Market Intelligence Report:

Commercial Property Market Intelligence Report: *Status and Business Opportunities*

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Executive Summary

General

Over the past few months, there has been a noticeable increase in long-term interest rates. A rising interest rate environment will likely test the sustainability of the recovery in commercial property values. While operating fundamentals for income properties have improved modestly, most of the increases in pricing have been driven by exceptionally low interest rates. Higher interest rates can be expected to lead to a number of adjustments. Overall price appreciation should slow and demand will likely gravitate even further toward areas where operating fundamentals have improved the most and prospects remain the brightest. Today, that still means the apartment sector where demand continues to be strong, and rents adjust relatively quickly. Industrial properties should also hold up relatively well, principally due to continued strong growth in online retailing, the energy boom and improving sentiment in the manufacturing sector. Demand for well-located office and retail properties have turned the corner as well, but the pace of recovery has been much slower and the improvement remains spotty.

Individual Property Types

Apartment fundamentals remain solidly in place, but the acceleration observed over the past few years is likely to moderate somewhat, particularly as investors become wary of rising interest rates. After 12 consecutive quarters of vacancy rate declines, the apartment vacancy rate has leveled off. The rate of decline over the past year decelerated principally because new construction fell more in line with demand. Notwithstanding, demand should continue to remain strong, reflecting improving employment conditions.

With overall economic fundamentals improving, including employment, income and consumer spending, demand for industrial space is increasing. Industrial vacancy rate declines have been pulled lower by the growing demand for warehouse space and minimal new construction. E-commerce continues to be one of the driving influences on demand, as large Internet retailers build out their distribution network and traditional retail chains add online distribution channels. Global economic growth and international trade are also expected to improve during the remainder of this year and into next year, which should further fuel the demand for industrial space in the major international trade gateways. Lastly, expansion of the Panama Canal to handle larger container ships is expected to increase trade volumes along the Gulf and East coasts once the expansion is completed by the end of 2015. The additional capacity is already driving demand for nearby warehouse and distribution space.

continued on page 2

Commercial Property Market Intelligence Report *(continued from pg. 1)*

The pace of the office sector's recovery has been weak, and the sector is still the laggard among all property types. Demand for office space is reviving slowly, as businesses have gradually ramped up hiring. Growth in professional and business services have been the primary drivers. New construction remains anemic at historically low levels. The market has not delivered much new space since the second quarter of 2010 when many projects were completed only because they had been started before anyone fully grasped the magnitude of the recession. However, there is some optimism now given the resurgence in the economy and this sector is expected to gain momentum in the final quarter of this year.

Recovery in the retail sector has been slower to take shape, although modest improvement is evident. Property fundamentals are posting marginal improvement as tenants remain cautious about committing to large chunks of space. Traditional retailers continue to battle increased competition from online merchants and value-oriented consumers. Higher-end chains and specialty retailers are tending to hold up better than discount stores. New development is principally focused on those select markets where prime locations are still available.

Continued moderate economic growth is expected to drive hotel performance improvement further for the remainder of the year. Underlying property fundamentals in the sector remain strong, with positive year-over-year performance. The hotel sector currently outperforms all other commercial property types except for apartments. With occupancies and revenues returning to pre-recession levels and at near-record highs, investors remain encouraged by the near-term prospects. This has resulted in transaction volume in the first half of the year being the highest it has been since 2007.

Construction

Commercial construction overall in the market continues to improve, albeit from an extremely low base. Construction of new factories and R&D centers has increased with help from foreign investment. Warehouse and distribution construction is also ramping up and construction of data centers remains strong. Apartment construction has increased as the market has tightened. Office and retail development is proceeding somewhat cautiously. Overall, the pace of new construction is expected to pick up in 2014.

Capital Markets

Financing and credit standards, while still constrained, are loosening. Capital markets continue do well and are anchoring the recovery in commercial real estate. The commercial mortgage market continues to expand as demand strengthens and lending standards loosen. Transaction volume is increasing across all major debt capital sources, including banks, CMBS, life insurers and GSEs, and should continue as the year progresses. Much of the capital markets' liquidity must still be credited to the Federal Reserve's continued quantitative easing which almost certainly will be changing in the coming year.

Lenders

The third quarter of the year finds lenders continuing to do well and commercial lending markets continue to strengthen. Provisions for loan losses are also falling. More and more banks are clearing through their distressed assets. Even underwriting criteria are beginning to loosen. At the same time, demand in the marketplace is increasing, driven in large part by the low interest rate environment and the expanding need for refinancing. The big uncertainty is related to when the Fed's quantitative easing program will phase out and end. This will result in a gradual rise in interest rates and adversely impact borrowing for commercial real estate transactions and the operating income of highly leveraged properties. It likely will also slow the pace of asset price appreciation unless underlying economic conditions improve much more than they have to-date.

Commercial banks and savings institutions insured by the FDIC continue to get stronger. The FDIC's *Second Quarter 2013 Quarterly Banking Profile* reported an increase in both bank profits and lending volumes as well as a continued decline in the number of problem banks. The FDIC reported an aggregate profit for FDIC-insured banks of $42.2 billion in 2Q13, an all-time high. This is the 16th consecutive quarter that earnings have registered a year-over-year increase. The number of FDIC-insured institutions reporting financial results fell to 6,940 in 2Q13 from 7,019 in 1Q13. In 2007, prior to the last fiscal crisis, there were 8,559 FDIC-insured banks reporting. During the second quarter of the year, twelve insured banks failed. A total of sixteen banks failed in the first half of the year. In 2012, there were a total of 51 bank failures. Commercial real estate exposure continues to be the main driver behind problem loans at banks that failed in the quarter.

The number of institutions on the FDIC's problem list in 2Q13 fell for the ninth consecutive quarter, after increasing for 19 quarters (since 3Q06). The number of "problem" institutions declined from 612 in 1Q13 to 553 in 2Q13. Significantly, this is the first time since the first quarter of 2009 that the number of problem banks declined to under 600.

continued on page 3

Real Capital Analytics (RCA) tracks the distressed asset market and recently reported $152.9 billion in distressed loans associated with 11,275 properties, down from $158.7 billion in distressed loans associated with 11,566 properties reported in the last quarter. The size of the distressed asset market peaked at $191.5 billion in October 2010. The $152.9 billion total consists of $102.4 billion in troubled loans associated with 7,397 properties (down from $106.6 billion associated with 7,646 properties in the last quarter) and $50.5 billion in lender REO associated with 3,878 properties (down slightly from $52.1 billion in lender REO associated with 3,920 properties in the last quarter). Of the $394 billion of mortgages that became troubled since the 2007 market peak, more than 60% have been resolved, and new instances of distress continue to decline.

More banks are jumping on the commercial real estate bandwagon as they continued to report improving commercial real estate credit quality, increased lending and strong competition for property financings. A significant portion of the increase in commercial real estate mortgage activity is associated with refinancing of existing loans from other institutions. The CBRE *Lending Momentum Index* noted that lending activity was very strong in the second quarter, with the index reaching its second highest level since the market began to recover in mid-2010.

The Federal Reserve's July 2013 *Senior Loan Officer Opinion Survey on Bank Lending Practices,* found that 36 of the 76 banks (49.3%) surveyed indicated that they experienced "moderately stronger" or "substantially stronger" demand for commercial real estate loans in 2Q13. All except one of the remaining banks indicated the demand at least "stayed about the same as in the previous quarter." Nineteen (19) of the 38 large banks (50%) responding (with total domestic assets of $20 billion or more as of December 31, 2010) indicated that commercial real estate loan demand was "moderately stronger" or "substantially stronger." This compares to 17 of the 35 smaller banks (48.6%) responding to the survey.

This same survey found that lending requirements for approving commercial real estate loans were beginning to loosen at more and more banks. Although the majority of banks (75%) surveyed have not changed their bank's credit standards, almost one quarter of both the large banks and the smaller banks were found to have eased their standards.

CMBS/CDOs

Commercial mortgage-backed securities issuance has been a cornerstone of commercial real estate financing. Overall, CMBS originations for the first half of the year were almost double that of the year-earlier period, a promising sign that broad-based liquidity has been restored to the commercial mortgage markets. CMBS origination projections earlier this year were in the $70 billion to $100 billion range. However, fear that the Federal Reserve may end its bond-buying program along with the expectation of rising interest rates will likely cool the CMBS market by making borrowing more expensive. Many lenders are already pricing in an additional cushion to hedge against future volatility.

At the end of August, CMBS issuance was at $56 billion. Analysts are now projecting that CMBS issuance will come in at the lower end of earlier projections, approximately $70 billion for the full year, which still is significantly greater than the $48 billion in originations for all of last year. September already has about $7 billion slated for sale. In 2007, the last year before the financial crisis hit the CMBS market, there was almost $250 billion in issuance.

Delinquency rates continue their improvement trend. The most recent quarterly decline in the 30-plus day delinquency rate on loans held in CMBS was the largest on record, decreasing 0.74 percentage points in the second quarter to 7.81%. The recovery rate on loans liquidated in the first half of the year was 66%. The percentage of CMBS loans in special servicing has fallen to 9% since peaking at 12% in 2010.

REITs, Life Insurance Companies and Pension Funds

A rising interest rate environment means that low-leverage and all-cash buyers have a renewed advantage in chasing deals. Entities having a low cost of capital, such as REITs, also have an advantage. REITs continue to have good access to the capital markets. Good property fundamentals and low cost capital continue to enable REITs to upgrade their portfolios as they sell lower-quality assets and re-invest in higher-quality core assets.

MetLife launched MetLife Real Estate Investors last year to build upon the company's experience in originating both commercial mortgages and private placement debt as well as investing in real estate equities. In August, MetLife and SunTrust Banks announced a three year agreement that SunTrust will finance as much as $5 billion in commercial real estate mortgages originated and managed by MetLife Real Estate Investors.

The California State Teachers Retirement System (CalSTRS) recently announced it will move more of its real estate assets to core assets. The plan calls

continued on page 4

Commercial Property Market Intelligence Report *(continued from pg. 3)*

for moving more of its holdings out of opportunistic assets into the core category. The announcement was unusual in that it was made at a time when more investors are seeking higher yields by moving outside core markets into secondary and tertiary locations. CalSTRS currently has about $22.3 billion in commercial real estate assets, with 37% core, 17% value-add and 46% opportunistic. The new risk goal is to reach 50% core, 20% value-add and 30% opportunistic by 2015.

Foreign Investors

Foreign investors continue to acquire ownership stakes in Class A U.S. properties, with no sign of slowing any time soon. The volume of foreign capital flowing into U.S. commercial real estate has been increasing for the past three years and sales activity to-date this year is no different. As of the end of August, there were $22.2 billion in closed transactions, which is on pace to exceed the $27.6 billion in all of last year. Canadians, Singaporeans, South Koreans, Israelis, Germans, Chinese, Swiss, Australians and Norwegians, in particular, have made significant purchases of U.S. real estate attracted to America's growing economy and rebounding prices. Noteworthy foreign investors include:

- Norges Bank Investment Management (administrator of the Norwegian Government Pension Fund Global)
- UBS (Switzerland)
- Investcorp International, Inc.
- Agellan Commercial REIT (Canada)
- AMP Capital Investors (Australia)
- Ivanhoe Cambridge (the real estate arm of Caaisse de Depot et Placement du Quebec, Canada's largest pension fund manager)
- Harel Insurance Investments and Financial Services, Ltd. (Israel)
- Menora Mivtahim Insurance Ltd. (Israel)
- Overseas Union Enterprises Ltd. (Singapore)
- Government of Singapore Investment Corp. (GIC)
- Korea Investment Corp. (KIC)
- National Pension Service of Korea (NPS)
- Mirae Asset Global Investments (Seoul, South Korea)

Property Transaction Market

According to the Mortgage Bankers Association's (MBA) *Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations*, *Q2 2013*, commercial and multifamily mortgage origination volume (dollar basis) in the second quarter of this year was 7% higher than in the second quarter of last year and 36% higher than in the first quarter of this year. Compared to the second quarter of last year, loans originated by life insurance companies increased by 16%, loans originated by commercial banks increased 13%, loans originated by GSE (Fannie Mae and Freddie Mac) increased 8%, and loans originated by conduits for CMBS decreased 14%.

Total property transaction volume (on a dollar basis) increased more than 25% year-over-year, with office and industrial experiencing double-digit gains. Investors have very strong expectations that both occupancies and rents will continue to grow across property types in the coming year.

The volume of foreign capital flowing into commercial real estate investment has been on the rise for the past three years and continues to be strong. During the first half of the year, foreign transaction volume was ahead of the same period of last year by 63%.

Law firms represent an important role in structuring property transactions for clients. The leading real estate law firms serving the industrial and commercial sector include:

- Latham & Watkins
- DLA Piper
- Morrison & Foerster
- Jones Day
- Kirkland & Ellis
- Squire Sanders
- Reed Smith
- Baker & McKenzie
- Kaye Scholer
- Fullbright & Jaworski
- Blank Rome
- Akerman Senterfitt
- Sheppard Mullin
- Holland & Knight
- Morris, Manning & Martin
- Bryan Cave
- Wilmer Cutler Pickering Hale & Dorr
- Drinker Biddle & Reath
- Duane Morris
- Fox Rothschild

continued on page 5

Italics indicates this buyer has acquired additional properties beyond what was reported in last quarter's Property Intelligence Report.

Bold indicates a buyer newly added to the list in the quarter.

Regular font indicates no change from last quarter's report.

Where the Action is…

Most Active Buyers of High Quality Properties ($10 Million or Greater) in the Past 12 Months (in order of dollar volume acquired) as tracked by Real Capital Analytics:

All Property Types

1. Equity Residentail – 89 properties	6. **American Realty Capital**– 341 properties
2. *Blackstone Group* – 1,406 properties	7. TIAA-CREF– 41 properties
3. AvalonBay Communities – 76 properties	8. *Realty Income*– 598 properties
4. Caisse de Depot (Quebec) – 85 properties	9. **Brookfield Associates**- 160 properties
5. **WP Carey (REIT)** – 213 properties	10. **Vornado Realty** - 7 properties

Multifamily

1. Equity Residential– 82 properties	6. TIAA-CREF– 8 properties
2. AvalonBay Communities – 70 properties	7. Goldman Sachs– 31 properties
3. **Blackstone**– 89 properties	8. American Campus Communties – 48 properties
4. *Greystar Real Estate Partners*– 55 properties	9. Caisse de Depot (Quebec) – 27 properties
5. **MAA** – 119 properties	10. **Invesco Real Estate** - 14 properties

Office

1. *Clarion Partners*– 13 properties	6. Caisse de Depot (Quebec)– 3 properties
2. RXR Realty– 4 properties	7. **Related Companies**– 5 properties
3. **Norges Bank Investment Management**- 11 properties	8. JP Morgan – 9 properties
4. **Vornado Realty** – 4 properties	9. **Cousins Properties** – 5 properties
5. **American Realty Capital** – 32 properties	10. **Rockpoint Group** - 5 properties

Hotel

1. *Blackstone* - 1,174 properties	6. **Witkoff Group** 2 properties
2. GIC (Government of Singapore Investment Corp.) - 4 properties	7. Sahara India Pariwar- 2 properties
3. Omni Hotels - 6 properties	8. **Carey Watermark** - 11 properties
4. **Hyatt Hotels**- 4 properties	9. Summit Hotel Properties - 27 properties
5. Starwood Capital - 139 properties	10. **LaSalle Hotel Properties**- 27 properties

continued on page 6

 (continued from pg. 5)

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Where the Action is…

The Most Active Buyers of High Quality Properties ($10 Million or Greater) in the Past 12 Months (in order of dollar volume acquired) as tracked by Real Capital Analytics:

Retail

1. DDR - 50 properties	6. **American Realty Capital** - 277 properties
2. Macerich- 4 properties	7. Kimco - 54 properties
3. *Realty Income Trust* - 447 properties	8. Blackstone Group - 49 properties
4. **Simon Property Group** - 7 properties	9. The Inland Real Estate Group of Companies - 39 properties
5. *TIAA-CREF* 9 properties	10. QIC Properties - 8 properties

Industrial

1. **WP Carey (REIT)** –145 properties	6. Blackstone– 86 properties
2. *Brookfield Asset Management*– 133 properties	7. BioMed Realty - 16 properties
3. **Liberty Property Trust (REIT)**– 112 properties	8. *DivcoWest Properties* – 57 properties
4. *Industrial Income Trust (IIT)* – 47 properties	9. **Prologis**– 77 properties
5. Realty Income Trust –64 properties	10. TPG Capital– 55 properties

Senior Housing & Care

1. *HCP, Inc.* - 129 properties	6. **Ventas Inc. -** 11 properties
2. *Formation Capital* - 108 properties	7. Harrison Street Real Estate Capital **-** 11 properties
3. *Safanad* - 105 properties	8. **American Realty Capital** - 23 properties
4. *CNL Financial Group*- 45 properties	9. Engel Burman Group - 6 properties
5. *Health Care REIT* - 99 properties	10. **Brookdale Senior Living (BKD) -** 21 properties

Development

1. Hines	6. JDS Development
2. Genting Group	7. Amazon
3. ProLogis	8. Irvine Company
4. Boston Properties	9. Baupost Group
5. Brookfield Homes	10. **McCourt Group**

Most Active Sellers of Commercial Real Estate (over last 12 months)

1. Lehman Brothers	6. Goldman Sachs
2. Blackstone	7. Hines
3. **GE Capital**	8. Carlyle Group
4. Equity Residential	9. **WP Carey (REIT)**
5. **Inland Real Estate**	10. **Colonial Properties Trust (REIT)**