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## Changing Priorities

February 2009

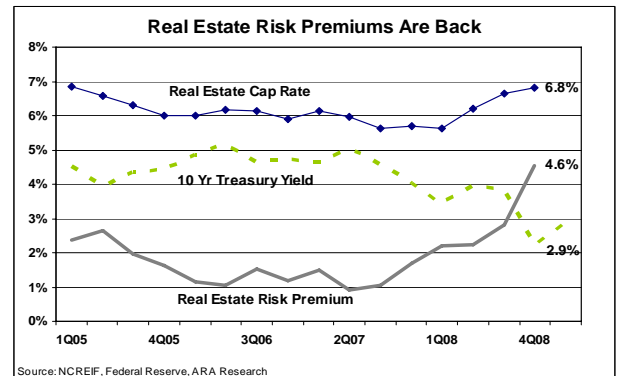
In this newsletter, we will identify how the current recession is changing the priorities of the economy and the real estate markets. Additionally, we will discuss strategies for dealing with these changes, and provide some information regarding where real estate investments stand in this ever-changing environment.

### New Priorities

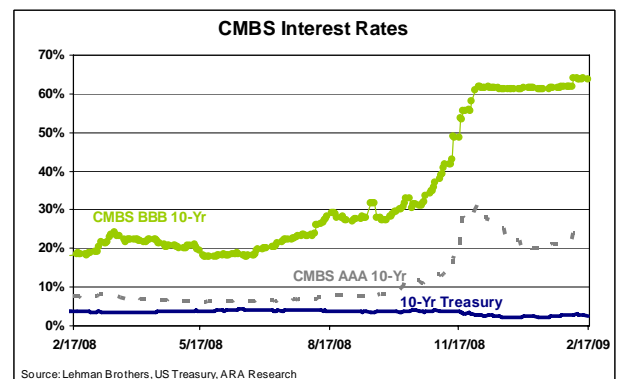
The economy and political environments are shifting priorities to require higher investment risk premiums, as well as allowing for more government involvement in the economy. In addition, longer-term demographic trends currently favor certain risks over others.

#### ◆ Increased Risk-Return Premium

As we move through the current recession, investors now are placing more emphasis on security and clearly want to be compensated for taking any risk. In real estate, this risk premium has manifested itself through a 1% rise in cap rates for core properties. When combined with the falling yields on so-called “risk free” Treasuries, this has resulted in a 3.5% increase in real estate’s relative risk premium.



A strategy of investing in senior debt, AAA CMBS or mezzanine loans could offer some of the best returns in years, although we urge caution since it is almost impossible to pinpoint the bottom in real estate prices. However, with enough cushion equity built into underwriting assumptions, careful investors should be rewarded handsomely for taking these moderate risks at this point in the economic cycle.



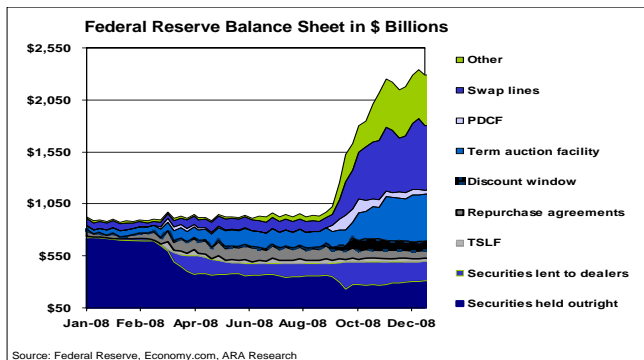
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◆ **Increased Government Involvement in the Economy**

With the new administration and changes in Congress from the past election, we are now witnessing one of the largest increases in government involvement in the economy since the 1930s. The Federal Reserve balance sheet has doubled since this past fall, as the Fed has truly become the “lender of last resort” to the financial services industry, and, the federal government has created new programs both to stimulate the economy and to dampen the pace of housing foreclosures.



Investors will be cautious of these new programs, as many of them will be short-lived and the effect of others will not be immediate. Programs related to infrastructure and slowing housing foreclosure rates are likely to be short lived whereas those related to health care could last beyond the next few years. As such, American is considering, among other opportunities, health care related investments, such as medical offices, where we anticipate solid demand resulting from increased government spending in the sector.

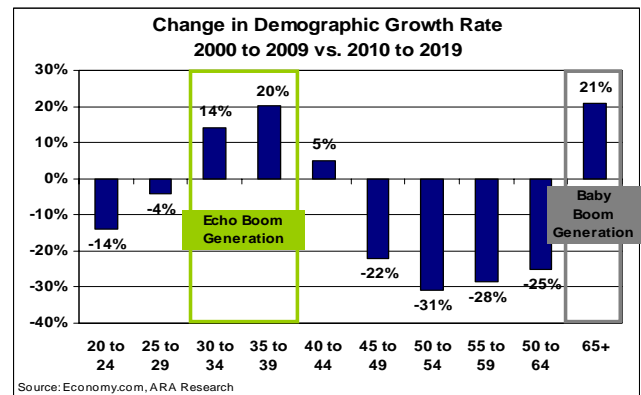
◆ **Demographics Based Changes**

As the Baby Boom Generation ages, this is likely to result in two related trends. First, baby boomers in retirement (those who can still retire!) will increase demand for recreational, leisure and health care services. Over the next decade, growth in the over-65 age group should be 21% faster than currently, with a remarkable 35% (14 million people) increase by 2019.

This increase in senior citizens should spur the need for more health care related real estate services, especially in non-traditional settings such as retail strip centers or as part of active adult developments.

While smaller than the Baby Boom Generation, the Echo

Boom Generation (children of the Baby Boomers) will reach the 30 to 39 age group in the next decade, which should fuel the demand in areas needed by newly established households -- rental multi-family housing and first time home purchasers. The Baby Boomers are likely to downsize their housing needs, so we expect new home construction sizes to fall, presenting an opportunity for investors to focus on smaller and more affordable housing in locations near employment centers.

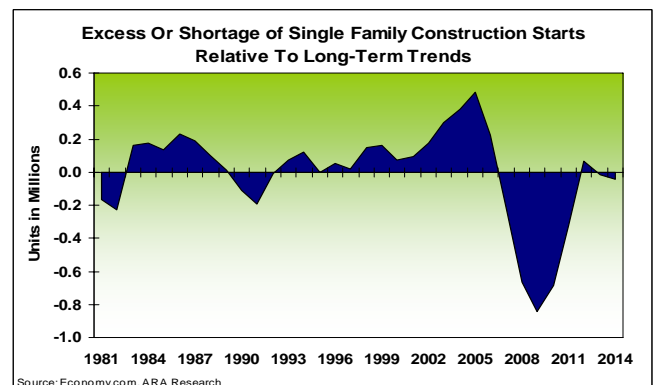


**Excesses Being Removed From the Market**

The sharp shift away from housing demand and the overall deleveraging brought on by last year’s turmoil and the current recession will have marked effects through 2009 and beyond:

◆ **Excess Housing Construction**

From 1996 to 2006, home building in the U.S. exceeded long-term demand by one to two million new homes. Due to this excess construction, it is likely to take several years (until 2011) of below-average construction activity for housing inventories to return to more normal levels. When construction does return, we believe new demand is likely to be more concentrated to closer-in urban locations as rising energy costs are likely to push workers to live closer to employment centers.



Location is likely to continue to be the most important predictor of investment success in the near term. Investors in housing driven sectors, such as retail, would be wise to choose infill locations, as these should be the first to recover due to their lower construction risk and established demand.

◆ **Excess Leverage**

A general deleveraging of the economy is now well underway putting deflationary pressures on asset values across the board. While debt continues to exist at all levels of the economy, household sector debt levels that regulate the consumer’s ability to purchase goods and services is critical. We have seen a 2% decline in household debt as a percentage of GDP in the latest downturn and are anticipating that it is likely to take until 2011 for debt levels to stabilize at less than 90% of GDP and return to 2004 levels.

In a deleveraging economy, cash is king. For real estate investors, this means that those who have low leverage levels, like American, should be in a stronger position to hold on to assets and avoid forced sales. Furthermore, for those with available cash for new investments, they should be able to achieve better pricing than those dependent upon loans to finance transactions.

returns to the markets, we would expect that occupancy (and eventually rent levels) will rise significantly.

Changes in Market Fundamentals					
		Office	Industrial	Multi-Family	Retail
<b>Demand (MSF)</b>	2007	56	112	138	61
	2008	18	-42	-109	-114
	2009	-118	-138	-69	-134
	2009 Change	-3.3%	-1.8%	0.5%	-2.0%
<b>Supply (MSF)</b>	2007	64	126	144	138
	2008	76	123	163	144
	2009	63	41	71	78
	2009 Change	1.8%	0.7%	0.6%	1.2%
<b>Rent Change</b>	2007	9.8%	3.6%	3.4%	1.7%
	2008	3.7%	0.2%	2.0%	-3.5%
	2009	-7.0%	-3.0%	-2.5%	-7.8%

Source: TWR, PPR, Economy.com, NCREIF, ARA Research

◆ **Office Subleasing**

In contrast to the last recession, the level of office sublease has been low this time around, with a 1.3% sublease vacancy rate as of 4Q08. This rate is less than half of the level experienced at the same point in the last recession, which should result in less downward pressure on office rents, as landlords face property valuation issues that are not part of a tenant’s subleasing decision set.

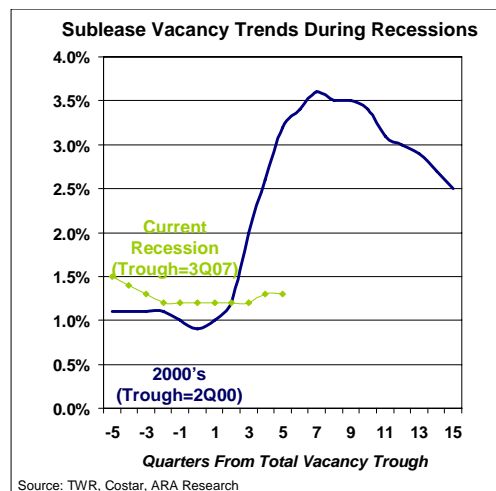
As a side note, so far in this recession, net office absorption has remained slightly positive at 18 million SF in 2008 (only the fourth quarter was negative). This net absorption level is significantly stronger than in 2001, when net absorption was a negative 84 million SF. While we are expecting 118 million SF of negative net absorption in 2009, we are holding out for the market to positively continue surprisingly this year.



**So Where Are We Now?**

◆ **New Construction**

We are pleased to see that the level of new construction for most property types is down by over 50% so far in 2009. It appears that constraints in the financial markets are limiting the ability of new real estate supply to come on-line. As job growth turns positive and net absorption



◆ Real Estate vs. Stock Earnings

The stabilizing impact of long-term leases on real estate net operating income (“NOI”) is becoming evident, as same store NOI reported by NCREIF is down only 1% from the market peak, compared to a 39% decline in operating earnings for the firms in the S&P 500. While we expect real estate NOI to decline by at least 5% in this recession, historically real estate has never had greater than an 11% decline in NOI. From an investment return standpoint (NOI accounts for 80% of the long-run return), we should see again that real estate income returns are clearly less volatile than stocks.

Peak to 4Q08 Change in Income	
S&P 500 Operating Income	-39%
Real Estate Net Operating Income	-1%

Source: S&P, NCREIF

**Conclusion**

A recession is a cruel event and this one may turn out to be worse than previous downturns. In many respects, recessions represent a large shift in priorities that can offer investors who clearly understand the inherent risk some unique opportunities for substantial returns. At American, our efforts have been focused on:

- 1) **Lowering Risks** by preserving capital. We emphasize maintaining high property occupancy levels and have one of the real estate industry’s lowest leverage ratios.
- 2) **Actively Seeking Opportunities** by taking advantage of the changing risk/return environment, the drive toward greater government involvement in the economy and the longer-term demographic trends that are going to take place regardless of the economic cycle.

So far in this economic cycle, real estate has performed as expected, with the impact of long-term leases holding income nearly level. Fully cognizant that the recession is not over and that real estate performance is likely to lag that of other investments, we are confident that the eventual stabilization of the financial sector and the return of more normal investment activity will spread throughout the economy and to the real estate market as well.

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