

2011 Investment Outlook: Commercial Real Estate

Executive Summary

Investment Drivers

1. Spread between cap rates and interest rates near all-time high
2. The U.S. economy will improve further in 2011, and mounting evidence suggests a double-dip recession is unlikely
3. Office and retail hardest hit, but all commercial property occupancy levels at or near bottom
4. Apartment market is well into recovery and showing rent growth ahead of expectations
5. Overall price corrections have bottomed; pricing gap by quality significant
6. Lenders still avoiding fire sales on quality assets by extending, modifying loans
7. Financing availability improving, with underwriting remaining tight
8. Overbuilding in the next three years highly unlikely, allowing for a recovery in rents

Investment Trends and Opportunities

1. Institutional capital flows increased dramatically into top-quality properties in primary markets in 2010
 - a. Overall sales on track to increase 68% in 2010
 - b. \$20 million-plus sales volume more than doubled
 - c. \$10 million to \$20 million sales volume increased 50%
 - d. \$10 million sales volume increased 15%
2. Yields for flight-to-safety or Class A assets have recompressed and range from 4.5% to 6.5% vs. the sector average of 8.5%
3. Class B and B- buying opportunities exist within all property sectors and will become more pervasive, with cap rates averaging 7% to 8%
4. Opportunistic buying in lower-grade or value-add properties are also attractive but more risky, with cap rates ranging from 9% to 10%
5. Volume of distressed sales or auction properties is growing, but majority of sales are lower-quality assets in secondary or tertiary locations
6. Public REIT valuations have jumped 132% since the market bottom in 2009, double the rise in the S&P 500, but still provide relative safety and a 3% to 4% dividend
7. Investors can take advantage of market dynamics by acquiring small to mid-sized properties and locking in still-low interest rates ahead of rent growth

Investment Ranking Based on Recovery Outlook and Risk/Return Profile

1. **Apartments:** Already in recovery due to release of pent-up renter demand, strong renter demographics, job growth and homeownership reversal
2. **Retail:** May surprise to the upside; consumer spending has been surprisingly strong, and core retail sales have returned to pre-recession levels; retail properties in suburban areas hardest hit due to housing overbuilding; infill neighborhood/community centers and newer malls lead; single-tenant still attracting capital
3. **Industrial:** Demand improving with movement of goods and trade volumes; warehouse/distribution space leads as manufacturing, R&D lag
4. **Office:** Demand typically last to recover; lack of overbuilding a major positive; space demand could increase more than anticipated in second half of 2011 or early 2012

Investment Ranking by Metro Area

1. **Market leaders – coastal, supply-constrained metros:** Boston, Los Angeles, New York City, Orange County, San Diego, San Francisco, San Jose, Washington, D.C.
2. **Leading-recovery markets:** Austin, Charlotte, Dallas/Fort Worth, Denver, Miami, Philadelphia, Portland, Seattle
3. **Second-tier recovery markets:** Atlanta, Chicago, Fort Lauderdale, Houston, Minneapolis, Oakland, Orlando, Phoenix, Tampa
4. **Stable markets:** Cincinnati, Cleveland, Columbus, Indianapolis, Milwaukee, New Jersey
5. **Most-challenging markets:** Detroit, Jacksonville, Las Vegas, Pittsburgh, Riverside-San Bernardino, Sacramento