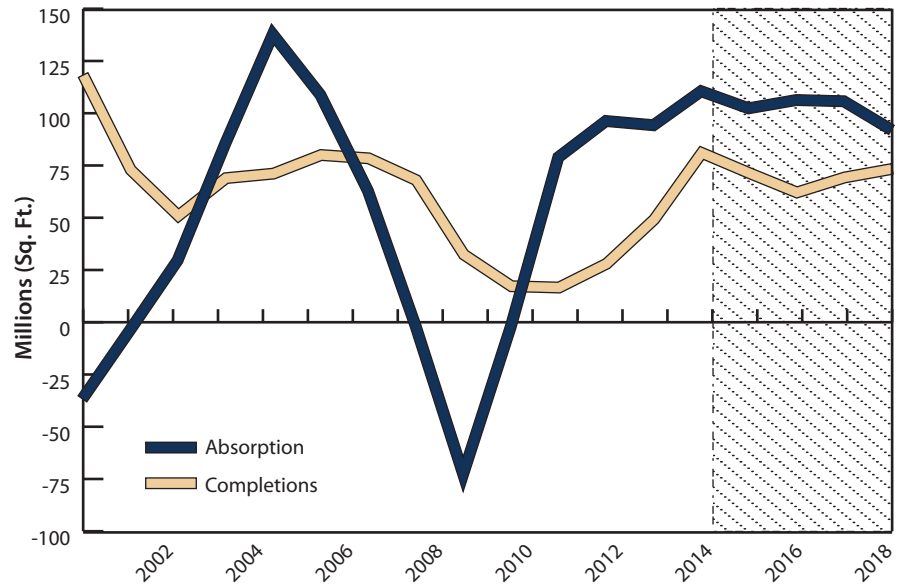
Even as strong demand for industrial space led to declines in availability rates, demand accelerated in the first 6 months of the year as net absorption totaled 37 million square feet, per Reis, Inc. In the third quarter of 2014, an additional 18.3 million square feet of stock was occupied. As shown in Exhibit 4-B4, absorption was estimated to total 110.5 million square feet by the end of 2014, a 17-percent yearly increase. Supply of industrial space was tight, leading to increased construction activity. In the first 3 quarters of 2014, 41.4 million square feet of new industrial space came online, a volume which exceeded the total supply from 2013 by 11 percent. The estimated total for 2014 called for 81.0 million square feet of new completions, a 65-percent gain over 2013 (see Exhibit 4-B4).

Regionally, the largest warehouse and distribution center properties outperformed smaller ones. East coast markets also witnessed particularly strong demand, as the anticipated 2015 completion of the Panama Canal widening likely drove activity. According to Reis, Inc., Baltimore, Richmond, Raleigh-Durham, Palm Beach, and Ft. Lauderdale, along with both northern and central New Jersey, placed in the top 10 metros when measured by the ratio of net absorption-to-inventory.

Outlook

The near-term outlook for the industrial sector is expected to remain positive. Net absorption is projected to reach 102.3 million square feet in 2015, per Reis, Inc. Supply is scheduled to continue rising, with industrial property completions adding 71.3 million square feet of new space. Given the strong and rising demand, industrial vacancies are projected to decline to 8.6 percent in 2015. Asking rents are

Exhibit 4-B4. Industrial Property Absorption vs. Completions

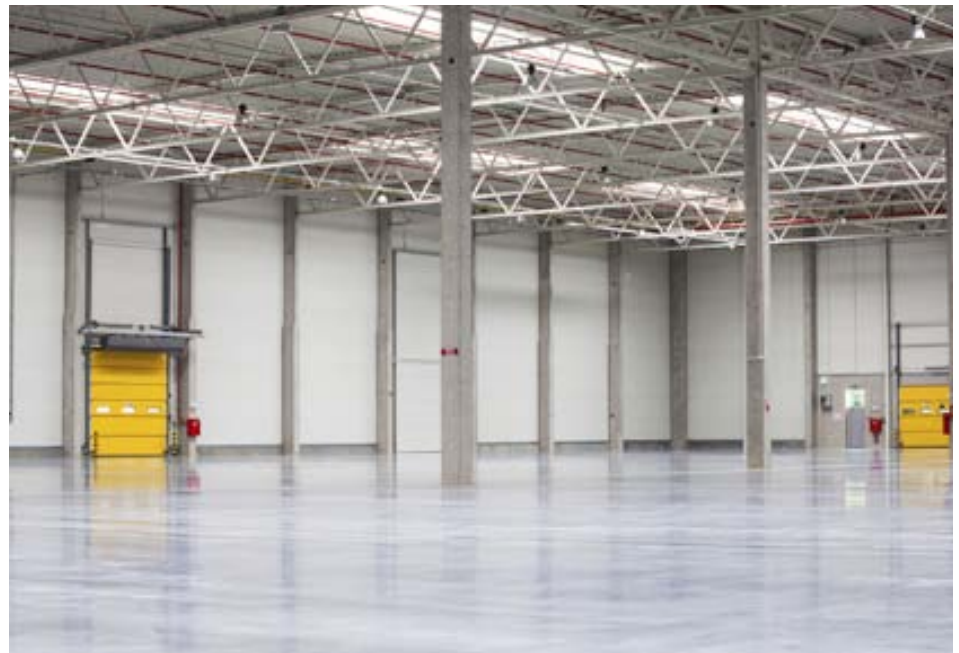


Source: Reis, Inc., 3q 2014.

estimated to increase 2.7 percent in 2015, to an average of \$4.90 per square foot, while effective rents will likely rise 3.1 percent, to an average of \$4.60 per square foot, per Reis, Inc.

Investments in industrial properties should continue on an upward trend,

as well-positioned distribution and intermodal center properties will likely dictate higher cost efficiencies. As cap rate compression brought industrial yields more in line with the other property types, a rising interest rate environment is likely to add downward pressure on spreads.



THE RETAIL MARKET

According to Retail Metrics, Inc., there was a 4.3-percent increase in year-over-year same-store sales for November 2014, largely attributed to early holiday deals. Although there was growth, retailers generally viewed this shopping season as spotty and not as robust as expected. Some thought this represented a still cautious consumer. However, the International Council of Shopping Centers (ICSC) expects an annual growth of 4 percent for the November to December 2014 period over the prior year. The Thomson Reuters/University of Michigan Survey of Consumer Confidence Sentiment reported an increase in the consumer sentiment index to 88.8 for November, which was the highest point thus far in 2014 and the highest since July 2007.

Holiday sales were expected to climb to between \$981 and \$986 billion for the months of November 2014 through January 2015, according to Deloitte’s 2014 Annual Holiday Survey, and represent a 4-percent to 4.5-percent increase over last season, which grew by 2.8 percent. While it appears consumers are snatching up goods, the cautious atmosphere remains, likely due to the lack of wage growth and more focus on strengthening the household financial position. Survey respondents indicated they would most likely use the Internet and discount/value department stores as their primary places to shop. Furthermore, although 28 percent indicated they would visit malls less this year due to the crowds and price, 68 percent said they would shop local to support the local economy and find unique gifts.

What does this all mean for traditional bricks and mortar retail real estate? As witnessed in recent years, online retail sales increased exponentially, while some traditional shopping malls and retail centers suffered from

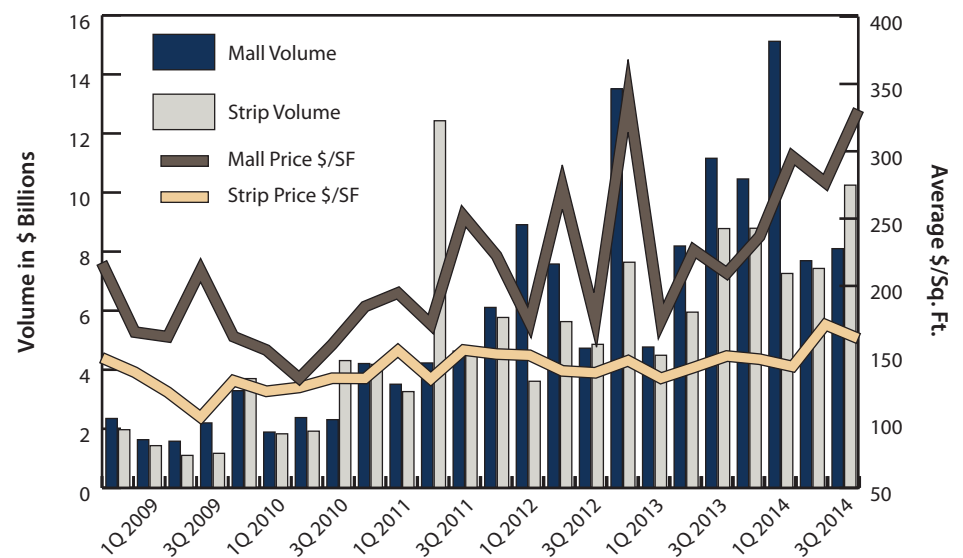
decreased sales, increased vacancy, and postponed capital projects. However, the balance may be shifting back in favor of the traditional store for several reasons. The avoidance of sales tax was once a big attraction for many online shoppers, but due to changes in internet sale tax laws by some taxing authorities, many companies are now collecting tax on any order shipped to a state where that company has a presence. Amazon, for example, is now collecting taxes on purchases shipped to 23 states. With respect to shipping costs, the idea of free shipping is slowly fading. Many online retailers are increasing the prices of goods to maintain the illusion of free shipping or are requiring larger minimum purchases to qualify for this benefit. In addition, the idea of price steering or targeted marketing gives some consumers reason to pause. The combination of these and other practices may be enough to get consumers back in the stores to regain their sense of connection with sellers and the products they are shopping for.

Year-to-date 2014 sales of significant retail properties totaled \$55.9 billion

through September 2014, which is a nearly 30-percent increase compared with the same 9-month period in 2013. Third quarter 2014 data presented by Real Capital Analytics shows that the volume is comprised of 44 percent mall sales and 56 percent strip center sales compared to 56 percent mall sales and 44 percent strip center sales in the prior year. The current trend appears to be a continued rebalancing or culling of large portfolios to dispose of underperforming properties. As shown in Exhibit 4-C1, mall transactions are up 28 percent over the prior year by \$6.8 billion during the first 3 quarters. This may indicate that many investors are willing to invest in trophy malls again. Retail property transactions for both mall and strip center sales showed that the average price per square foot year-to-date was \$209 compared to \$167 in the prior year (see Exhibit 4-C1).

Average capitalization rates reported by Real Capital Analytics have remained rather constant over the year. September 2014 ended with a reported average cap rate of 6.8 percent for all retail properties compared with 7.0 percent

Exhibit 4-C1. Retail Property Volume and Pricing



Source: Real Capital Analytics, 3q 2014.

in September 2013. As shown in Exhibit 4-C2, the September 2014 rate was comprised of average cap rates of 6.2 percent for malls and 7.5 percent for strip centers (compared with 6.5 percent for malls and 7.4 percent for strip centers in September 2013).

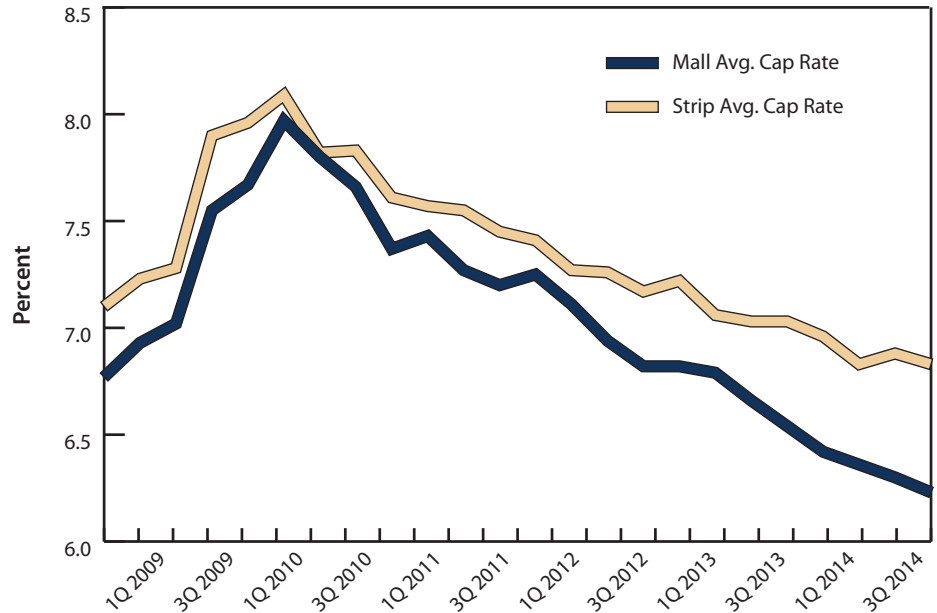
Investor Composition

According to Real Capital Analytics, the retail property market continued to be dominated by private investors, who comprised 38 percent of the buyer pool year-to-date through August 2014 (the latest data available); however, the private investor market share consisted of 43 percent in the 2013 buyer pool. Real Capital Analytics indicated that private investors are heavily active in strip centers, making up 44 percent of the active buyers in that subtype. These deals typically involve single transactions as opposed to portfolios. Listed REITs made up the second-largest buyer pool, at 36 percent. Real Capital Analytics noted that there were nearly 4,000 transactions in first half 2014, with 2,524 transactions in the first quarter alone. Even looking back to 2007 when the total dollar volume of transactions was historically at its highest, there were not as many property transactions as seen in the first quarter of 2014.

Retail Property Fundamentals

According to Reis, Inc., the combined vacancy rate for retail community centers and neighborhood centers decreased to 10.3 percent in third quarter 2014 (see Exhibit 4-C3) from 10.5 percent in the third quarter 2013. The vacancy rate for community centers fared slightly better at 9.5 percent for the quarter compared to the vacancy rate for neighborhood centers at 11.1 percent. However, occupancy in all retail subtypes has shown improvement over the past 4 quarters.

Exhibit 4-C2. Average Retail Property Cap Rates

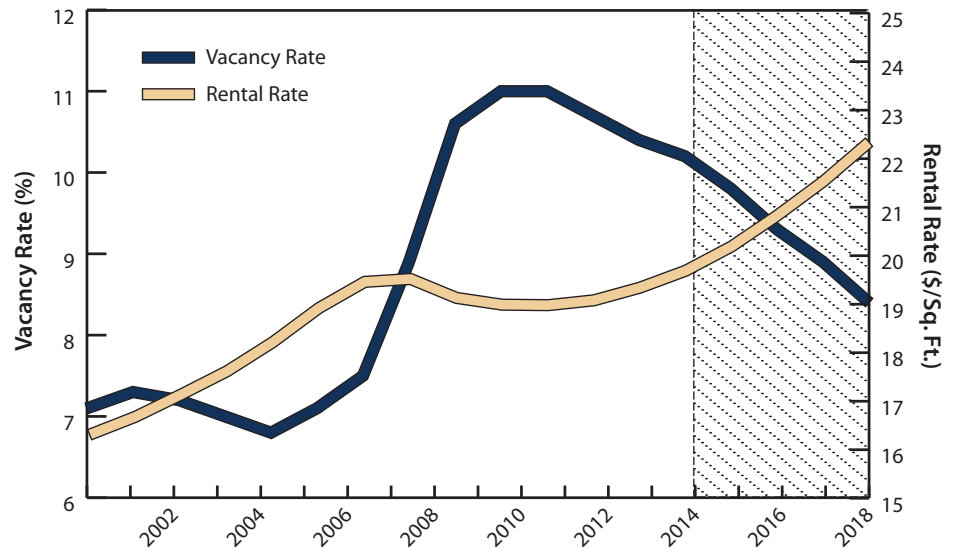


Source: Real Capital Analytics, 3q 2014.

According to Reis, Inc., asking rental rates for community centers and neighborhood centers increased to \$19.59 per square foot in third quarter 2014, a 0.4 percent growth over the prior quarter, as shown in Exhibit 4-C3. Reis, Inc. projects that rental growth will be about 1.4 percent for

2014, increasing annually to 2.5 percent and 3.2 percent over the next 2 years, respectively. It is expected that demand for retail properties will likely continue to outpace supply over the next 4 years, with positive absorption through 2018.

Exhibit 4-C3. Retail Property Vacancy and Asking Rental Rates



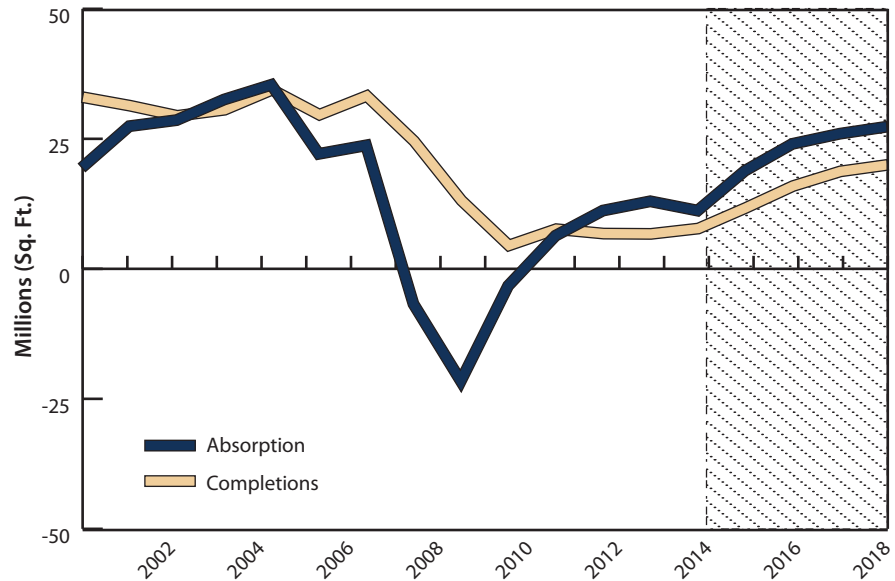
Source: Reis, Inc., 3q 2014.

Positive absorption, as reflected in Exhibit 4-C4, may be a result of increased leasing momentum and tepid new completions coming online in the next 2 years. According to the Reis forecast, 2014 is expected to end the year with a little more than 7 million square feet of new development coming online. That is well below the 25 million square feet or more completions per year prior to the Great Recession.

Also keeping completions and new inventory low is the resurgence of redevelopment at existing retail centers. After several years of constricted capital spending, many retail centers are finally finding money in the budget to perform a wide range of capital plans from minor updating to full remodeling. In addition, some malls are seeing the closing of major anchor tenants as an opportunity rather than a detriment. The recent closing of certain anchor stores gives owners the chance to update and reposition the space either as a high-end anchor or as multiple mid-size tenants. Some malls are even taking the opportunity to expand at the same time in order to add more inline space. Of course this also comes with the challenge of leasing up the space and finding the right complement of tenants for the property.

Another popular trend in the market is converting certain businesses into an operating company and property

Exhibit 4-C4. Retail Property Absorption vs. Completions



Source: Reis, Inc., 3q 2014.

company (opco/propco) in order to raise cash to boost business operations, while creating a REIT in the underlying real estate assets. Sears is a prime example of this strategy and has announced that it is exploring a REIT transaction involving 200 to 300 owned properties through a rights offering to its shareholders.

Outlook

The retail property market appears to be on an upward trajectory in both the operations and the sales transaction

metrics. Retail properties are seeing increased occupancy and asking rental growth, as well as encouraging investment in capital projects and strategic leasing. Fundamentals should continue to strengthen in the coming years, as indicated by Reis, Inc. As for transaction volume, 2014 will surpass 2013 volume if the sales pace continues as expected. If this occurs, 2014 will have seen the highest retail transaction volume since the record-setting year of 2007. Furthermore, with significant deals already announced for 2015, the coming year looks to continue the momentum started in 2014. The battle of virtual shopping versus brick and mortar continues, however, with continued reinvestment and development at certain shopping malls and strip centers. This, along with a focus on using technology to bring in customers, will likely help the retail property market return in 2015 to the levels experienced before the Great Recession.



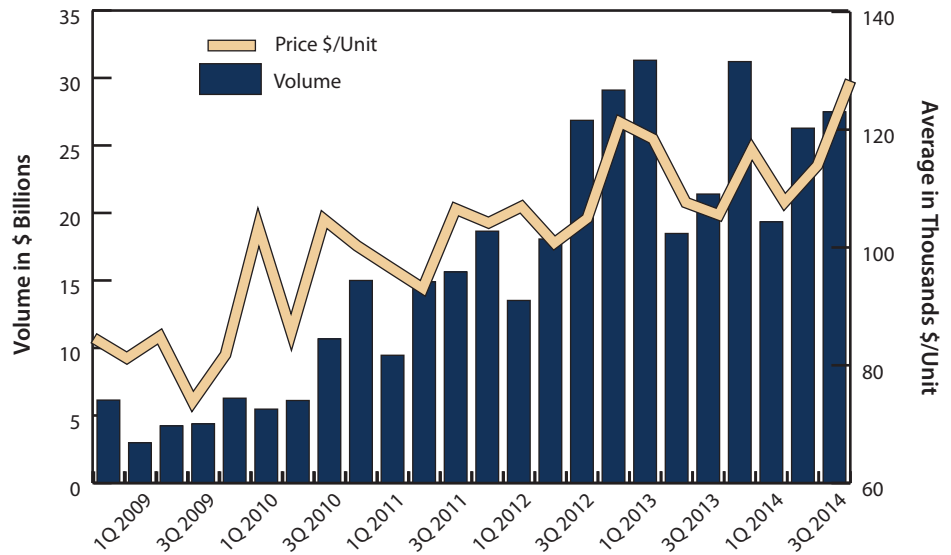
THE APARTMENT MARKET

The apartment sector, largely considered the strongest performer of the major commercial real estate property types in the recent past, continued to show stability in the first half of 2014. A total of \$45.6 billion of significant apartment properties were sold in the first half of 2014, representing a year-over-year decrease of 9 percent, according to Real Capital Analytics. However, nearly half of the total volume in the first half of the prior year was related to portfolio sales, including the sale of nearly \$15 billion of Archstone apartment properties. As such, the year-over-year sales volume in 2014 is still strong, despite a smaller contribution of portfolio sales volume. In fact, excluding the impact of portfolio sales or entity transactions, sales volume for apartment properties was up 25 percent year-over-year in the first half of 2014. An additional \$27.5 billion of significant apartment properties were sold in third quarter 2014 (see Exhibit 4-D1). Following significant increases of 51 percent in 2013, 104 percent in 2012, and 23 percent in 2011, sales volume appears to be leveling, which is expected following the unsustainable increases experienced in this sector in previous years. Among apartment types, mid/high rise apartment properties accounted for over 60 percent of the total sales volume in the first 3 quarters of 2014.

Apartment properties had the second highest transaction dollar volume of all major property types (trailing office volume slightly) in the first half of 2014, and many investors continue to favor this category of commercial real estate.

Based on the Moody's/RCA CPPI, pricing for apartment properties nationally has increased approximately 16 percent year-over-year through September 2014, and is now 18 percent above previous peak levels from late 2007. In the first 3 quarters

Exhibit 4-D1. Apartment Property Volume and Pricing

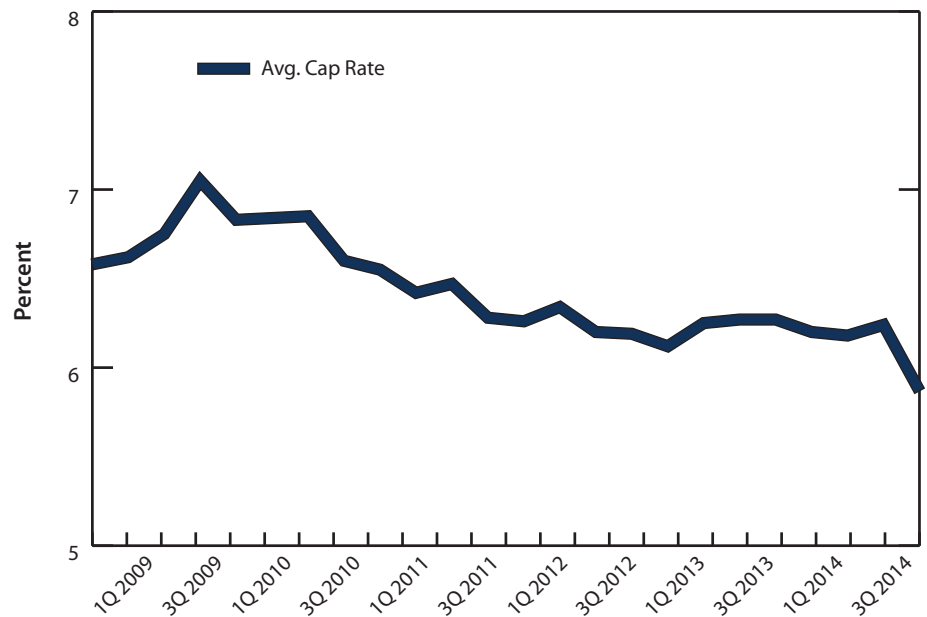


Source: Real Capital Analytics, 3q 2014.

of 2014, the average price per apartment unit decreased slightly below the average 2013 level, per Real Capital Analytics. However, this reflects the impact of increasing transaction activity in secondary and tertiary markets, with lower price points (on a per unit basis).

As presented in Exhibit 4-D2, average capitalization rates for the apartment sector have compressed during the last year, decreasing slightly to an average of 6.10 percent during the first 3 quarters of 2014. This represents a 15-basis point decrease from the average cap rate in 2013. Notably, capitalization

Exhibit 4-D2. Average Apartment Property Cap Rates



Source: Real Capital Analytics, 3q 2014.

rates for top-tier assets continue to compress, with cap rates in major markets falling to 3.60 percent for mid/high-rise properties in the third quarter, per Real Capital Analytics. This reflects intense competition for core properties and is a primary reason why investors continue to adjust their focus to secondary and tertiary markets in search of higher yields.

The average cap rate for garden apartments in the first 3 quarters of 2014 (6.35 percent) continues to be well above that of mid/high-rise apartments (5.09 percent), according to Real Capital Analytics. However, cap rates for both apartment types has continued to trend downward reflecting the availability of capital and low mortgage rates.

Based on Real Capital Analytics data, the apartment sector is one of two property sectors where the national average cap rate is back to levels exhibited prior to the start of the economic downturn in 2008. Several factors that have contributed to lower cap rates include sustained and historically low interest rates, increased availability of capital, strong sector fundamentals, and the perceived safety of apartment assets relative to other property types. Additionally, GSEs Fannie Mae and Freddie Mac often provide apartment properties with a financing advantage relative to other property types. Investors are likely to see upward pressure on the average cap rate in the apartment sector in 2015, given the potential impact of rising interest rates and an even greater proportion of transactions occurring in secondary and tertiary markets.

Investor Composition

Throughout the first half 2014, competition for multi-family product by REITs, private investors, equity funds, and institutions has continued. However, the composition of buyers has begun to shift away from listed REITs in favor



of the private sector. According to Real Capital Analytics, private investors have comprised 60 percent of purchases in the first half of 2014, which is significant relative to the last 4 years in which private investors represented approximately 50 percent of the total buyer pool. Essex Property Trust, which acquired BRE Properties in the second quarter 2014 for \$4.3 billion, was the most active buyer (in terms of investment volume) by a large margin, according to Real Capital Analytics. Other notable buyers were Berkshire Property Advisors, Related Companies, and Blackstone. After BRE Properties, Crow Holdings, Broad Street Development, LLC, and Berkshire Property Advisors were the top sellers during the period.

According to Real Capital Analytics, transaction sales volume for apartment properties in major markets such as New York City, Washington, DC, Los Angeles, Boston, Chicago, and San Francisco has decreased year-over-year. Instead, continuing the trend over the last several years, many investors have broadened their focus to secondary and tertiary

markets in search of greater returns. As a result, markets such as San Diego, Philadelphia, Portland, Baltimore, and Nashville have experienced elevated transaction volumes throughout the first half of 2014. Other smaller markets experiencing increasing levels of activity include Colorado Springs, Tallahassee, Tulsa, and Birmingham.

A diminishing supply of apartment properties, strong sector fundamentals, and intense competition has led to a significant pipeline of new apartment projects, as developers look to capitalize on the tight market conditions. According to Reis, Inc., 180,796 apartment units are expected to be delivered in 2014, followed by 210,669 more units in 2015 and 165,339 more units in 2016. These figures are significant compared to the new supply of approximately 43,000 units, 79,000 units, and 133,000 units built in 2011, 2012, and 2013, respectively. As noted by the data above, new supply is projected to peak in 2014. The total apartment stock as of third quarter 2014 was approximately 10.2 million units.

From a supply standpoint, another interesting trend has been the size of the new units being built. Many developers, particularly in more urban areas, have continued to decrease the average unit size and offsetting size with better building amenities in response to renter demand. In cities such as San Francisco and Seattle, apartments are approximately 18 percent smaller than they were 10 years ago, according to Bloomberg.

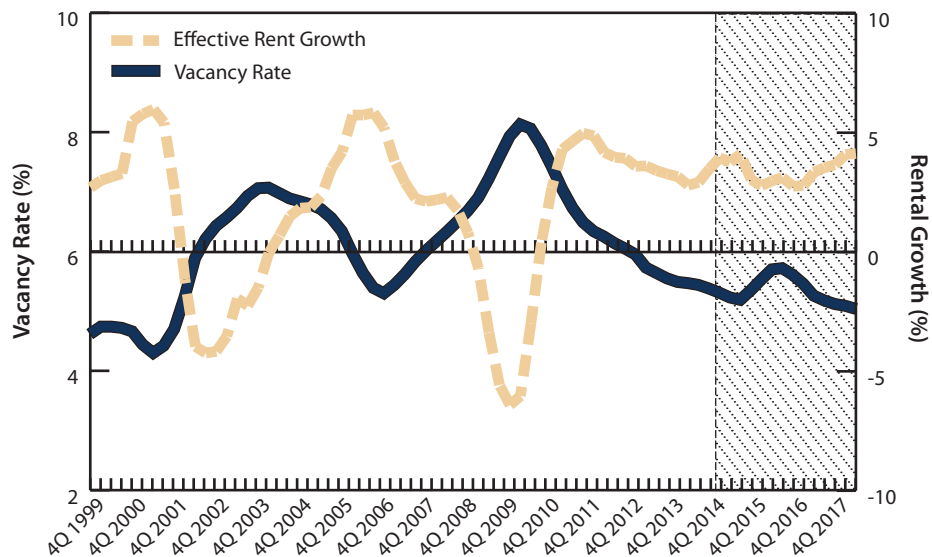
Apartment Property Fundamentals

U.S. apartment market fundamentals continue to perform well in 2014. Nationally, annual effective rent growth peaked in second quarter 2011 at nearly 5 percent, according to Axiometrics, Inc. Although rent growth has steadily decreased since then, the trend has begun to reverse in the second and third quarters of 2014. As shown in Exhibit 4-D3, vacancies have continued to decline, moving from a peak of 8.1 percent in fourth quarter 2009 to 5.3 percent in third quarter 2014. Since the apartment recovery began in second quarter 2010, annual effective rent growth has been positive for 18 consecutive quarters, averaging approximately 3.6 percent per year. Over this same time period, the vacancy rate has fallen from 7.8 percent in second quarter 2010 to 5.3 percent in third quarter 2014, as shown in Exhibit 4-D3.

According to Axiometrics, Inc., annual effective rent growth is expected to be approximately 3.8 percent by the end of 2014, inch up to 4.1 percent in first quarter 2015, and decline to approximately 3 percent by the end of 2015. The vacancy rate is expected to begin increasing to approximately 5.7 percent by the end of 2015, due to an anticipated increase in supply brought about by new construction.

A number of markets may continue to outperform the U.S. average in terms of cumulative potential rental revenue

Exhibit 4-D3. Apartment Market Vacancy and Effective Rental Rate Growth



Source: Axiometrics, Inc., 3q2014.

growth from 2015 to 2017. (Potential rental revenue growth is the combined change in effective rental rates and occupancy.) Several of the top 20 markets in Exhibit 4-D4 are expected to outperform the U.S. average over the

specified period, with San Francisco, Seattle, Boston, Houston, Los Angeles, and Chicago leading in expected performance. The lower performing markets are expected to be New York City, Las Vegas, and San Diego.



Exhibit 4-D4. Forecasts of Effective Rental Rate Growth, Vacancy, and Potential Rental Revenue for the Top 20 Markets (2015-2017)

Market	Effective Rent Growth						Vacancy						Potential Rental Revenue					
	2013A	3Q14	2014F	2015F	2016F	2017F	2013A	3Q14	2014F	2015F	2016F	2017F	2013A	3Q14	2014F	2015F	2016F	2017F
Atlanta	5.3%	7.4%	6.3%	3.8%	2.7%	3.6%	6.8%	6.2%	6.0%	5.3%	5.9%	5.6%	6.2%	8.1%	7.2%	4.2%	1.8%	4.1%
Austin	5.2%	4.6%	4.1%	2.8%	3.2%	4.3%	4.8%	4.8%	4.8%	5.6%	5.5%	5.0%	5.2%	4.4%	3.8%	1.8%	3.7%	4.7%
Boston	2.2%	2.5%	3.8%	3.1%	3.8%	4.2%	4.5%	4.5%	4.5%	4.9%	4.2%	3.9%	2.1%	2.8%	3.9%	2.6%	4.9%	4.6%
Charlotte	2.5%	3.5%	4.0%	2.8%	3.3%	4.0%	5.2%	5.2%	5.1%	5.7%	5.5%	5.3%	2.3%	3.5%	4.4%	1.8%	3.7%	4.2%
Chicago	1.4%	3.1%	4.0%	3.7%	4.5%	3.9%	4.9%	4.9%	4.7%	4.9%	4.5%	4.9%	1.3%	3.5%	4.9%	3.2%	5.1%	3.4%
Dallas	3.7%	4.4%	4.4%	3.2%	3.6%	4.6%	5.4%	5.4%	5.3%	6.1%	5.9%	5.3%	4.0%	4.5%	4.6%	2.1%	4.1%	5.2%
Denver	7.0%	9.3%	9.0%	4.8%	3.1%	3.9%	4.5%	4.2%	4.2%	5.1%	5.7%	5.0%	7.4%	9.6%	9.2%	3.6%	2.9%	4.6%
Houston	4.9%	5.2%	5.0%	3.1%	3.7%	5.1%	5.9%	5.5%	5.4%	6.1%	5.8%	5.4%	5.8%	5.6%	5.5%	2.0%	4.5%	5.4%
Las Vegas	1.7%	4.2%	4.2%	3.8%	3.2%	2.3%	8.3%	7.4%	7.0%	5.3%	5.9%	6.5%	2.4%	5.8%	5.7%	5.4%	1.9%	1.9%
Los Angeles	3.2%	4.6%	4.8%	2.9%	3.5%	5.3%	4.7%	4.3%	4.1%	4.6%	4.5%	4.0%	3.0%	5.4%	5.4%	2.3%	3.7%	5.8%
New York Metro	-0.2%	1.7%	3.4%	3.0%	2.4%	3.7%	3.1%	3.1%	3.1%	3.2%	3.7%	3.4%	-0.4%	1.7%	3.4%	2.8%	2.0%	4.3%
Orlando	3.2%	4.8%	5.0%	2.6%	3.2%	4.3%	5.7%	5.4%	5.1%	5.5%	5.3%	4.9%	3.4%	5.4%	5.9%	1.6%	3.8%	4.7%
Phoenix	3.2%	5.0%	4.5%	3.3%	2.6%	4.1%	6.7%	6.2%	6.1%	5.8%	6.4%	5.8%	3.6%	5.6%	5.0%	3.7%	1.9%	5.1%
Riverside	3.3%	5.0%	3.9%	3.3%	2.4%	3.7%	5.5%	4.9%	4.9%	5.1%	5.8%	5.3%	3.8%	5.7%	4.0%	3.0%	1.7%	4.5%
San Diego	4.1%	4.8%	4.6%	3.2%	2.7%	3.4%	4.1%	4.0%	3.9%	4.5%	5.2%	4.5%	4.3%	4.9%	5.0%	2.3%	2.1%	4.4%
San Francisco	7.4%	6.9%	6.8%	4.4%	3.7%	5.1%	4.8%	4.5%	4.3%	4.7%	4.5%	4.1%	8.1%	7.5%	7.3%	3.6%	4.0%	5.8%
Santa Ana	3.3%	3.7%	3.4%	3.1%	4.5%	3.9%	4.7%	4.4%	4.2%	4.4%	4.1%	4.3%	3.4%	4.5%	4.1%	2.5%	5.1%	3.6%
Seattle	5.7%	6.6%	7.8%	4.2%	3.3%	5.0%	4.5%	4.4%	4.2%	5.2%	5.1%	4.5%	5.6%	6.9%	8.3%	3.2%	3.8%	5.6%
Tampa	2.0%	3.9%	4.0%	2.7%	3.1%	4.1%	5.8%	5.4%	5.2%	5.8%	5.5%	5.0%	2.1%	4.6%	4.8%	1.8%	3.7%	4.6%
Washington, DC Metro	-1.4%	0.3%	1.6%	2.0%	3.9%	4.5%	5.2%	5.1%	5.0%	5.1%	4.5%	4.0%	-1.9%	0.5%	2.0%	2.0%	4.3%	5.1%
U.S.	2.8%	3.9%	3.8%	3.0%	3.3%	4.1%	5.5%	5.3%	5.2%	5.7%	5.3%	5.0%	2.9%	4.2%	4.1%	2.3%	4.1%	4.3%

Source: Axiometrics, Inc., 3q 2014.

Outlook

The overall outlook for the apartment sector appears to be positive, given the strong fundamentals, demand, and the relative availability of financing for apartment investments. The positive fundamentals have largely been a direct result of the decreasing homeownership rate, which has fallen to the lowest level since 1995 (from its peak of over 69 percent in 2004 to nearly 64 percent in third quarter 2014, per the Census Bureau). It is noted that the decline in homeownership has been most heavily impacted by households under age 35, where the rate has fallen to 36 percent (this is down from 43.6 percent just 10 years ago). However, this downward trend in homeownership may begin to reverse, with housing affordability still at historic lows in many markets and apartment rents on the rise. It remains to be seen whether there has been a more permanent shift in views towards homeownership for the Millennial demographic.

Also contributing to the positive fundamentals in the apartment sector over the last several years has been a lag in new supply coming online. However, the growing pipeline of apartment development projects, the increase in unit completions in 2014 and over the next couple of years, and the potential for further increases in interest rates may cause headwinds for the apartment sector. Continued job growth (as

presented in Exhibit 4-D5) and pent-up demand from the younger demographic group that never moved out or returned to their parents' homes after their college years is expected to at least partially offset the new supply. It appears that many investors will continue to favor the apartment sector in

the foreseeable future, as evidenced by transaction volume and supply trends. Based on the aforementioned factors, apartment properties are well-poised to possibly experience another year of solid growth in 2015, albeit at a slightly more moderate pace.



Exhibit 4-D5. Key Assumptions for U.S. Forecast

Key Variable	Actual					Forecast				
	2009	2010	2011	2012	2013	3Q14	2014F	2015F	2016F	2017F
Employment (000)	130,954.7	131,658.3	133,630.3	135,860.7	138,272.7	139,157.3	140,767.3	143,386.8	145,792.5	147,978.8
Job Growth (000)	(5,615.7)	703.7	1,972.0	2,230.3	2,412.0	2,625.3	2,494.6	2,619.5	2,405.7	2,186.4
Job Growth %	-4.15%	0.53%	1.48%	1.64%	1.74%	1.89%	1.77%	1.83%	1.65%	1.48%
Total Residential Permitting	139,190	131,950	155,456	213,471	237,562	275,500	274,889	356,888	289,915	251,944
Demand/Supply Ratio	-38.4	5.1	14.9	14.3	11.3	11.1	9.1	9.5	6.7	7.5
Housing Affordability Index	194.6	209.2	214.4	219.6	161.4	149.3	146.6	137.3	149.3	158.2

Sources: Axiometrics, Inc., U.S. Bureau of the Census, U.S. Bureau of Labor Statistics, Housing Affordability Index, DataQuick, NATIONAL ASSOCIATION OF REALTORS®, U.S. Department of Housing and Urban Development, Federal Housing Financing Agency, 3q 2014.

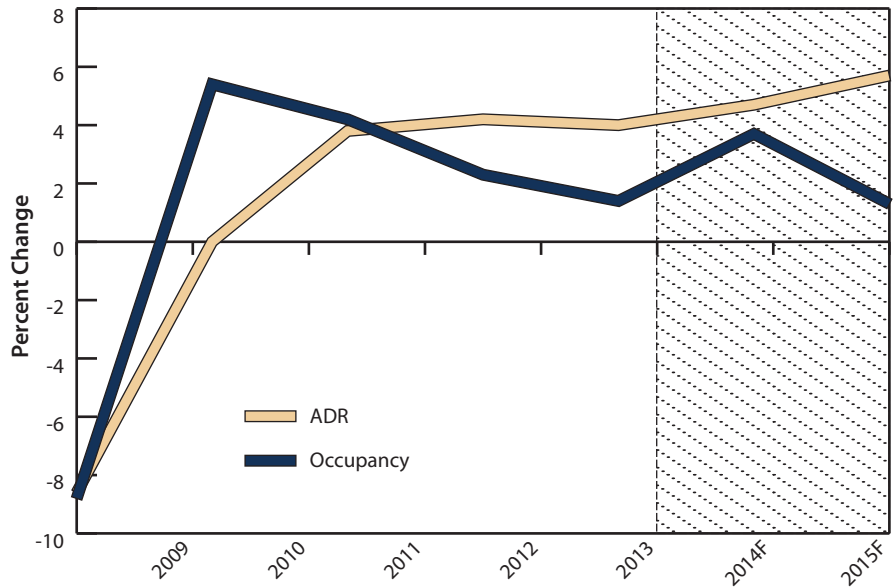
THE HOTEL MARKET

Many hotel property investors are expressing strong interest in hotels due to improving property level metrics and low supply additions. As a result, national hotel sector occupancy has risen to nearly 64.4 percent in 2014, which is above the long-run average of 61.9 percent and will settle at the highest recorded level in nearly 20 years, according to PKF-HR.³¹ The average daily room rate (ADR) has climbed to a post-recession high, jumping nearly 17.4 percent since 2009 to approximately \$115.62 a day. These high room rates have frustrated some tourists, but those visitors are largely responsible for driving up demand for hotel rooms. In addition to the sharp rise in leisure travel, overnight business stays and convention bookings are growing, albeit at a slower pace. While occupancy is not expected to increase much higher, room rates in the near term may increase at a rate greater than 5 percent per year on average.³² Exhibit 4-E1 shows the pricing power built up in the market where ADR has been, and which is expected to outpace occupancy in terms of growth.

Geographically, all location segments are expected to record an average annual ADR increase above the long-run average (4.2 percent through 6.2 percent per year, on average), with suburban hotels leading the group, followed by airport, urban, resort, small metro, and interstate hotels. When combined with nominal occupancy change, suburban hotels led the hotel segments, with urban and airport hotels close behind (in a virtual tie), and then followed by interstate, small metro, and resort hotels.³³

Of the top 25 markets, STR reported two double-digit ADR percentage

Exhibit 4-E1. Hotel Occupancy and ADR Dynamics



Source: PKF-HR, September 2014–November 2014.

increases through the end of November 2014: Nashville, (12.9 percent) and San Francisco/San Mateo (10.2 percent). Rounding out the top five ADR percentage increases nationwide were Denver, CO (9.1 percent), Seattle, WA (8.5 percent) and Boston, MA (7.7 percent). The worst performing markets in terms of ADR growth were New York

City, NY (2.2 percent), New Orleans, LA (1.8 percent), Norfolk/Virginia Beach, VA (1.7 percent), Philadelphia, PA-NJ (1.4 percent), and Washington, DC-MD-VA (0.7 percent).³⁴

Supply growth is expected to be somewhat muted in the near term, as hotel openings have been slow to close. As



³¹ PKF-HR, December 2014-February 2015 Edition Hotel Horizons® report.

³² "Above The Long Run Average of 3% ADR Growth Per Year" – PKF-HR, December 2014-February 2015 Edition Hotel Horizons® report.

³³ PKF-HR, December 2014-February 2015 Edition Hotel Horizons® report.

³⁴ STR Presentation, Jan D. Freitag, SVP, STR, US YTD Results as of November, 2014.

shown in Exhibit 4-E2, supply growth is expected to remain above average for the near term, per PKF-HR,³⁵ although supply growth is trending downward and is expected to eventually decline below the long-run average. However, there is a large amount of new hotel construction in progress in New York/Manhattan. Despite the significant number of new hotel rooms coming online, New York/Manhattan has unique market dynamics that will likely easily absorb the new supply and limit the impact on the market as a whole. Looking at the rest of the country, the majority of the new supply growth is premier select service products located in suburban and airport hotel locations.

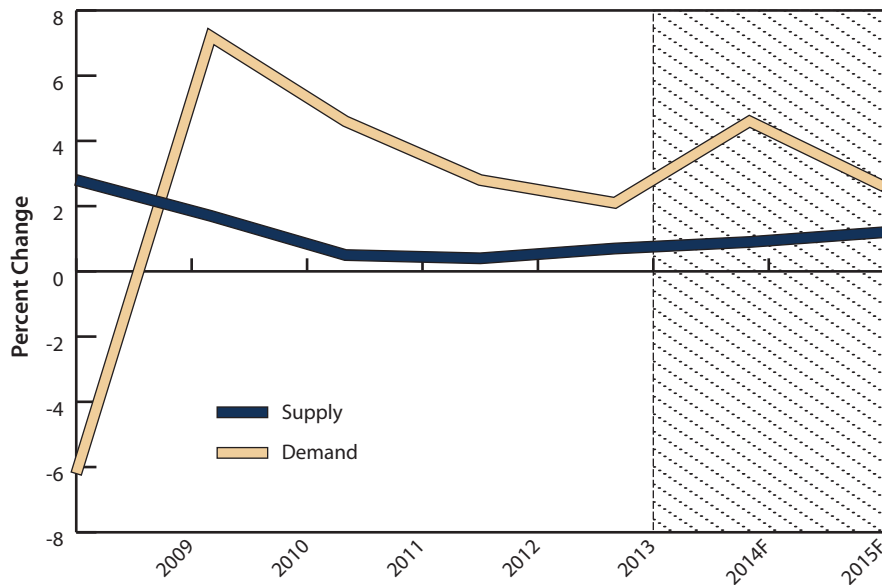
As depicted by PKF in Exhibit 4-E2, the national hotel market outlook indicates investors should expect greater balanced supply and demand. In the past, oversupply of hotel rooms, oil/gas pricing, and real estate/industry bubbles have negatively influenced the hotel sector performance. For the present, these influences are not expected to rematerialize in the near term and are not thereby expected to derail continued growth.

Investor Composition

According to Real Capital Analytics, over the past 12 months, the number of entities that have made significant hotel acquisitions is up 69 percent on a year-over-year basis (see Exhibit 4-E3). Although most capital sectors report fewer active participants, the institutional/fund segment contracted significantly, especially in tertiary markets. A shift from tertiary markets to major metros and secondary markets was evident, and cross-border acquisitions contributed significantly, primarily in major metros.

The re-emergence of REITs and foreign capital caused a decline in the market

Exhibit 4-E2. Hotel Supply and Demand



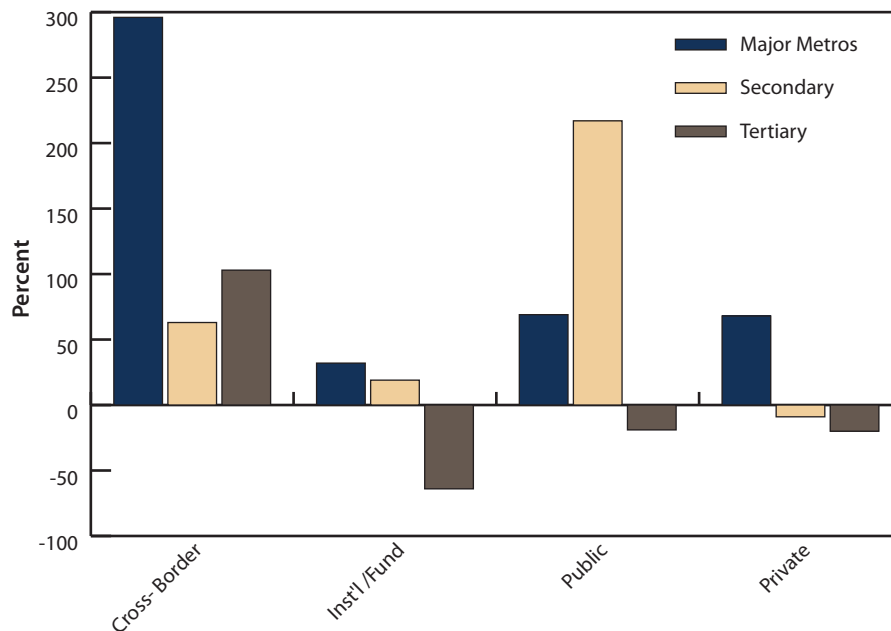
Source: PKF-HR, September 2014–November 2014.

share of private investors and discouraged institutional investments in 2014. The recent growth in acquisitions has been supported by the easy access to debt capital, which is expected to remain favorable in the near term.

Market Fundamentals

Hotel sector transaction volume has been displaying a strengthening growth trend. According to Real Capital Analytics, year-end 2014

Exhibit 4-E3. Hotel Property Change in Acquisitions



Source: Real Capital Analytics, 3q 2014.

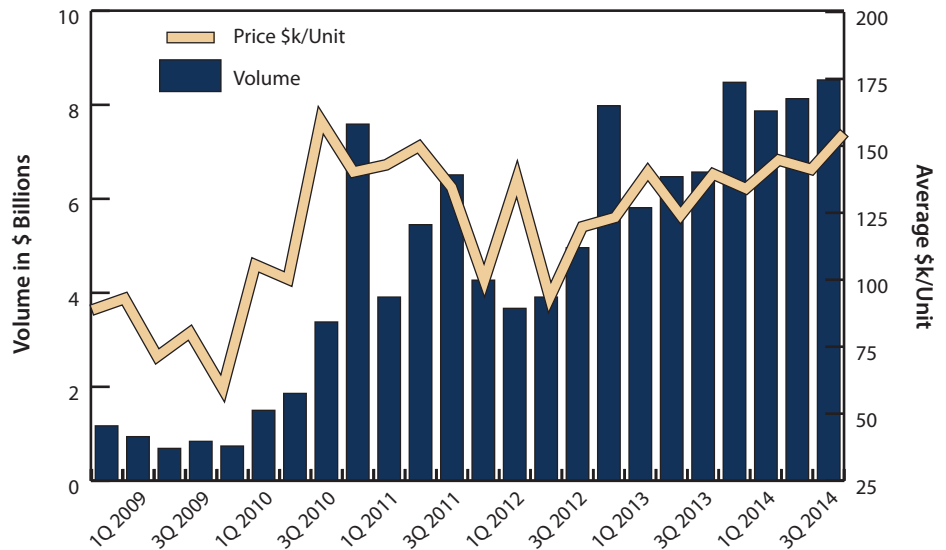
³⁵ PKF-HR, December 2014-February 2015 Edition Hotel Horizons® report.

sales of significant hotels have averaged \$144,000 per unit (an increase of approximately 7 percent over the previous year's results).

Considering previous market highs, significant growth is still needed to match the transaction volume recorded in fourth quarter 2007, as year-end 2014 total hotel sector transaction volume remains 42 percent of the transaction volume recorded in fourth quarter 2007, per Real Capital Analytics. Sixty-five percent of the activity was concentrated in the full-service hotel sector, where volume was \$22.2 billion in 2014, a 14-percent increase over previous year-end results. Although transaction volume was dominated by the full-service hotel sector, the limited-service hotel sector recorded a 39-percent gain over previous year-end results.³⁶

By the end of 2014, the hotel full-service sector surpassed peak prices in second quarter 2013. However, the hotel sector overall was still 3 percent off peak prices for the year, and trending above \$150,000 per unit by year end, indicating opportunities do exist, primarily in the limited service sector (see Exhibit 4-E4). The lack of interest by private, public, and institutional investors may have suggested that pricing is near the peak of the cycle primarily in the major metro markets. However, some investors continue to bet on New York supported by high-profile transactions such as the Waldorf Astoria. The pricing of the Waldorf was a new record for a single hotel property transaction, and was \$1.95 billion, or \$1.368 million per key paid by the Chinese foreign buyer Anbang Insurance Group. Notably, cross-border buyers accounted for almost one-fourth of all hotel property transactions in 2014, according to Real Capital Analytics.³⁷ The Park Hyatt and Four Seasons Resort Hualalai acquisitions were significant as well, trading

Exhibit 4-E4. Hotel Property Volume and Pricing



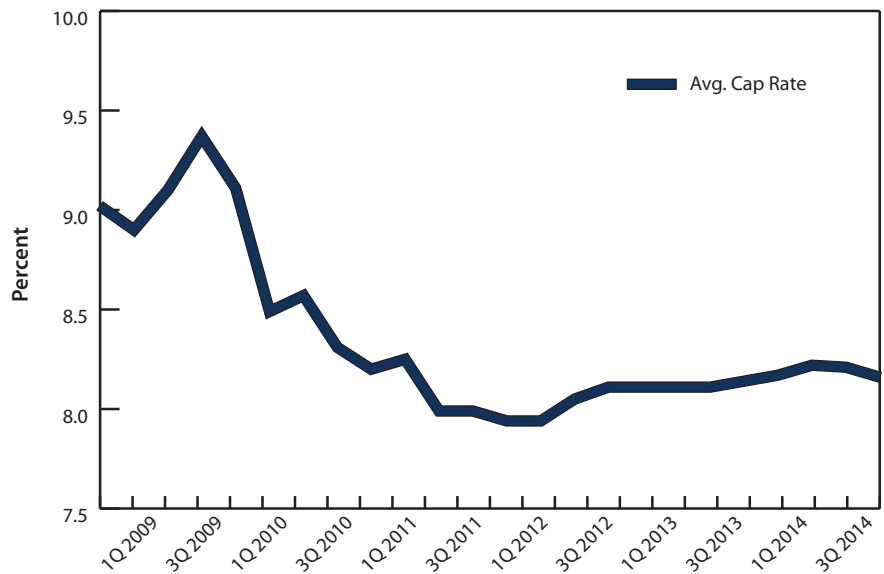
Source: Real Capital Analytics, 3q 2014.

at \$1.857 million and \$2.247 million per key, respectively. Other notable acquisitions greater than \$350 million include the Diplomat Resort and Spa in Hollywood, FL, the Hotel Del Coronado in Coronado, CA, the Las Vegas Cosmopolitan, and the Standard High

Line in New York. Coastal markets continue to attract capital.

According to data from Real Capital Analytics through year-end 2014, average cap rates on hotel property acquisitions overall have been stable

Exhibit 4-E5. Average Hotel Property Cap Rates



Source: Real Capital Analytics, 3q 2014.

³⁶ Real Capital Analytics, *Trend Tracker*, January 15, 2015.

³⁷ *Ibid.*

at approximately 8.2 percent to 8.3 percent throughout 2014, and have remained relatively flat since third quarter 2012, as shown in Exhibit 4-E5.

The U.S. lodging industry continues to outperform the broader market primarily due to demand outpacing supply additions and greater availability of capital. Short-term considerations regarding managing the transaction pipeline fluctuations appear to be relatively mute based on slower closing activity of new supply and firming fundamentals. For the hotel sector, the recovery appears to be in full cycle with room to grow.

HOTEL PROPERTY MARKET FORECAST
(Provided by PKF Consulting USA, LLC)

As 2014 comes to a close, PKF-HR has observed a continual increase in the pace of ADR growth that we believe will likely continue another year or two. According to STR, Inc., the ADR for the U.S. lodging industry in the third quarter of 2014 was 5.2 percent greater than it was in the third quarter of 2013. This follows increases of 3.8 percent and 4.5 percent, respectively, for the first two quarters of the year.

The accelerating pace of ADR growth can be attributed to continued increases in the demand for lodging accommodations, and resulting high levels of occupancy. PKF-HR is forecasting 2 consecutive years of national occupancy levels above 65 percent, both of which eclipse the former record annual occupancy level of 64.7 percent set back in 1995.

The combination of continued growth in occupancy with strong gains in ADR results in annual revenue per available room (RevPAR) increases two to three times the rate of inflation. Further, with RevPAR growth being driven primarily by ADR, PKF-HR is forecasting double-digit annual growth in unit-level hotel profits through at least 2015. This run of

Exhibit 4-E6. National Forecast Summary

Year	Occ	Δ Occ	ADR	Δ ADR	RevPAR	Δ RevPAR
2009	54.50%	-8.80%	\$98.17	-8.60%	\$53.54	-16.70%
2010	57.50%	5.40%	\$98.20	0.00%	\$56.43	5.40%
2011	59.90%	4.20%	\$101.92	3.80%	\$61.01	8.10%
2012	61.30%	2.30%	\$106.20	4.20%	\$65.06	6.60%
2013	62.10%	1.40%	\$110.40	4.00%	\$68.59	5.40%
2014F	64.40%	3.70%	\$115.62	4.70%	\$74.49	8.60%
2015F	65.30%	1.30%	\$122.25	5.70%	\$79.81	7.10%

Source: PKF-HR, December 2014 - February 2015 Edition Hotel Horizons® report, STR.

double-digit growth in profits is the longest observed by PKF-HR since it began collecting data in 1936.

projections of real RevPAR growth through 2015 at least, as shown in Exhibit 4-E7.

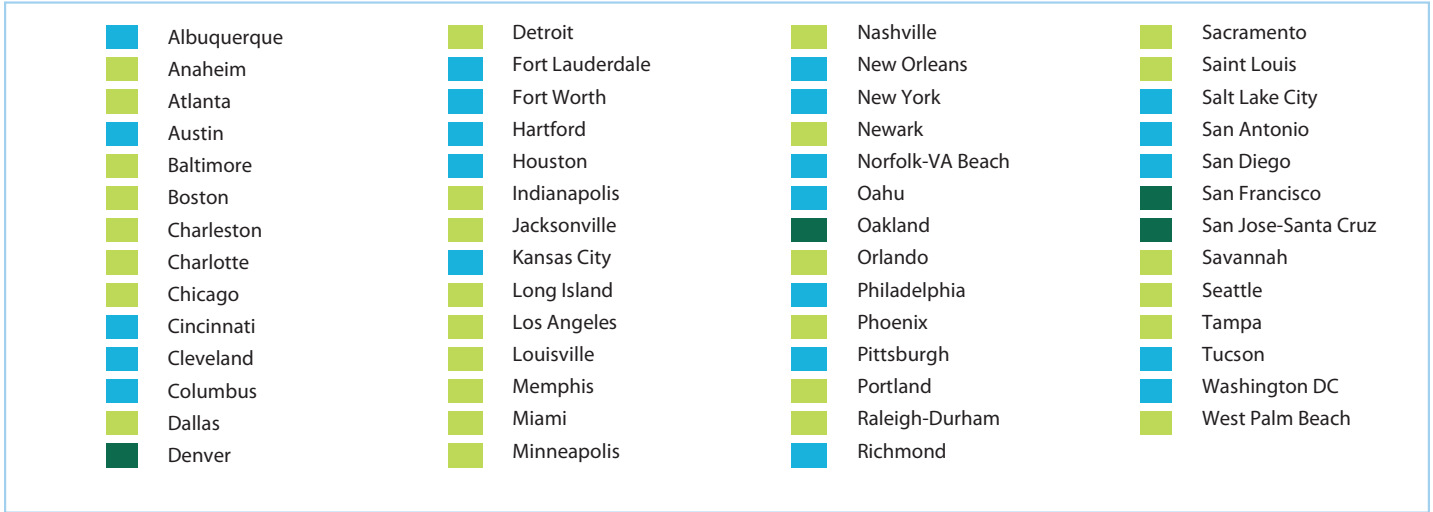
A continuation of favorable market and economic fundamentals supports



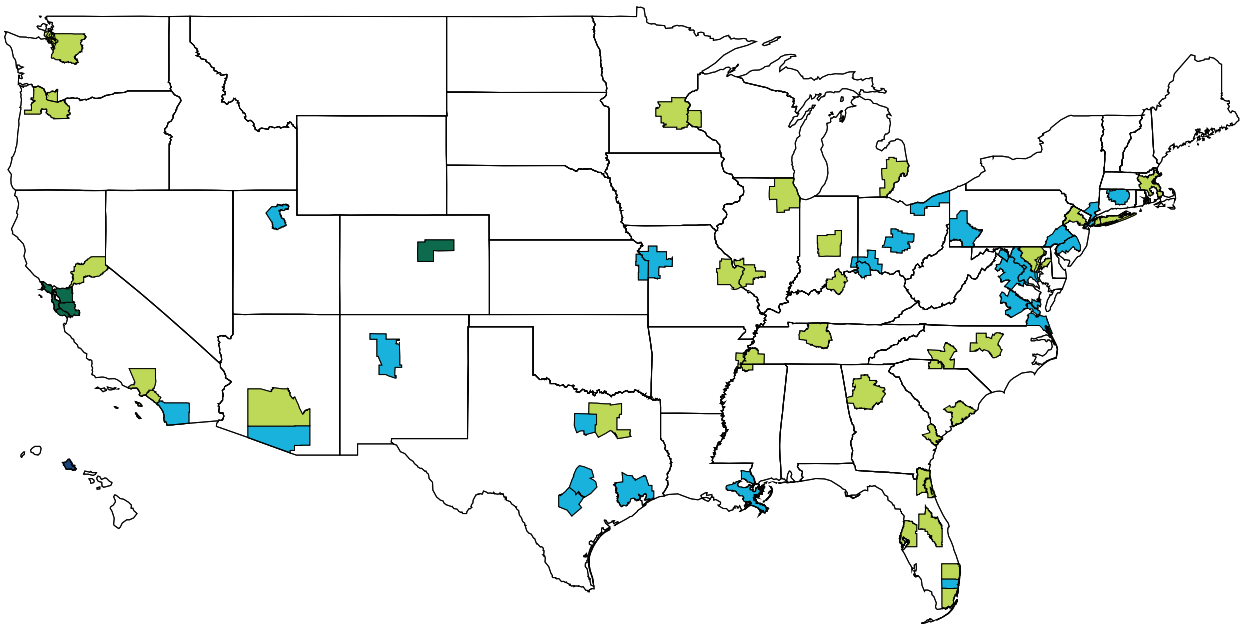
Exhibit 4-E7. National Horizon Profile

National Horizon Profile: Annual Change in ADRs for 2015

The map below displays the year over year change in hotel ADRs forecasted for all hotels in each market for 2015.



■ Less than 5%
 ■ Between 5% and 9%
 ■ Greater than 9%



Source: PKF-HR, December 2014 - February 2015 Edition Hotel Horizons® report, STR.

The background of the entire page is a photograph of railway tracks receding into the distance under a warm, golden sunset sky. The tracks are made of steel rails on a bed of dark gravel. The sun is a bright, glowing orb in the upper right, casting a long, soft light across the scene.

5

SUMMARY & OUTLOOK

LOOKING AHEAD TO 2015

LOOKING AHEAD TO 2015

As we look ahead to 2015 and beyond, it appears that although the world faces a host of continued challenges, the U.S. economy has finally turned the corner. We have seen strong economic growth heading into 2015, and new price and performance records have been set in the financial markets and in the commercial real estate market. This may be another “new normal”—the next chapter in an economic expansion that is dominated by our continued reflections back to the credit crisis and the structural changes that will linger with us for the foreseeable future. This new normal will likely involve the transition to an investment environment where the Federal Reserve increases short-term rates.

Although the Federal Reserve is winding down its critical role with the economy and financial markets, and in late 2014 concluded its monthly purchases of bonds and securities, monetary policy remains generally very accommodative. Although the interest rate outlook is currently unclear, many investors believe that the Federal Reserve will begin to gradually increase short-term rates in 2015. Other investors think that given the economic challenges in Europe and elsewhere, the Federal Reserve will hold back on rates a while longer. However, even if the Federal Reserve starts to raise short-term rates in 2015, the likelihood is that long-term rates will remain low, given the global environment, low inflation, and the pursuit of safety in the form of long-term U.S. Treasuries.

Meanwhile, the markets are flush with investment capital, and 2014 saw the financial markets break one record after another. According to *The Wall Street Journal*, the Dow Jones Industrial Index closed at record highs 38 times in 2014, and the S&P 500 did so 53 times.

Further, the Chinese e-commerce firm, Alibaba Group Holding, raised the bar for initial public offerings with a \$25 billion listing in September 2014, and rising 38 percent in the first day of trading. Commercial real estate enjoyed the rally as well, as REITs produced a total return of 32.3 percent, including dividends, according to the FTSE NAREIT Equity REITs Index, the highest total return since 2006.

Commercial single-property prices also set some new records in 2014, according to Real Capital Analytics, both in the primary markets and in some secondary and tertiary markets:

- St. John’s Town Center retail property in Jacksonville, Fla., sold for \$1,218 per square foot for a total of \$757 million. This is Jacksonville’s most expensive property ever.
- Four Seasons-Resort Hualalai in Kailua Kona, Hawaii, sold for \$546

million, or \$2,246,914 per room, the second highest price per hotel room since the Great Recession.

- The 20-story Gucci office building in Manhattan sold for \$3,285 per square foot for a total of \$460 million, the second-most expensive price per square foot single-property transaction ever.
- The Human Genome Sciences industrial building in the Washington, DC/Maryland suburbs sold for \$1,112 per square foot, or \$322 million, the second-highest industrial transaction ever.

The sale of an office building in Houston (1000 Main) is pending at a reported \$450 million, or \$537 per square foot. Although it is not certain that this sale will go through at this price (given the drastic reduction in oil prices), it would be the highest price ever paid in Houston. In addition, there is new



construction in a few areas with strong demand, with reports of Hines investing in a downtown Houston skyscraper, the largest spec office project in the nation. According to *RealtyNewsReport*, construction for this 48-story, 1-million square foot office tower is underway, and rents have been quoted in the range of \$50 per square foot.

The trends, analysis, and outlook for the year ahead, as presented by Situs RERC, Deloitte, and NAR in *Expectations & Market Realities in Real Estate 2015*, are summarized in this chapter.

ECONOMIC HIGHLIGHTS

- The impact of the Great Recession continues to be felt, given that GDP is approximately \$2.5 trillion less than it would have been absent the recession, per the BEA. The growth of personal income, real median family income, and total household assets (real estate and durable goods) still has not recovered from pre-recession levels.
- As the economy improves, the outlook for GDP growth is over 3 percent in 2015, according to NAR.
- The unemployment rate has declined, but the projected 5.6-percent unemployment rate by late 2015 is still higher than what has been considered “normal,” based on historical levels.
- Consumers are likely to have more money to spend in 2015, given expected additional job creation, the recovery in the level of household assets (both in terms of home values and stock market returns), reduced levels of consumer debt, and lower fuel prices.
- A variety of risks which may negatively affect the U.S. economy remain in 2015, including foreign economic trends, monetary policy



and interest rates, and a possible decline in credit availability if major financial institutions’ face balance sheet problems. However, if credit remains abundant, housing and construction may increase, which would positively affect the U.S. economy.

CAPITAL MARKETS HIGHLIGHTS

- The Federal Reserve concluded its monthly purchases of bonds and securities as the economy showed signs of strengthening, and has initiated conversations about when it may begin to gradually increase the federal funds rate.
- Ten-year U.S. Treasury yield rates were around 2.0 percent as of January 2015. We do not see a significant increase in these rates in the near term, as the weight of capital and search for safety put strong downward pressure on these “risk-free” rates.
- Many investors expect interest rates to remain very low through-

out 2015, even if they begin to increase slightly later in the year.

- The major U.S. stock market indices recorded new highs in 2014, but as 2015 commenced, volatility increased due to declining oil prices and concern about economic conditions in the euro zone.
- According to Situs RERC’s analysis, an estimated \$5.06 trillion is currently invested in commercial real estate in the U.S. Of this total, \$3.29 trillion is debt-driven, and \$1.77 trillion is equity-driven.
- CMBS issuance was \$94.1 billion in the U.S. in 2014, an increase of 9 percent from 2013, per *Commercial Mortgage Alert*. Total worldwide CMBS issuance was \$99.9 billion in 2014.
- The availability of capital for commercial real estate investment outpaced the discipline of capital (underwriting standards) in 2014. This generally resembles capital investment in the pre-credit crisis years and is expected to continue in 2015.

- We are at an inflection point with commercial real estate investment. Investment is expected to further increase, along with property prices (which are pressuring values), for another 1 ½ to 2 years before there is a new down cycle.
- Although very low already, capitalization rates are likely to continue to compress on a broad market basis.

PROPERTY MARKETS HIGHLIGHTS

- Commercial real estate benefited from a favorable macroeconomic environment in 2014. Fundamentals strengthened, as demand for space advanced across all property types, driving vacancies lower and rents higher.
- Total 2014 transaction volume of major properties reached \$288.5 billion in third quarter 2014, according to Real Capital Analytics.
- Commercial property prices rose an average of 15 percent in first half 2014 compared with the prior

year, according to Moody's/Real Capital Analytics CPPI.

- Cap rate compression moderated in 2014, as investors braced for the Federal Reserve to end their purchases of bonds and securities and prepared for possible increases in the federal funds rates.
- Outstanding commercial distressed volume totaled \$103 billion across all property types in the first 9 months of 2013, per Real Capital Analytics. Continuing a positive trend, workout rates have been steadily climbing, reaching 63 percent in the first half of 2014.
- Given the volatility in the equity markets and across global economies, 2015 appears to be a strong year for commercial real estate investment, with property prices expected to hold or further increase beyond current levels.

Office Sector

- Year-to-date transaction volume in the office sector reached \$82.6 billion in third quarter 2014, and

average prices for office properties rose 10 percent on a yearly basis during the first 3 quarters of the year, according to Real Capital Analytics. The average cap rate for the office sector overall declined to 6.7 percent in third quarter 2014. Manhattan retained the top spot for office investment, but transaction volume increased 400 percent on a year-over-year basis in San Francisco during the first half of 2014.

- The outlook for the office sector is moderately positive for 2015. While the vacancy rate was 16.8 percent in third quarter 2014 according to Reis, Inc., the vacancy rate is expected to decline to 16.3 percent by the end of 2015 due to positive net absorption of an additional 50 million square feet during the year. Asking rental rates are expected to increase 3.2 percent in 2015, per Reis, Inc.

Industrial Sector

- Industrial properties garnered significant interest in the first 9 months of 2014, with transaction volume totaling \$37.8 billion in sales and the average price increasing 10 percent to \$71 per square foot, per Real Capital Analytics. In addition, the average capitalization rate for the industrial sector decreased to 7.2 percent in third quarter 2014. Chicago was the most active location with \$1.4 billion in transactions during the first half of 2014.
- Industrial sector fundamentals improved during the year, with the third quarter 2014 vacancy rate declining to 9.0 percent, according to Reis, Inc. and the vacancy rate expected to decline to 8.6 percent in 2015. Given rising demand, asking rents are estimated to increase 2.7 percent in 2015, to an average of \$4.90 per square foot, while



effective rents will likely rise 3.1 percent to an average of \$4.60 per square foot.

Retail Sector

- Compared to the previous year, retail property transaction volume increased nearly 30 percent to \$55.9 billion in third quarter 2014, according to Real Capital Analytics, with the average price for retail mall and strip center space at \$209 per square foot compared to \$167 in the prior year. The average capitalization rate remained at 6.8 percent for all retail properties in third quarter, compared to 7.0 percent the previous year.
- According to Reis, Inc. the combined vacancy rate for retail community centers and neighborhood centers declined to 10.3 percent in third quarter 2014 from 10.5 percent a year earlier, as asking rental rates increased to \$19.59 per square foot. Reis, Inc. projects that rental growth will increase to 2.5 percent in 2015 and 3.2 percent in 2016, with demand for retail properties likely to continue outpacing supply over the next 4 years.

Apartment Sector

- The booming increases in transaction volume for the apartment sector appeared to be leveling off in 2014, although transaction volume increased slightly on a year-over-year basis to \$73.1 billion in third quarter 2014, per Real Capital Analytics. The average price per unit decreased slightly in 2014 compared to the previous year, reflecting the impact of increasing transaction activity in secondary and tertiary markets with lower pricing. The average cap rate decreased slightly to 6.1 percent in third quarter 2014, with the average cap rate for top-tier assets in major metros falling to 3.6 percent.



- The pipeline for new apartment properties has been increasing, with 180,796 apartment units expected to be added in 2014, followed by 210,669 units in 2015 and 165,339 more units in 2016, per Reis, Inc. The vacancy rate declined to 5.3 percent in third quarter 2014 but is expected to increase to 5.7 percent by the end of 2015, according to Axiometrics. Following this trend, effective rental growth is expected to be 4.1 percent in first quarter 2015, but is expected to decline to about 3 percent by the end of 2015, per Axiometrics.

Hotel Sector

- Although hotel investment has been improving, year-to-date transaction volume for hotels totaled \$21.4 billion as of August 2014, which was less than the high recorded in 2007, according to Real Capital Analytics. In addition, hotel prices remain about 25 percent below previous peaks. Cap rates have been generally stable at 8.2 percent to 8.3 percent during the past year.

- Hotel occupancy was expected to increase to 64.4 percent by year-end 2014, according to the PKF-HR. The ADR rate has climbed to a post-recession high of \$115.27 per diem and is expected to increase another 4.5 percent per year on average through 2018. Meanwhile, lodging demand is expected to increase in 2015. With minimal lodging supply increases, PKF projects the pace of ADR growth to improve to 5.7 percent, resulting in a 6.7-percent annual RevPAR gain for 2015.

VALUE VS. PRICE AND RETURN VS. RISK

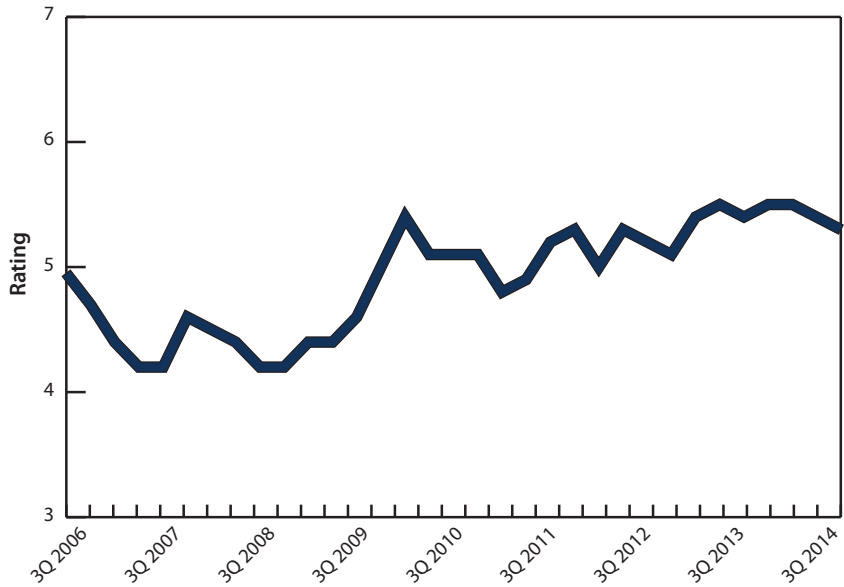
The investment environment for commercial real estate will likely remain very attractive as long as U.S. Treasury rates and interest rates remain low, which according to most economic projections, will continue throughout 2015. Investors will likely continue to purchase real estate; prices will likely continue to increase; and values will likely continue to chase prices. Capitalization rates on a broad market basis will likely further compress.

As shown in Exhibit 5-1, Situs RERC's **value versus price**³⁸ rating for commercial real estate overall has been trending downward during the past few quarters as prices rose relative to the valuations being done. With the midpoint of the rating scale at 5.0, a rating of 5.3 indicates that value can still be found in commercial real estate, despite the decline in this rating, which may indicate that higher prices are having a negative impact on overall values. (A rating below 5 indicates that the value is less than the price, a rating of 5 is neutral, and a rating above 5 indicates that the value is greater than the price.)

Most importantly, a rating above 5.0 suggests that the value versus price of commercial real estate is holding up, even with the flood of capital in the marketplace.

As demonstrated in Exhibit 5-2, returns for commercial real estate are

Exhibit 5-1. Situs RERC Historical Value vs. Price Ratings



NOTE: Ratings are based on a scale of 1 to 10, with 10 being high, and mean that value > price. Source: Situs RERC, 3q 2014.

more than keeping up with the amount of perceived risk involved, which is reflective of the generally bullish

views on commercial real estate and the amount of capital being invested in the market. This bullish sentiment



³⁸ Situs RERC. With respect to the difference between price and value of commercial real estate, price is simply an observation, and is a number that one buyer is willing to pay for a property. The value is the intrinsic worth of a property. In a very fluid market (like the stock market), prices should ultimately match value because of the level of activity occurring. That is not always the case with commercial real estate, however. We are currently at an “interim moment” or “inflection point,” where some prices are believed to be higher than the perceived value, although there is some speculation that high prices could eventually lead to higher values (<http://research.erc.com/blog/value-vs-price-the-story-continues>).

on return versus risk that is pushing up pricing and having the market be more aggressive with underwriting deals is creating the recent downward trends and tension with value versus price ratings (compare to Exhibit 5-1). Valuations are lagging the prices paid by investors today, with prices moving very quickly. This will likely continue in 2015.

COMMERCIAL REAL ESTATE VALUE EXPECTATIONS FOR 2015 AND BEYOND

As the year 2015 gets underway, we are at an inflection point with respect to the price and value of commercial real estate. Thus far, price and value seem to be balanced, but it is uncertain whether high commercial real estate prices and/or values are sustainable. At this time, many investors are willing to pay extremely high prices for the value that commercial real estate offers. However, given the high prices of commercial properties we have been



TOP 10 MARKET ANALYSIS

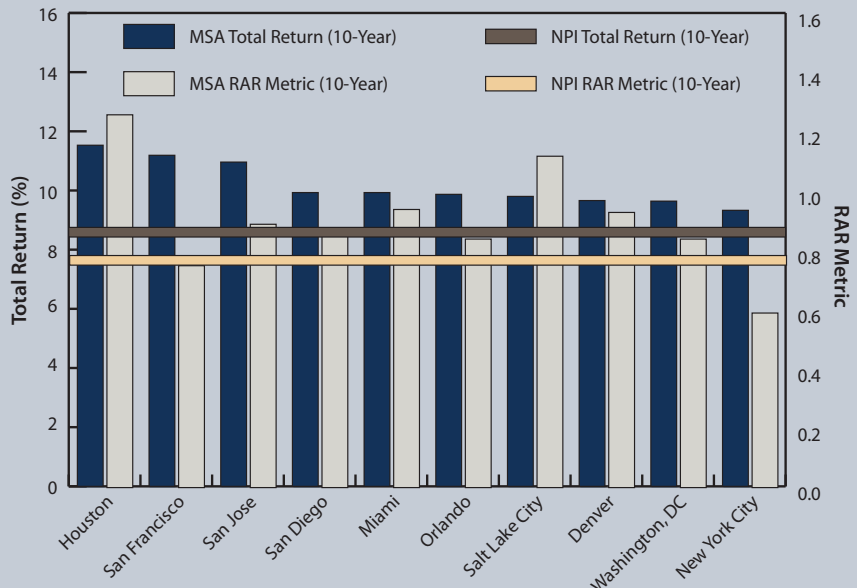
According to Situs RERC’s analysis of the third quarter 2014 NCREIF Property Index (NPI), the top 10 markets with the highest total commercial real estate returns over a 10-year period are: Houston, San Francisco, San Jose, San Diego, Miami, Orlando, Salt Lake City, Denver, Washington DC, and New York City.

Perhaps surprisingly, it isn’t one of the major coastal markets that has the highest total commercial real estate return performance. Instead, Houston leads the top 10 markets with the highest 10-year total commercial real estate return on an actual and a risk-adjusted basis. San Jose, San Diego, Miami, Orlando, Salt Lake City, Denver and Washington DC all attained risk-adjusted returns that outperformed the NPI benchmark. Although San Francisco and New York City posted high returns, there are also notable downside risks and volatility compared to the other metros. Houston, San Francisco, San Jose, San Diego, Miami, Orlando, and Denver

have all been consistently outperforming the total National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI) benchmark during the past 10 years. Austin and Los Angeles just miss being part of the list of top 10 markets with the highest commercial real estate returns, but they are also high performing markets, ranking 11th and 12th, respectively.

Since the top 10 commercial real estate markets may be approaching their peaks and may have little room to grow, some of the smaller markets with growth potential are also drawing investor interest. Riverside, Seattle, Nashville, and Portland all have strong commercial real estate return potential, and all of them have been outperforming the NPI benchmark on 10-year basis. Nashville in particular has higher risk-adjusted return compared to that of top 10 markets, although its 10-year risk-adjusted return is still outperformed by Houston and Salt Lake City.

Top 10 Commercial Real Estate Markets Based on NCREIF Return



Note: MSA: Metropolitan statistical area, RAR: Risk-adjusted return. Sources: NCREIF, 3q 2014. Analyzed and compiled by Situs RERC.

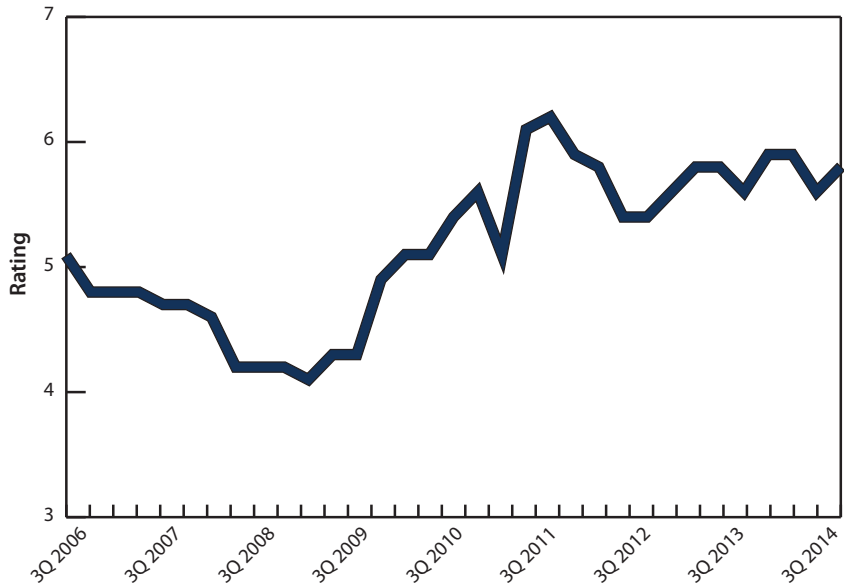
seeing during the past year or two, the risk remains that prices may outpace values.

When examining value in relation to price, however, analysis shows that values have held their own and more. As demonstrated in Exhibit 5-3, Situs RERC notes that as of third quarter 2014, values have recovered more (44.21 percent since first quarter 2010) than they lost in the most recent down cycle (29.31 percent from second quarter 2008 to first quarter 2010), according to our analysis of NCREIF’s cash flow return. (Note: this scenario represents “gross” return on investment.)

The year 2015 will be an interesting period for investors, and Situs RERC expects commercial real estate values to continue to increase slightly or to remain about the same as currently. Following the base scenario as presented in Exhibit 5-3, it appears that broad market prices and values have room to increase for approximately 12 to 18 months, after which we will enter a period where values most likely will begin to level off.

Although there are substantial economic risks and uncertainties, many investors are currently focused on returns, and commercial real estate has historically offered reasonable risk-adjusted return performance on capital and income (as of January 2015, income was approximately 60 percent of returns, according to Situs RERC’s estimate). Expected real estate returns will likely be above average, assuming that the economy and capital markets continue to function as anticipated (see collective summary of our baseline economic expectations in Exhibit 5-4).³⁹ We have also provided a forecast of what investors might expect to occur in 2015 if the economy does not grow as anticipated, or if it grows more rapidly than expected, and what these effects

Exhibit 5-2. Situs RERC Historical Return vs. Risk Ratings

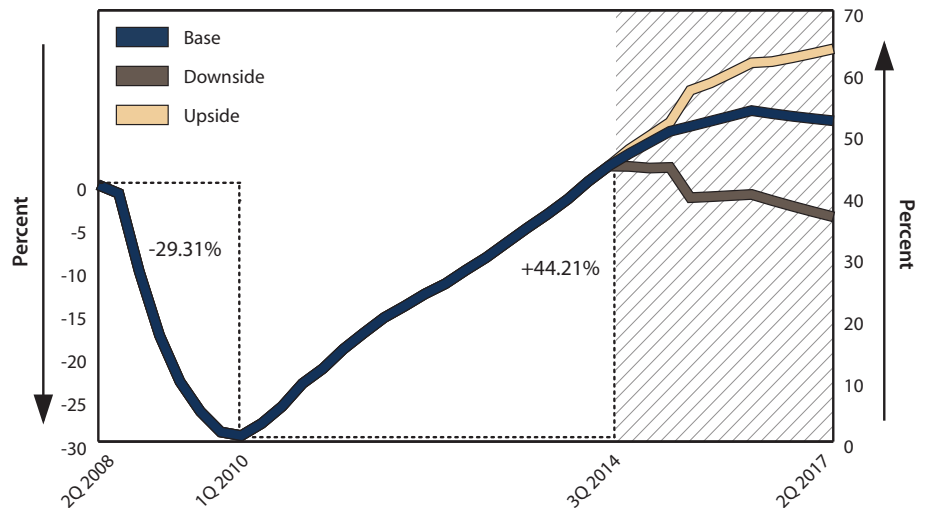


NOTE: Ratings are based on a scale of 1 to 10, with 10 being high, and mean that return > risk. Source: Situs RERC, 3q 2014.

would likely be on commercial real estate. In these alternate instances, commercial real estate may still be a favored investment alternative on a risk-adjusted basis. Compared with many investment alternatives, many

investors perceive commercial real estate to be relatively safe, it is a tangible hard asset, transparent in that it is relatively easy to understand, and can be a hedge against inflation (especially on a long-term basis).

Exhibit 5-3. Gross Value Expectations (Appreciation plus Cap Ex)



Note: This outlook is based on NCREIF’s capital information. This scenario includes cap ex (capital appreciation + cap ex), and represents the “gross” value. Sources: Situs RERC Estimate, NCREIF, 3q 2014.

³⁹ We note that these are not the only scenarios that are possible. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

Exhibit 5-4. Alternative Economic Scenarios for 2015

	Slowing Growth - Contraction/Risk of Deflation/Recession	Baseline - Continued Expansion and Stronger Economic Growth	Stronger Growth - Progress Towards Historical Long Term Averages and Full Employment
U.S. GDP Real Growth	Less than 2.0 percent	2.0 percent to 3.5 percent	3.6 percent or greater
Probability	Slightly likely	Most likely	Reasonably likely
Employment	Demand for labor decreases and discouraged job seekers leave the workforce or take jobs where they are overqualified. As the labor participation rate slides further, chronic long-term unemployment and wage stagnation increase.	Unemployment declines to roughly 5.6 percent and averaging 250,000 new jobs per month. The labor participation rate remains around 63 percent. Increasing demand for labor causes wage growth to increase.	With average job growth of 300,000 or more workers per month, the economy comes close to full unemployment of 5 percent. Overqualified workers matriculate to respective fields, and discouraged workers re-enter the workforce, creating 5-percent wage growth.
Housing Market	Prospective buyers are unwilling to purchase or unable to secure financing for a new home. The housing recovery completely stagnates, decreasing home values. This reduces homeowners' wealth and overall consumption.	Existing home sales bounce back and stabilize around 5.3 million units annually, which gives new home sales the traction to begin moving noticeably forward. Top markets establish new price highs, while bottom markets make more significant headway towards a full recovery.	Millenials with more secure jobs and job growth outside major metropolitan areas help to initiate the rebirth of the housing market. The supply of homes dwindles, pushing up prices and giving a sizeable boost to new home starts.
Consumer Spending	Consumers retrench as personal and real disposable incomes fall. Large durable goods are hurt the most, but all non-essential product sales suffer.	Consumer confidence continues to improve to levels near 100, and personal consumption expenditures are estimated to grow at a rate of 2.7 percent. Consumer spending is likely to increase based on lower costs for fuel. This creates a positive feedback loop for inflation and GDP.	Consumers reach pre-recession levels of job security, and with significant wage growth, they begin to spend freely. Major purchases and upgrades to durables goods will occur.
Business Spending	Layoffs commence, and new hiring and wage increases cease. Efficiency is paramount for survival, and costs, including business investment and benefits like health care, are cut.	Business profits expand and spending increases, as businesses gains more confidence in positive economic growth and fuel costs decline. Business investment is expected to grow at a rate of 3 percent, per NAR.	Businesses spending increases, especially on infrastructure. Ensuing competition for the growing market drives more investment in R&D.
Government Spending	Possible increase in government spending to stimulate growth. The Federal Reserve initiates QE4.	Federal deficit is reduced due to revenue increases and some budget adjustments.	Dent is made in federal debt, and discussions about reducing the costs of government programs commence.
Trade Balance	European deflation, along with a more widespread global economic slowdown, may raise the deficit above \$500 billion.	The trade deficit remains steady as the domestic economy strengthens and trading partners continue to recover and import increases resume. Global GDP accelerates above 3 percent, per NAR.	The trade deficit narrows as Europe and our major trading partners' economies strengthen.
Inflation	Inflation drops below 1 percent as wage growth stagnates and consumers reduce spending.	Inflation remains in the Federal Reserve's target range of 1.5 percent to 2.0 percent, led by growth in services (particularly in housing, recreation, and food services).	Inflation increases by more than 2.0 percent from services and the first price increases in durable goods in more than 3 years.
Interest Rates	Continued concern about the lack of global growth, as well as lackluster inflation, keep the Federal Reserve from increasing the federal funds rate. The 10-year Treasury yield remains low.	The federal funds rate increases in the middle of 2015 to 0.50 percent. Given global dynamics and pressure, 10-year Treasury yields are likely to remain below 3.0 percent.	The U.S. economy quickly accelerates. As a result, the Federal Reserve begins raising the federal funds rate in early 2015 and incrementally to 1.0 percent by year end. Ten-year Treasury yields rise to 3.0 percent or higher.
Commercial Real Estate	Ten-year Treasury rates remain where they are or decline slightly. Debt market quickly responds to the changes, while the equity market is slower to react because of global capital pressures. Sales volume and property prices drop, while cap rates increase and most wait to watch the dust settle. At the same time, the 3-year wave of debt maturities hits, with a significant portion requiring special servicing and delinquencies increasing to between 5.0 percent and 6.0 percent.	Commercial real estate prices enjoy one of their best years in 2015. Fundamentals continue to improve, and this pushes transaction volume to 2006 levels through price increases and demand across markets. Price increases will be uneven, depending on the quality and location of the properties (likely to peak in coastal markets and begin to increase more broadly in other markets). Foreign investment will continue to increase. Cap rates are likely to continue to compress for the near term. According to Situs RERC's value outlook, total returns are expected to be approximately 8.0 percent to 10.0 percent for institutional properties on an unleveraged basis.	Fundamentals increase significantly, particularly for office and retail properties. Old and outdated properties (suburban offices and small-to-medium sized malls) are updated to more desirable buildings. Volume reaches 2006 levels. Pricing continues to surpass historic highs and begins occurring more robustly in all property types and markets. Debt maturities are almost all refinanced via increased property performance and capital appreciation. CMBS issuance reaches \$150 billion or more with minimal impact on loan quality.

NOTE: These are not the only scenarios that are possible. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

Sources: Situs RERC, Deloitte, and NAR. January 2015.

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Sources: ENR (4/14-8/14), Builder Online 2013, NAREIT (4/14), The Stranger Report (Spring 2014), P&I (May26, October 27, November 12, 2014), INREV/ANREV Fund Managers Survey 2014, Prequin (5/16/14), Private Equity Intl (5/14), Fortune 500 (2014), NREI (2014)

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