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CORE AND VALUE-ADDED REAL ESTATE INVESTING: KEY FACTORS IN EVALUATING THE RECOVERY

FIRST QUARTER 2011 NEWSLETTER

SIGNS OF CONTINUED RECOVERY IN TODAY'S REAL ESTATE MARKET

With the apparent upturn in the economic cycle, 2011 is showing signs of being an ideal time to invest in both core and value-added real estate, due in part to both an improving risk profile and significant value upside potential. In this newsletter, we will discuss the factors most strongly affecting opportunities currently available to real estate investors including:

- ❖ Demand Growth
- ❖ Limited Supply
- ❖ Occupancy Gains
- ❖ Net Operating Income Gains
- ❖ Rent Upside
- ❖ Relative Pricing

Evaluating each of these carefully should yield key insights into the best strategies for both core and value-added real estate in an overall real estate portfolio.

DEMAND GROWTH

In 2010, all property types experienced positive net absorption — a sharp contrast to the declines experienced in 2009. The fuel for this demand growth has been, in part, an expansion of employment by 900,000 jobs for 2010. Multi-family tends to be an early recovery property type and, not surprisingly, it

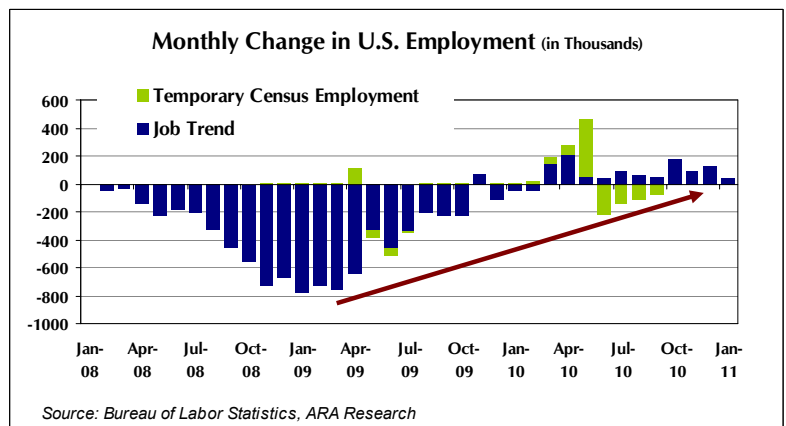
experienced strong demand growth totaling 1.3% during the year, while industrial demand growth was minimal at only 0.1%. American's current forecast calls for a 1.5% to 2.5% gain in total employment in 2011, as historically the second full year of a recovery achieves



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at least 1.5% job growth, with similar growth in 2012 and 2013 expected. Corresponding to employment gains, we expect overall real estate demand to improve, with a reduction in the gap between the top-performing multi-family sector and the trailing industrial sector. Industrial markets hardest hit by the recent recession, such as California’s Inland Empire and Phoenix, Arizona, respectively, experienced a solid 0.47% and 0.95% gain in demand during the 4Q10. This is the first significant gain in demand that both of these markets have seen in several years.

| Real Estate Demand Fundamentals | | | | | |
|--|---------------|-------------------|---------------|---------------------|-------|
| | 2008 | 2009 | 2010 | 2011 | |
| Job Trends | -2.6% | -3.5% | 0.7% | 1.5% to 2.5% | |
| | Office | Industrial | Retail | Multi-Family | |
| 2010 Market Size SF (in millions) | 3,573.4 | 12,572.3 | 9,607.8 | 13,144.7 | |
| Net Absorption SF (in millions) | 2008 | 19.5 | -68.2 | 105.3 | -11.5 |
| | 2009 | -39.7 | -253.6 | -5.8 | -58.6 |
| | 2010 | 17.1 | 12.9 | 51.6 | 154.2 |
| 2010 Demand Change % | 0.6% | 0.1% | 0.6% | 1.3% | |

Source: CBRE Econometric Advisors, AxioMetrics, PPR, CoStar, Economy.com, ARA Research

LIMITED SUPPLY

Construction of new real estate continued to fall during 2010 and is likely to reach a recessionary low in 2011. During 2010, office completions were down 73% from 2008, industrial was down 90%, retail down 82% and multi-family completions were down 63%. As most of the demand gains will be absorbed through an increase in occupancy of existing space, growth in new supply will continue to be low and is expected to remain well below historical averages for several years.

| Real Estate Supply Fundamentals | | | | | |
|-------------------------------------|----------------------|--------------|-------------|--------------|--------------|
| | Office | Industrial | Retail | Multi-Family | |
| Completions SF (in millions) | 2008 | 79.1 | 188.5 | 181.9 | 145.7 |
| | 2009 | 51.9 | 75.5 | 93.1 | 119.8 |
| | 2010 | 21.2 | 17.5 | 32.9 | 53.9 |
| | 2011 Forecast | 10.0 to 20.0 | 5.0 to 20.0 | 20.0 to 30.0 | 25.0 to 50.0 |
| 2010 Change in Supply % | 0.6% | 0.1% | 0.3% | 0.4% | |

Source: CBRE Econometric Advisors, PPR, CoStar, ARA Research

With rents below construction justification levels in most markets, most speculative new construction will likely be limited to multi-family in Washington D.C., New York, and coastal California, as only these markets can achieve at least a 6.5% to 7.5% unleveraged return

on investment cost. As a result, now is one of the few times in the market cycle that real estate investors can remove near-term supply risk from the typical list of concerns.

OCCUPANCY GAINS

The trend in vacancy rates is important in predicting the direction and magnitude of future real estate returns. For core real estate, returns are typically 3% to 4% higher when vacancy rates are falling than when they are rising, as there is strong relationship between occupancy trends and net operating income (NOI). We have found that, for every 1% improvement in real estate occupancy rates, within two years real estate NOI typically grows by 2% to 3%, as increases in occupancy not only reduce the percentage of space not earning rent, but also are associated with gains in rental rates. For value investors, a positive trend in market occupancy reduces investment risks for lease-up strategies and should allow value investors to buy occupancy-challenged value-add properties with the intention to sell, upon lease-up and stabilization, into the core market demand.

NET OPERATING INCOME GAINS

| Real Estate Occupancy Fundamentals | | | | | |
|------------------------------------|----------------------|----------------|----------------|----------------|----------------|
| | Office | Industrial | Retail | Multi-Family | |
| Occupancy | 2008 | 86.0% | 88.2% | 93.4% | 92.1% |
| | 2009 | 83.7% | 85.7% | 92.5% | 91.7% |
| | 2010 | 83.6% | 85.7% | 92.7% | 93.1% |
| | 2011 Forecast | 84.0% to 85.0% | 86.0% to 87.0% | 93.0% to 94.0% | 93.5% to 94.5% |

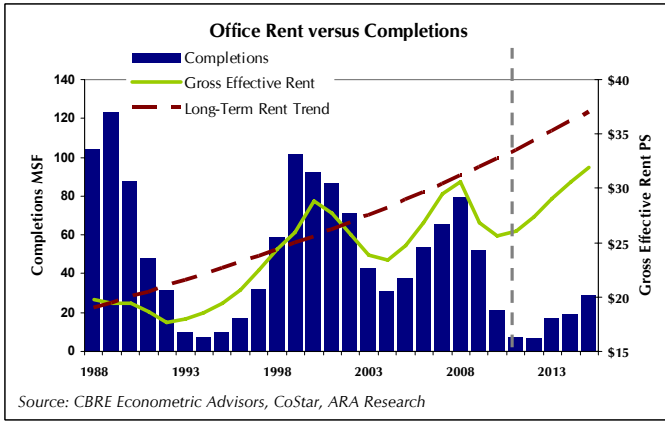
Source: CBRE Econometric Advisors, AxioMetrics, CoStar, ARA Research

With long-term leases, real estate NOI in a predominantly diversified portfolio would likely trail a recovery in the broader economy by about 18 to 24 months. This means that while total employment gains were recorded in 2010, real estate portfolios are unlikely to experience increasing NOI before the second half of 2011 or even 2012. Based on prior economic recoveries, NOI growth should then generally trend upward with a cumulative 15% increase in NOI expected by 2015. Given stable market capitalization rates, this would equate to a 15% gain in property values on top of the normal income return. The gains



in NOI are likely to first favor the multi-family sector due to short lease terms, with a catch-up period for the other property types following.

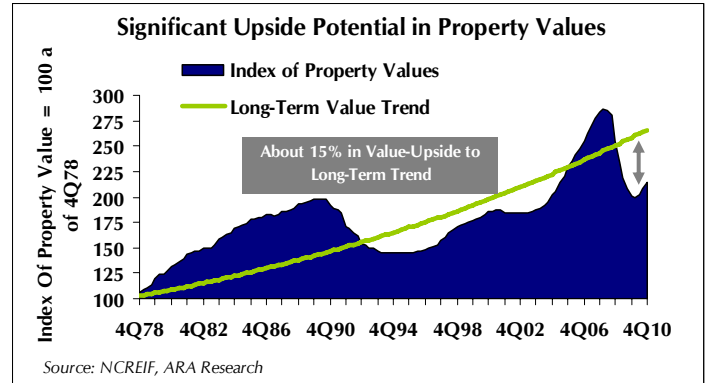
RENT UPSIDE



Construction costs tend to rise with inflation over time and real estate rental rates in the long-run tend to follow suit. Within the office sector, the long-term trend in effective rent growth is 2.25% (shown by the dashed red line in the adjacent chart.) Over time, office rents tend to revert to this trend encouraging new construction. This means investments timed to periods such as today are likely to achieve above inflation rent growth with office currently showing 13% to 20% rent upside to long-term trends. Similarly, our analysis shows that retail has 13% to 20% of rent upside, while multi-family has the lowest amount of rent upside to the long-term trend at 5% to 10%.

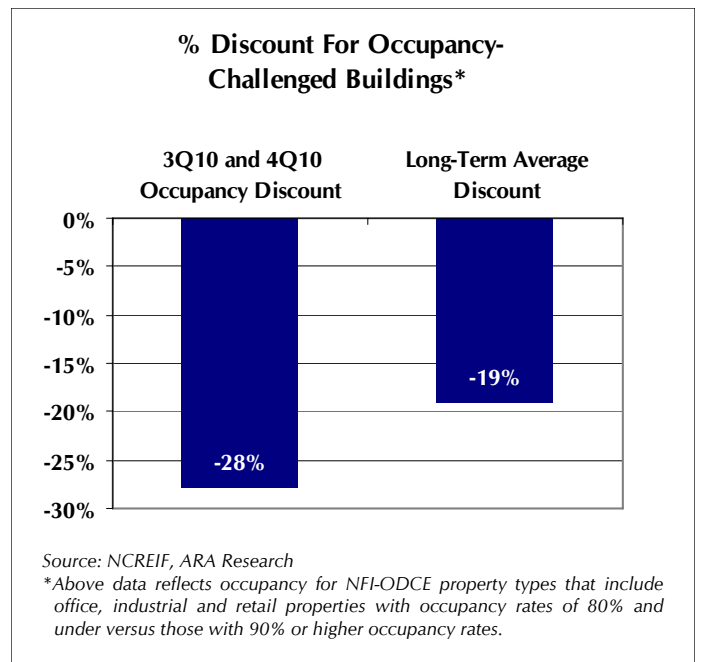
RELATIVE PRICING

Accounting for rent, occupancy and NOI growth potential, property values in the NCREIF Property Index (NPI) are roughly 15% below long-term trends. Given the economy is now in recovery mode, this favorable valuation provides investors with less downside risk and above-average upside potential. Value-added investment prices are currently less aggressive than core and the upside there is correspondingly greater.



STRATEGIES FOR VALUE INVESTORS

At this stage of the market cycle, the increase in market occupancy rates should allow value investors to realize gains by purchasing occupancy-challenged properties in stable markets and selling these properties upon lease up into the core space demand. It is significantly easier to lease up an occupancy-challenged property now when demand is generally increasing than when it is contracting or when the market faces meaningful new construction. Based on recent NCREIF data, such occupancy-challenged properties may now be priced at a 28% discount to highly-occupied core properties; a significantly greater discount than the typical 19% discount to core observed in more normal market conditions.



CONCLUSION

If a recovery in the economy is now firmly in-place, with several years of improving real estate occupancy expected, investment returns from real estate are likely to be above average. Specifically, during periods of rising occupancy rates, core investments have averaged 3% to 4% higher returns than in periods of falling occupancy. Likewise for value investors, the 28% average discount between value and core properties offers investors significant value upside if they can buy in the value market and eventually sell in the stabilized core real estate market. Based on the history of past economic cycles, the window of opportunity for making a real estate investment in today's market is quite favorable.

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