

REAL ESTATE VALUE TRENDS

April 2008

In this month's newsletter, we will discuss current and forward-looking trends in commercial real estate property values and discuss why one should remain invested in real estate.

The press and even some investment banks are reporting that commercial real estate values have declined since last year due to the slowing economy and the credit crisis. While this may be true, how much have values already changed and how much more are these likely to change in the future? To answer these questions and more, we will examine:

- Current Sales
- Current Pricing
- Historical Returns
- Forecasted Returns
- Alternative Investment Returns
- Returns on Publicly Held Real Estate

Before we answer these questions, though, it should be noted that our analysis is based on current data available for institutional quality real estate on a national level. While this historical data is mainly fact-based, our forecast is subject to some level of error and revision.

Current Sales

Institutional property sales volumes are down 78% from the peak recorded just one year ago. In fact, office sales are now at the lowest monthly level in five years, and even multi-family sales are down by 27% from one year ago. We feel this reduction in sales indicates a large difference in buyer and seller expectations. In many cases, real estate owners have chosen not to sell because prices are not matching their expectations; even highly leveraged owners who might be required to liquidate in a slowing economy are, for the most part, still holding properties. Because of limited sales activity and a lack of sales comps, it is difficult for appraisers and other industry participants to accurately determine current market values.

Sales Activity: January & February			
<i>in billions</i>	2007	2008	Change
Closed	\$102	\$22	-78%
Offered	\$54	\$46	-15%

Source: Real Capital Analytics

Current Pricing

Because sales volumes are reduced and currently skewed toward "core" middle market properties, value declines for "non-core" properties are likely masked, as most of the pricing information is reported on an average basis. Despite this caveat, current sales price data reported by Real Capital Analytics shows cap rates have increased by an average of 0.24% for all property sectors since the market peak in the second quarter of 2007. At this point, only the multi-family sector has not experienced an increase in cap rates, although this is likely to change as multi-family pricing is indicated as being significantly more aggressive than other real estate sectors.

Cap Rate Trends			
	2Q07	Feb. 2008	Change
Office	6.49%	6.76%	0.27%
Retail	6.60%	6.79%	0.19%
Multi-Family	6.05%	6.07%	0.02%
Industrial	6.89%	7.37%	0.48%
Average	6.51%	6.75%	0.24%

Source: Real Capital Analytics

How do cap rate changes translate into real estate value trends? If one assumes a typical building in the NCREIF Property Index achieved a 1.8% increase in NOI (the actual market average over this period), a 0.24% increase in cap rate equates to a 1.80% loss in property value.

Value Impact of Change in Cap Rate			
	2Q07	Feb. 2008	Change
Cap Rate	6.51%	6.75%	0.24%
NOI*	\$1,000	\$1,018	1.80%
Value	\$15,361	\$15,081	-1.80%

* Assumes 1.80% NOI Growth to match NCREIF Property Index for period.

Source: ARA Research

Historical Returns

Comparing the current market to historical precedent, we feel that real estate total returns over the next few years are likely to perform somewhere between that which occurred during the relatively mild downturn in the 2000's and the more significant downturn which occurred in the 1990's.

Historical NCREIF Performance in Downturns		
	1990's	2000's
Length of Downturn	24 Quarters (1Q90 to 4Q95)	7 Quarters (3Q01 to 1Q03)
Cumulative Total Return During Downturn	7.2%	11.2%
Cumulative Pricing Adjustment	-32.3%	-3.5%
Change in Income Return	from 6.3% to 8.8%	from 8.3% to 7.8%
Total Annual Return For 5 Years Following the Market Bottom	12.7%	15.0%
Worst 8 Quarter Cumulative Total Return	-9.2%	13.5%
Worst 8 Quarter Cumulative Pricing Adjustment	-21.8% (3Q91 to 2Q93)	-3.4% (3Q01 to 2Q03)
Worst 8 Quarter S&P 500 Total Return	11.5% (1Q93 to 4Q94)	-41.6% (4Q00 to 3Q02)

Source: NCREIF, ARA Research

Income Returns – Of note, during the 1990's and 2000's downturns, real estate income returns remained positive at between 6.3% and 8.8% annual levels. In both downturns, this income more than offset the adjustments in pricing which occurred over the duration of the downturn period. As a means of comparison, current income returns are 5.5%.

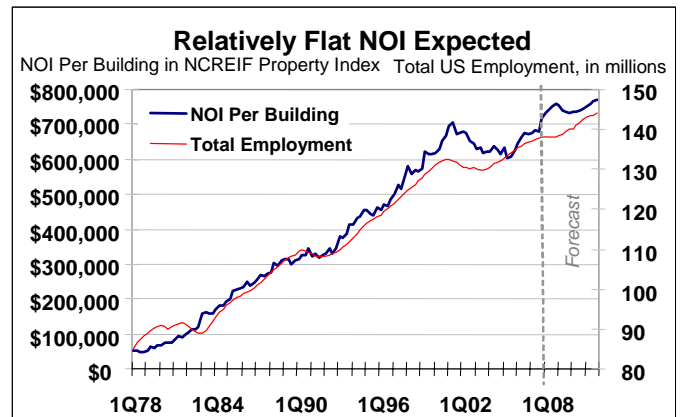
Pricing Adjustments – There was a 32% cumulative decline in market value during the six-year, 1990's downturn, compared to only a 3.5% decline during the seven quarter 2000's downturn. The 1990's downturn was particularly extreme due to changes in tax laws that eliminated passive tax losses. Because of this one-time change, real estate investors shifted to making investment decisions based on sound operating decisions as they do today, rather than tax losses. While changes are occurring in today's financing market, we feel the impact will be less significant than the tax changes which occurred previously.

Total Returns – During the worst 8 quarters of both downturns, total returns ranged from a 9.2% cumulative loss to a 13.5% gain. This relatively low level of loss

suggests that real estate has less risk than other alternative investments.

Forecasted Returns

Since real estate returns are driven by both income and appreciation, it is important to understand that, during price declines, real estate's income return is likely to rise as a percentage of the building's value. This is because NOI often remains stable during economic slowdowns due to the long-term nature of leases, and because NOI has historically shown a strong relationship to total employment trends. For example, during the 1990's downturn which experienced stable employment, NOI was relatively stable. In contrast, during the 2000's downturn, NOI declined by approximately 8% as employment in tech-related industries declined sharply.



Source: Economy.com, NCREIF, ARA Research

Due to long-term leases for some property types, American is forecasting NCREIF income returns to increase from a 5.5% annual rate to an average of 6.0% to 6.5% over the next two years.

Projected NCREIF Cumulative Returns	
March 2008 to March 2010	Total Return Swap Closed Levels
Income Return	12.00%
Appreciation	-15.3%
Total Return	-3.3%

Source: ARA Research, Markit Group Limited as of 4/15/2008

While income returns are expected to be positive over the next two years, the appreciation component of real estate returns may be negative. In fact, the NCREIF Index derivative, which forecasts total returns, is currently forecasting a 3.3% cumulative, two-year

decline. To achieve this 3.3% total return decline, values would need to decline by 15%, assuming a 12% two-year, cumulative income return.

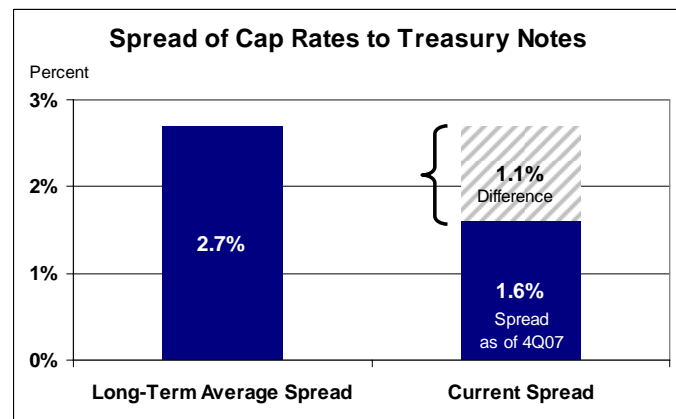
On a broader basis, the consensus forecast is for a 10% to 20% cumulative decline in real estate prices by 4Q2009. Assuming a 12% to 13% income return, this would place cumulative total returns for 2008 and 2009 in the +3% to -8% range. This is not bad considering the S&P 500 total return was -12.5% over the past two quarters.

Alternative Investment Returns

In reviewing the long-term spread of cap rates to alternative investments – such as the 10-year Treasury – we have found that real estate’s risk premium is now about 1.1% below the long-term average. If real estate cap rates were to return to the historical risk premium, as is expected in the futures market, a 15% decline in property values would be needed under the assumption of stable interest rates and NOI levels.

Returns on Publicly Held Real Estate

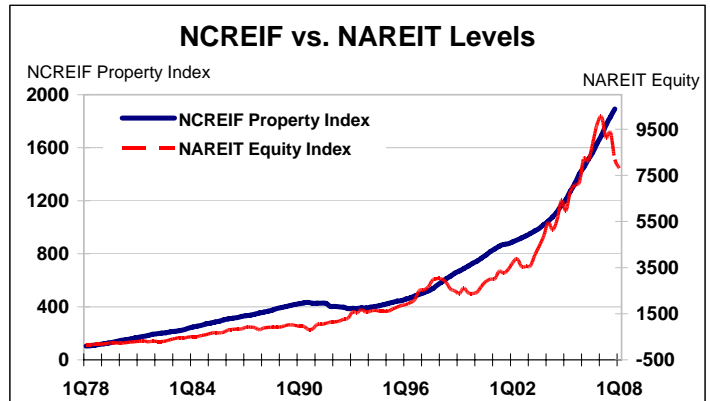
Another way to estimate the future direction of returns for privately held real estate is to look at REITs, as they hold similar real estate assets. As publicly traded securities, REIT pricing usually reflects market valuations more quickly than actual, private real estate transactions, as tracked by NCREIF. In fact, since 1978, returns for both privately held and publicly held real estate have followed a similar trend.



Source: NCREIF, Economy.com, ARA Research

However, since the beginning of 2007, while NCREIF returns continued an upward trend, REIT total returns fell by 22%. Since these indices track similar paths, it is

reasonable to assume that NCREIF returns should trend lower as well. Nevertheless, private real estate returns will most likely show less downward pricing pressure compared to REITs, because REIT pricing in early 2007 included a premium related to converting REITs back to private ownership.



Source: NCREIF, ARA Research

Conclusion

Value Trends – The slowing US economy has begun to impact institutional real estate markets with lower sales volumes and leasing activity. This is likely to slow returns, with the futures market currently pricing a 3.3% cumulative decline in total returns for the NCREIF Property Index by year-end 2009. The corresponding decline in property values over the next two years would be around 15%, with general market consensus being that property prices are likely to decline by 10% to 20% over the next two years.

Why Invest In Real Estate? – With real estate values expected to decline, why should an investor stay in real estate? The first reason is that the income return from real estate should offset about 80% of the forecasted value decline. The second reason is strategy, as it is very hard to time the markets. While values are likely to decline in the near-term, periods that follow market bottoms tend to be very good for investors. For example, the NCREIF Property Index recorded a 12.7% total annualized return in the five years following the 1990’s recession and recorded a 15.0% total annualized return in the five years following the 2000’s downturn.

Key Indicators			
Interest Rates	4/7/2007	3/7/2008	4/7/2008
10-Year Treasury Yield	4.7%	3.5%	3.6%
CMBS AAA Yield	5.0%	8.3%	6.9%
CMBS BBB Yield	6.0%	21.5%	21.8%
Cap Rates	1Q2007	4Q2007	Feb. 2008
Office	6.7%	6.5%	6.7%
Industrial	7.0%	7.1%	7.4%
Multi-Family	6.1%	6.1%	6.1%
Retail	6.7%	6.7%	6.8%
12 Mo Private Real Estate Returns	4Q2006	3Q2007	4Q2007
NCREIF - All Properties	16.6%	17.3%	15.9%
Office	19.2%	22.8%	20.5%
Industrial	17.0%	16.6%	15.0%
Multi-Family	14.6%	13.3%	11.4%
Retail	13.4%	13.0%	13.5%
Vacancy	1Q2007	4Q2007	1Q2008
Office	12.7%	12.6%	12.9%
Warehouse	9.7%	9.9%	10.2%
Apartment	4.6%	4.6%	NA
Retail	9.9%	11.0%	11.5%
Employment	Mar. 2007	Feb. 2008	Mar. 2008
Unemployment	4.4%	4.8%	5.1%
Total Employment Monthly %	1.5%	-0.7%	-0.7%
Total Employment Yr/Yr	1.2%	0.6%	0.4%

Walter Page
 Managing Director, Research and Strategy

Stanley Iezman
 President & CEO

For more information regarding
 American Realty Advisors, please contact:

Jay Butterfield, CFA
 Managing Director, Fund/Separate Accounts
 801 North Brand Boulevard, Suite 800
 Glendale, CA 91203
 Phone: (818) 545-1152 ▪ Fax: (818) 545-8460
butterfield@americanreal.com ▪ www.americanreal.com

GLENDALE ▪ ATLANTA ▪ CHICAGO ▪ SANTA FE ▪ CINCINNATI ▪ ORLANDO

This newsletter is for your information only and is neither an offer to sell nor a solicitation of an offer to buy any securities or financial instruments. The information in this newsletter has been obtained or derived from sources believed by American Realty Advisors ("American") to be reliable but American does not represent that this information is accurate or complete. Any opinions or estimates contained in this newsletter represent the judgment of American at the time this newsletter was prepared and are subject to change without notice. Models used in any analysis may be proprietary, making the results difficult for any third party to reproduce.

Forward-Looking Statements

This newsletter may contain forward-looking statements within the meaning of the federal securities laws. Forward-looking statements are statements that do not represent historical facts and are based on our beliefs, assumptions made by us, and information currently available to us. Forward-looking statements in this newsletter are based on our expectations as of the date of this newsletter. Actual results may differ materially due to a variety of uncertainties and risk factors. We assume no obligation to update any such forward-looking statements.

This newsletter should be considered confidential and may not be reproduced in whole or in part, and may not be circulated or redelivered to any person without the prior written consent of American. Past performance is not a guide to or otherwise indicative of future results. As with all investments there are associated inherent risks.

