

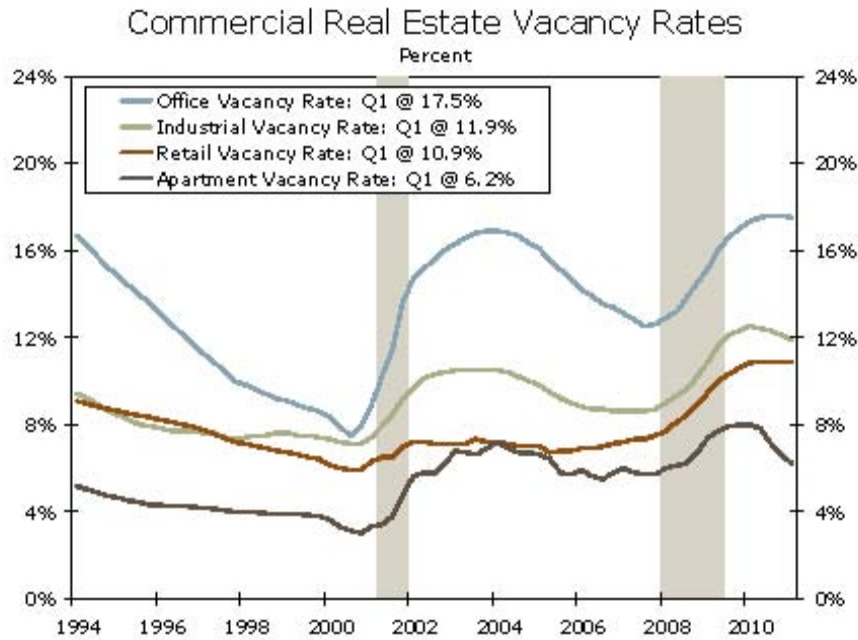


Commercial Real Estate Outlook Summer 2011

By Daniel Owen Mee

U.S. Commercial Real Estate (CRE) experienced a severe, demand-driven downturn beginning in 2007 and accelerating into 2008 and 2009. This is quite different from the unprecedented supply-driven downturn for-sale single family housing has endured during the same period. Historically, supply-driven recessions tend to require long, extended periods to work through the excess capacity. Fortunately for its owners and lenders, CRE did not drastically overbuild across most asset classes, so the re-pricing has been more of a function of the state of the economy. Thus, the recovery in valuation should correlate well to the country's economic recovery. Moreover, because there have been very few construction cranes visible along US skylines since the first hints of the recession began, the resultant supply constraints may indicate that CRE will enjoy a recovery in advance of other segments of the general economy.

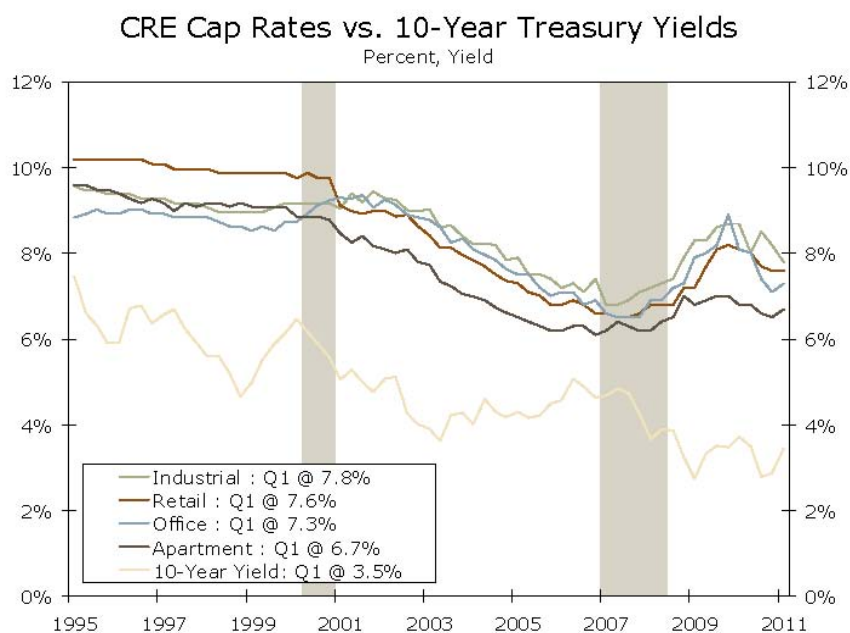
The recent combination of a modest pick up in private sector job growth and near zero construction have produced some solid improvement in operating fundamentals across all real estate property types. The following chart illustrates CRE vacancy rates across sectors. Note how apartment/multifamily recovery is leading the industry with vacancy rates that have fallen almost 2% in the last 18 months.



Source: PPR, REIS

Virtually all CRE sectors and regions have at least seen conditions stabilize in recent months. Thus the improvement trend nationally is clear, although somewhat lumpy. Certain regions have endured such chaos in the home and condo sale markets that all sectors are suffering. In other areas, namely the technology centers of Austin, San Jose, Seattle, Boston and Raleigh, rates are well ahead of national trends. In addition, demand for office and industrial space is tightening in major energy markets such as Houston, Oklahoma City and Denver. Industrial development is also producing some job growth in markets such as Greenville, SC, which is home to the new BMW operations, and Charleston, SC where Boeing is completing a new assembly plant. Markets where the housing crisis was most severe, such as Atlanta, Phoenix, Las Vegas and Tampa, continue to lag. However, even these locations have seen some gains in key submarkets.

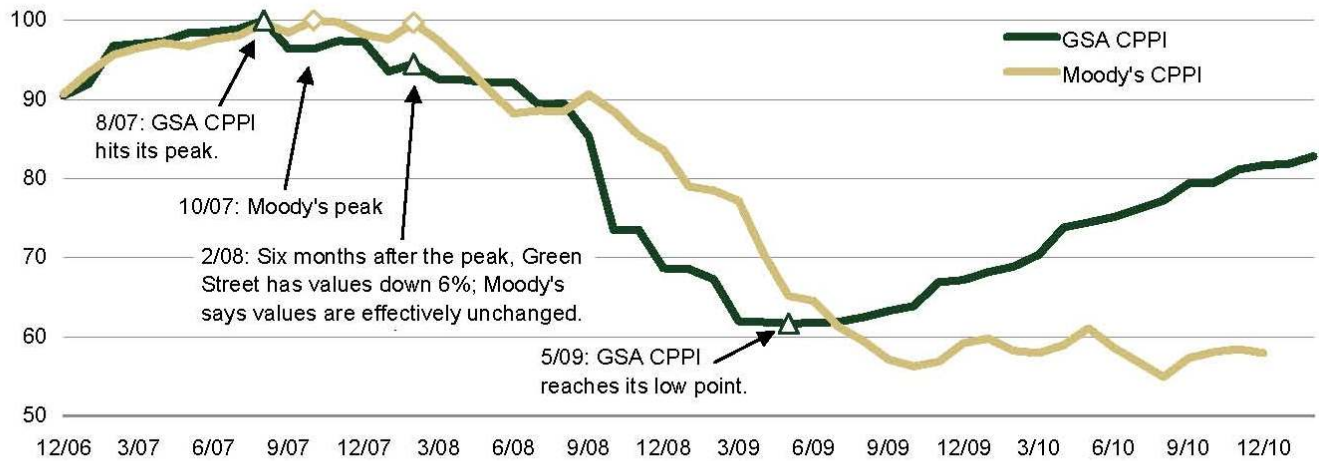
Evidence of the improving fundamentals can be seen in capitalization rates which have all declined from their recession driven highs.



Source: PPR

To understand where values are today consider the following chart depicting two CPP indices from respected research firms. The primary difference between the two is that Moody's includes only closed transaction data, while GSA purports to also include negotiated, but not closed transactions. Such data would be useful as it would reveal real-time valuations versus the lagged values closed transactions indicate. However, we believe it is challenging to attempt to widely ascertain terms of non-closed deals as these transactions tend to be highly confidential. TR Capital believes that actual prices probably fall somewhere in between the two illustrated graphs. More importantly, both graphs indicate that the free fall in values has ended. Factors cited for this improvement include a) lower return hurdles, b) few deep discount distress sales, c) weak, but improving capital markets, d) improving fundamentals across all sectors.

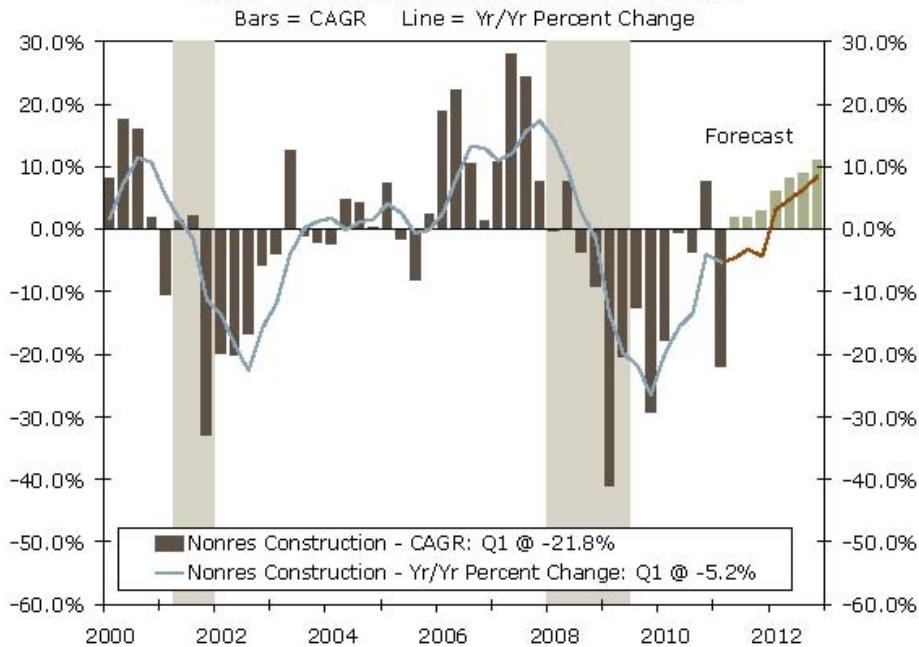
Commercial Property Price Indices: Green Street Advisors vs. Moody's



GSA CPPI and Moody's CPPI are indexed to 100 at their respective peaks, Aug '07 and Oct '07.
 Moody's Investor Services, Inc

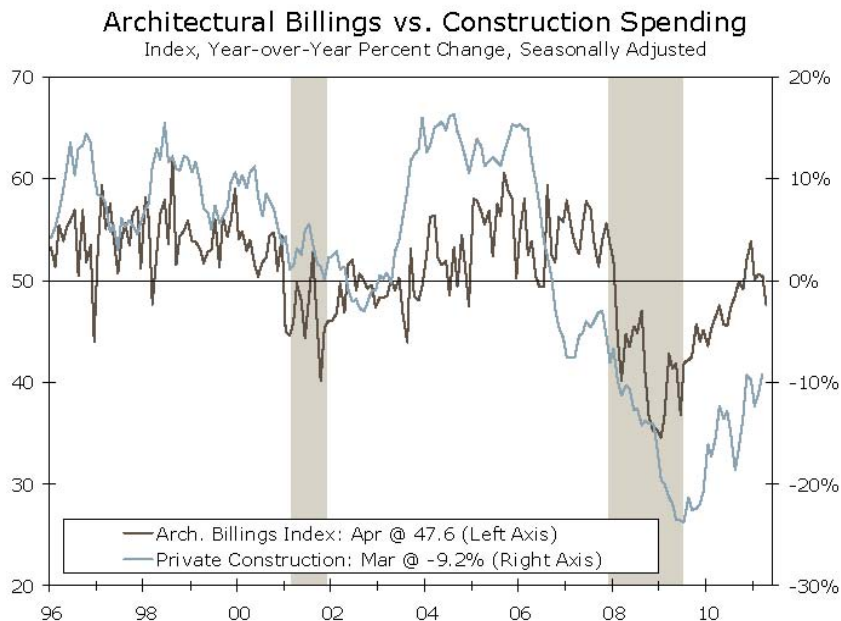
While the CRE market conditions today are clearly better than we saw in 2008-2010, we are far from a healthy or robust market. Headwinds include: the need to deal with the hundreds of billions of dollars in maturing CRE debt over the next half dozen years; identifying new economic drivers to push employment; massive federal, state and municipal budget crises, that will lead to cutbacks, layoffs and potential bankruptcies. The uncertainty of these and other issues seem to be keeping significant capital on the sidelines to date. In some ways this is a positive for the industry as the tight constraints on development capital have all but eliminated speculative construction. This lack of building should lead to a speedier recover for CRE than seen in previous cycles.

Real Nonresidential Construction



Source: PPR, REIS and Wells Fargo Securities Economics Group

The above chart illustrates the reduction in nonresidential construction beginning in 2008 and continuing through today. The forecasted up-tick in development seems to have merit, especially if traditional predictors are examined. Architectural billings tend to precede construction by about 12 months. The general trend of this data as displayed below supports the above forecast. Note that the 2nd Q 2011 downturn has been attributed to the end of the federal stimulus and continued difficulty facing developers in obtaining financing.



Source: American Institute of Architects, U.S. Dept. of Commerce, U.S. Dept. of Labor and Wells Fargo Securities, LLC

In summary, the CRE market appears to have bottomed. While there is no robust recovery afoot, the improvement trends appear consistent. CRE will benefit from the absence of new supply, and with the value declines since 2007 resulting in today’s prices largely below new construction costs, excessive new building seems highly unlikely to impede the anticipated recovery.



Daniel Owen Mee is cofounder and Executive Director of Tremont Realty Capital, LLC. He has over 30 years real estate industry experience. Prior to forming Tremont, Mr. Mee worked for JP Morgan Chase, the Federal Deposit Insurance Corporation and other real estate capital companies. Mr. Mee holds an AB in Economics from Harvard University and an MBA from Harvard Business School. Tremont Realty Capital is a national real estate investment management and advisory company. Primarily active in CRE debt markets, Tremont’s track record includes over \$700 million in AUM.