Research

USAA
USAA Real Estate Company

U.S. PROPERTY MARKET OUTLOOK

Improvement in the Commercial Real Estate Market Continues

- The outlook for the U.S. economy remains optimistic driven by continued moderate GDP growth and the improving employment market. The U.S. economy is expected to continue to improve well into 2015.
- The optimistic outlook for the U.S. economy is based on the expectation of a continued low interest rate environment, strong corporate profits and investments, a recovering housing market and increasing consumer spending.
- While policy-related uncertainty has declined somewhat, decisions still must be made on spending cuts and deficit reduction which continue to cause business and consumer concern.
- Despite continued concerns over the economy, the outlook for the U.S. commercial real estate market in 2013 is favorable. While demand could be stronger, market fundamentals continue to improve in general, driven by the gradually improving economy and the lack of supply.
- Investors in both the private and public commercial real estate markets continue to be attracted to the income yield, diversification, and potential inflation hedge that real estate can offer. With the recession in Europe and the lack of understanding about Asia, the U.S. continues to provide a safe harbor and attractive risk-adjusted returns for international investors.
- The debt markets continue to perform well on a relative-basis and provide attractive returns for debt investors in both the whole-loan and CMBS markets. The low-interest rate environment also continues to make it attractive for investors to borrow and invest in the private real estate market.
- Going into 2013, REITs continue to outperform stocks and have been raising a record amount of capital. Industrial and retail REITs are the best performing with apartment REITs lagging all sectors.
- The private commercial real estate market, as represented by the NCREIF Property Index, produced a 10.5% return in 2012. Returns should continue to moderate but still remain relatively attractive when compared to other investment vehicles.

- We expect privately held core real estate and publicly traded REITs to provide an 8% to 10% and 10% to 12% total return for 2013, respectively. In addition, private real estate income returns are expected to remain near 6% with REIT dividend yields approximately 3%.

THE ECONOMY

- During the fourth quarter of 2012, real GDP contracted by an annual rate of 0.1%, as policy makers addressed the fiscal cliff. However, it appears that the U.S. data were distorted by one-off factors and the underlying growth likely remained positive. The likely main driver behind the drop in GDP was a decline in government spending (primarily defense). Although, GDP contracted in the fourth quarter of 2012, the U.S. economy added approximately 1.8 million jobs for the year and has regained more than half of the jobs that were lost in the last recession. (Chart 1, 2, 3)

- Continued growth in the energy, technology and medical sectors along with the recovery in the housing market should provide continued improvement in the economy for 2013.

- Manufacturing surveys for January suggest that industrial activity has accelerated in the U.S. and is likely to be the strongest globally.

- Retail sales growth remains steady at around 2% annually while consumer confidence has been improving. Household debt as a percentage of disposable income continues to decline in the U.S. and is much lower as compared to Canada and the U.K. (Chart 4)

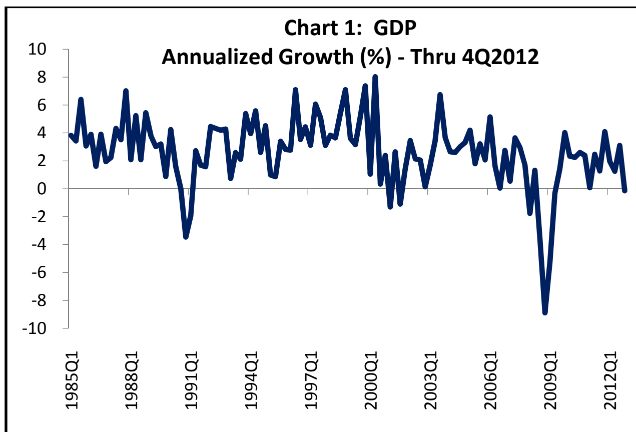
- Increased residential values should have a positive impact on consumers in 2013. Moody's Analytics is forecasting a 0.5% positive impact on GDP in 2013 and 0.7% in 2014. (Chart 5)

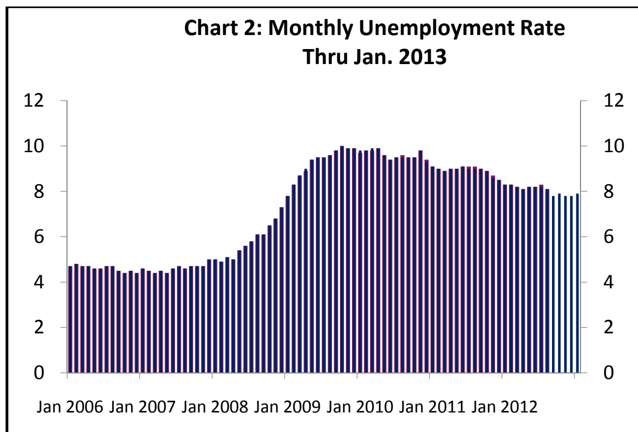
- The Case-Shiller Index indicates that house prices rose 7% in 2012 which is likely to continue as the economy and consumer confidence improves. (Chart 5)

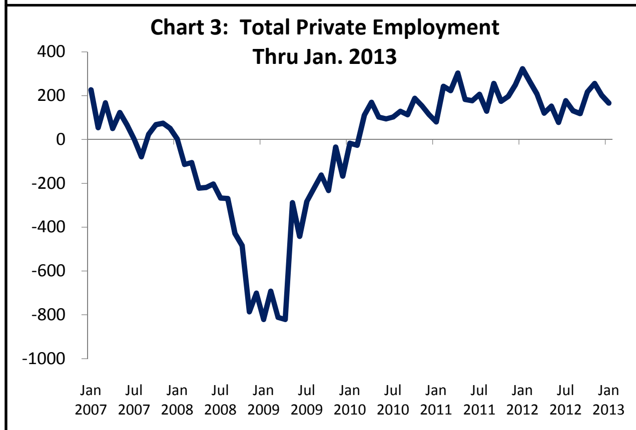
- Increases in payroll tax and tax rates on upper income earners will likely reduce spending in 2013.

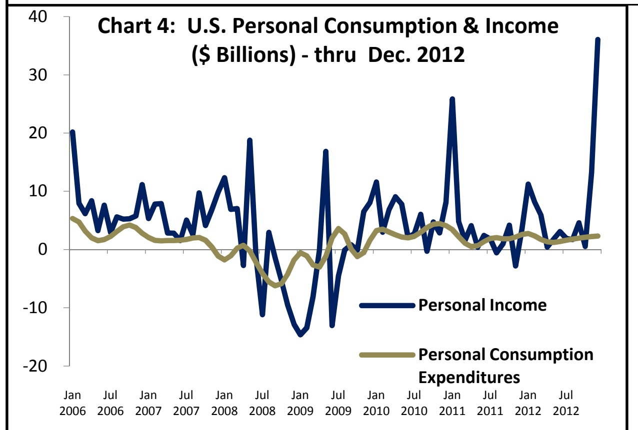
- Some uncertainty related to the federal government's tax and spending plans still exists and continues to create a drag on corporate investment.

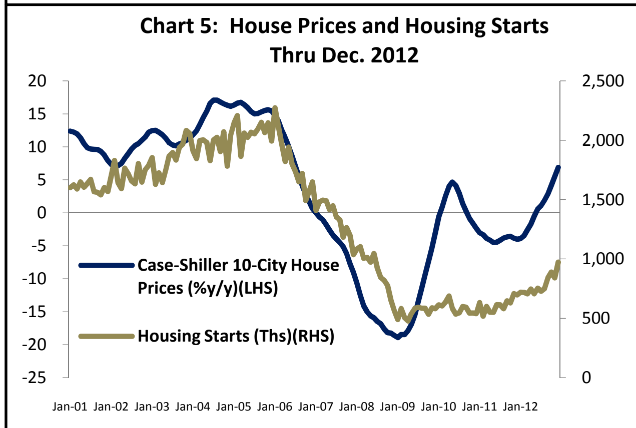
- The Federal Reserve Board has indicated that it plans to keep interest rates low until the unemployment rate drops to 6.5% or inflation forecasts exceed 2.5%. Currently the unemployment rate is hovering around 7.9% and inflation is below 2%. (Chart 6)

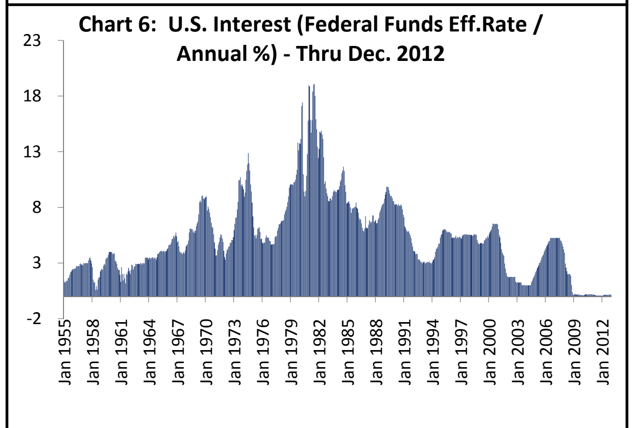












Source: Moody's Analytics, USAA Real Estate Company Research

DEBT

While 10-year Treasury rates are inching up, low interest rates continue to make real estate debt attractive for investors and lenders alike . . .

- Even with 10-year Treasury rates creeping up, they remain near all-time low levels. Mortgages are providing lenders and investors with an attractive return relative to other fixed-income investments. The Giliberto-Levy Commercial Mortgage Performance Index (GLCMPI), which tracks private-market loans held in investor portfolios, posted a 4.68% total return for 2012, lower than the 6.9% in 2011.

- The GLCMPI composite spread measure showed lower spreads for 2012 across all property sectors. Fortunately, spread declines, on an absolute basis exceeded Treasury yield increases. A relatively flat credit curve continues with loans, on average, in the 50% to 70% range carrying the same spread, all else equal. At around 50%, there is approximately a 10 basis points reduction in the spread. Credit losses continued to abate in 2012.

- We expect good opportunities for balance sheet lenders in 2013 even with increased competition from conduits. The mismatch between the amount of debt rolling over and the capacity of the lending community is well known. There will be plenty of demand for financing but parts of the demand will have difficulty in underwriting. Balance sheet lenders appear to be taking on a little more risk in 2013 in the form of higher loan-to-value ratios (LTVs).

- The prospect of increased competition for quality loans is putting downward pressure on spreads. As Treasury yields rise, we will likely see spreads narrowing into the sub 200 basis point range. If Treasury yields stay relatively stable, we expect total returns for 2013 to be similar to those in 2012.

- Borrowers have been benefiting significantly from the continuing low interest rate environment. Life insurance companies and the agency lenders (Ginnie Mae, Fannie Mae and Freddie Mac) are writing commercial real estate loans with interest rates at or below 4%. Banks and CMBS programs are writing loans in the 4.5% to 5% range. Concerns over low Treasury rates have caused some life companies to set rate floors in the 3.5% to 3.625% range.

- Most life companies have plenty of capital to invest and are focused primarily on the very best properties. Some are actually making construction loans to get a higher yield and some are pricing five- to ten-year fixed-rate financing off corporate debt equivalent returns with spreads at roughly 150 basis points but have ranged as low as 30 basis points and as high as 250 basis points. Even at the current low interest rates, mortgage investments are still relatively attractive for these lenders when compared to other fixed income investments.

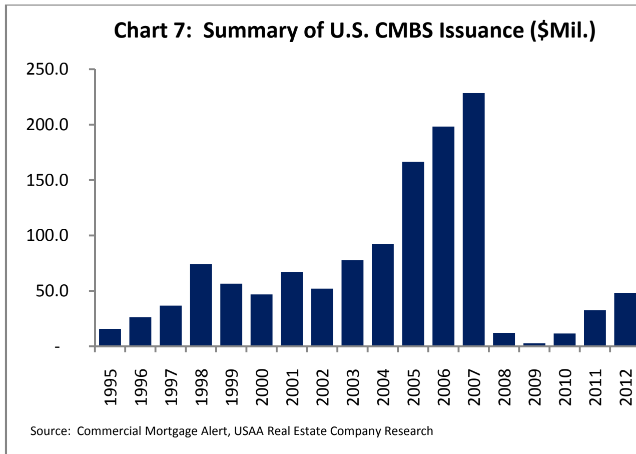
- Life companies are expected to exceed their record volume of mortgage lending in 2013. Through the third quarter of 2012, life companies wrote $34.8 billion of mortgages, according to the American Council of Life Insurers (ACLI).

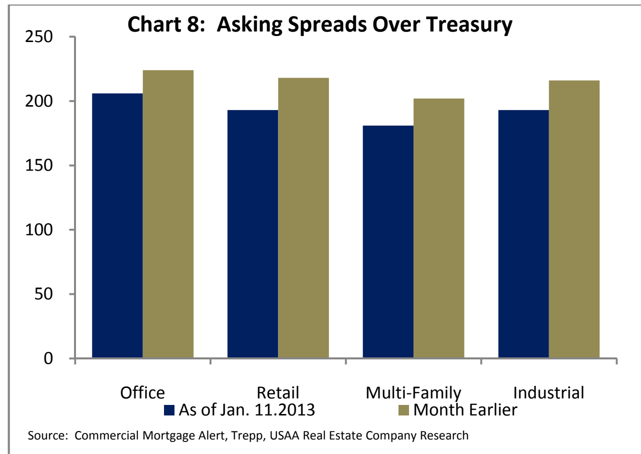
- Apartments have been easier to finance. Commercial Mortgage Alert (CMA) reports that the agency lenders wrote a record $50.9 billion of volume in 2012. CMBS lenders are providing debt for below A quality apartments.

- According to CMA, CMBS had its most active year since 2007. Volume rose to $48.4 billion in 2012. The CMBS pipeline for 2013 looks very aggressive. There are seventeen transactions totaling $12.5 billion scheduled to come to the U.S. market by the end of March in addition to the $13.5 billion that has already priced since the beginning of 2013. This incredible activity puts issuance on track to reach $26 billion for the first quarter of 2013. That is four times higher than a year ago and the highest quarterly total since the fourth quarter of 2007. The CMBS market is now on a $100 billion issuance pace for 2013. (Chart 7)

- CMA reports that CMBS loan asking spreads over treasuries ranged from 163 basis points for apartments to 180 basis points for office properties for a 10-year loan with 50% to 59% LTV (as of February 22, 2013). CMBS new issue fixed rate spreads (conduit) over swaps ranged from 47 basis points for AAA to 317 basis points for BBB. Agency CMBS spreads (Freddie K Series) ranged from 23 basis points for A1 to 260 basis points for C tranches. (Chart 8)

- The more active CMBS market should provide additional debt for higher risk properties and markets.





REITS

REITs continued to outperform in 2012 and the outlook for 2013 looks good . . .

- REITS outperformed the broader market in the fourth quarter of 2012 and for the year. For 2012, the NAREIT Equity Index was up 19.7% on a total return basis, slightly ahead of the S&P 500 (+16.0%), the Dow (+10.2%), NASDAQ (+15.9%) and Russell 2000 (+16.4%). From our perspective, outperformance was driven by historically low 10-year Treasury yields continuing to drive investors to seek yield and the broader market uncertainty related to the fiscal cliff as REITs were viewed as a relative safe harbor. (Chart 9)

- Industrial REITs outperformed all REIT sectors with a 31.3% total return in 2012, followed by retail (+26.7%), health care (+20.4%), self-storage (+19.9%), office (+14.2%) and hotels (+12.5%). Apartments underperformed all sectors with a 6.9% total return for the year. Investors rotated out of the apartment sector due to concerns over new supply and the slowing of net operating income growth (NOI) in 2012. (Chart 10)

- Real estate mutual fund net flows totaled close to $15 billion in 2012, by far the most in the last decade.

- REITs continued to raise significant amounts of capital in 2012. The $71.8 billion of debt and equity raised was the most ever.

- REITs continue to be well-positioned to find accretive investments. Their cost of capital is very low making them tough competitors for institutional real estate investors.

- Net operating income grew significantly in 2012, but growth is expected to slow for some property types (such as apartments) in 2013.

- REIT equity yields stood at 3.70% at the end of 2012 which was very attractive when compared to the 2.24% S&P 500 dividend yield and the 1.76% 10-year Treasury yield. REIT equity yield spreads stood at 146 basis points over the S&P 500 dividend yield and 194 basis points over the 10-year Treasury yield.

- REIT funds from operations (FF0) multiples traded at 18.3 in 2012, the lowest since 2008 and 131% above S&P 500 multiples. We expect REIT earnings to grow approximately 10% in 2013. (Chart 11)

- Looking ahead, we anticipate real estate fundamentals generally to remain solid with stable occupancy and increasing rents across most property types providing further upside to earnings. REITs should produce returns in the 10% to 12% range.

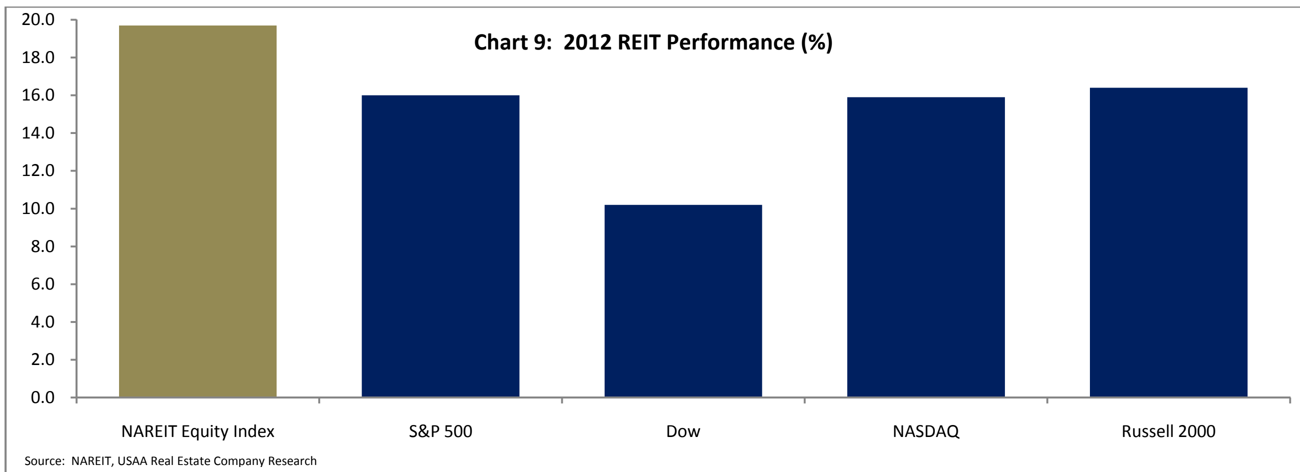


Chart 9: 2012 REIT Performance (%)
20.0
18.0
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
NAREIT Equity Index
S&P 500
Dow
NASDAQ
Russell 2000
Source: NAREIT, USAA Real Estate Company Research

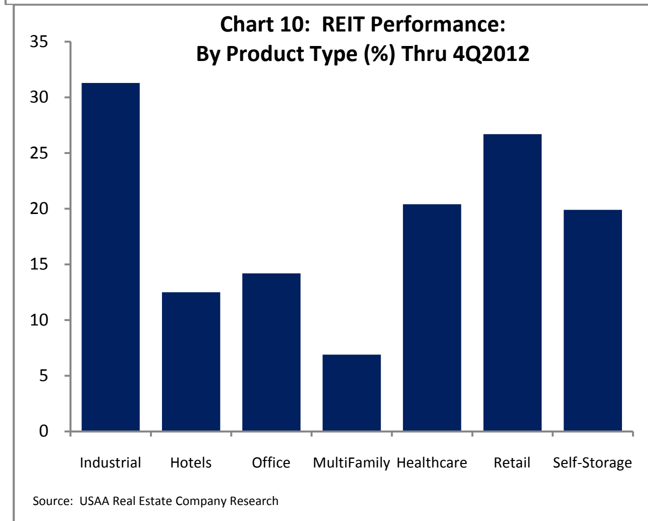


Chart 10: REIT Performance:
By Product Type (%) Thru 4Q2012
35
30
25
20
15
10
5
0
Industrial
Hotels
Office
MultiFamily
Healthcare
Retail
Self-Storage
Source: USAA Real Estate Company Research

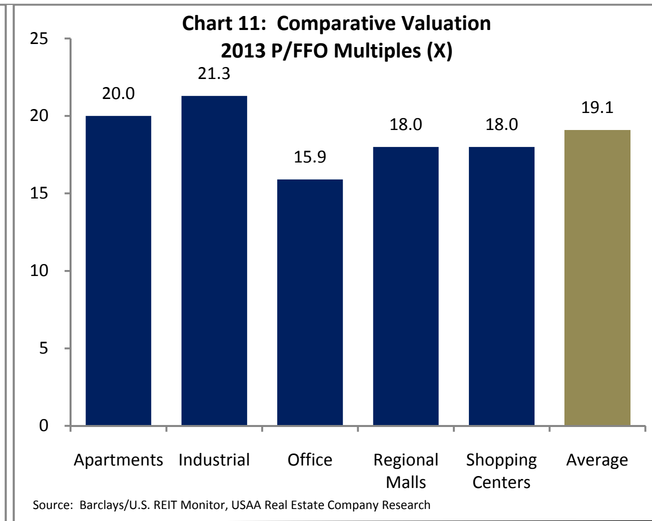
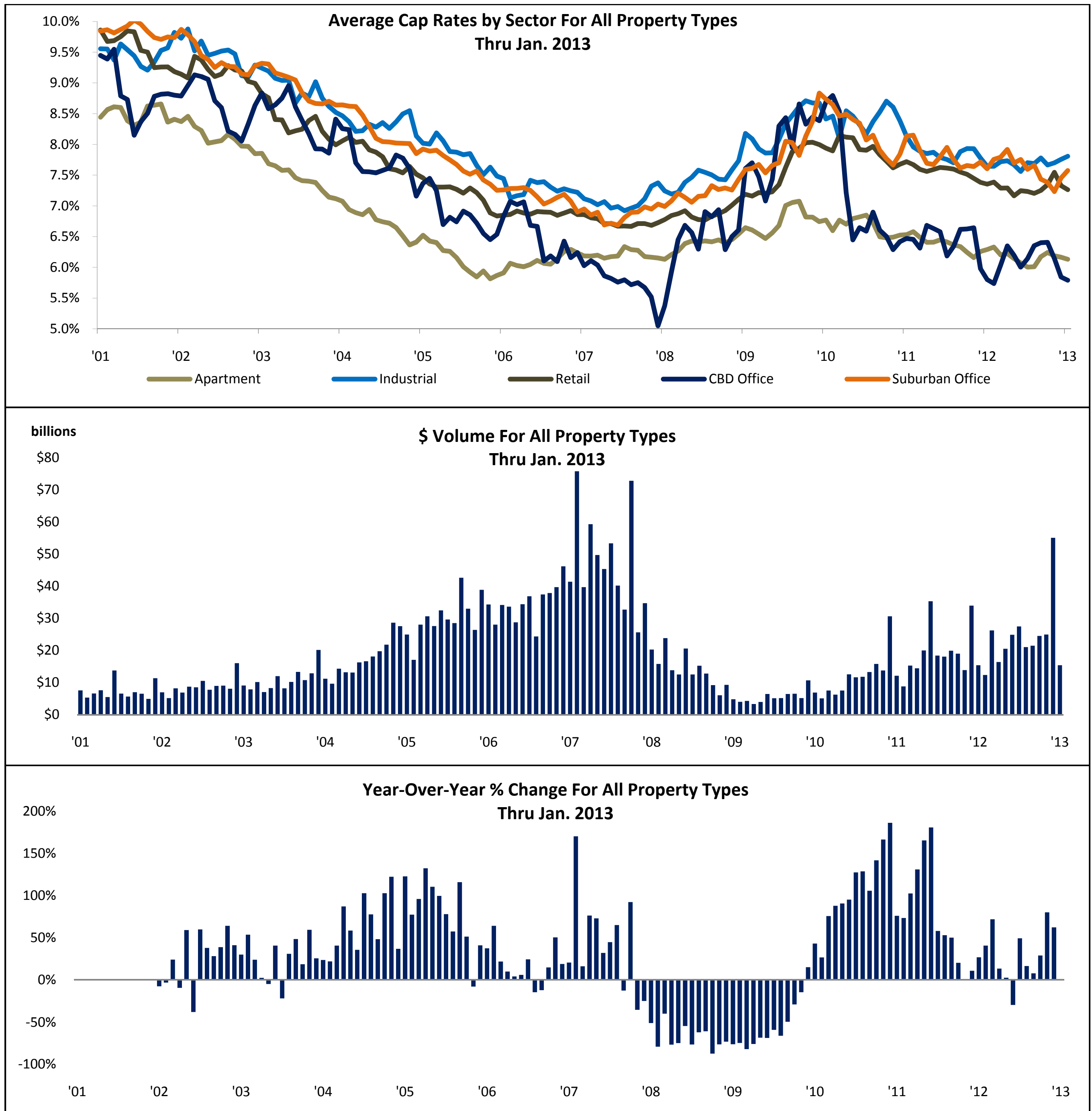


Chart 11: Comparative Valuation
2013 P/FFO Multiples (X)
25
20
15
10
5
0
20.0
21.3
15.9
18.0
18.0
19.1
Apartments
Industrial
Office
Regional Malls
Shopping Centers
Average
Source: Barclays/U.S. REIT Monitor, USAA Real Estate Company Research

Property

Transactions



Source: Real Capital Analytics, USAA Real Estate Company Research

Apartments

A strong finish to 2012 for the apartment sector . . .

- According to REIS, the national vacancy rate declined again in the fourth quarter, dipping 20 basis points to end the year at 4.5%. As a confirmation to the incredible momentum of the apartment sector, this is the lowest vacancy rate since the year 2000. (Chart 12)

- Demand picked up in the fourth quarter as net absorption was approximately 47,000 units, surpassing the 25,000 units absorbed in the third quarter. Demand continues to be strong, driven by a slowly improving economy, the growing number of renter households, increased household formation and a declining homeownership rate. Declining vacancies still point to how easily the market can absorb the influx of new units. (Chart 12, 13)

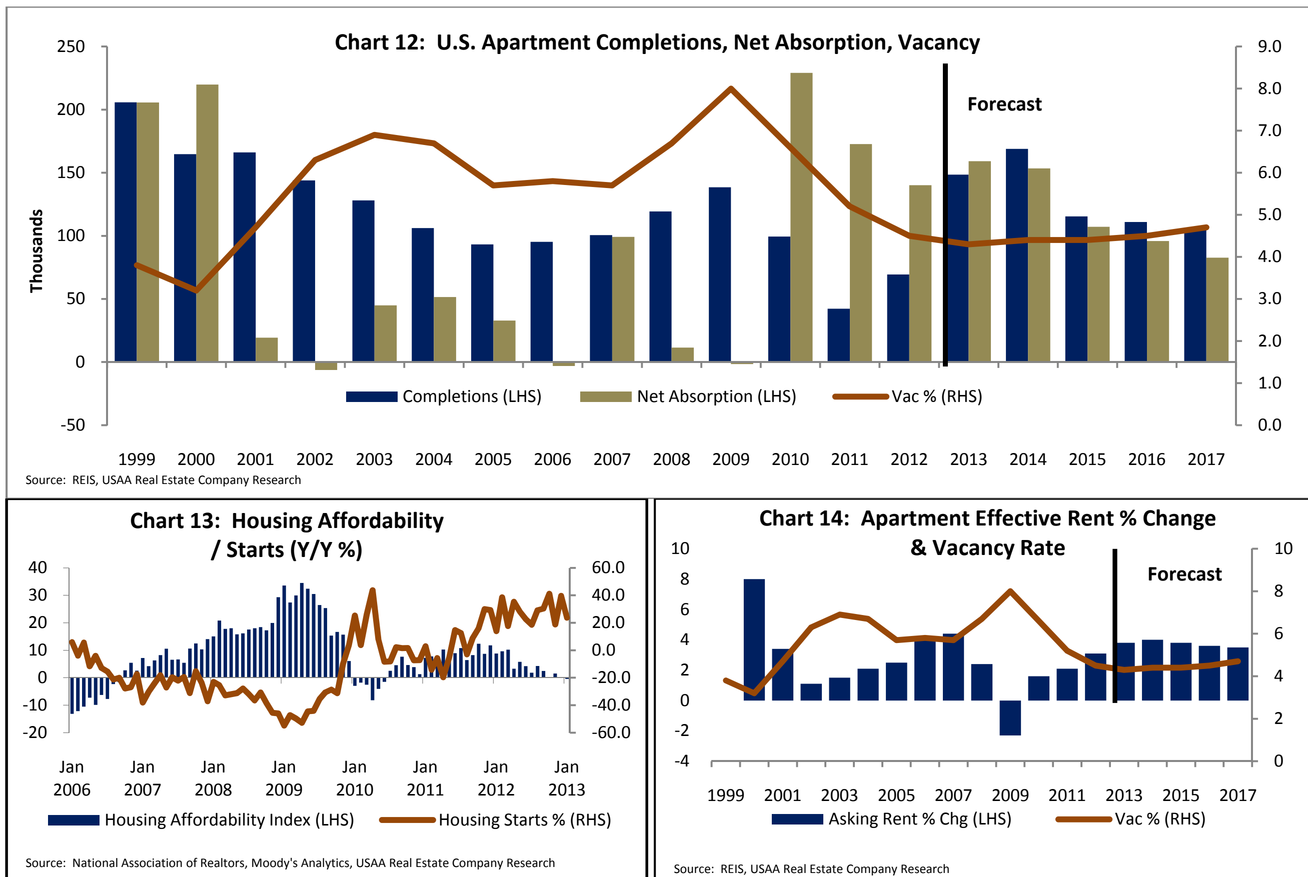
- Supply growth has continued to ramp up as 27,000 units were delivered in the fourth quarter of 2012, versus the 17,000 units completed in the third quarter. New supply is expected to ramp up in 2013 and 2014, but then drop back slightly in 2015 and beyond. While it is important to keep an eye on new supply, there should be enough demand in most markets to occupy the new units that are in the pipeline. (Chart 12)

- Asking and effective rents both grew by 0.6% during the fourth quarter, hitting another national all-time high at end of the year. With most markets experiencing very low vacancies, landlords have shifted their strategies for growing revenue to accelerating rent increases instead of from occupancy improvement. (Chart 14)

- The apartment sector appears to be transitioning to a point where market fundamentals are stabilizing and a slight slowdown in growth should be anticipated. For 2013, vacancy rates should continue to decline further, albeit at a slower pace. (Chart 12, 14)

- The best locations with high growth and supply constraints should continue to provide attractive investment performance. Although affordability is becoming a concern, the backdrop for apartment demand should remain very favorable for at least a few more years.

- One word of caution – investors should start to be careful when considering multi-family development in low-barrier-to-entry markets. These locations tend to overbuild quickly, softening rent growth potential and weighing down occupancy levels.



Industrial

Industrial sector posts a solid fourth quarter . . .

- According to CBRE-EA, the national availability rate dropped to 12.8% for the fourth quarter, a 30 basis points decline from the third quarter, and down 50 basis points for the year. (Chart 15)

- Net absorption was a positive 56.8 million square feet during the quarter, more than double the amount from the third quarter, and the highest amount in a quarter since Q3 of 2006. For the year, net absorption was a positive 127.9 million square feet. (Chart 15)

- New supply increased to 18.3 million square feet for the quarter as construction activity has started to rise with improving market fundamentals. It is expected that new construction deliveries will average around 15 million square feet per quarter over the upcoming year. But market fundamentals will continue to improve, as net absorption is expect to be at least twice that amount. (Chart 15)

- Rent growth has gained some traction as leasing concessions have continued to shrink. Asking and effective rents were up 0.2% and 0.4%, respectively, for the quarter. For the year, asking rents improved 1.0% and effective rents increased by 1.7%. In fact, some select markets have

already seen rents fully recover. In Denver, for example, effective rents are now more than 3% above their pre-recession peak.

- Industrial demand drivers such as total trade gained additional momentum as exports and imports expanded faster. Thus trade continues to provide stable support for the industrial recovery. (Chart 16)

- Of the property subtypes, the larger bulk distribution buildings continue to be one of the best performers in the sector. Demand for large, high-quality warehouse space is being driven by firms that have large-scale, complex, and technologically advanced supply chains. For instance, there has been significant demand from e-commerce tenants who require customized space with elaborate racking systems to accommodate pick-and-pack operations, utilizing robots and automated equipment.

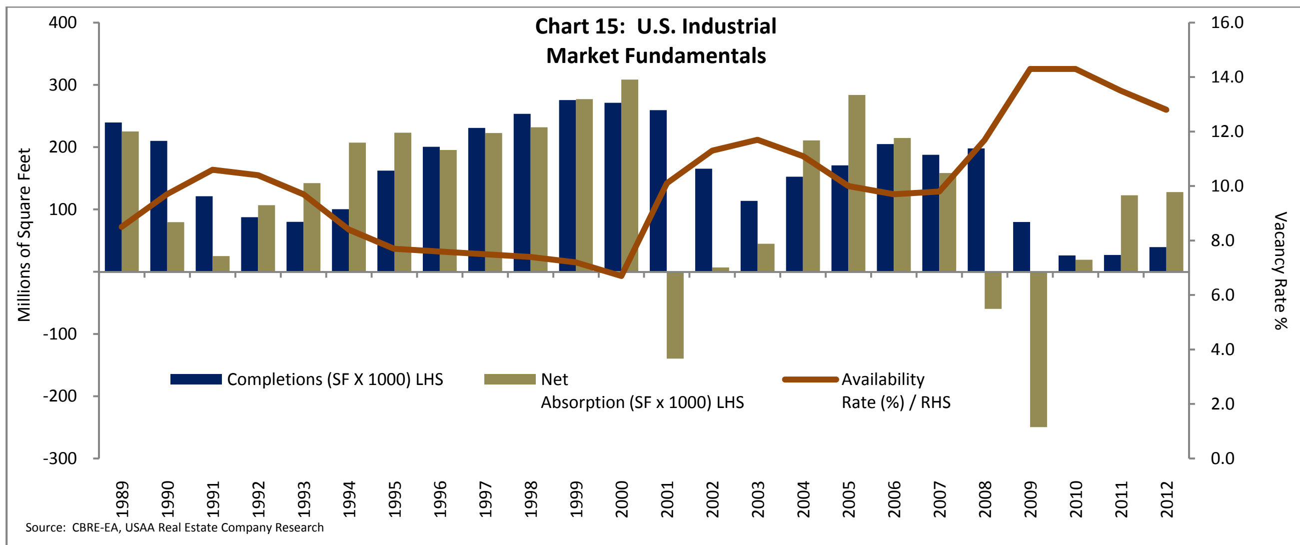
- In many areas, demand for large, high-quality warehouse & distribution space far outpaces available supply. Big blocks of space will continue to be harder to find, leading to new development projects.

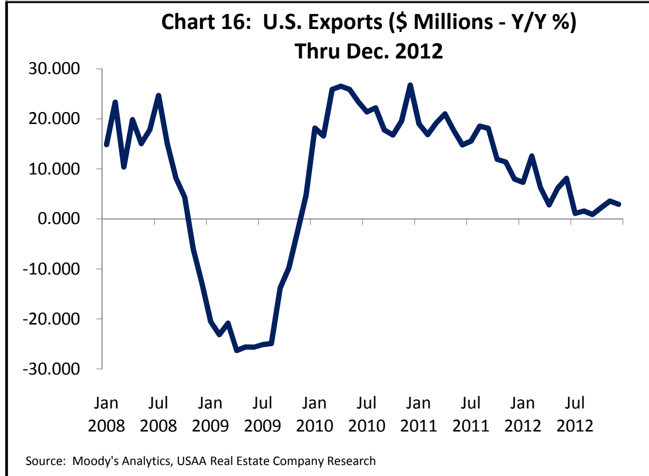
- Although the demand for light industrial properties (less than 250,000 square feet) has trailed the strong demand of their large bulk warehouse brethren, the outlook for this warehouse segment has brightened. Lackluster housing market performance and tight credit standards have been a drag on the health of small businesses, which has posed a barrier to the near-term recovery of the light industrial product. However, the burgeoning recovery of the housing sector should provide a well-received boost in small bay warehouse demand.

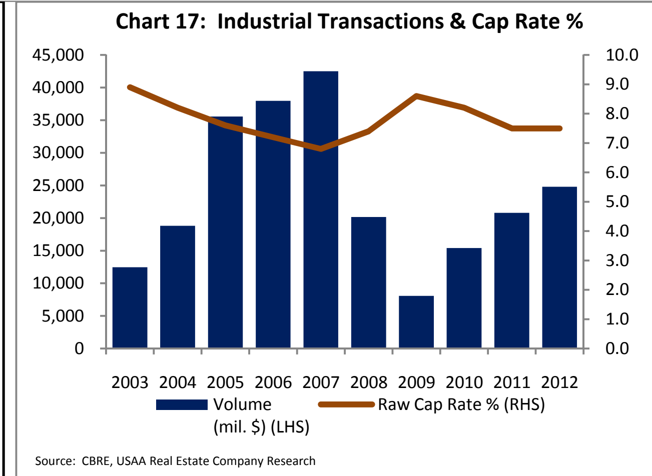
- Sales volume for industrial properties in the fourth quarter was $13.5 billion, the highest quarterly total since the third quarter of 2007. Increasingly, the industrial sector is becoming perceived as a relative value compared to the other property types where prices have improved more substantially. (Chart 17)

- Cap rates have averaged 7.7% and are down slightly over the past year, declining by just 10 basis points from 2011. Despite the significant motivation of sellers, industrial prices held firm during the quarter, indicating that buyers have been more than willing to acquire at current price levels. (Chart 17)

- The U.S. industrial market continues to head in the right direction. Even though it has lagged behind other property sectors, the industrial sector's recovery should start accelerating over the next two years, especially for warehouse & distribution space. The prospects for 2013 look favorable, with the top markets experiencing respectable improvements in absorption, vacancies, and rents.







Office

The office recovery remains intact, despite challenges . . .

- CBRE-EA reports that the national vacancy rate declined 10 basis points to 15.4% in the fourth quarter and fell by 60 basis points for the year as a whole, slightly better than 2011's 50 basis point decline. (Chart 18, 19)

- Net absorption was a positive 8.1 million square feet for the fourth quarter, slightly below the 8.5 million square feet absorbed in the third quarter. (Chart 18, 19)

- New supply growth is likely to remain very low for several years to come as construction activity remains well below historical norms. The extended slowdown in new construction will benefit the office sector—the vacancy rate should continue to decline over the next several years, eventually dipping below 13% by 2017. (Chart 18, 19)

- Technology, software, and energy-driven markets were the best performers in 2012. Vacancy rates in markets such as San Jose, Austin, Raleigh, Boston, and Houston fell by 200 basis points or more during the year. These types of markets should continue to offer some of the best risk-adjusted returns going forward.

- On the demand side, full-time office-using positions were revised upward by 85,000 jobs for 2012, taking last year's total to 464,000. Nevertheless, healthy growth in office-using employment sectors has yet to translate to meaningful net absorption. Despite strong profits, corporations remain cautious about hiring, especially with the added uncertainty of the fiscal situation. (Chart 20)

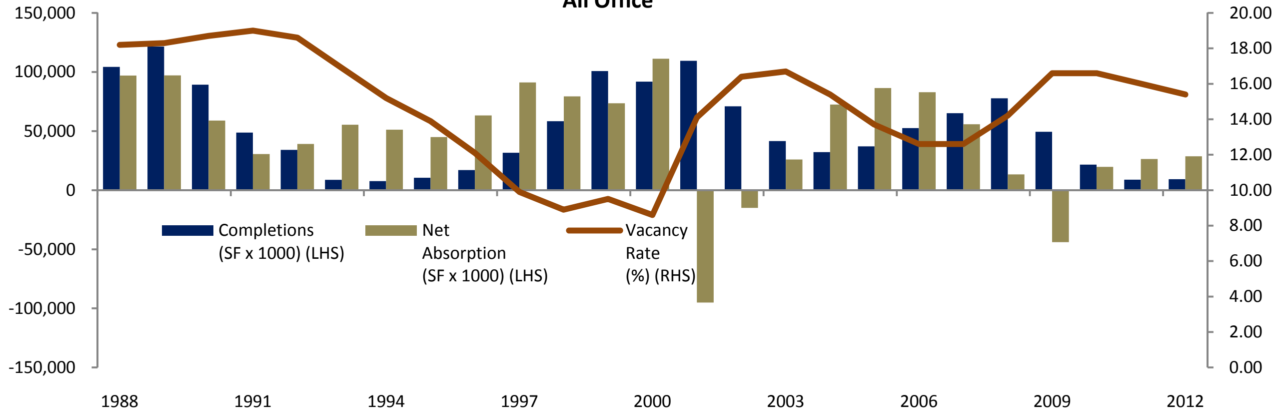
- Transaction activity surged at year-end with volume in Q4 rising to $29.1 billion, well above any prior quarter since the end of 2007. Nearly half of the quarter's volume occurred in December which was the most active month for office sales since July 2007. (Chart 20)

- Pricing for office properties increased over the quarter and cap rates declined slightly indicating that, despite the significant motivation of sellers, buyers were perhaps even more motivated. (Chart 21)

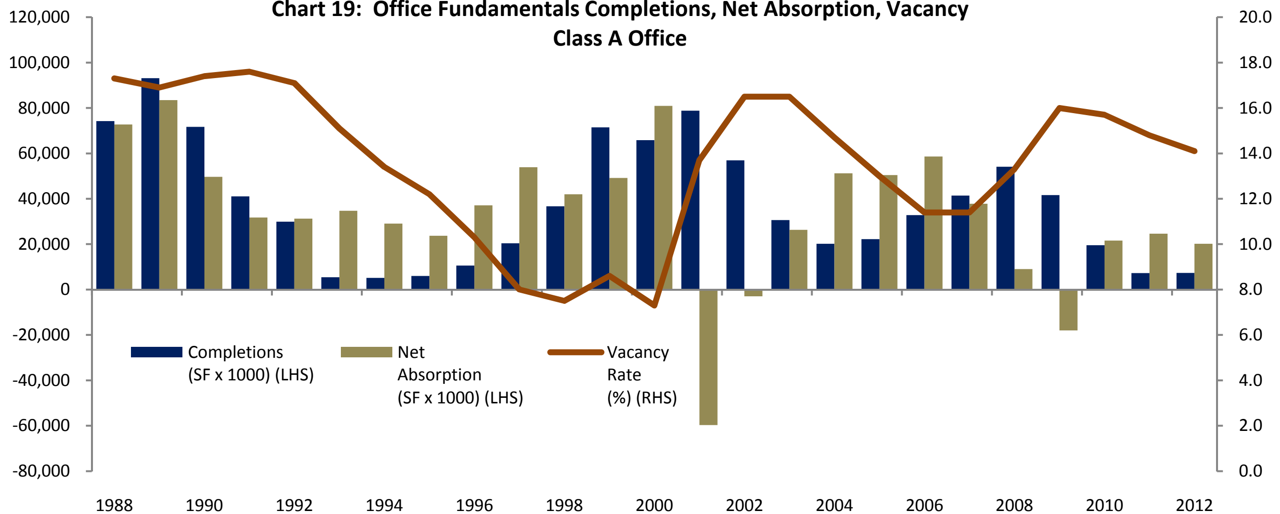
- Cap rates for properties in primary markets changed little over the year, but cap rates in secondary markets have started to fall with a particularly sharp decline noted in Q4. (Chart 21)

- The office sector continues to face headwinds from the ongoing structural changes with how firms use office space. Tenants continue to downsize space-per-capita requirements, and technology enables more people to work away from the office or spend less time there. "Value-conscious" businesses want hyper-efficiencies, looking to take 80 percent of the space they previously leased, in relentless pursuit of higher density and less cost per employee.

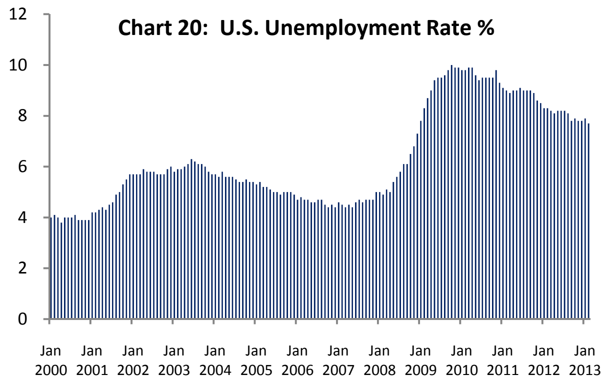
- Buildings are best positioned to outperform if they can offer tenants flexibility allowing cost-effective layout changes to accommodate open-space plans and Wi-Fi technologies. Green buildings with high ratings under the Leadership in Energy and Environmental Design (LEED) program and energy-efficient systems will have an upper hand over the competition: tenants calculate operating savings and find they can attract young talent who favor "cool space" and employer sensitivity to environmental correctness.



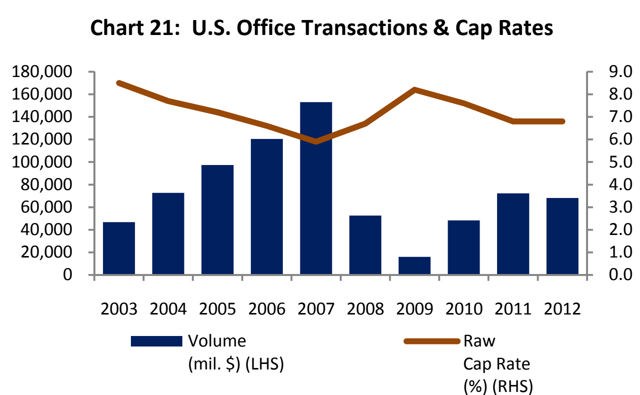
Source: CBRE-EA, USAA Real Estate Company Research



Source: CBRE, USAA Real Estate Company Research



Source: US Bureau of Labor Statistics, USAA Real Estate Company Research



Source: CBRE, USAA Real Estate Company Research

Retail

Although retail sales were a mixed bag at year-end, the recovery of the retail sector continues . . .

- After increasing by a decent 0.5% in December, retail sales were almost stagnant in January, growing by a paltry 0.1%, undeniably dampened by the expiration of the payroll tax cut. But with income growth likely to recover later this year and the housing recovery set to continue boosting household wealth, the outlook for retail sales is promising. In the second half of 2013, consumption growth is forecast to accelerate to around a 2.5% annualized rate. (Chart 4, 22, 23)

- REIS reports that the national vacancy rate declined to 10.7% at the end of the fourth quarter, dropping 10 basis points from the third quarter. Net absorption improved to a positive 2.3 million square feet for the quarter, up from the 1.4 million square feet absorbed during the previous quarter. (Chart 24)

- New construction added only 915,000 square feet during the fourth quarter of 2012, a slight increase from the 723,000 square feet added in the third quarter. Supply is expected to increase slowly over the next several years, but still far below the pre-recession levels. (Chart 24)

- Demand should continue to outpace supply, with net absorption exceeding new supply by at least 4 million square feet over the next several years. This will systematically drive the vacancy rate lower – it is forecast to drop below 10% by 2015, and under 9% by 2017. (Chart 24)

- Overall, retailer health is good, but high-end retailers continue to perform more favorably than the national retailers. As can be expected, affluent metro areas continue to be the strongest markets in the country - the top nine markets by lowest vacancy are all in California and New York area suburbs.

- As for e-commerce, internet sales over the web will continue to chip away at bricks-and-mortar margins. Retailers will likely continue to reduce store square footage and rely more on clicks-and-bricks strategies than bricks alone. As such, retail owners should consider reconfiguring their space to handle retailers' morphing to new in-store/online marketing schemes – smaller stores, more showroom and promotion space, and less storage.

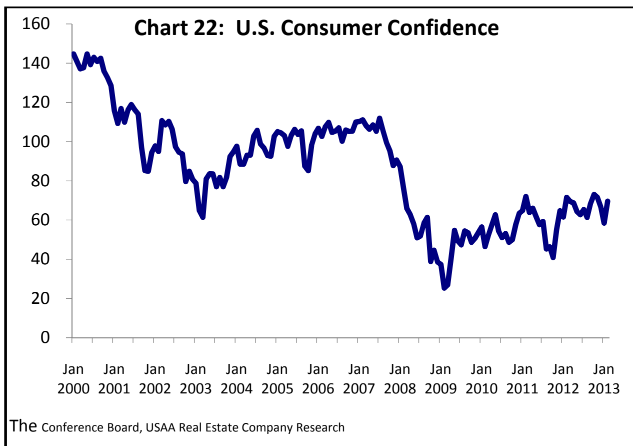
- Big-box formats are energetically pursuing how to shrink into urban streetscapes to capture business from "move-back-in" trends. Multifamily developers are similarly trying to accommodate necessity retail components – supermarkets, drugstores, and cleaners – into their infill projects. Urban retail development is one of the most promising areas for retail over the next several years.

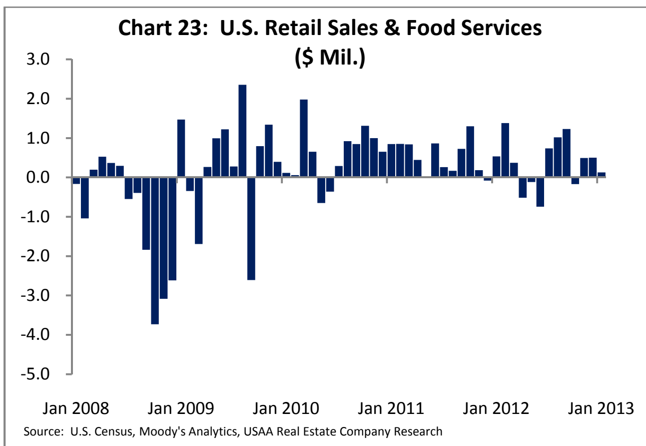
- Transaction activity surged at year-end with volume in the fourth quarter of 2012 rising to $18.4 billion, nearly double the prior quarter and up 54% from a year earlier. Nearly half of the quarter's volume occurred in December as sellers were highly motivated to close deals prior to the rise in taxes.

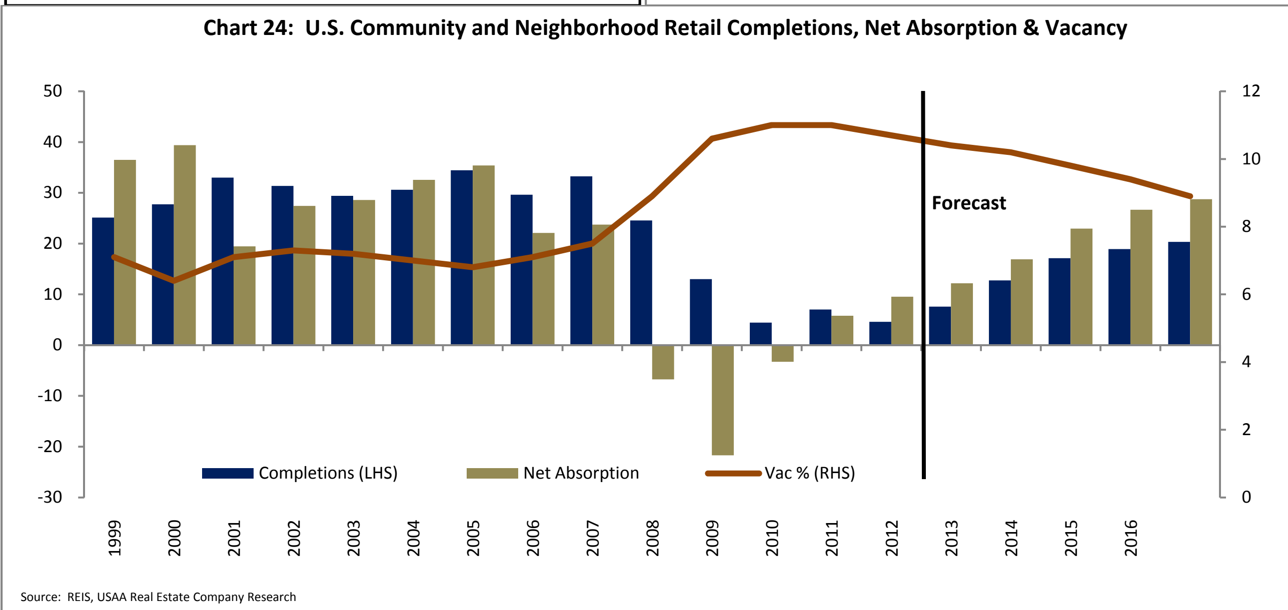
- Cap rates for retail properties have been averaging around 7.3% as of the end of the year. Pricing trends in the retail sector have been difficult to pinpoint as cap rate averages are being influenced by a broadening of investment to higher yielding markets. However, cap rates in the six Major Metros, a more equal comparison, steadily declined over the year including a 10 basis point fall in Q4. (Chart 25)

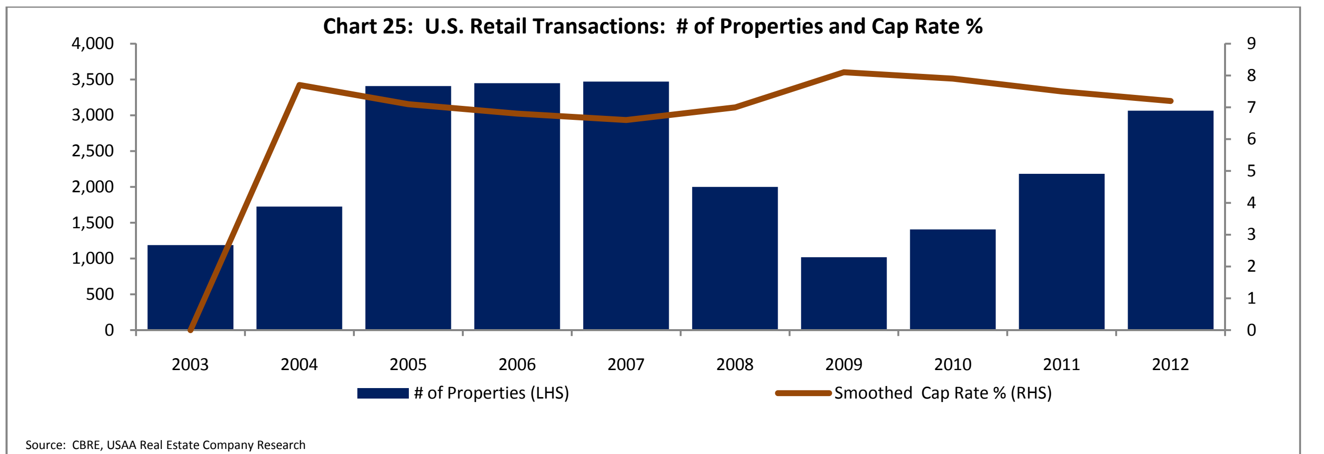
- Single tenant retail properties have held value better over the cycle and are now within 15% of peak price levels compared to the entire retail sector, which is 30% of peak. Prices for unanchored retail properties remain the farthest from peak levels, but finally experienced some rebound in prices in 2012 as private investors returned to the market.

- Grocery-anchored neighborhood and community centers should continue to out-perform non-anchored centers as the majority of consumers continue to focus on non-discretionary spending. One word of caution – as J.C. Penney's turnaround continues to be fraught with missteps, investors should proceed with caution when considering the acquisition of retail centers anchored by this tenant.









Hotels

A strong finish to end the year . . .

- Despite continued uncertainty with the U.S. economy, the hotel sector enjoyed another strong quarter of performance to cap off an impressive year. Hotel demand in 2012 set new records for room nights sold in a month (105 million in July) and for the year (1.1 billion). Demand continues to be bolstered by increased tourism and the thriving technology, health care, and business and professional services sectors. (Chart 26, 27, 28)

- According to PKF-HR, national hotel occupancy rates will likely improve another 1.0% to reach 62.1% by the end of 2013. As proof of the resurgence in the hotel industry, this will be the first time that the national occupancy is forecast to exceed its long-run average (of 61.9%) since the start of the economic downturn. Solid demand growth combined with a limited increase in supply should serve as the base for above average occupancy levels in 2013 and beyond.

- In the fourth quarter, the national Average Daily Room rate (ADR) increased to an average of $106.05 per room, representing a 4.1% growth rate over the past four quarters. Growth in room rates has been strongest in the luxury and upscale segments.

- ADR growth is forecast to continue in 2013, achieving a 5.0% growth rate by the end of the year, increasing to $111.31. ADR growth is expected to continue in the 5% to 6% range for 2014 and 2015, and then slightly decline to a 4.5% growth rate in 2016.

- RevPAR (revenue per available room) ended the year at $65.17, achieving a stellar 6.8% growth rate over the past four quarters, and significantly higher than the long run average of 2.7%. RevPAR growth is forecast to continue its whirlwind pace over the next three years, achieving gains of 6% to 7% per year, before settling back to a more typical 4% pace in 2016. (Chart 27, 28)

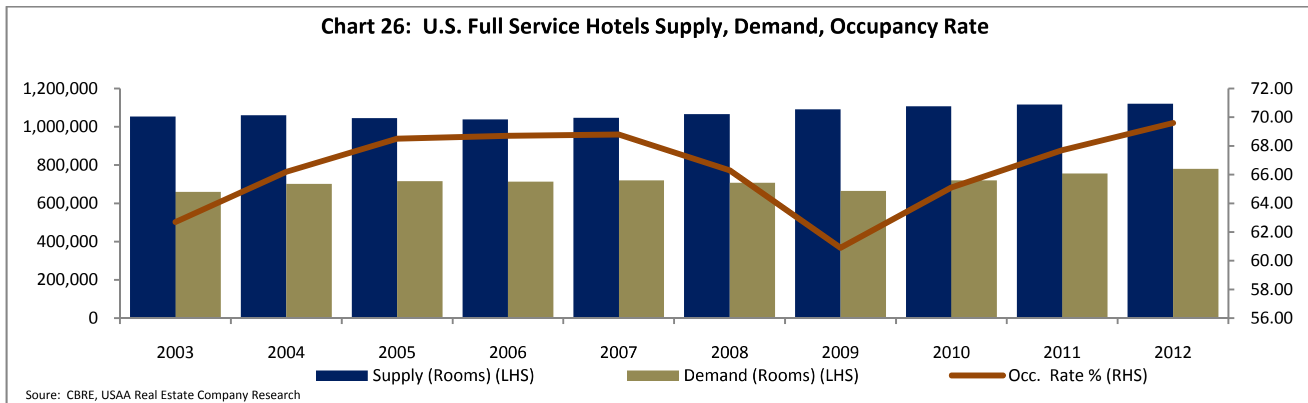
- The hotel sector is reaching a point in the business cycle where market conditions should allow hotel operators to raise room rates significantly. Managers are increasingly shifting their focus on boosting the bottom line through higher prices rather than increasing occupancy.

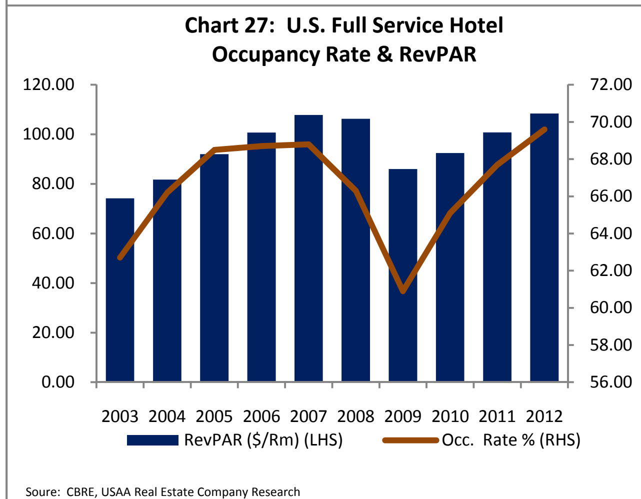
- For 2013, demand is expected to decelerate slightly to a 1.8% growth rate, but still outpace the amount of new supply, which is forecasted to increase by 0.8% for the year. (Chart 26)

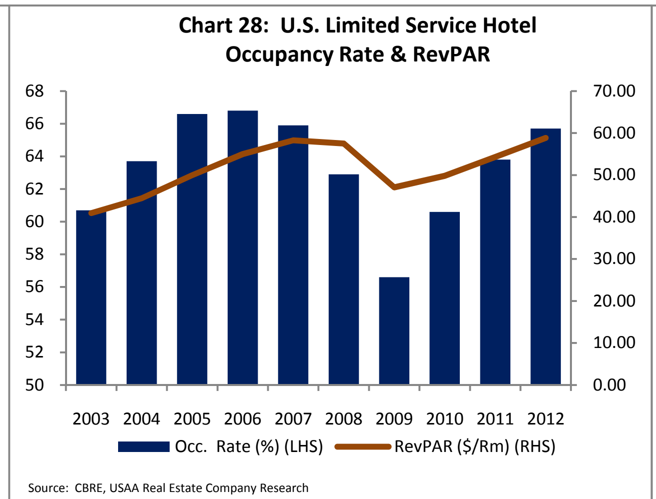
- Although overbuilding in some segments was an issue prior to the recession, supply growth has since hovered at extremely low levels. New supply should continue to be constrained over the short term as the availability of construction financing remains elusive and most markets have yet to recover to a point where development is justified.

- Transaction activity increased dramatically at year-end with fourth quarter volume rising to $7.1 billion, driven largely by individual property sales which totaled $4.5 billion, the highest since the peak of the market in 2007. The largest transaction of 2012 was the $1.9 billion sale of the Motel 6 chain to Blackstone. The largest single asset sale of the year was the Grand Hyatt in Washington, DC for $397 million.

- Currently, investors seem to prefer full service hotels over the limited service hotels. According to RCA, cap rates averaged 7.4% for full service hotels and 8.6% for limited service hotels over the past 12 months. Nationwide, cap rates have been flat for the past two years, with increased trading in secondary markets counterbalancing lower yields in gateway cities.







USAA Real Estate Company – A Market View

Given current and expected economic and real estate market conditions, numerous attractive investment opportunities exist . . .

- Strong demand for core real estate as investors chase yield and a safe harbor will continue to make core real estate an attractive investment. Even at current low cap rates in some markets, yields still look attractive relative to alternatives. In fact, one could argue core real estate is trading at historic premiums to other investments. While we believe opportunities remain in the top gateway markets, particularly for recapitalizations and value add investments, these markets are becoming increasingly expensive and investors should consider other markets that have strong demand growth fundamentals and supply constraints. Emphasis should be placed on markets with heavy employment concentrations in energy, technology, and health care as they should provide significant income growth opportunities.

- Changing demographics in the U.S. are providing opportunities for long-term real estate investors across various sectors and subsectors. The echo baby boom is in its family formation and marriage cycle phase which correlates with the peak in demand for rental apartments and multifamily housing. This should continue through at least 2016 or 2017. While housing affordability may cut into demand somewhat, apartment demand should remain strong until then. Apartments have gotten very pricey in some markets and the volume of proposed new development is increasing, but demand drivers, including reduced homeownership, urbanization, and mobility remain strong. Moreover, a limited supply of development capital will continue to constrain the level of new supply in the near term in most markets. New development will not start impacting the markets for another year or two. That said, there are a handful of markets where supply concerns should discourage further development activity including, Washington, DC and Austin. There are still attractive opportunities for investors to take advantage of apartment demand by developing infill locations in strong growth markets that can provide attractive development risk-adjusted return premiums. In addition, buying in strong locations in growing secondary markets with supply constraints can provide attractive returns.

- Another changing demographic that is providing attractive real estate investment opportunities is the aging of the population. This demographic is producing demand for senior housing and medical office facilities. While senior housing can provide attractive returns across the investment spectrum from independent or minimal assistance with activities of daily living to acute care, investment in this area is tantamount to investing in an operating business and as a result we are not actively investing in this sector. While the same can be true for investing in medical office, this varies by the type and location of medical buildings. The demographic trends, among others, provide strong support for investing in this subsector. However, the opportunity should be implemented with a strong operator/partner who can execute transactions with major health care systems. Medical office investments have historically provided higher returns than traditional office with less volatility.

- Approximately $1.5 trillion in commercial real estate debt will need to be refinanced over the next five years. Opportunity exists to purchase underperforming loans as lenders are in a better position to accept the losses. In addition, new loan opportunities exist that can provide investors with attractive returns relative to other fixed-income investments. Given that most new first mortgage loans are being made at low loan-to-value ratios, an opportunity exists to provide debt in the 70% - 85% segment of the capital stack. This segment can provide very attractive returns with a measure of protection given that the loan is still senior to the equity position. Finally, as this

large amount of debt is resolved, there will be significant opportunity to recapitalize the underlying real estate, much of which has been capital starved over the past several years as lenders “kicked the can down the road.” While this produced positive results for the senior lenders, the assets have suffered from deferred maintenance and lack of leasing capital and in many cases occupancy has moved steadily downward.

- As the economy slowly recovers in a constrained supply environment, there are opportunities to take advantage of increasing demand across all property types. Industrial/warehouse assets in select inland and coastal port markets that are along the path of goods movement and near population centers are particularly attractive. Well-located, modern functional warehouse space that is responsive to the needs of e-commerce tenants should provide attractive total returns with a strong income component. Moreover, the rapid expansion of e-commerce tenants has led to build-to-suit opportunities and strong demand combined with diminished supply and has justified speculative development in the healthiest industrial markets such as Central Pennsylvania and the Inland Empire in California.

- The retail market is very similar to the apartment market as it has to expand to meet the shopping needs of new households. Given the current economic environment, the retail market has become bifurcated in that there is continued demand for necessity shopping and luxury items. Therefore, demand driven investment opportunities exist for necessity-focused neighborhood retail centers, typically grocery anchored, and higher-end regional malls. Investment in grocery anchored centers should focus on locations with steady or growing populations and emphasis should be placed on the quality of the grocer. As Wal-Mart and Target continue to expand its grocery business, investors should focus on major metropolitan areas where multiple strong grocers exist and on smaller markets were a dominant grocer exists. The dominant high-end mall in major markets is also attractive, but investment opportunities are very limited. In general, retail investors must be mindful that internet commerce is slowly causing retailers to consider changing their formats.

- The demand for office property tends to correlate with the office-using workforce and the strength of the economy. As office employment slowly improves and vacancy rates continue to drop, there are attractive opportunities to invest in office in the gateway markets with cap rates still at attractive spreads over Treasuries. Yields can be enhanced in these markets by accepting leasing or vacancy risk, but this requires a strong understanding of market fundamentals, as well as a careful selection of quality assets that possess competitive leasing advantages. For those looking for even higher yields, strong locations in the major non-gateway markets can provide attractive returns, particularly as greater amounts of institutional capital returns to these markets over the next several years. As a result of the previously mentioned shortage of capital for maintenance and leasing costs, the office sector represents the most appealing area for value-add investment.

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