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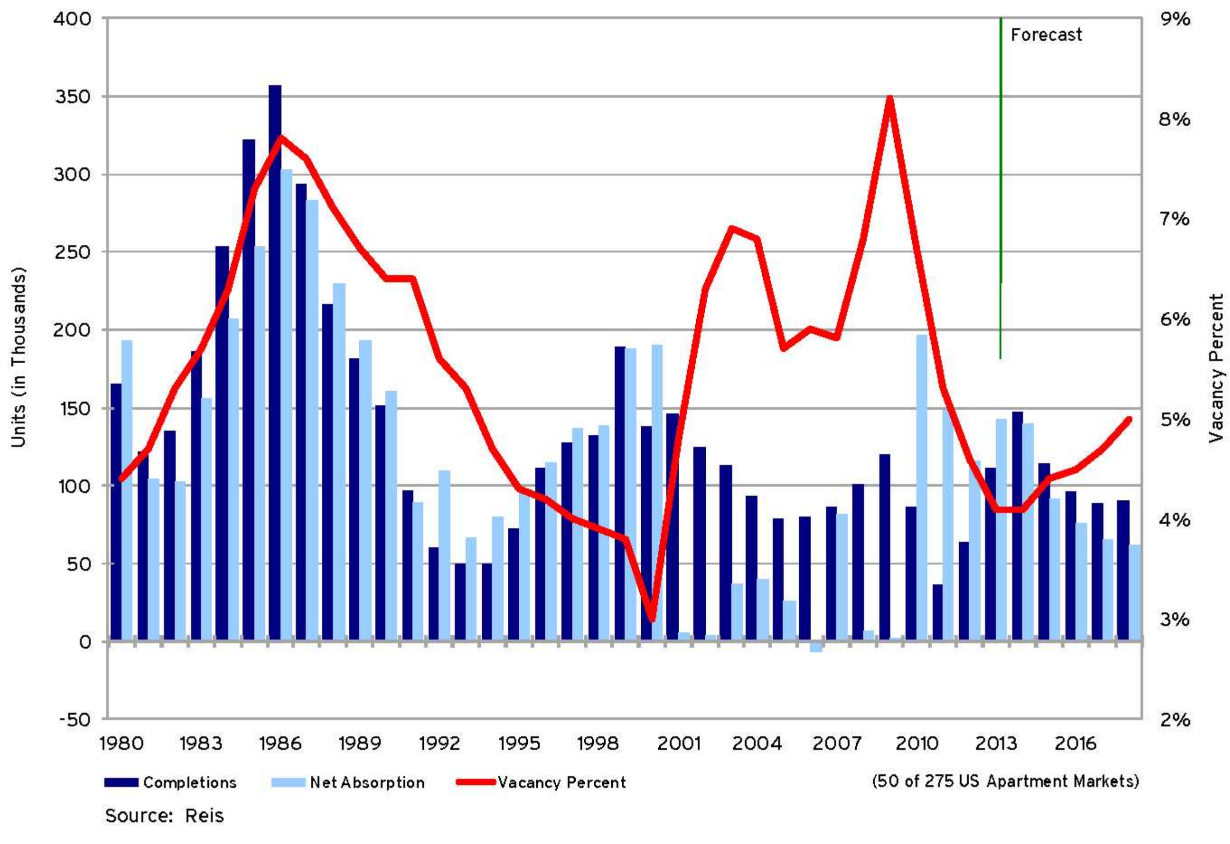
The State of the Market – March 2014

Multifamily

Fundamentals within the multifamily segment have never been stronger. After decades of generally increasing home ownership rates, the national home ownership rate began a sharp decline in 2005 and has since continued. At 65.2%, home ownership is as its lowest level in 15 years. Some market participants believe the housing crisis of 2008 and 2009 has largely reshaped how people view home ownership and will subdue home ownership for the foreseeable future. Stricter lending standards are also holding back first time homebuyers and forcing many into rental situations.

Fueled by this declining home ownership and stable job and population growth, fundamentals within the multifamily segment are extremely strong. According to REIS.com, as of 4th quarter 2013 the national apartment vacancy rate was 4.1%, down 10 basis points over the prior quarter and down 50 basis points from one year ago. Vacancy dipped below 5.0% in 2012 after having been above 5.0% since 2001.

Over the past 11 years, the national apartment market inventory has grown at a compound annual growth rate of .70%, adding approximately 100,000 units per year. New deliveries hit a post recession peak of 145,000 units in 2013, up sharply over the past several years.



While market participants expect vacancy to rise as a result of new deliveries, most expect demand will keep pace with supply leading to a long term vacancy rate at or near 5.0%.

As of year-end 2013, the average asking and effective rents were reported at $1,131 per month and $1,083 per month, respectively. Due to the steady demand and lagging supply, the average asking rate is forecast to grow at a compound annual growth rate of 2.71%. In addition, rental rate spreads (between asking and effective rents) will remain lower than during the recession as landlords regain pricing power and concessions decline.

Multifamily investment market activity in 2013 neared its prerecession peak pursuant to year-end 2013 data from Real Capital Analytics. At $103.5 billion, volume was up 18% over 2012, nearing the all-time high of $105.4 billion in sales during 2007. The US average cap rate fell 10 basis points during the 4th quarter to reach a level of 6.4%, near the level at which cap rates ended 2012.

Retail

The US retail industry gained substantial ground in 2013. Overall, retailers experienced a healthy holiday shopping season during 2013 with sales up 2.3% year-over-year, although online shopping continues to grab a growing share of overall commerce. Online sales on "Cyber Monday" reached a record $2.3 billion, up 23% over 2012. Retailers continue to focus on a strategy that can target consumers in traditional brick and mortar form, as well as online.

The gradual demand recovery seen over the past couple of years, coupled with what are historically low levels of new construction, have enabled vacancy rates to decline across the country, albeit slowly. According to REIS the national retail vacancy rate now stands at 10.4%, down 30 basis points over the past year, however, still well above pre-recession levels. While many predicted the decline of the regional mall following re-emergence from the great recession, the regional mall has actually fared better than its inline or standalone counterpart. The regional mall vacancy rate now stands at 7.9%, down 70 basis points year-over-year.

The slow recovery in demand has been met with little or no growth in asking rental rates. REIS data indicates a growth rate of just 1.4% in 2013, reaching an average asking rental rate of $19.34/SF. Effective rates meanwhile, lag even further with a 4th quarter 2013 level of $16.83/SF, up 1.4% over the year as well. As a result of slow new development, REIS forecasts declining vacancy and improving rental rates over the near term.

According to Real Capital Analytics retail sales transactions totaled $61.6 billion during 2013, up 8.8% over 2012. According to REIS.com the national average retail cap rate compressed in 2013, ending the year near 7.7%, down 30 basis points during the year. The 12 month rolling average capitalization rate, considered a more stable indicator of cap rates, stood at 7.8% as of year-end 2013.

Industrial

The US industrial market ended 2013 at its strongest point since 2007. Mostly as a result of the growth of e-commerce and the need for better supply chain networks to support online retailing, demand for industrial space continued to climb during the 4th quarter of 2013. According to CB Richard Ellis, the 40 basis point decline during the 4th quarter marked the 14th consecutive quarter in which availability decreased. The national average vacancy rate now stands at 11.3%, down 22% from its post recession peak during the 3rd quarter of 2010. The nation as a whole saw over 233 million square feet of positive absorption during the 4th quarter, the highest quarterly absorption rate since 2005. The South and West are the most active markets in the country, driven by strong demand in Dallas/Ft. Worth and Houston, Texas, Denver, Colorado, the Inland Empire, California and within the Pacific Northwest.

New construction starts have increased gradually, however, are well below pre-recession construction levels in 2005 and 2006. The majority of today's deliveries are build-to-suit for larger users; however, speculative development is in the pipeline. New construction completions totaled 36.8 million square feet in the 4th quarter, more than double the level found in any quarter dating back to the recession.

The average net asking rent ended the year at its highest level since 2009. At $5.74/SF per year the current rate is up approximately 3% from one year ago. Most of the rental rate growth is concentrated within newer, Class A space (32' clear height, cross-docked, 100,000+ SF footprint, tilt-wall construction). However, growing demand for older Class B/C space is helping to shore up growth rates as well. Concessions offered for Class A space are also declining.

From an investment market standpoint strengthening underlying fundamentals is driving renewed investment activity into the industrial segment. Real Capital Analytics ("RCA") reports investment sales activity of $45.9 billion during 2013, up 12% over the previous year. RCA reported cap rates held steady at 7.5%, despite gains in the US treasury rate, as institutional demand for quality space diminished the impacts of increasing interest rates.

Office

On a national basis, job growth is slowly leading to improvement in the US office market. According to REIS.com the national average vacancy rate is now 16.9%, down 20 basis points over the level found at year-end 2012. Well after most economists declared an end to the great recession, the office vacancy kept rising, reaching a peak of 17.6% in the 1st quarter of 2011. From that point, however, improvement will no doubt take some time. Rental rates still remain flat for the most part, growing just 1.1% during 2013. Any meaningful acceleration in rental rate growth appears unlikely until vacancy rates cross the 13-14% threshold.

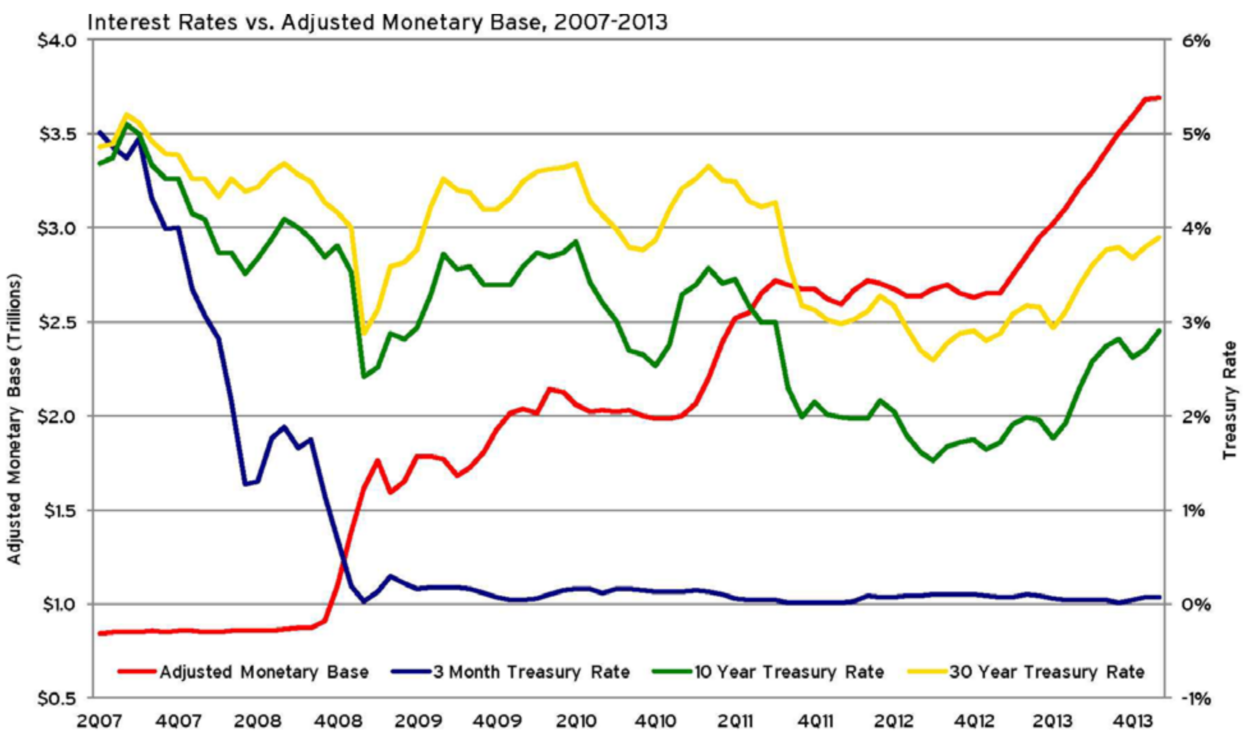
Although office-using job growth is up, a new problem is confronting office owners. With employers adding to their payrolls again, many are looking to optimize the space they already use, or reduce their footprint. While originally pioneered in high-tech companies, many traditional users are now demanding highly efficient space. The reduction of hard-walled offices in favor of cubicles and also a shift in many organizations to "free address" or "open subscribe" system to increase utilization has led to an overall decline in the space requirement per person. By adopting these strategies, tenants are able to bring on additional staff without leasing additional space.

By historical standards, new construction remains relatively mild. In total CB Richard Ellis reports a total of 18.6 million square feet of office development in 2013. A majority of these projects, however, were either build-to-suit or preleased projects. Speculative development was confined to high-demand markets such as Houston, where a true shortage of space exists as a result of the energy boom.

While RCA reports transaction activity within the office investment market, transactions are skewed towards "trophy" assets. Manhattan accounted for over 20% of the $101.5 billion in reported office transaction activity during 2012, with sales of $20.9 billion. Investors continue to gravitate towards core assets, however, some have branched back out into key suburban locations in an effort to boost yields. REIS reports the average office capitalization rate is now approximately 7.2%, near the same level reported as of 4th quarter 2012. The 12 month rolling average cap rate is now 7.1%.

NNN Leased

Investor demand within the NNN leased space continues to remain strong, despite interest rate uncertainty. The perception by many investors that rising interest rates would result in an increase in capitalization rates simply did not materialize in the 4th quarter. A limited supply remains the primary driver behind this reverse correlation as many institutional real estate funds had strong 3rd and 4th quarter acquisition targets, resulting in higher transaction volume and lower cap rates. Uncertainty within the industry will continue to grow amid talk of higher interest rates. While the Fed has committed to keeping short term interest rates low, long term interest rates have already begun to rise.



Source: Federal Reserve

As a result of interest rate increases, many NNN leased investment market participants anticipate capitalizing rates will rise during 2014; however, most believe the increase will be limited to 25-50 basis points.

A summary of the three major NNN leased property types and their respective average capitalization rates are presented below:

Property Type	Q3 2013	Q4 2013	Basis Point Change
Retail	7.02%	6.85%	-17
Office	7.70%	7.40%	-30
Industrial	8.00%	8.15%	+15

Our firm's concern, of course, remains the financing strategies employed with NNN assets, as we believe matching amortizing debt to the asset lease term is the most prudent approach.