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Future Return Potential Driven by Market Selection

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While the economy is still clearly in one of the worst downturns since the Great Depression, signs of improvement are now starting to surface. Rather than looking at the real estate asset class as a whole, American seeks to identify those markets that are likely to lead or lag in the eventual recovery. We anticipate that market selection will be a key driver of investment returns over the next part of the cycle, as we expect there to be over a four-year span between when the first markets enter the recovery phase versus the last markets. In this newsletter, we identify our top four tactical market picks by property type for an early recovery and provide reasons that support our expectation of a relatively large return differential between markets in the impending recovery.

Defining the Start of a Recovery

While defining a recovery can mean different things to different investors, for our purposes we have chosen to define the start of the recovery as the point when above-inflation rent growth returns, as this point often has a significant impact upon property values. While this rent growth “tipping point” varies by market and product type, in general the level of vacancy, and sometimes the trend in vacancy, is in our experience, one of the best predictors of when a market is likely to start achieving above-inflation rent growth. Corresponding to this recovery stage, in each of the sections below, we have identified the vacancy metrics that have historically signaled when a market is entering the recovery mode.

Property Sectors

Office

American’s research shows that above-inflation rent growth typically starts when the following occurs:

- The market’s vacancy falls to the lower of 14%, or the long-term average rate of vacancy in that market, as this is the vacancy level when tenant choices typically become constrained.
- The trend in vacancy is moving downward, as vacancy expectations are key drivers of office rent trends.

For example, the following graph shows that when the office vacancy rate reaches 14% or less and is falling, rent growth averages a robust 8% per year. This compares to 3% or less rent growth for all other times in the market cycle. While this trend does not hold true for every market, our adjustment to account for differences in the long-term average vacancy has generally helped with comparisons between markets that normally have low vacancy rates versus markets with higher vacancy rates.

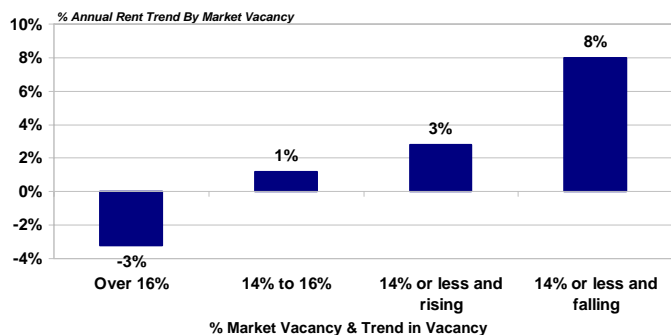


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Office: Vacancy Levels & Trends Influence Rent Trends



Source: Torto Wheaton Research, ARA Research

Office Highlights

- In looking at the office sector, we have identified that the greatest near-term opportunities are likely to be concentrated in markets that have entered this recession with low levels of new office construction and generally below average market vacancy rates.
- American’s detailed downtown and suburban office forecasts suggest that the following markets are likely to lead the next recovery: Austin Central Business District (“CBD”), Boston CBD, metro San Francisco and metro Houston. In contrast, Miami is likely to be among one of the last markets to stage a recovery due to an elevated vacancy rate following several years of heavy new construction.

OFFICE	
Early Recovery Markets	Lagging Recovery Markets
Austin CBD	Chicago Suburban
Boston CBD	Denver CBD
San Francisco Metro	Miami Metro
Houston Metro	N. New Jersey

Source: ARA Research

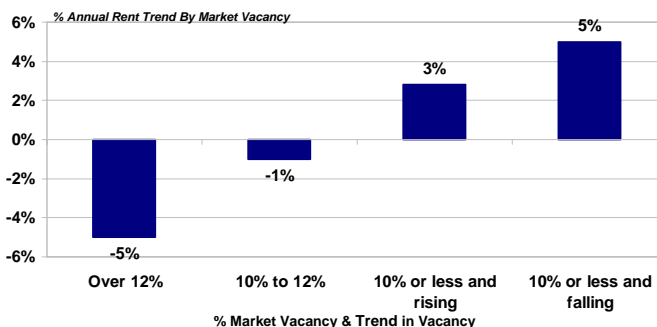
- Based on historical trends in prior recoveries, net absorption in suburban markets should be 50% higher than in downtown markets, with a 2.5% annual growth rate versus 1.7% for downtown markets. This would suggest that if all other things are equal, suburban markets should recover before CBD markets, which is similar to the last recession.
- As the office markets enter a recovery mode, the traditional high growth locations should experience a fairly sizeable occupancy gain, since new construction

has slowed in every market and most of the gains in demand will be focused on supporting occupancy and rent gains.

Industrial

Because industrial construction is highly responsive to changes in market demand, the tipping point for significant rent growth starts at 10%, or approximately 4% lower than in the office sector. Supporting this view, industrial rent growth has averaged 5% per year when the market vacancy was under 10% and falling. In contrast, at vacancy rates exceeding 12%, annual rent declines in the 5% range are typical.

Industrial: Vacancy Levels & Trends Influence Rent Trends



Source: Torto Wheaton Research, ARA Research

Industrial Highlights

- Within the industrial sector, we expect Houston, Los Angeles, Seattle and Oakland to buck the national trend with the best fundamentals for an early recovery. In Los Angeles, Seattle and Houston, the peak market vacancy should be in the 10% to 12% range, which is 3% under our forecasted 15% peak in the national vacancy rate. Oakland’s vacancy is projected to peak in the 13.5% range, which is still 1.5% below the forecasted national peak.

INDUSTRIAL	
Early Recovery Markets	Lagging Recovery Markets
Houston	Boston
Los Angeles	N. New Jersey
Seattle	Phoenix
Oakland	West Palm Beach

Source: ARA Research

- Market selection within the industrial sector is likely to become more important than for the other property types, as we are seeing that the excess capacity (measured by vacancy) that has been built up in the sector during this recession is likely to delay the sector’s recovery relative to other property types.

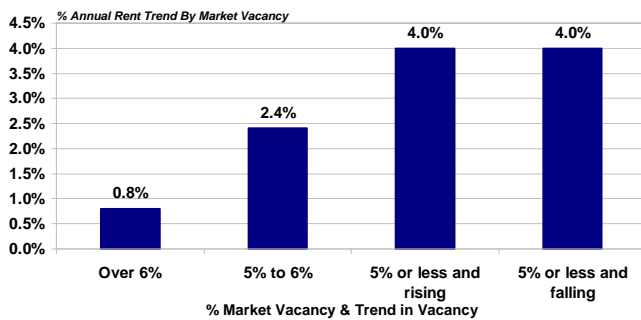
MULTI-FAMILY	
Early Recovery Markets	Lagging Recovery Markets
Orange County (CA)	Chicago
Portland	Nashville
Washington, DC	Phoenix
San Francisco-Bay Area	San Diego

Source: ARA Research

Multi-Family

The tipping point for multi-family rent growth starts at a 5% vacancy rate according to our research. Confirming this view is the fact that at vacancy rates under 5%, the multi-family sector has historically averaged 4% annual rent growth, which occurs regardless of market vacancy trends.

Multi-Family: Due to Short Leases, Vacancy Trends Have Little Impact on Rent Trends



Source: Totto Wheaton Research, ARA Research

Multi-Family Highlights

- Due to a lower starting vacancy rate and a smaller run-up in vacancy than office or industrial during this recession, multi-family should be able to stage a recovery ahead of the other property types.
- Because of the likely early recovery in the multi-family sector, combined with the ability of investors to rapidly raise lease rates due to short-term leases, we are recommending a gradual property sector shift over the next two years to an overweighted position.
- Our top picks for the multi-family sector include supply constrained metros, which either entered the recession early, like Orange County (CA), or markets with stronger employment trends than the nation, like Portland, Washington, DC and the SF-Bay Area.

Retail

Since retail is very location-specific, with far less substitution between locations than in the other property types, analysis by metro is less reliable than for the other property types. However, some metrics, such as the amount of retail space per capita, expected employment trends and vacancy, can be used on a big-picture basis to identify metros that are likely to have a more promising retail outlook.

For example, as of year-end 2008, the retail square footage per capita ranged from a low of under 40 square feet per person in Washington, DC, Austin, Los Angeles and Orange County (CA) to over 60 square feet per person in Ft. Lauderdale, Denver and Las Vegas (the national average is approximately 50 square feet per person).

Retail Highlights

- Because of less retail space per capita and below-average current vacancy rates, we expect above-inflation rent growth to start appearing in Austin and Washington, DC, with San Francisco and Houston also likely to be early recovery markets.
- In our analysis, we found that stronger retail markets tend to have stable housing markets and have better employment numbers (less job losses) than the nation. In particular, supply constrained, in-fill locations in markets with highly educated people are likely to be some of the first retail markets to experience robust rent growth.
- Generally, retail markets, such as Las Vegas, with “over built” conditions are likely to trail in this recovery. While “over building” is likely to be evident in the outer reaches of most metros where some retail was constructed in anticipation of roof top growth, we have found that in-fill locations within most metros are likely to stage an early recovery.

- Clearly metros with less retail space per capita should have better retail characteristics than those with higher space allocations, although the correlation of retail space per capita to retail vacancy is only 40%, suggesting that other local factors, such as trade area demographics and competition are very important for retail investors.

RETAIL	
Early Recovery Markets	Lagging Recovery Markets
Austin	Las Vegas
Washington, DC	Atlanta
San Francisco	Phoenix
Houston	N. New Jersey

Source: ARA Research

Conclusion

- With recent hopeful news on the economy, investors are looking for a staged recovery in all asset classes. For real estate, American defines that “feel good” point as the point when vacancy falls to a level where above-inflation rent growth can be expected. While real estate is likely to lag in the recovery due to the same factors that helped in the start of the downturn — long-term leases and an appraisal based index — our best estimate is that by end of 2011, some 25% of the markets are likely to be experiencing favorable market fundamentals of above-inflation rent growth, with a stabilization of the current “pain” likely in most other markets.
- The tail of this recovery could be very long in some areas, with weaker markets such as the Miami office market and the Las Vegas retail market potentially waiting several years for recovery.
- Due to the expected divergence in when markets are likely to start recovering, market selection is likely to be the key factor in determining return potential from real estate.
- Analysis of property sectors shows that multi-family could lead in the recovery as it has a low overall vacancy rate and had a smaller vacancy increase during the recession, while industrial is likely to trail. However, a word of caution is in order — capital market pricing is at risk of moving in the opposite direction. Hence, picking the “right” segments within the “right” metros will be much more important than a strategy focused to underweighting a particular property sector.
- American is fully aware of changing market dynamics and our active investment strategies will allow us to take advantage of the investment opportunities that are likely to unfold over the next few years.

American is pleased to announce that **Walter Page**, Managing Director of Research and Strategy at American, has been appointed as Vice Chair of the National Council of Real Estate Investment Fiduciaries (NCREIF) Data Products Council, a newly-established committee comprised of nine distinguished members of the real estate investment community. More information can be found online at www.americanreal.com.

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