

Stanley Iezman
President & CEO

Walter Page
Managing Director,
Research & Strategy

Searching For A Needle In A Haystack

How to Locate and Price Core Real Estate Investments in Today's Market

September 2009 Newsletter

While foreclosures and short sales have dominated the residential market over the past year, distressed sales of core and value-added properties have yet to hit commercial real estate in large numbers. With commercial real estate loan maturities expected to reach record levels over the next few years, however, it is only a matter of time before quality properties appear on the market through distressed sales.

So how do you determine when getting a property for “50 cents on the dollar” is a good deal and when it is not? Finding the best long-run core and value-added investments in this market can be like searching for a needle in a haystack. In this newsletter, we discuss why the long-run submarket occupancy performance, the current and expected market fundamentals for growth and the pricing basis are all critical factors in evaluating potential investment opportunities.



Establishing Acquisition Pricing in a Market With Limited Sales Activity

The typical core real estate investor looks to market transactions to gauge the appropriate metric to price assets. However, due to a decline of more than 90% in the volume of property sales since 2007, confidence in real estate capital market sales data (the primary source for local market prices) is low. For example, how could one price a multi-family asset in the District of Columbia when that market has had limited closed sales in nearly a year? Although one can still use sales data, when looked at on a national level and compared to historical local data, as a valid overall view of real estate market pricing, in today's market, one may need to look elsewhere. In particular, before we find the needle, we need to determine where the most favorable haystacks are in which to start our search.

We are increasingly examining market fundamentals as key factors in predicting those markets that are most likely to outperform going forward. Over long periods of time, our research shows that core assets, such as properties that we would like to own in any market cycle, including Class A buildings in top-tier locations, generally earn 1% to 2% higher total returns than the national benchmark. Additionally, we are looking at markets that are likely to deliver the highest growth in property net operating income, as historically this is a key driver of core returns over the long run.



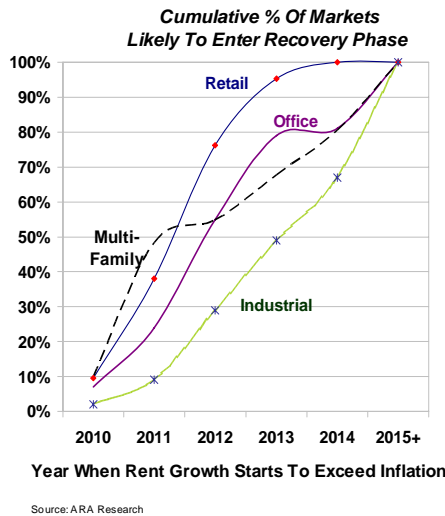
**AMERICAN
REALTY ADVISORS**

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

www.americanreal.com

So, Which Markets Have the Best Real Estate Fundamentals for Growth in Core Assets?

To help forecast net operating income growth, we estimated when each of the metro markets by property sector is likely to return to achieving above-inflation rent growth, as the timing of this will have a major impact upon the near-term growth in net operating income. We then examine current rents relative to long-term trends by market, as some markets have rents that are well below construction justification levels but show the potential for strong growth, while others may have more limited upside potential before the next wave of construction is likely to occur.



From this, American has identified the following markets that we believe are most likely to achieve the greatest growth in rents within their respective property sectors through 2014.

Projected Rent Growth During Next Recovery (2010-2014)			
	Office	Industrial	Multi-family
Greatest Rent Growth	San Francisco	Los Angeles	New York
	Boston	Seattle	Boston
	Orange County	San Francisco	Washington, DC
	San Diego CBD	Minneapolis	San Diego
	Houston CBD	Orange County	Orange County

Source: ARA Research

Due to a wide range in both projected recovery dates and in vacancy peaks, there should be a wide disparity in rent growth across all markets. For example, rents across the five strongest office markets could grow by a cumulative 32% on average, more than six times the cumulative growth rate of the weakest office markets. In comparison, during the last recovery, the range in rent growth between the top and bottom achieving metros was slightly greater than this forecast, with office markets exhibiting the widest

range in rent growth performance at nearly 40%, while the high level of construction activity in the multi-family sector tended to narrow the range of rent growth between the top and bottom performing markets to only 20%. As a result of this gap in rent growth rates, cumulative total returns on core office properties in Manhattan were 174% over this five-year period, while suburban Chicago, for example, achieved cumulative total returns of 55%, as Chicago only experienced a 2% gain in rents vs. the 60% gain experienced in Manhattan.

Since growth in rents is a key factor in determining total returns, our long-term core strategy has been focused on selecting submarkets that historically achieve the highest occupancy rates, as high occupancy rates are the number one predictor of above-average total returns regardless of the market cycle.

Estimating Cap Rate Differences by Market

In today’s market, core investors are keenly focused on current income trends, as measured by cap rates and price per square foot metrics. For opportunistic investors, this is certainly key; however, while current pricing and the ability to buy at a low-cost basis can be important factors, core investors are tending to discount the importance of rent growth potential or are declining to integrate it into the pricing metric. This would be similar to stock investors only focusing on the stock price-earnings ratio or its price compared to past peaks and not factoring in different earnings growth rates.

This narrow focus on cap rates can lead to opportunities for investors and American looks closely at metrics such as these that can drive net operating income trends. For example, our rent growth forecasts examine today’s rents versus the long-term rent trends, construction pricing and vacancy rates. From this information, our research can estimate approximately when new construction is likely to return to the market, and how much existing market rents will need to change before rental rates on new speculative construction become competitive with existing property rents (after adjusting for age and condition).

The real value of this analysis, however, is to provide an estimate of how to price the trade off between rent growth and cap rates. After all, higher expected rent growth should impact cap rate pricing, but by how much? This is

an important question given that rent growth varies significantly from market to market and is historically one of the key predictors of which market segments are likely to provide above-average returns to the core investor. Looking towards the next recovery, we have identified the markets that in our view are likely to achieve the greatest rent growth and those that will lag behind. The next step is to determine what effect these rent growth expectations should have on cap rates. We understand that there are numerous moving parts that are factored into cap rates — however, we have attempted to isolate the adjustment needed to account for differing rent growth expectations.

Which is the “Best” Haystack to Look in?

After applying this analysis of rent growth and cap rates across all of the office markets that we forecast, the result was a 2.0% spread in cap rates between the market that is projected to have the greatest rent growth (San Francisco) and the market with the least anticipated rent growth (Miami). The spread between markets in the multi-family and industrial sectors was only 0.6%, which was expected

since the likely differences in rent growth by market should be smaller than for the office sector.

The table below lists those markets today that are likely to offer the core investor the greatest investment returns in the near term (over the next three years) as well as those on the horizon period for entry during the next three years.

Strongest Market Opportunities			
	Office	Industrial	Multi-family
Near-Term Opportunity	San Francisco Houston CBD Austin CBD Boston CBD		Boston Washington DC San Diego Portland Los Angeles San Francisco
On the Horizon	Orange County San Diego CBD Suburban Boston	Los Angeles Seattle Minneapolis Bay Area Orange County	Minneapolis Orange County New York

* Office markets listed above are those that could trade at cap rates 50-100 bps below national cap rates based on American's internal rent growth forecasts. Industrial and multi-family markets are 10-30 bps below national cap rates.
Source: ARA Research

Example: Estimating The Impact That Rent Growth Has On Cap Rates

Let us assume we have two different investments that will both provide investors with \$100 in property NOI over the next year. One of the investments is in a market deeply depressed by the recession while the other investment is in a market doing better than the nation. In looking to the future, one market is projected to achieve a 20% cumulative rent growth over the next 5 years, while the other market's rent is expected to remain flat. Investors need to know what difference in market cap rate should exist between these markets, assuming everything else remains constant.

Answer:

Let us assume cap rates in the high growth market are known to be pricing at 8% currently and that we have several sales comps to support this. Since we are forecasting a 20% rise in NOI over the next five years, this means that NOI is expected to grow from \$100 to \$120. This also means that over the five-year investment horizon this investment will be providing about \$550 in property NOI, assuming that NOI grows by \$5 per year.

Next, we perform this same analysis for the investment with zero rent growth and see that it only generates \$500 in property NOI, or \$50 less than the other investment. Stated in an alternative way:

$$\frac{(\$550 \text{ in NOI from the strong market})}{(\$500 \text{ in NOI from the weak market})} = 1.10 \text{ ratio between strong and weak market pricing}$$

This 1.10 ratio between strong market and weak market pricing means that on a relative basis, the cap rate in the weaker market needs to be 10% higher than in the strong market to keep expected returns at similar levels. Hence, if the strong market cap rate is 8.0%, then the weak market cap rate needs to be 8.8% as shown below:

$$8.0\% \text{ cap rate in the strong market} \times 1.10 \text{ adjustment for lower rent growth} = 8.8\% \text{ cap rate in the weak market}$$

In general, these same metros will most likely also justify some of the lowest cap rates in the market, as we believe they could generate either the largest rent growth over the next five years or the most near-term rent growth within their respective sectors. This grouping is broken down into two categories, “Near-Term Opportunity” and “On the Horizon.”

Markets listed as near-term opportunities are those in which markets we expect to see the most rent growth over the next three years due to low vacancy peaks relative to the national average. Those markets deemed “On the Horizon” are projected to obtain rent growth well above the national average, but due to higher forecasted vacancy peaks, their recovery could still be a few years away. Regardless, these are markets that should still be on the radar for new investments.

Conclusion

Due to the extreme decline in property sales volumes, pricing core and value-added real estate in today’s market has become more difficult. However, with a potential wave of properties coming to market through distressed sales, it is imperative to determine a clear pricing methodology, as just because a deal can be had at “50 cents on the dollar” or at a high cap rate does not mean it is necessarily a good investment. Consequently, American is focusing more on market fundamentals as a predictor of future asset value. In particular, we examine the effect rent growth projections can have on cap rates. The results of this analysis show:

- Based on American’s rent growth projections for various core office markets, we believe there should be up to a 2.0% spread in cap rates between the market with the strongest rent growth forecast and the weakest.
- The spread in cap rates across the multi-family and industrial sectors could be only 60 basis points as we do not expect as big of a disparity in rent growth between markets.

While there are many moving parts that go into determining asset values for core assets, our analysis shows in a relative sense that when determining pricing, markets should be treated differently based on multiple valuation metrics that include: expectations for growth, cap rates and other risk factors. Despite the limited number of asset sales to guide pricing, having a stronger sense of where market fundamentals are going will better equip investors to make investment decisions and locate the best “haystacks” in which to find opportunities for returns.

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.

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.

