

Stanley Iezman
President & CEO

Walter Page
Managing Director,
Research & Strategy

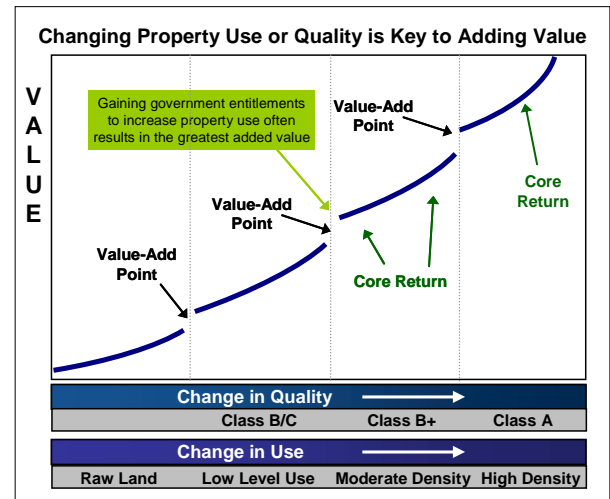
Value Investing in Today's Market

May 2009

This month, we will focus on value-added real estate investment strategies by examining their long-run return and risk characteristics. As one moves through the market cycle, value-added investing can provide strong risk-adjusted returns but has associated risks that must be clearly understood. We will examine what strategies are most appropriate at various stages of the cycle, including a look at investment opportunities presented in today's market by the increasing level of distressed real estate.

Value-Added Real Estate Investing

Value-added real estate investment strategies generally involve an investment manager taking on an active role in changing or improving the underlying assets. Traditional value-added approaches, such as a renovation or lease-up strategy, are at the lower-end of the risk spectrum. The manager's actions typically result in a higher property income stream from either higher rental income from repositioning the property and/or higher occupancy from a successful leasing strategy. This active management can lead to a spike in property values and provides the investor with compensation in the form of higher returns for the associated risk (see graph).



This is in contrast to riskier opportunistic investment strategies that have multiple sources of volatility, such as those associated with properties with significant redevelopment activities, substantial leasing risk, located in out-of-favor markets and/or secondary/tertiary markets, non-core property types such as hotels, land and international investments and operating company investment structures. The risk with these types of investments is exponentially higher as the factors that influence values and income are more volatile and unpredictable than those of lower risk strategies.

Core, value-added and opportunistic strategies may all have an appropriate role in a real estate investment portfolio. It is, however, important to understand clearly the source of returns and the associated risks of each.



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

www.americanreal.com

Returns by Investment Style

The table below shows the NCREIF Property Index (NPI) returns by investment style for the 5 to 20 year periods ended 4Q2008. The general trend over an extended time period provides a good proxy of future expectations of returns.

Real Estate Returns & Risk by Investment Style			
Return History (Annualized), as of 4Q08			
	Opportunistic Funds	Value-Added Funds	Core Funds
20 Years	10.5%	8.0%	7.6%
15 Years	16.2%	11.4%	10.5%
10 Years	13.7%	10.7%	10.1%
5 Years	15.9%	11.1%	10.9%
Risk History (20-Year Annualized, 1Q89 to 4Q08)			
Standard Deviation of Returns	11.9%	7.0%	4.7%
# Down Quarters	15	12	12
% Return from Appreciation	39.0%	9.0%	0.0%

Source: NCREIF, ARA Research

- To compensate for higher risk, value-added funds earned higher returns, exceeding those of core funds by 0.4% over the annualized 20-year period. Opportunistic funds, on the other hand, achieved a 2.9% premium on an annualized basis over core fund returns over this period.
- Value-added and opportunistic fund risks were 46% and 162% higher than those of core funds, respectively. While the incremental step-up in risk from core to value-added usually results from different approaches to similar properties, the investments undertaken by opportunistic funds are often substantially different, again with the forces impacting investment valuations being substantially different for opportunistic funds.
- Note that for opportunistic funds, the source of nearly 40% of the expected total return is future market appreciation, as opposed to less than 10% for value-added and core fund returns. The higher contribution to return from income is the principal reason why value-added and core funds exhibit significantly lower risk. For example, a core fund investing in a stabilized fully-leased property has very low variability of expected returns. The value-added fund may invest in a similar property that is only 60% leased with a clear timetable for leasing up the asset, including an

associated elevated level of risk to achieving this goal. The opportunistic fund, conversely, that invests in yet a third possibly vacant property, faces a shorter window in which to achieve returns where there is no income and thus has an even higher level of risk.

- Approximately 75% of the return earned by value-added funds is directly correlated to the returns earned by core funds. For investors, this means that, as opposed to being market diversifiers, these strategies provide more opportunity for return enhancement than for portfolio risk reduction.

Typical Value-Added Strategies

When examining potential value-added strategies, an investor is faced with a broad range of alternatives, as everyone's definition of "value-added" seems to be different. The following are typical approaches to adding value in an institutional portfolio:

- Renovation:** A good example of this approach is the renovation of a multi-family development. A manager might spend \$5,000 - \$15,000 per unit on renovation costs, such as for new flooring, updating kitchens and/or baths and providing for in-suite washers/dryers. On average, the renovated units can then substantiate a \$100 to \$300 monthly increase in rental rates, providing a 10% to 20% rate of return in short order on the renovation cost. Once all of the units are updated and leased, the property can be sold as a core real estate investment and the appreciation gain can be realized.
- Under-managed Assets:** This strategy may involve a retail property where the anchor or brand-name tenant can be changed, superficial modernization such as improved signage can be implemented, and improved marketing strategies can attract higher paying tenants. When the improved rental income stream is realized, the property is sold.
- Changing to a Higher Value Use:** Some of the largest potential gains can be realized by changing property use. Converting a warehouse to retail use is a good example, especially if the surrounding neighborhood characteristics have changed since the original property was built.

- **Lease-up:** A fully-leased building is almost always worth more than a comparable underleased or vacant building. As such, investment strategies that successfully attract tenants to available space will tend to increase the property value, although knowing when and where to take occupancy risk is the key to this strategy.

Distressed Assets and Market Timing Strategies

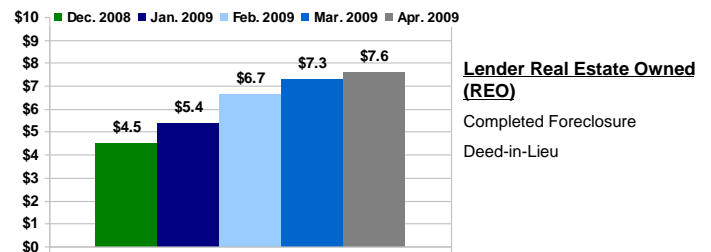
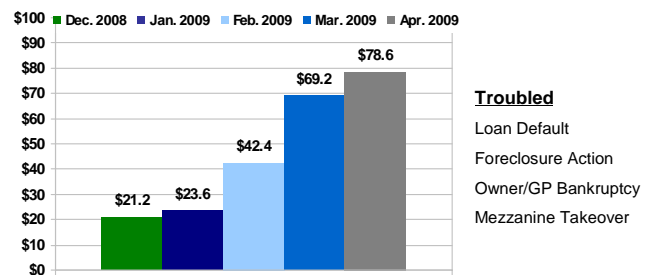
Distressed assets can be part of a successful value-added investment strategy in all phases of the market cycle. History has shown, though, that most of the distressed investment opportunities are likely to be concentrated in periods of weaker fundamentals, such as in the current environment where the level of distressed assets spiked upward by 200% in 1Q09. These assets can be acquired for less than their intrinsic value due to some features that motivate a seller to seek market-clearing prices at lower levels.

Distressed asset situations may include:

- Under-capitalized owners who are unable to obtain funding to lease or maintain the property
- Properties forced to be sold due to lender requirements or foreclosures
- Distressed debt sold at a discount
- Re-capitalization opportunities for those seeking refinancing

When the above situations result in lower rents and values are significantly (10% to 50%) below replacement costs, investors should turn their attention to timing “riskier” investment strategies. In any cycle, high vacancies, low rents and high capitalization rates, such as those seen in today’s market, reverse and can provide investors with excess returns for taking market risk when others were fearful. For example, the chart of Orange County, CA office rents shows that since 1990 the market has experienced three periods of significant rent decline, with the two prior down periods followed by increasing rents. Yet, few investors were willing to price correctly the above inflation rent growth that followed each of the declines that occurred prior to the current decline.

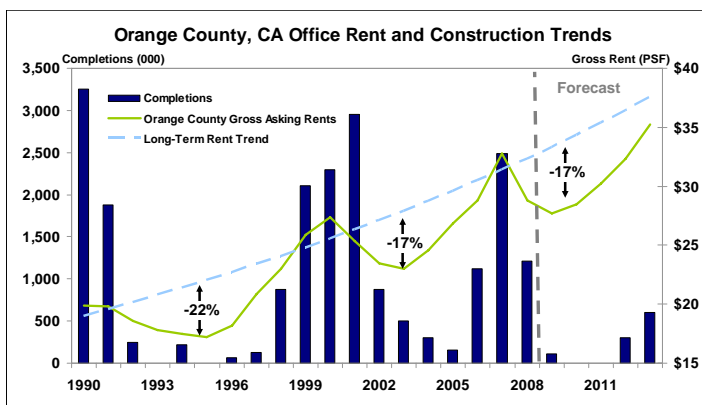
Distressed Assets, in Billions \$



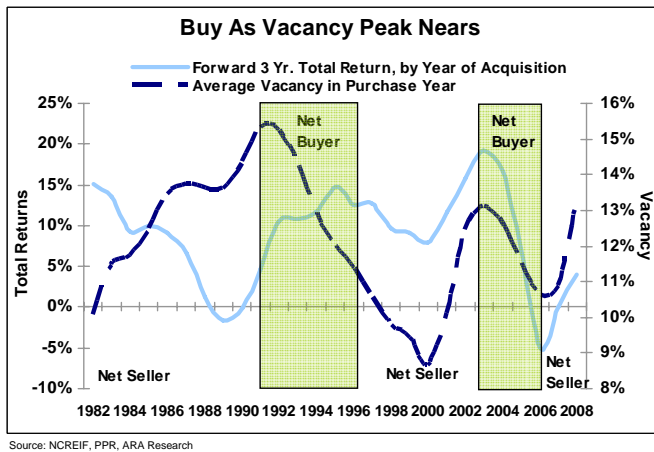
Source: Real Capital Analytics, ARA Research
Note: Data is for institutional quality assets valued over \$5 million and can include distressed land holdings

- **Timing: When to Buy**

Historically, investors who are taking market timing risk tend to make investment purchases at the peak of market vacancy, as historically the unleveraged returns on such investments over the following three years have averaged 5% above the long-term NPI average. Recognizing and acting upon the exact peak in vacancy is difficult to do; however, history has proven that acquisitions made within 12 months of this peak have offered significant opportunities.



Source: TWR, CoStar, ARA Research



- **Timing:** *Why Higher Returns*

Elevated investment returns from market timing typically result from both growth in net operating income (NOI) and the potential for favorable movement in cap rates. Specifically, for every 1% gain in market occupancy, property NOI typically rises by 3% during the next few years. The reason for the excess NOI growth includes:

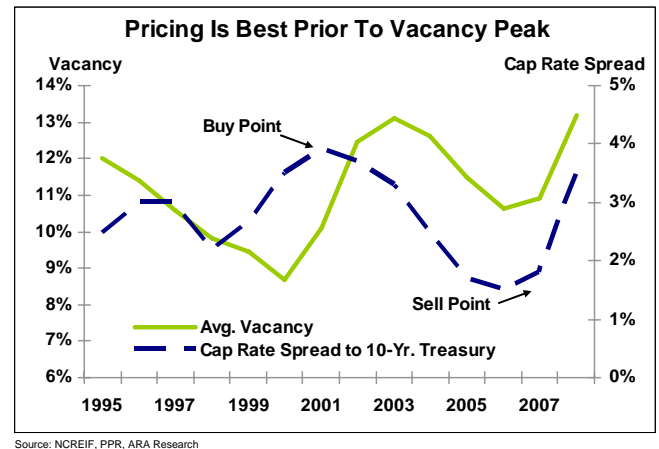
1. **Increased rents** as falling vacancy helps push rents back to the long-term trend line.
2. **Increased occupancy** which generates rent on space that was previously not providing rental income.

For investors, a 3% to 5% rise in market occupancy means up to a 9% to 15% increase in property NOI and, under a stable cap rate environment, corresponds to a similar rise in property values. The relationship between occupancy and rent is so strong that, historically, the correlation of occupancy to the forward two-year NOI trend is almost 70%.

- **Timing:** *When to Sell*

Analysis of cap rate trends shows that the highest relative cap rates are typically achieved one to two years prior to the vacancy peak. This cap rate peak reflects investor fear of the market, allowing other investors to price in negative trends. In contrast, at vacancy low points, investors often price assets for perfection, pushing cap rates to unrealistically low levels. For the disciplined investor, the ability to take

advantage of the cap rate cycle by buying near vacancy peaks and selling at vacancy low points is a key timing strategy.



Plan for Problems

If the current recession is teaching us anything, it is that, regardless of how well thought out a value strategy is, investors need to plan for downside risks and establish downside plans/reserves prior to the actual investment. Typical risks to the value-added model include:

- **Slower than anticipated construction or renovation work:** Construction schedules should plan for delays due to weather and other non-controllable factors with contingencies for built-in catch-up periods.
- **Slower than anticipated leasing activity:** If leasing activity falls below expectations, it may be due to unanticipated factors or an overall misguided outlook. This could be an indication that components of the strategy, such as pricing assumptions, may be too aggressive. It is always recommend that the investor have a downside forecast where expected returns are still acceptable, as well as perform rigorous research prior to investing.
- **Underestimation of costs:** This is a common problem in value-added investing and can easily be solved by a thorough review of budget forecasts prior to making an investment. Additionally, actions such as “not-to-exceed” construction contracts and choosing partners and/or contractors with proven track records should help reduce this risk. However,

even with these efforts, the underwriting must provide for a contingency reserve to account for potential unforeseen costs.

- **Use of leverage:** A misguided “value” strategy in the past has been to purchase a core property and then borrow heavily to leverage the investment for quick returns. However, this is not value creation. Like musical chairs, as long as you and the market are moving, everyone is still in the game. However, this strategy, undertaken at the wrong part of the cycle, can be devastating, especially when the music (i.e., available financing) stops.

- **Monitor investments closely:** Since it is better to fix a problem at its early stages, one of the best ways to avoid problems is for a manager to be closely involved with the investment. Frequent on-site inspections, monthly or even weekly financial reports and detailed communication are all essential to keeping tabs on the progress. In short, the more involved the manager is, the more likely problems will be identified and early corrective actions can be undertaken.

Conclusion

Value-added real estate investments carry the potential for greater rewards than core investments and correspondingly have higher risk. By properly setting expectations, understanding the risks and planning ahead for problems, value-added investments can provide attractive above-average returns. These superior returns are often generated by improving the underlying property, but can also be earned when acquiring good quality properties at below-market prices, timed near market vacancy peaks, and then exiting the investment near the vacancy bottom. With employment growth currently projected to pick up in 2010, we anticipate that market vacancy could peak during 2010 and 2011. If this forecast holds true, the point in the cycle where new acquisitions can generate the highest returns is rapidly approaching.

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

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