

Stanley Iezman
President & CEO

Walter Page
Managing Director,
Research & Strategy

Deploying Capital in a Banged-Up Market

January 2010 Newsletter

As we see signs that the recession may be ending, selectively deploying capital into this market and repositioning existing portfolios is likely to be the key to outperformance in the years ahead.

In this newsletter, we will discuss the following:

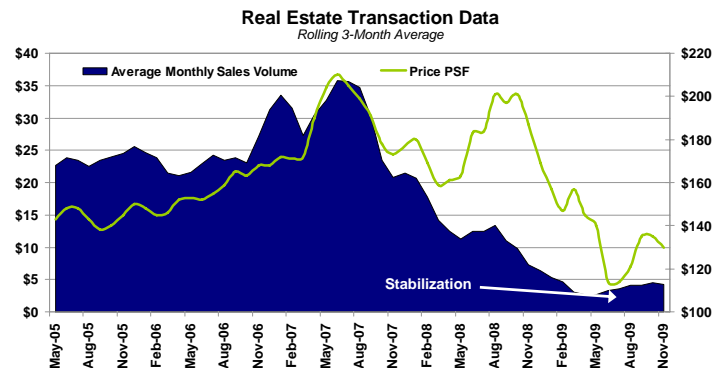
- Why the outlook for investing in commercial real estate is better now than it has been in years
- Which property types appear to be fairly priced and which are not
- What are today's successful core and value-add strategies

Why Invest Now?

Many have said “never waste a good crisis”, and, for real estate, we certainly have one today. Appraised values for fund indices are 19% under their long-term averages, the greatest discount ever recorded by NCREIF and, according to the MIT Center for Real Estate, distressed real estate assets are selling for over a 20% discount vs. non-distressed assets. While real estate has yet to stage a recovery in pricing, many brokers are reporting that the best buildings in top-tier locations have already begun to experience stabilization in pricing.

Furthermore, analysis of transaction data from Real Capital Analytics reveals that, since the summer of 2009, real estate transaction volume and pricing levels have generally reached a bottom. For investors, this means that the pricing basis of today's real estate market is very favorable.

Transaction Data Indicates a Stabilization



Source: Real Capital Analytics, ARA Research

Data represents rolling three-month average of closed real estate deals of office, multi-family, retail and industrial properties, which are commonly referred to as institutional quality and valued over \$10 million each.



AMERICAN
REALTY ADVISORS

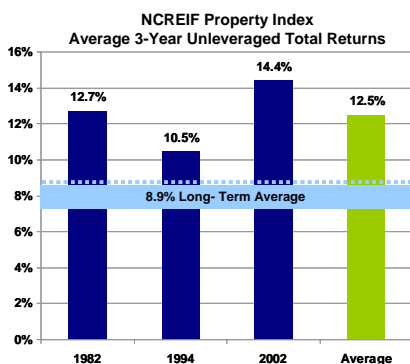
Corporate Headquarters
801 North Brand Blvd.
Suite 800
Glendale, CA 91203
818.545.1152
818.545.8460 fax

www.americanreal.com

In fact, looking back at past periods of market stress, we have found that real estate generally achieves above average returns as a recovery in job growth begins. In particular, our analysis of returns during such periods shows that they have averaged 12.5% per year over the next three years, or 3.6% above the long-term average. Although there may not be, as one investment guru put it, “blood in the streets”, there is certainly enough uncertainty to provide ample attractive investment opportunities for the savvy investor.

Investing in Downturns Results in Higher Returns

- ❖ In previous periods of weak economic performance such as 1982, 1994 and 2002, total returns invested in private real estate averaged 12.5% over the next three years.
- ❖ This is 3.6% higher than the long-term average for real estate.



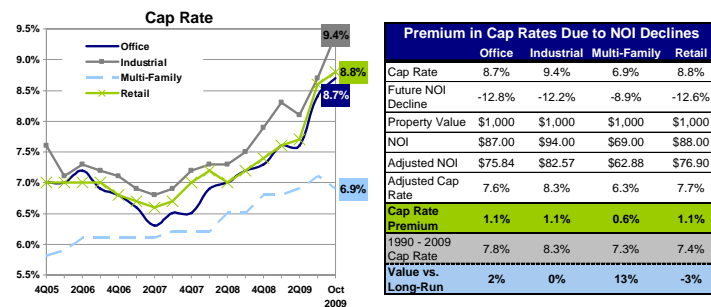
Source: NCREIF, ARA Research

What Property Types?

Potentially curtailing future multi-family returns, the presence of government supported debt means that the multi-family sector is valued at a 10% to 13% premium vs. the other major property types. Supporting this view, the difference in cap rates among property types is about as wide now as has ever been recorded. In fact, the 3Q09 multi-family cap rate of 6.9% is substantially below the 8.7% to 9.4% cap rate range reported by Real Capital Analytics for other major property types. While one can debate the reasons for cap rate divergence, the more important issue is that this 180 to 250 basis point spread is significantly above the normal 10 to 100 basis point spread. Even factoring in the fact that future declines in Net Operating Income (NOI) for multi-family should be lower than for other property types, due to the shorter lease term, we are finding that the current sales cap rates for multi-family assets are 1.0% below the long-term average, while for the other

property types, the current cap rate (after adjusting for NOI decline) is very close to the 1990 to 2009 average.

Multi-Family Cap Rates Show the Support of Gov't Financing



Source: Real Capital Analytics, ARA Research

For core investors, this wide spread in cap rates poses a substantial risk, especially if the difference in market financing between the property types narrows, and the 10% to 13% valuation premium for multi-family is eliminated. Under such conditions, our recommendation is to focus new investment activity on assets other than multi-family, at least until the pricing spread returns to more normal levels. For value-added investors, this pricing difference should be considered as a factor that is likely to lower the eventual sales price, and most likely means that other property types are going to provide a higher rate of return when all factors are considered.

Today's Successful Core Strategies - Focus on Occupancy and Price Paid

At American, we have focused our core and low-risk value-added investment activity on multi-tenant assets that are likely to achieve above average long-run occupancy rates, as our research shows that occupancy is the primary driver of total returns. In particular, historically, there has been a 70% correlation between the current market occupancy trend and the forward two-year trend in property NOI, a key factor in establishing value. For our investors, we target the submarkets with the highest long-term occupancy in the top 10 to 15 metro areas nationwide. While implementation may vary slightly by property type, our ultimate investment criteria are geared toward achieving



high occupancy rates and the resulting increase in market rents and thus, values.

In addition to a focus on occupancy, American is well aware that the price paid for an investment can have a significant impact upon the eventual total return earned by an investor. Hence, we focus on investments that provide the potential for upside in rental rates and market pricing relative to long-term trends, and seek to achieve a balance in expectations for growth in rents vs. the price paid. While some CBD office markets are clearly very attractive, especially if they are anticipated to have high relative occupancy rates, careful bottom-up research on each investment is needed to ensure that one does not overpay.

recent lender sales transactions shows that, on average, such investors can successfully find distressed properties at an average 40% discount to the lender’s par value. Similarly, investors could purchase the debt investment itself (at a discount) with the assumption that they will eventually acquire the asset via foreclosure. While both of these strategies can be highly profitable, we caution investors, especially lower risk core investors who may be “reaching for returns”, to be very careful, as most investments will require significant additional capital funding for tenant improvements, leasing commissions and other capital costs to bring the asset into good operating condition, as most distressed assets have significant deferred maintenance.

Long-Term Strategy for Property Markets



- ❖ High Occupancy Submarkets
- ❖ Class A Properties
- ❖ Middle Market Focus
- ❖ Transit Oriented Locations
- ❖ Small Tenant Properties
- ❖ Supply Constrained Locations
- ❖ Near Employment Centers
- ❖ Top Needs Based Retailers

Value-Added Investment Building Recapitalization Strategies

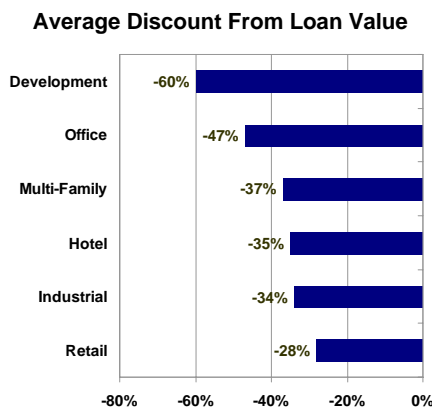
Some properties, offering value-added level return potential, are in need of capital to deleverage their position, to cover leasing costs and to complete value-added strategies left unfinished by the sudden lack of available financing. An excellent example of this was American’s recent acquisition of a suburban Denver office building



Value-Added Investing – Buy Discounted Properties or Loans From Lenders?

Due to the significant decline in real estate values over the past two years, many of the assets purchased during the 2005 to 2007 vintage years are currently “underwater”. That is, the existing loan balance is greater than the market value of the property. For value-added investors with capital, this presents an excellent opportunity to purchase properties at a substantial discount. Analysis of

for its open-end value-added fund. In this case, the building owner was out of capital to fund leasing costs, and the real estate community in Denver, aware of the situation, refused to show the building to potential tenants. Also, while the building’s largest tenant wanted to renew its lease, it refused to do so with the former owner since there was no capital to fund tenant improvements and leasing commissions. Additionally, the tenant did not want to make a lease commitment to an occupancy challenged building (popularly known as a “zombie” building) that would have a difficult time leasing space. Supporting this view, a recent broker newsletter highlighted the significant competitive disadvantages of buildings whose owners have little or no equity and thus have limited resources to fund tenant improvement costs and capital expenses.



Source: Real Capital Analytics, ARA Research

Risks

Investing in real estate carries with it specific risks and it is due to the current uncertainty by many investors in today's volatile market that we believe there are opportunities for attractive future returns from asset transactions becoming available now. However, one must be clearly aware of the challenges presented by today's unique market dynamics. As the economy is still very weak, we are expecting that it may take several years before we reach a new high in demand. The risk this poses for investors is that a slow recovery would

have a ripple effect of lowering rent growth, and ultimately property values and returns, below expected levels. Real estate, of course, carries other risks, such as the recent fiscal and monetary policies that stimulate the growth of asset bubbles and the tax policies that lead to artificial pricing models, as well as shifts in capital market pricing and asset specific risks. However, we believe the very real risk of a slower than expected recovery will be foremost in impacting investor results in that it cuts across all investment styles and, as such, is virtually impossible to diversify away.

Conclusion

While real estate has just experienced one of its worst pricing adjustments ever recorded, eventually the recovery in the broader economy will spread to commercial real estate resulting in rising prices and improved returns. Historically, some of the best investment opportunities in both core and value-added real estate have occurred at the tail end of recessions, when the market conditions looked the bleakest. The phrase "buy low and sell high" is never as easy to implement when markets look grim – but is quite apropos. In today's environment, we recommend following a strategy of investing in market segments that traditionally have high occupancy rates and have the potential for upside in rents relative to long-term trends. For value-investors (and, in some cases, core portfolios), we recommend discounted loan purchases, direct lender purchases and recapitalization strategies, with a goal of eventually selling into the non-distressed/core real estate market which has significantly higher property values.

For more information regarding
American Realty AdvisorsSM, please contact:

Jay Butterfield, CFA

Managing Director,

Fund/Separate Account Operations

801 North Brand Boulevard, Suite 800

Glendale, CA 91203

Phone: (818) 545-1152 ■ Fax: (818) 545-8460

butterfield@americanreal.com ■ www.americanreal.com

This newsletter is for your information only; is not intended to be relied on to make any investments decisions, 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. Past performance of any kind referenced in this newsletter in connection with any particular strategy should not be taken as an indicator of future results of such strategies. It is important to understand that investments of the type referenced in this newsletter pose the potential for loss of capital over any time period.

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.

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 current expectations as of the date of this newsletter, which could change or not materialize as expected. Actual results may differ materially due to a variety of uncertainties and risk factors. Except as required by law, we assume no obligation to update any such forward-looking statements.

