Real Estate Outlook Mid-2010: Reflecting on the Inflection

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Burns Coffee
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Burns School of Real Estate & Construction Management

by
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This is a presentation at a Burns Coffee sponsored by the Franklin L. Burns School of Real Estate and Construction Management made by Jim DeLisle, the 2010 designated Burns Visiting Scholar and the Runstad Professor of Real Estate and Director of Graduate Real Estate Studies at the University of Washington. The presentation provides a mid-year update on the macroeconomic environment, capital markets, and real estate fundamentals with a discussion of implications for real estate professionals. Readers interested in more insights into where the industry is headed are referred to the companion presentation to the Burns Society on April 20,2010 which covers my Top-10 Trends and talks about the upcoming "Revolution" in commercial real estate.

Presentation Overview

– I: Macroeconomic Environment

– II: Capital Flows & Real Estate

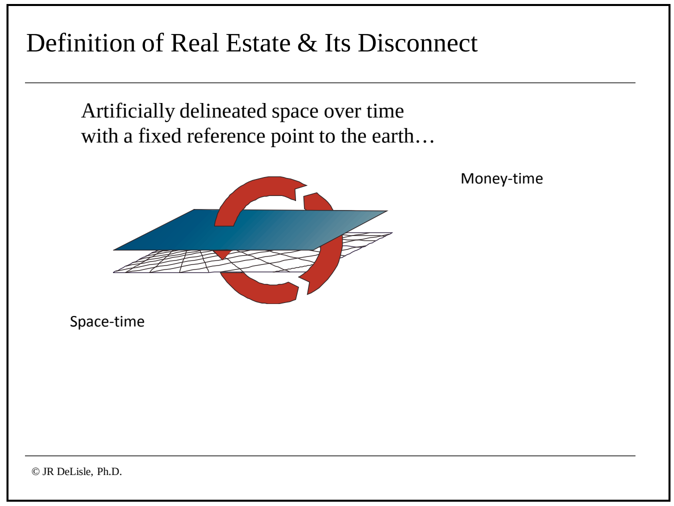
– III: Real Estate Market Fundamentals & Implications

Hyperlinked Table of Contents to Presentation

Overview

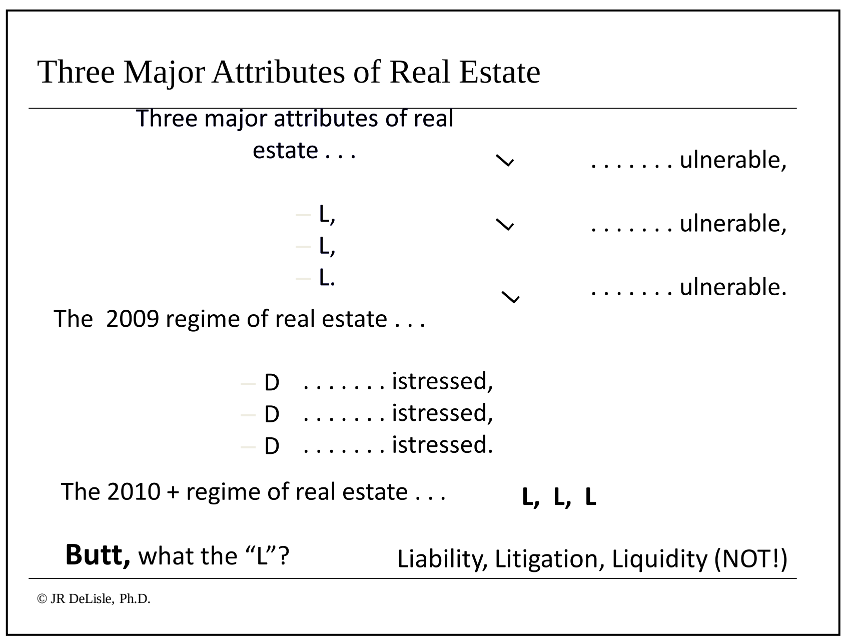
A Formal Definition of Real Estate

Real Estate consists of two major dimensions: a space-time dimension, and a money-time dimension. These dimensions are also referred to as the spatial or Main Street side of the industry, and the capital or Wall Street side. In general, real estate value relies heavily on the spatial side which includes the asset itself, along with its environs and linkages. It also includes the fundamentals of supply and demand that comprise the market for the actual asset. In my estimation, these spatial elements provide some 70% of the value proposition. On the other hand, the capital side which includes capital flows, pricing, return requirements, and financial engineering comprise the balance of the value proposition. Unfortunately, over the past 12-15 years, this ratio has been distorted, with the capital side driving prices and the spatial side taking a back seat. That proposition has dramatically changed with the collapse of the bubble market and has set the stage for renewed interest in fundamentals with special –and warranted-- attention on the spatial side of the equation.



The Three Major Attributes of Real Estate

This slide is designed to disarm the audience a bit and get them thinking creatively and out of the box. The play on the Location, Location, Location theme points to the Vulnerability of real estate due to the potential impact of a range of externalities. It also introduces the "D" word for distress. We also talked about the dreaded "R" word which to some might be "Recession" but to developers is "Recourse" which is coming in future loans resets which are hanging over the industry.



In something of a return to fundamentals, the L, L, L is back in vogue for 2010. Unfortunately, instead of Location, Location, Location, they will stand for Liability (recourse for borrowers), Litigation for a lot of players, and Liquidity (NOT) reflecting the inability to access debt capital and the challenges sellers will face when the glut of distressed assets clouds the market.

Part I: Economic Environment for Real Estate

Economic Snapshot

The economic snapshot is not as bleak as it was a year ago, with the economy moving out of its recessionary spiral. Despite positive GDP growth, the market is somewhat bifurcated with small businesses struggling and big business and the stock market heading upward and consumers largely out of the picture. Despite positive signals, the recovery will be tempered relative to other post-recessionary periods with some downside risk that may derail much of the recent upside momentum (which may be an overly optimistic term).

Part I: Economic Environment for Real Estate

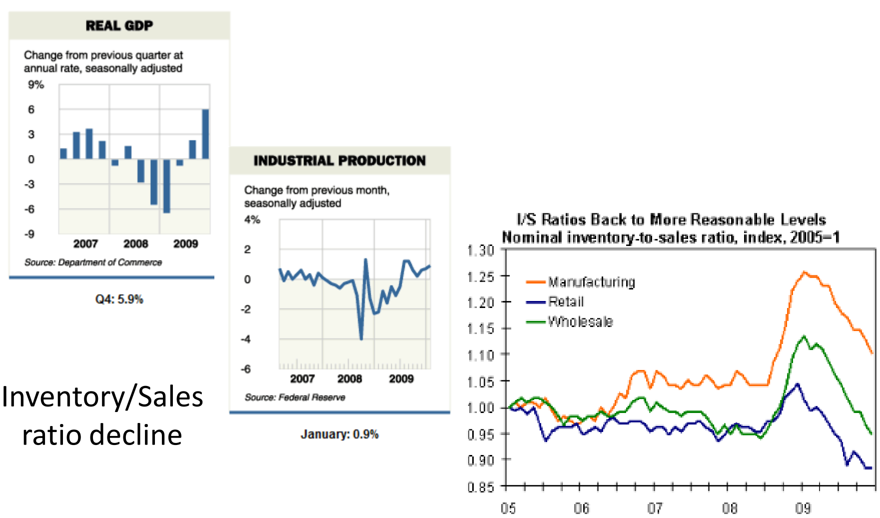
2010 Outlook

- Recession over; slow recovery; some downside risk
- Big businesses okay, Small struggling, stock market up
- Consumers guarded; CEOs hopeful

Economic Indicators

Recent economic data have shown a number of positive indicators, although not all are pointing up. Real GDP was strong at year-end, although the rate has flattened out a bit and is expected to be in the 2-3% range during 2010. The inventory buildup in 2009 has been burned off which might create added stimulus to production. Production has been trending upward, with some added pressure coming to replenish inventories which were burned off as companies tried to adjust to the tempered economy.

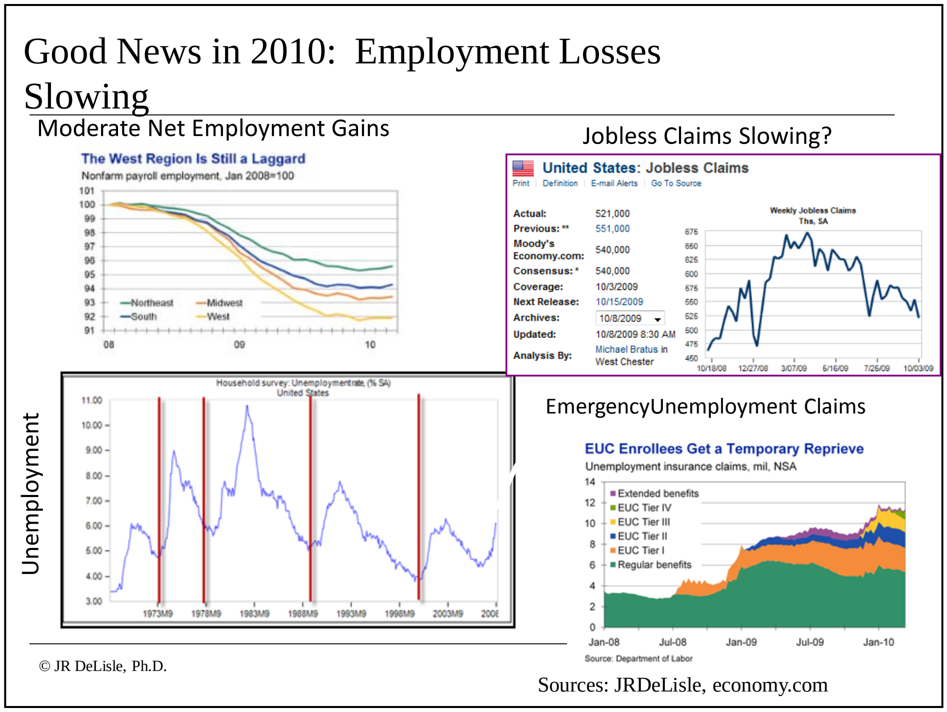
Economic Indicators: Showing Improvement



Sources: JRDeLisle, economy.com

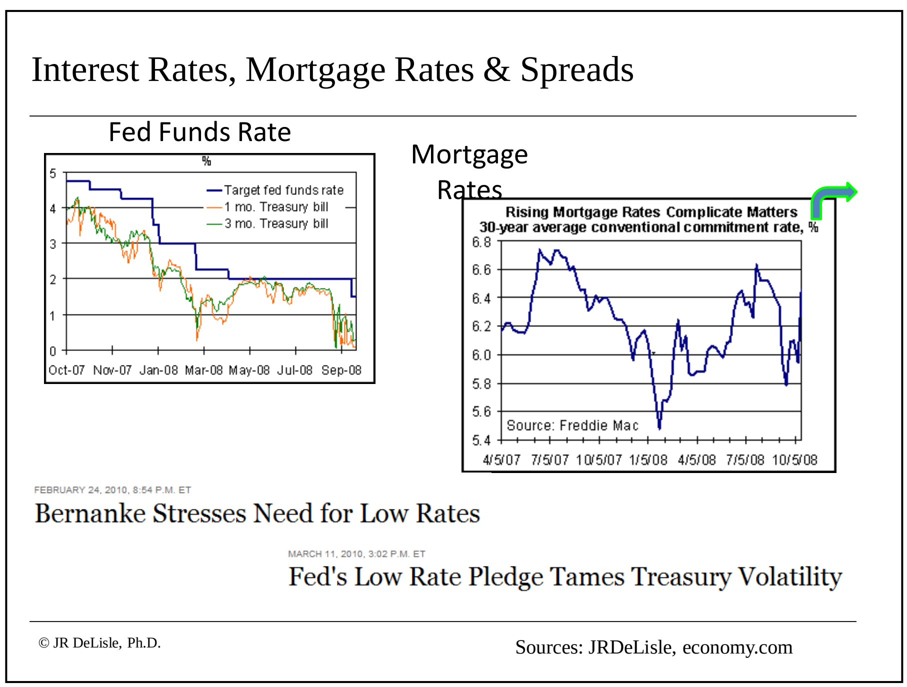
Employment Losses and Unemployment

The employment front remains a problem, with no signs of a quick turnaround. Some employment growth has been reported, but the bulk of that has been census workers and temporary employees as businesses remain cautious with respect to permanent hires. The plight of the unemployed benefited from extension of the emergency funding for longer term benefits although this issue will continue to resurface in the face of tempered job growth and a soft labor market.



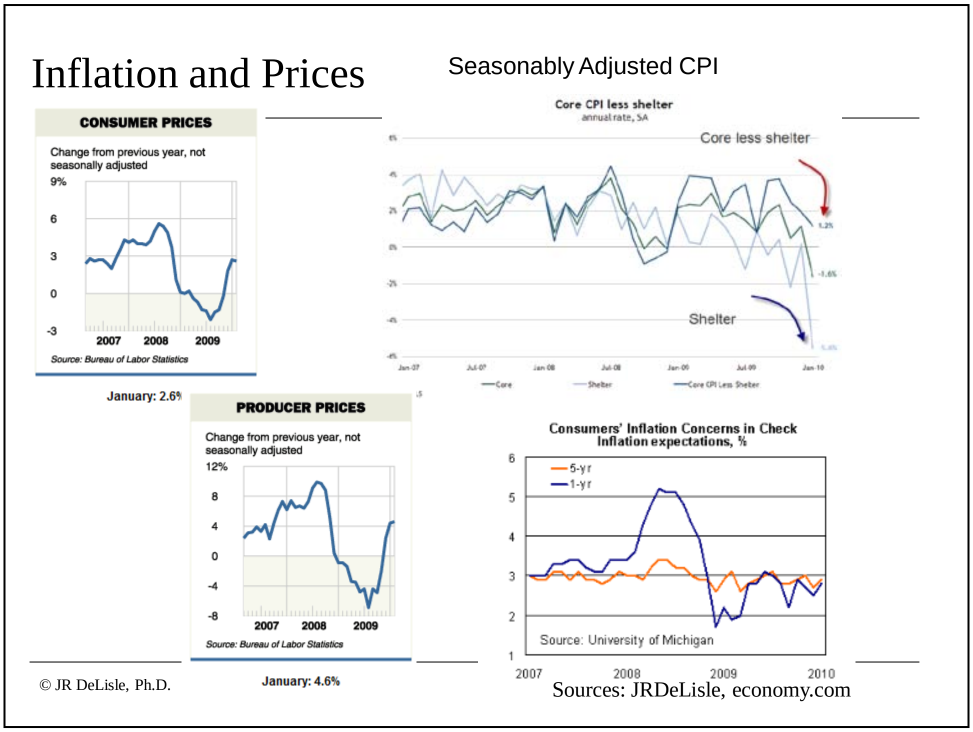
Interest and Mortgage Rates

The Fed has demonstrated its willingness to do what it can to stimulate the economy, holding the Fed Funds rate down before its recent uptick. Treasury support for residential mortgages has also held mortgage rates down, although the price support is being phased out in the 2nd quarter. Although efforts will be made to hold mortgage rates low, spreads on mortgage rates are likely to exhibit some upside pressure. This situation is expected to continue until the uncertainty surrounding the residential –and more recently the commercial– market abates. However, since the residential market has not bottomed out, and the re-pricing and shake-out in the commercial market is still being played out, access to mortgage capital may be more of an issue than rates. This is particularly true in the commercial market which is facing an impending crisis of capital access.



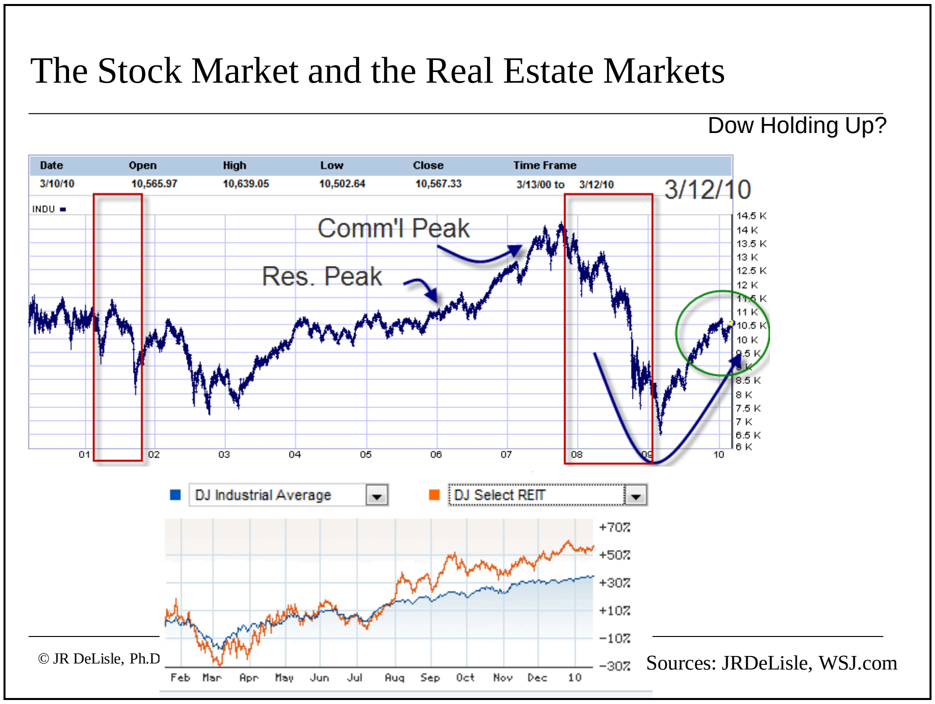
Inflation and Prices

Inflation has not been a major concern over the past, allowing the Fed to hold interest rates at record levels in an attempt to stimulate the economy. Indeed, until recently, there was concern that we would slip into a period of deflation with tepid demand creating a downward drag on prices. Although there are some signs that prices may start rising, especially with the impact of the weak dollar on imports and a strengthening global economy which the US is likely to lag, there is relatively little risk of a major inflationary spike that could derail the recovery. That said, the Fed will be paying close attention to inflation and will use interest rates to combat the pressure.



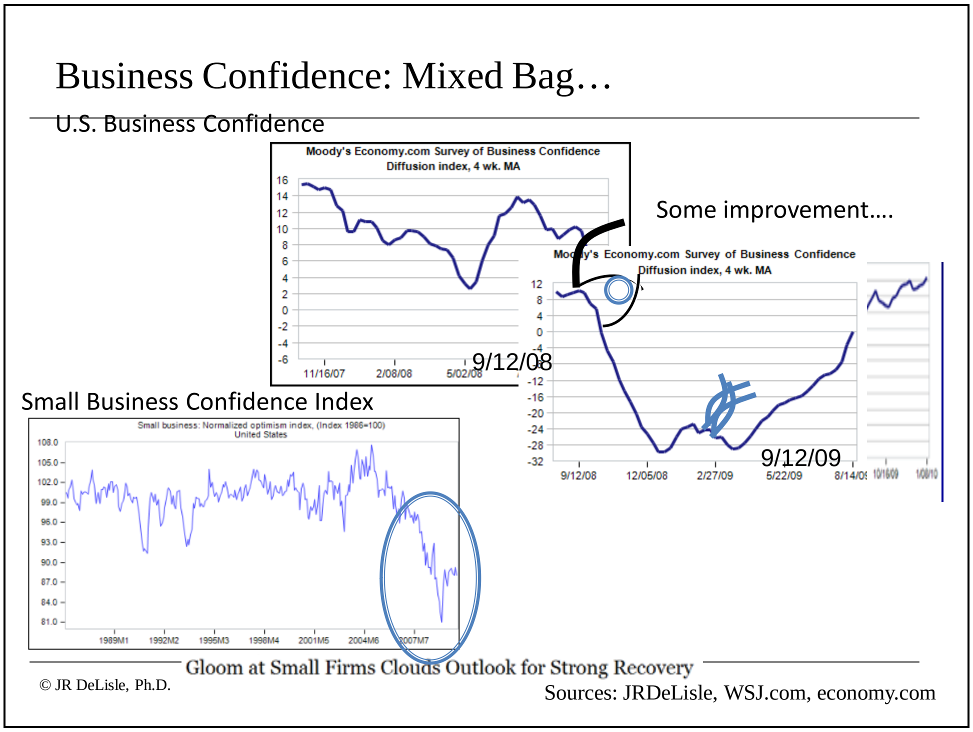
The Stock and Public Real Estate Markets

The stock market has bounced back with investors anxious to regain some lost ground and discount the expectation of improved economic prospects. Despite the recovery, the stock market is still below its peak and remains somewhat choppy. REITs have outperformed the broader stock market, a trend that is at risk as market fundamentals deteriorate even more. The outlook for the construction industry is based in part on recovery in the housing market which is somewhat tenuous. On the other hand, stimulus backed spending on infrastructure has provided some ballast for the somewhat beleaguered construction industry. However, the excess capacity built into the current commercial market will make that a lagging sector when the economy does recover.



Business Confidence

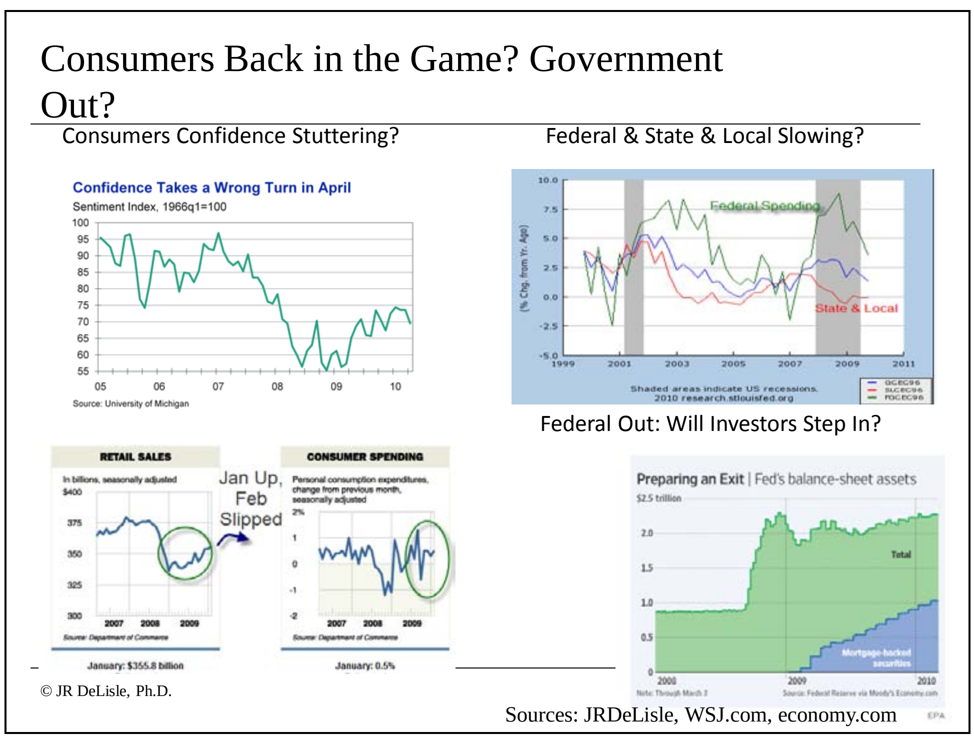
Business confidence remains weak in with respect to hiring and expansion planning. Unfortunately, businesses aren't receiving the same attention as households in terms of assistance with the exception of financial institutions and the auto industry. With credit tight, pessimism will likely pervade the near-term outlooks even more than in the recent past.



The situation is clearly global, with confidence levels down in most developed nations. Emerging markets are struggling even more than "normal" in the tight credit environment although spreads have eased a bit. The deficit remains a concern, especially with exports languishing in spite of the cheap dollar.

Consumer Confidence and Government Withdrawal

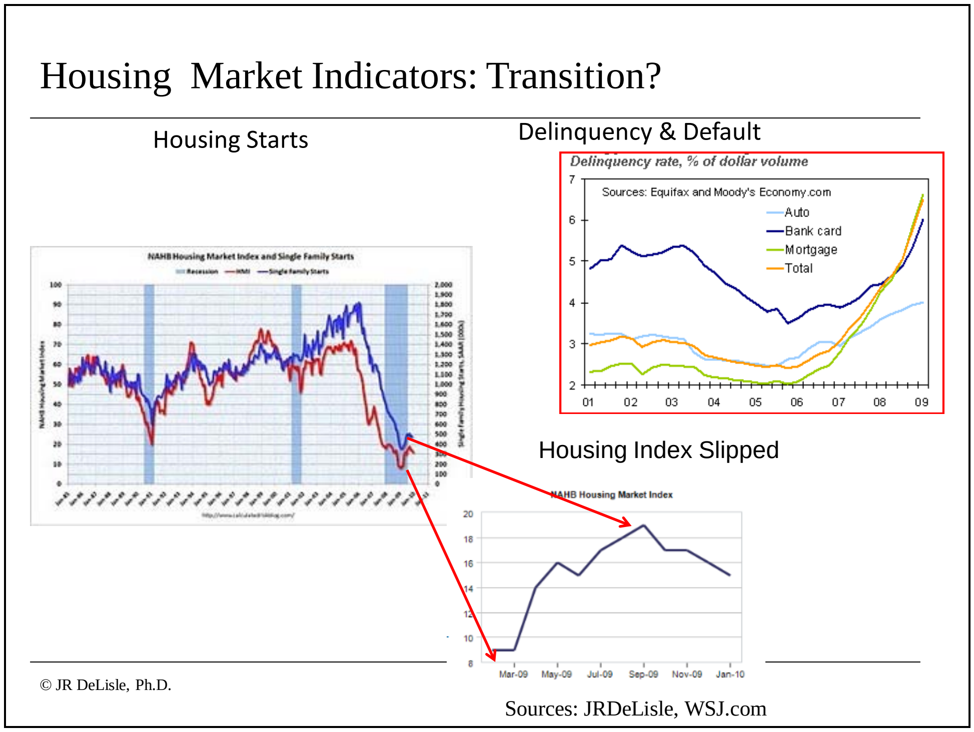
There is a high correlation between confidence levels and consumer spending; both of which are expected to continue to bounce around. Given how households are being squeezed in terms of wealth, the savings rates may move back into positive territory, especially as consumers have little confidence in the stock market and worry about retirement. It is well known that the US is a consumer led economy. Indeed, with the slowdown on the business side of the equation, retail drives over 70% of GDP. The recent numbers show some improvement, with sales up vs. year ago figures; unfortunately,



they were so bad last year this improvement is not very meaningful. The recent decline in consumer confidence reinforces the fact that consumers cannot be counted on to fuel the broader economy. Of particular importance is the withdrawal of government support as it phases out the stimulus programs.

Housing Market Indicators

The housing market is in a somewhat tenuous state, with some buyers being drawn back into the market due in part to the first-time homebuyer credits. Although there is a lot of positive rhetoric about it being time to get off the fence, there are few signs that the market has fully bottomed out. Housing permits and starts have picked up a bit after plummeting to the lowest level in over 20 years. While inventories have been declining, sales levels and traffic remain low as potential buyers wait for the economy to improve.

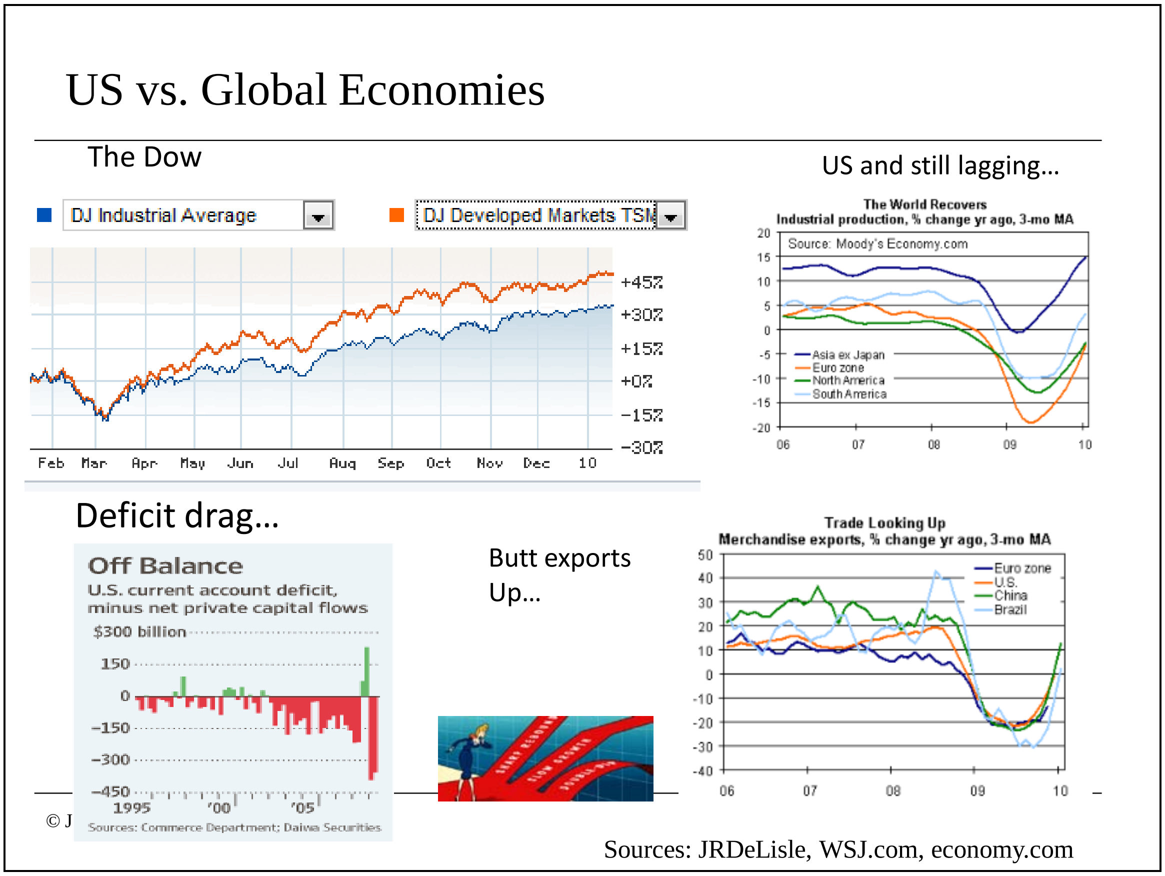


In a number of overheated markets, raw land values have already plummeted by 60-70% from their 2006 peak levels. Delinquency rates continue to rise at an accelerating pace, spreading across the country as the consequences of easy credit hit home. In the absence of meaningful intervention, this trend is likely to continue, especially with estimates that some 30% of households who bought in the last five years are underwater, the principal balances greater than market values. At this point, some lament the phrase they uttered in 2008 "It'll be fine in 2009," and are now resigned to the failure of the "But then again, it could be 2010." Unfortunately, even the "It'll be heaven in 2011" may be overly optimistic depending on how long it takes the market to bottom out and capital to return to the sector.

The Global Recovery

The improvement in the US stock market has received widespread attention and is welcomed news to many observers. While the recovery in the stock market has been positive, it is important to note that it lags its global counterparts. Indeed, the recovery in North America in terms of industrial production trails the exuberant growth in Asia and South America and is on par with more tempered recovery in the euro zone.

On a positive note, exports have turned up and are ahead of the euro zone, although still lagging Asia and other emerging markets. The deficit remains a concern, especially with exports languishing in spite of the cheap dollar and our dependence on foreign purchases of US securities.



Part II: Real Estate Capital Markets

Capital Market Snapshot

Looking at both the economic and capital markets, there are a number of danger signals for commercial real estate. For the first time in years, capital flows may actually decline as assets are repriced and owners forced to come up with more equity at higher yields that are commensurate with the attendant risk. The prospects of a deep and prolonged recession create significant downside risk that has yet been priced into the market.

Part II: Real Estate Capital Markets

2010 Capital Market

- Tentative, waiting to pounce, new players & rules
- Rising Cap rates, declining values de-capitalizing
- Challenges re-levering; credit crunch for asset class

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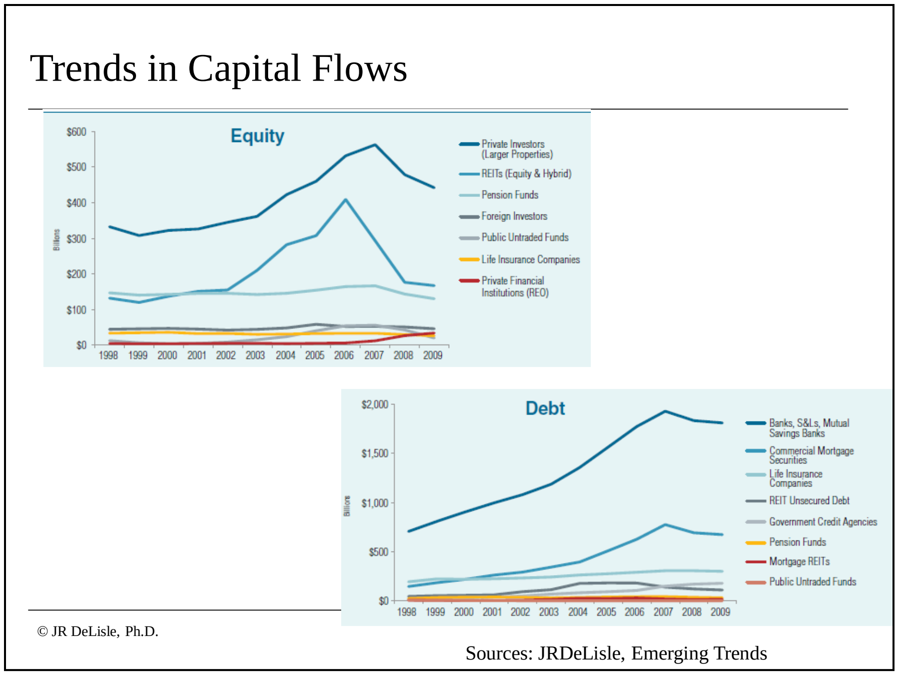
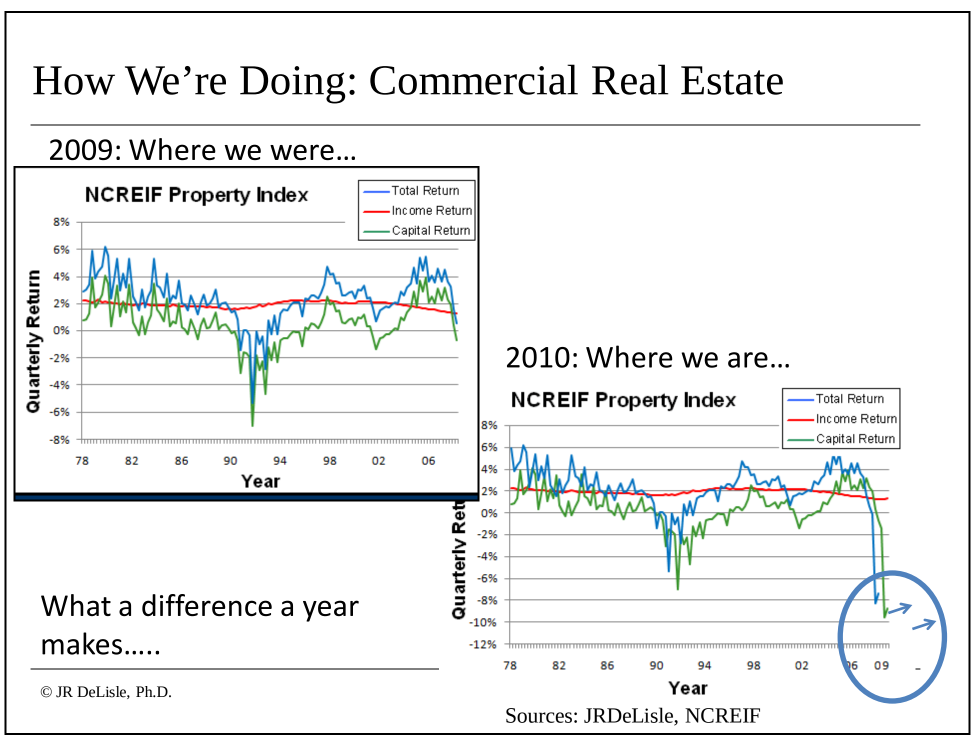
Trends in Capital Flows

The real estate capital markets are in the middle of significant turmoil which may turn into a tsunami of unprecedented proportions. Distress assets continue to build at a dramatic pace, while workouts have lagged. The CMBS industry has collapsed and continues in that moribund state although some deals are being done. Life insurance companies have stepped up lending activity but nowhere near the volume needed to recapitalize the impending surge in refinancing activity. In the face of this turmoil, capital deployment (vs. build-up) will be down for 2010 and into 2011 before the rookies get into the game…. Unfortunately, "rookie" mistakes will be costly and may exacerbate and already difficult position.



Commercial Real Estate Performance

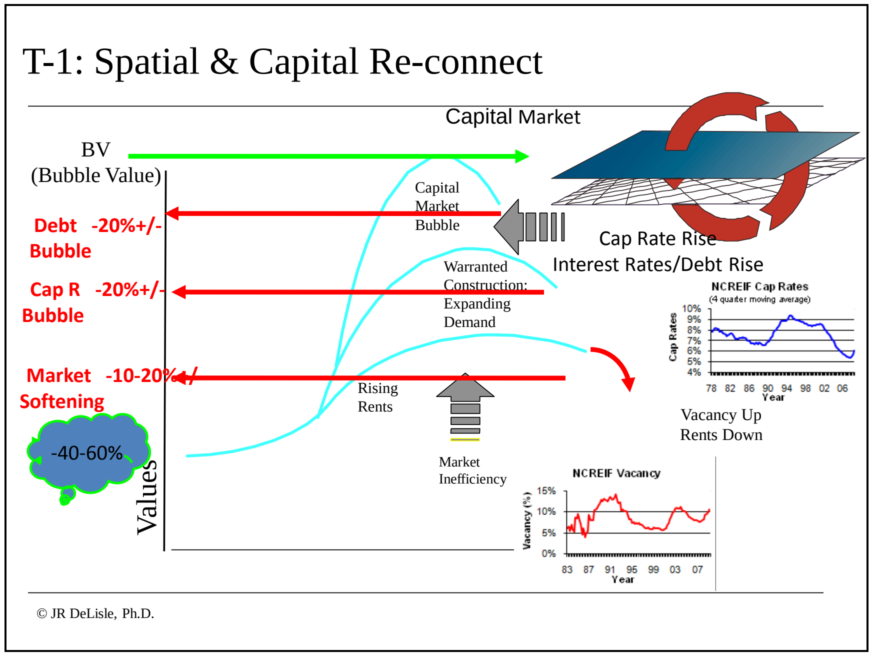
The private commercial real estate market –as measured by the NCREIF Open-end, Commingled Equity Fund Index– has plummeted since its peak in 2008, falling some 38% in value The speed and depth of this decline is unprecedented, exceeding that of the latter 80s and early 90s which lead to the previous "revolution" in commercial real estate which led to securitization of the debt (CMBS) and equity (REIT) sectors. In addition to the classic NCREIF Index which is largely core, private opportunity and value-add funds have had a very difficult time, falling even more dramatically in value. As noted in the graph, the speed of the collapse in



commercial values was unprecedented. Since we are facing a tempered economic recovery, it is likely the recovery will be choppy as it was in the early 90s and prolonged, dragging on for 5-6 years.

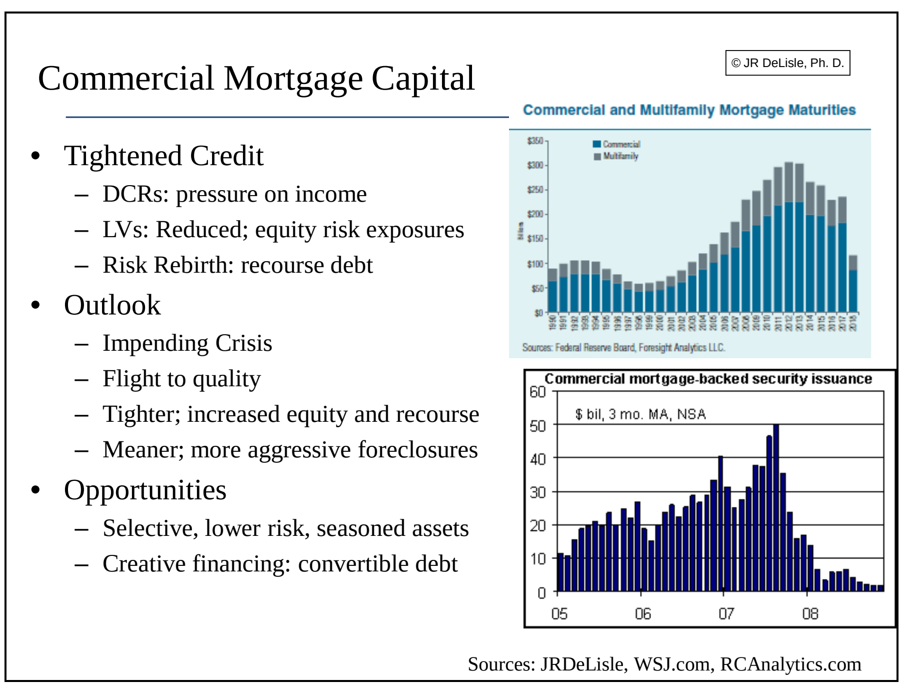
Spatial/Capital Market Reconnect

The drivers behind the recent collapse of commercial real estate market can be traced to a correction from the excesses caused by a combination of internal and external forces. On the internal side, the asset class is inherently cyclical, with periods of over and under building. This can be attributed to the lags in production, capital intensive nature and typically large size of transactions which tend to over-react to market conditions and lead to periods of overbuilding. On the other side of the cycle, after developers pull back, market conditions tighten up and drive rents up and vacancies down. The result is improved returns which then lead to the external side, which due to conditions in the broader macroeconomic environment and relative performance advantage of real estate, leads to a capital market surge. In the 2000s, these forces converged to create bubble pricing. Once the bubble burst and it became clear that values were unsustainable, values collapsed as capital pulled back, cap rates rose and market conditions deteriorated. Drawing on my experiences in the 90s and what I have seen in terms of the spatial/capital divide, I believe institutional property in mark-to-market accounts may lose 40-60% of value. If so, we're slightly more than half way there which suggests we are in for more difficult times ahead.



Commercial Mortgage Market

In the early part of the correction in real estate capital markets, much attention was focused on problems in the residential market, in particular the subprime credit market and credit swaps. Unfortunately, while the press, politicians and regulators have focused



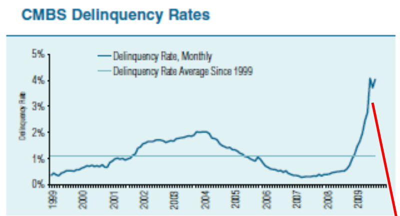
attention on those sectors, the commercial real estate market escaped outside scrutiny and continued to power on for another 18 months, driving prices upward past the peak. Since that time, the commercial sector has faced a number of problems stemming from the turning tide in credit markets affecting both the ability of borrowers to pay (i.e., rising vacancy rates, declining rents) , and in the willingness of borrowers to pay in the face of erosion of the equity value and tighter credit. The situation is likely to enter unprecedented crisis levels, with over $1 trillion in 3, 5, 7 year bullet loans maturing over the next several years in the face of tighter underwriting standards. Even more challenging is the absence of sources of capital with the demise of the CMBS industry which is in a moribund state.

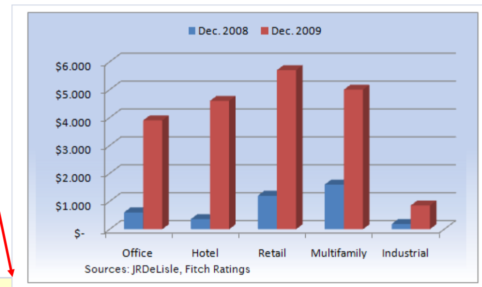
CMBS Market Conditions

The deterioration in real estate fundamentals coupled with excessive reliance on leverage and disconnection from market fundamentals has led to record delinquency rates in CMBS pools. The spike in troubled loans in CMBS pools has been dramatic, with signs for further increases which could affect all property types. While many of these troubled or distressed assets have moved into the hands of special servicers, little action has been taken to dispose of them in the market. Going forward, buyers and borrowers will face challenges in accessing credit and will have to meet higher equity requirements, and face a return to non-recourse debt.

CMBS Delinquency Rates by Property Type

Trends





Property Type	Delinquent CMBS Volume Dec. 2008	Delinquent CMBS Volume Dec. 2009	Current Rate
Office	$ 0.603	$ 3.900	2.7%
Hotel	$ 0.364	$ 4.600	9.1%
Retail	$ 1.200	$ 5.700	4.3%
Multifamily	$ 1.600	$ 5.000	7.5%
Industrial	$ 0.186	$ 0.851	3.6%

Sources: JRDeLisle, FitchRatings

Rates could hit 12%

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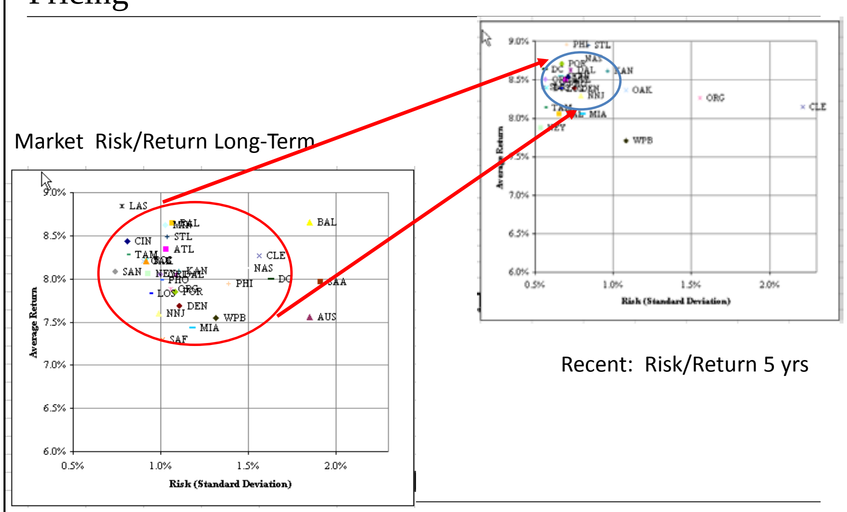
Sources: JRDeLisle, Fitch, RCAnalytics.com

What Happened During the Disconnect

One of the buy-products of disconnection between spatial and capital markets was the trend toward commoditized pricing. This term refers to the fact that investors --and indirect capital providers-- failed to price risk associated with property types and markets. As such, prices converged from historical levels. This is illustrated by comparing the long-term risk/return plots by market with the more recent

What Happened: Commoditization of Pricing



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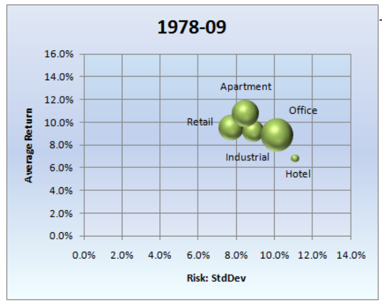
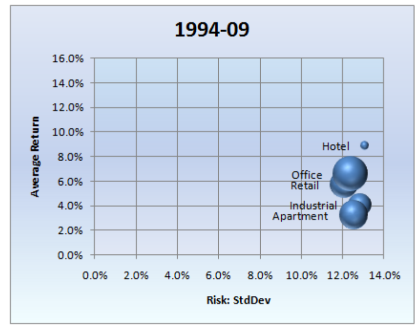
Sources: JRDeLisle, NCREIF

risk/return plots stemming back some 5 years. As noted, markets were drawn into a narrow band due in large part to surplus capital flows. Going forward, returns are expected to diverge or move to longer terms levels along with the attendant risk. If this occurs --as I believe it will-- 2nd and 3rd tier markets with limited exit strategies will fact particular challenges, as will weaker product which in the recent past benefited from the rising tide of values. On the other hand, there will be opportunities for those who can pick and time markets --which is possible in real estate-- as well as those with an understanding of fundamentals and the ability to "Create value."

Institutional Real Estate: Risk/Return Drift..





Type	1978-09 Average	1978-09 Std Dev	1978-93 Average	1978-93 Std Dev	1994-07 Average	1994-07 Std Dev	3Q 2009 Mkt Cap *
Retail	9.5%	7.8%	9.8%	5.6%	12.1%	5.7%	$ 54.13
Industrial	9.2%	8.9%	9.1%	7.3%	12.8%	4.1%	$ 37.09
Apartment	10.7%	8.5%	11.8%	7.8%	12.5%	3.2%	$ 59.10
Office	8.8%	10.2%	7.9%	10.7%	12.4%	6.6%	$ 88.75
Hotel	6.8%	11.1%	3.8%	4.0%	13.1%	8.9%	$ 4.76
Total							$ 243.82

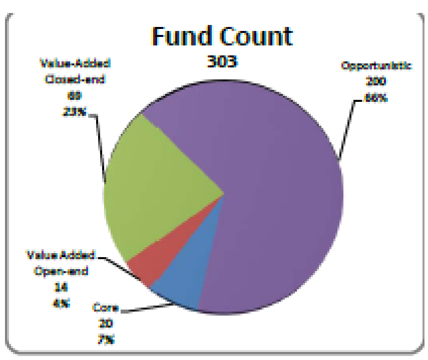
Sources: JRDeLisle, NCREIF * Market Cap in $billions as of 3Q 2009

Sources: JRDeLisle, NCREIF

Institutional Risk/Return Drift

As in the case of markets, the institutional real estate markets experienced significant commoditization across property types over the past decade. This is reflected in the shifts in the risk/return positioning of the office, retail, industrial, apartment and hotel sectors noted in this slide. Over the long term from 1978-2009, retail properties exhibited the lowest risk (i.e., standard deviation), while hotels had the greatest. In the 15 year period from 1978-1993, hotels had the lowest risk, while office properties had the highest. Finally, during the past 15 years, property types converged around the same risk level, which was elevated from the initial period and exceeded the highest level experienced by office properties. Going forward, risk and return are expected to diverge, returning to longer term levels which will add more uncertainty to the asset class.

Types of Institutional Allocations by Strategy



The CALPERs Story

Harvard, Stanford down…..

Pension Funds by Style

Trailing Four Quarters	Core: All Core	Core: Open-end	Core: NFI-ODCE	Value-Added: All Value-Added	Value-Added: Open-end	Value-Added: Closed-end	Opportunistic: All Opportunistic
Value Weight - Gross of Fee	-35.0%	-35.0%	-35.2%	-43.2%	-51.9%	-34.6%	-46.4%
Value Weight - Net of Fee	-35.3%	-35.3%	-35.7%	-43.9%	-52.6%	-35.1%	-46.2%

Sources: JRDeLisle, NCREIF

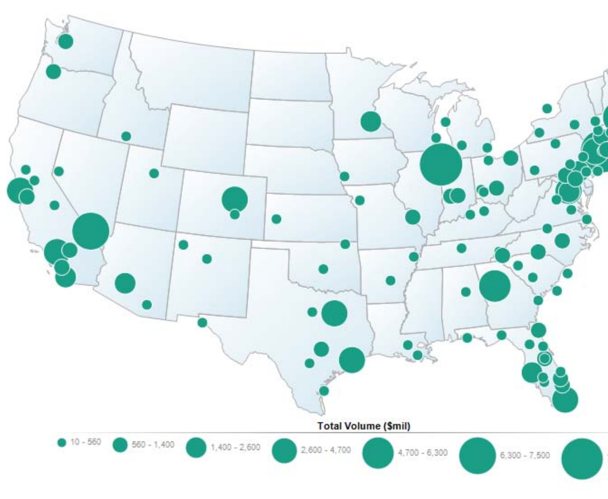
Mission Drift: Opportunity Funds

During the 1980s, institutional investors favored core investments with little appetite for value-add or opportunistic investments. Indeed, those terms weren't even coined until the mid-90s when advisors tried to differentiate themselves –all at the same time– and expanded their product lines to include higher return investments that could compete with Wall Street vulture funds which dominated the market in its early recovery phases. Over the past 10 years, this pattern was completely reversed, with value-add and opportunistic funds comprising over 90% of strategies for investors in the NCREIF universe. The collapse of the commercial market and the disappointing performance of higher risk funds has caused a reversal of fortunes, as punctuated by CALPERs which announced it is shifting back to a more traditional strategy after racking up significant losses. Other pension funds are expected to continue this trend setting the stage for significant increase in asset takeovers and upward price pressure on "core" assets.

Foreign Capital Flows to Real Estate

The influx of foreign capital has been critical to the economy as declines in real estate values made such investments attractive, both in absolute and relative terms as the US lags the world in its recovery. While foreign capital flows will be an important part of the re-capitalization, they will not help avoid the additional downturn on the horizon. That said, competition for managing foreign capital flows will be heated, making it difficult for potential investors to sift and winnow among the "compelling" stories that will be put together. Unfortunately, low barriers to entry in advising individual offshore investors will cloud the picture, placing capital in the hands of some who will lack the market connections, real estate acumen and experience necessary to target and then ultimately manage complex assets, many of which will need to be repositioned to create enduring value.

Foreign Capital Flows to US: 1Q 2010



Top Markets

Market	Total Props	Total Volume (in mil)
Manhattan	177	$34,887
Atlanta	156	$4,900.5
Houston	156	$3,783.6
Chicago	148	$8,622.9
Dallas	147	$4,259.3
Phoenix	85	$2,164.4
Boston	80	$6,169.8
Denver	68	$2,713.5
DC	63	$4,347.2
Other	3,071	$78,341.7
	4,151	**$150,189.9**

Top Property Types

	Total Props	Total Volume (in mil)
Strip	847	$18,613.5
Warehouse	785	$8,486.5
Mall & Other	560	$14,686
Garden	509	$10,830.3
Office - Sub	498	$17,782.5
Office - CBD	320	$54,159.5
Limited Service	238	$2,052.2
Full-Service	111	$8,597.4
Mid/Highrise	103	$3,685.8
Flex	100	$2,317.4
Other	80	$8,978.9
Total	**4,151**	**$150,189.9**

Sources: JRDeLisle, RCAnalytics.com

Part III: Spatial Market Fundamentals

Part III: National Spatial Markets

2010 Spatial Market

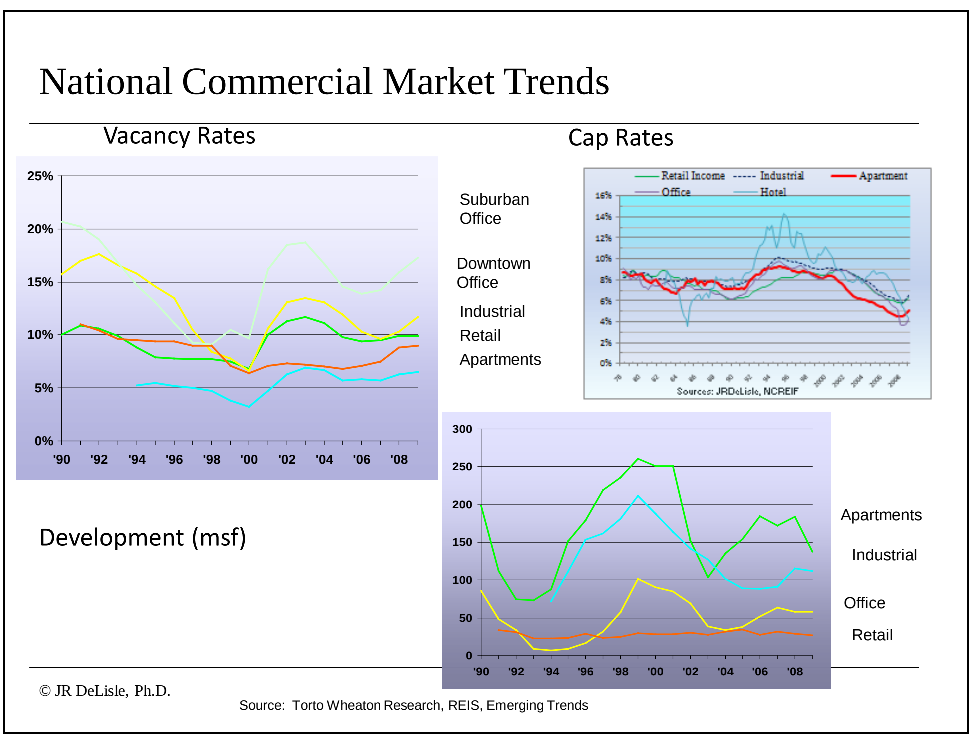
- Still weakening, negative absorption; more downside risk
- Vacancy rates pushing records, rents declining
- Negative absorption, lagged recovery

Spatial Market Snapshot

The commercial real estate market fundamentals are deteriorating across-the-board with rising vacancy rates and falling rents dominating the news. On the other hand, development activity has plummeted with the exception of projects in the pipeline. In some markets, developers have been forced to abandon projects during construction while in others they have filled in holes in anticipation of a long hiatus. This situation is expected to continue with further erosion in market fundamentals limited additions to supply.

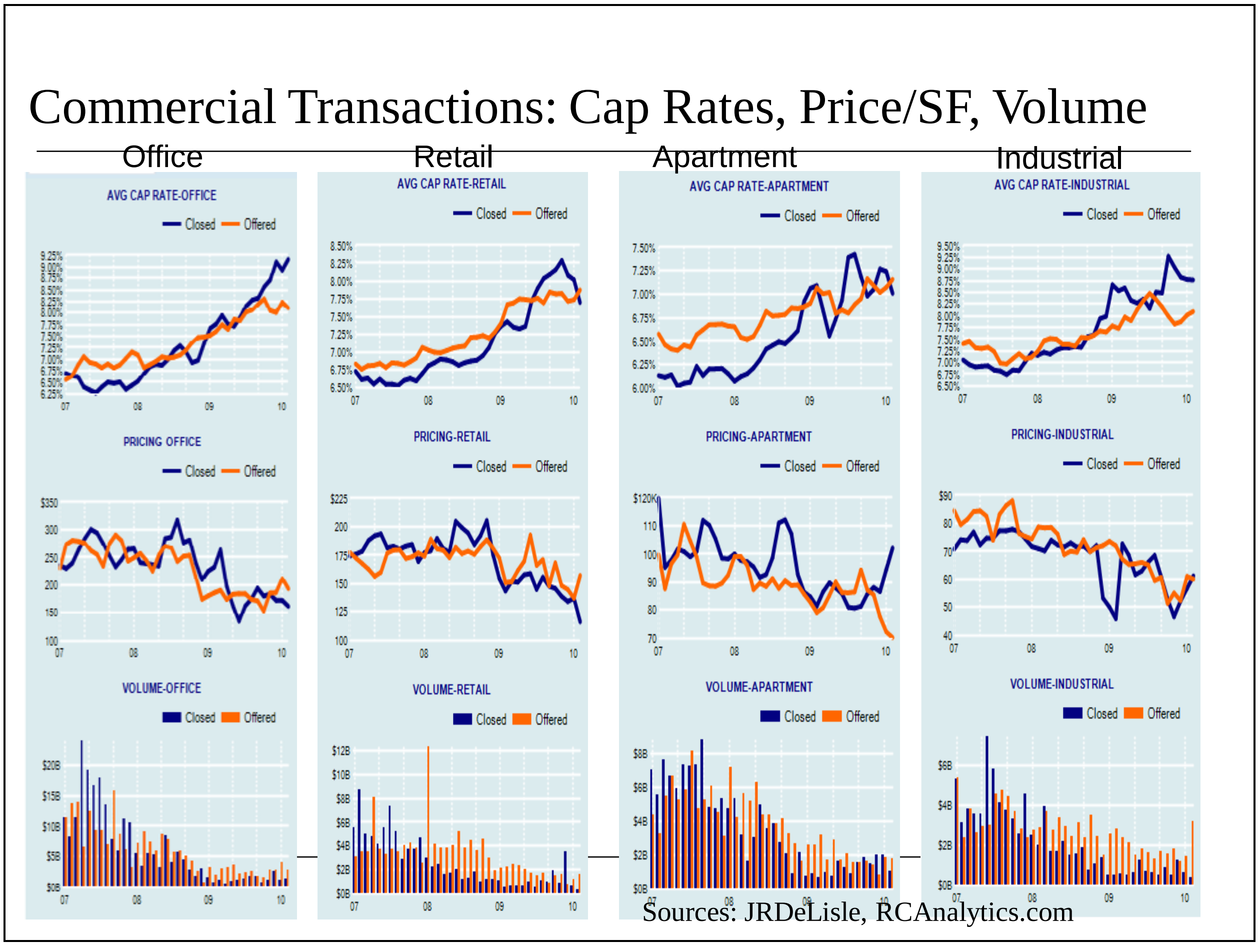
Commercial Market Trends

The commercial real estate market fundamentals are deteriorating across-the-board with rising vacancy rates and falling rents dominating the news. On the other hand, development activity has plummeted with the exception of projects in the pipeline. In some markets, developers have been forced to abandon projects during construction while in others they have filled in holes in anticipation of a long hiatus. This situation is expected to continue, with limited prospects for new construction, especially speculative construction which will be almost non-existent over the next several years.



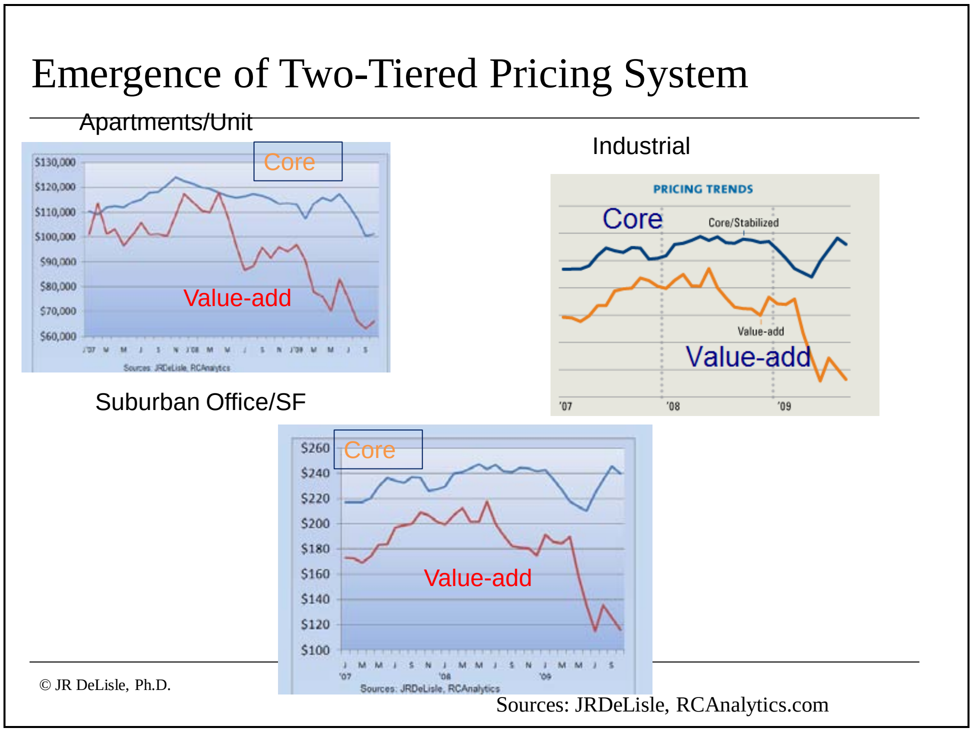
Trends in Transactions, Cap Rates

The deterioration in real estate fundamentals across the major food groups, has led to a consistent increase in cap rates for closed transactions. The flight to quality and competitive atmosphere surrounding the good projects have come to market have led to a convergence between bid and ask spreads. This situation is likely to change on the flood of distressed assets of the market and attention shifts to risks inherent in such investments. The pricing of assets that have sold has also trended downward, although not as much as cap rates have risen. This anomaly has been due to the higher quality of assets that have actually closed as well as a limited transaction volume in the face of significant capital chasing scarce deals.



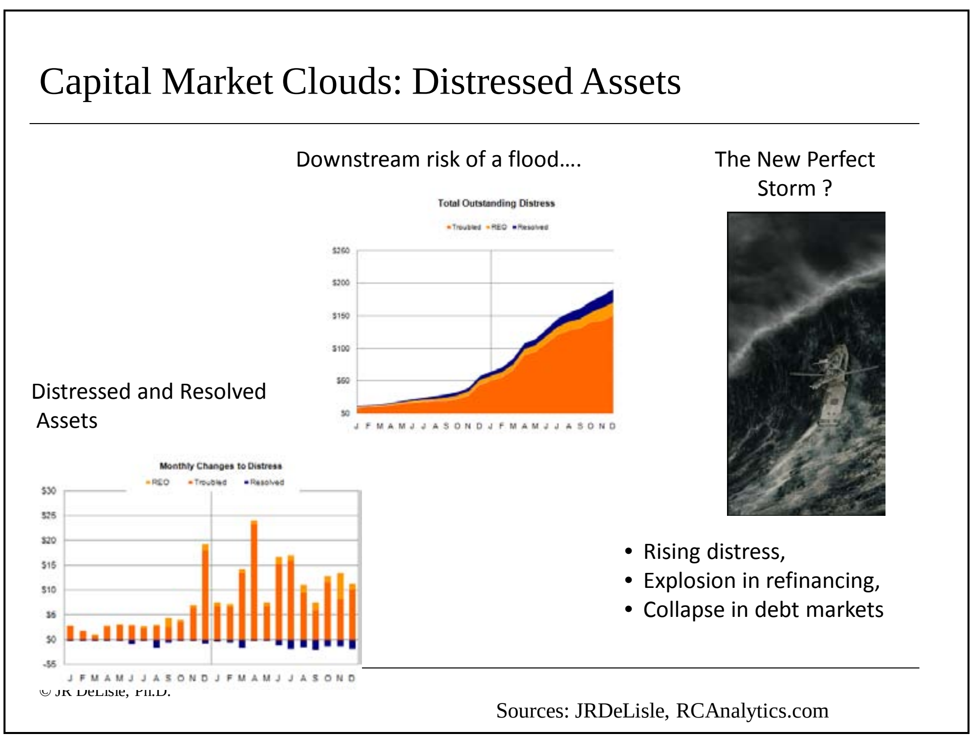
Emergence of Two-Tiered Pricing System

Although transaction levels have been relatively low, the transactions that have occurred reveal the emergence of a two-tiered pricing system in which core assets (e.g., proven assets, fully leased, solid cash flows) are trading at a much higher value than distressed assets. This situation is likely to hold, although the glut of distressed assets that will hit the market is likely to create some convergence as buyers find it difficult to identify core assets from the impending flood of listings.



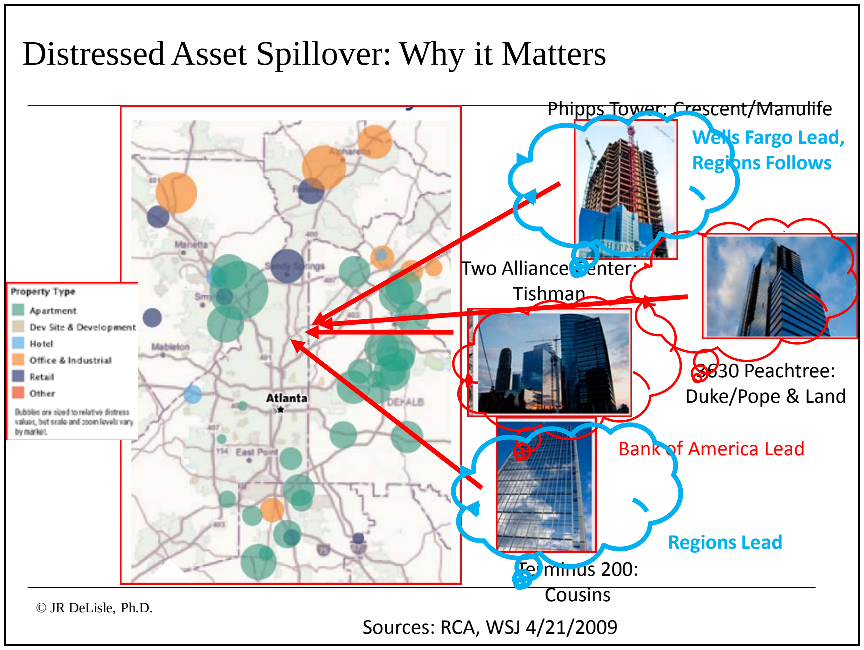
Capital Market Clouds

While the real estate market has been relatively slow, that situation will change over the next 12-15 months as distressed assets will start flooding the market. As of April 2010, the pent-up supply of distressed assets that have been documented is approach $300 billion. This figure understates the depth of the problem as it does not reflect the true picture in bank portfolios as well as additional assets that will fall underwater as comp prices start declining when servicers/investors/owners are forced to unload assets. It will be a perfect storm.



Distressed Asset Spillover

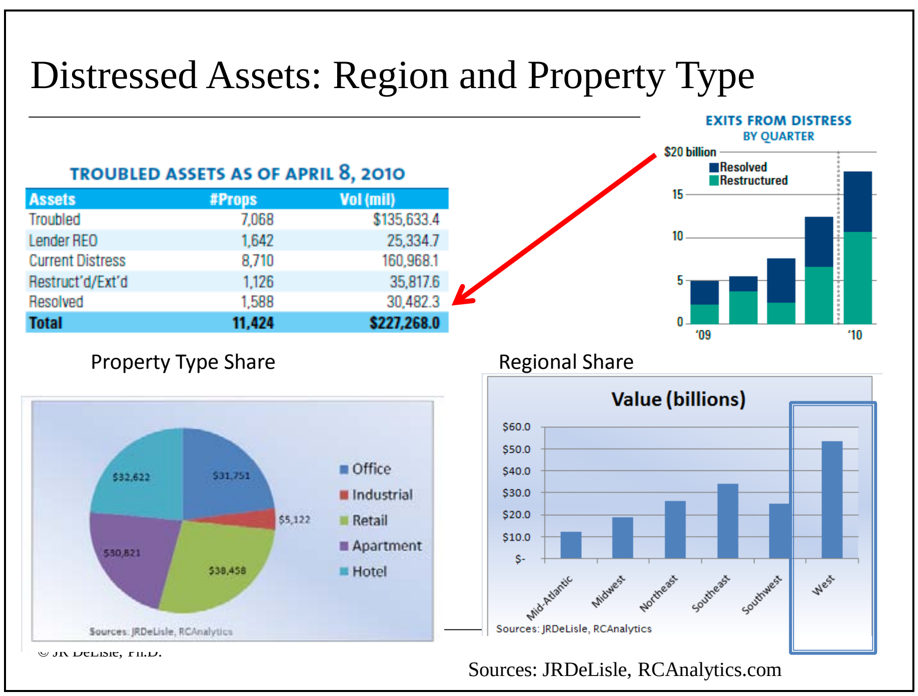
While some owners of commercial real estate may take solace in the fact that their assets are performing well, it's important to recognize that the potential disposition of distressed assets at bargain basement prices can have an eroding effect on the NOI of strong buildings. This risk was highlighted by exploring the distribution of "currently distressed" and "potentially distressed" assets in the Atlanta market. These troubled spots were then superimposed on a map indicating the imminent delivery of four major speculative buildings in Buckhead, one of the leading submarkets in Atlanta.



The slide also notes the "doubling down" of some of the major banks who have assumed significant risk exposures in concentrated areas. To the extent that distressed buyers are willing to discount rents to capture tenants, grab landlords should be on notice and paying much more attention to their existing tenants. Indeed some owners are renegotiating leases to try to extend the terms in return for a reduction in rents. The strategy may become more widespread but may also be delayed as tenants are developing a better understanding of the condition in Outlook for the commercial market.

Distressed Assets by Region and Property Type

Over the past several years, the queue of distressed assets has built up to some $230 million. The most significant category is the "current distress" indicating they have moved into imminent danger, followed by the general "troubled" category. Slightly more than 10% of distressed assets have been resolved, suggesting the market has not been able to get ahead of the problem, with an even greater



TROUBLED ASSETS AS OF APRIL 8, 2010

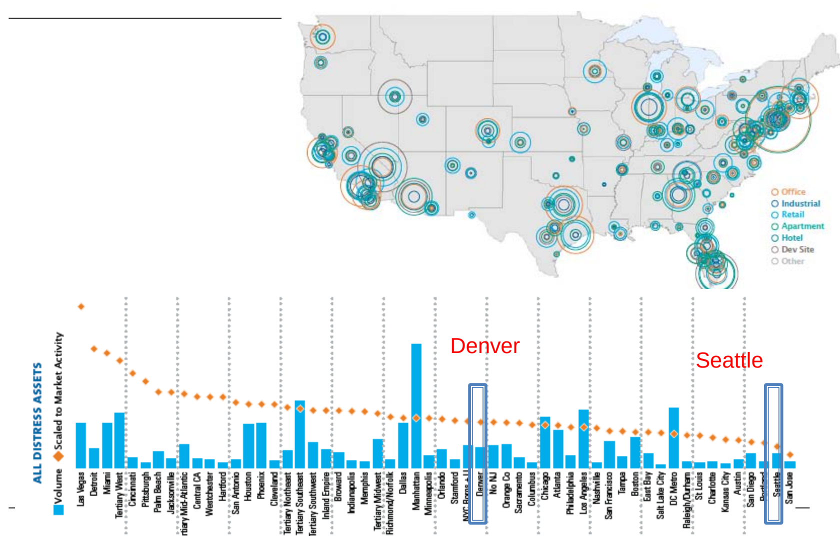
Assets	#Props	Vol (mil)
Troubled	7,068	$135,633.4
Lender REO	1,642	25,334.7
Current Distress	8,710	160,968.1
Restruct'd/Ext'd	1,126	35,817.6
Resolved	1,588	30,482.3
Total	**11,424**	**$227,268.0**

spread on the horizon. The distribution of distressed assets across property types is fairly widespread, with industrial the exception. The west has the greatest market share, although no regions have been immune to the problem.

Troubled Asset Radar: US, Denver and Seattle

The troubled asset radar map generated by real capital analytics indicates the widespread nature of distress in the commercial real estate market. As noted, few major markets have escaped the downturn which has affected almost all property sectors. Denver and Seattle have both experienced an increase in distressed assets with more on the horizon. While creating much consternation for troubled owners, the level of distress in these markets is relatively low especially on a scaled to market basis.

Troubled Asset Radar: US, Denver & Seattle



Sources: JRDeLisle, RCAnalytics.com

Denver Transactions

Denver, like other major US markets, experienced a dramatic decline in transaction volume over the past 15-18 months. Despite a contraction in overall activity, some sales did close including $141 in offices at an 8.55% cap rate, $168 million in retail, $194 in apartments at a 6.6% cap, and $98 million in industrial at a 9.45% cap. This difference in pricing is symptomatic of the type of assets being offered and the level of distress and/or motivation by buyers and sellers. The low cap rate on apartments likely reflects relatively strong demand for good assets. Of the $913 million offered for sale overall, $425 million closed during the quarter.

Denver Transactions: First Quarter 2010

	Office Market Data In USD mil.; Oct '09 thru Feb '10	Closed Transactions $ Vol	# Props	Avg PPU	Cap Rate	Offered Properties $ Vol	# Props	Avg PPU	Cap Rate
Office	Southwest Austin	$95	3	$174		$52	5	$119	
	Dallas	$201	15	$84		$510	20	$136	7.35%
	Denver	$141	8	$148	8.55%	$229	11	$157	8.72%
	Houston	$542	10	$204		$133	13	$103	8.79%
	Phoenix	$70	9	$116	10.50%	$235	20	$188	9.40%
	San Antonio					$66	7	$104	9.46%
	Tertiary Southwest	$136	20	$98	8.80%	$211	20	$112	7.60%
	Total	$1,185	65	$158	9.28%	$1,436	96	$136	8.58%
Retail	Denver	$168	8	$147		$188	9	$287	7.69%
	Houston	$151	8	$30	9.46%	$187	23	$80	8.00%
	Phoenix	$180	15	$143	9.44%	$173	16	$276	8.53%
	San Antonio	$17	1			$68	9	$137	7.79%
	Tertiary Southwest	$119	9	$98		$174	23	$128	8.29%
	Total	$854	50	$100	9.45%	$1,080	101	$128	8.23%
Apartment	Denver	$194	7	$104,076	6.60%	$13	1	$43,333	
	Houston	$409	25	$60,950	9.00%	$536	39	$42,244	8.28%
	Phoenix	$360	24	$69,053	7.09%	$325	22	$50,859	6.31%
	San Antonio	$113	7	$71,994		$60	6	$36,357	6.58%
	Tertiary Southwest	$126	10	$53,057	8.09%	$321	36	$40,737	8.63%
	Total	$1,531	95	$70,508	7.27%	$1,668	142	$43,343	7.86%
Industrial	Denver	$98	11	$67	9.46%	$94	11	$64	8.29%
	Houston	$38	4	$67	9.40%	$83	10	$82	7.96%
	Phoenix	$145	12	$50	8.75%	$196	21	$88	8.36%
	San Antonio	$20	1			$84	4	$42	9.07%
	Tertiary Southwest	$58	5	$33		$184	22	$42	8.97%
	Total	$425	40	$51	9.15%	$913	88	$59	8.85%

Sources: JRDeLisle, RCAnalytics.com

Players in Distressed Asset Market

A number of sources have suggested that well over $200 billion of equity capital has been assembled to acquire commercial real estate at distressed prices. While much of this capital remains on the sidelines, it is interesting to note the general sources of capital that are lined up. After a difficult 2008, REITs have been doing fairly well in year-to-date performance, with a number of larger REITs raising some $12 billion of capital in the first half of the year. The ability to raise capital for the otherwise distressed asset class is reminiscent of the mid-90s when REIT market cap surged from sub-$10billion to some $200 billion.

Players in Distressed Asset Market

- REITs
  - Have reversed downward spiral
  - Significant new capital raised through Sept 2009
  - Low Dividends suggest accretive opportunities
- Global Investors
  - Western European
  - Middle East
  - Asia/Australia
- Domestic Funds
  - Positive denominator
  - Core vs. Opportunity Funds
  - New Value-Plus Funds

Offshore investors will also likely be active players in the US real estate market when it begins to move, although the US real estate recovery is expected to lag other developed nations. Finally, a number of existing and new domestic funds will be established over the near term as sponsors try to take advantage of the market malaise and the strong talent who could implement successful investment programs on the street.

Greatest Risks

In exploring the greatest risks faced by the commercial real estate market in the aftermath of the credit crunch and slowing economy, respondents a withdrawal of capital --both debt and equity-- and requirements for higher returns is the greatest danger. There is also much concern over how the highly leveraged buyers who took advantage of easy credit would fair when they attempted to refinance or rollover existing loans. Similarly there is concern about the ripple effects of the slowing economy on job formation and demand, leading to the anticipation of weakening fundamentals overall in terms of spatial supply and demand. Finally, re-pricing of the asset class as risk took center stage and investors, lenders and other players demanded higher returns from the asset class.

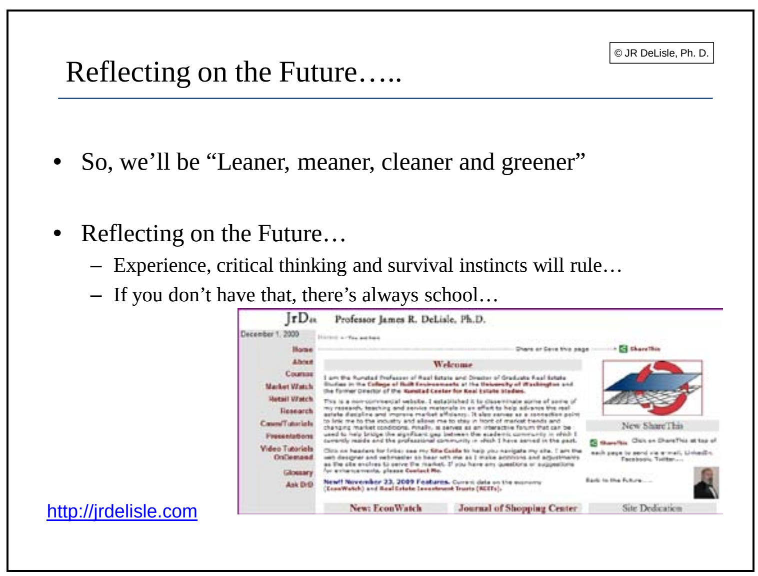
Greatest Risks to Commercial RE?

- Equity
  - Decline in qualified buyers
  - Capital shortage near-term
  - Players on sidelines
- Debt Access
  - Tightened credit
  - Credit hangover
  - General shortages
  - Deleveraging effects
  - Illiquidity
- Debt Rollover
  - Maturing bullets
  - Mezzanine
  - Default increases
  - Non-recourse walk-always
- Demand
  - Employment losses
  - Tenant Bankruptcies
  - Consumers and confidence
- Fundamentals
  - Overall deterioration
  - Erosion in market balance
  - Rising vacancies, rents declines
  - Rising costs
- Re-pricing/Valuation
  - Some already occurred
  - Further valuations slippage
  - Foreclosures
  - Non-recourse walk-always

Greatest Opportunities

To tap into the collective expertise of the group --especially those who had lived through prior downturns-- we explored respondents' views of the greatest opportunities that would come out of the current and impending crisis. One of the common themes was to just "get in the game" or stay in the game; to be a player with the ability and will to act in an opportunistic manner. Many respondents believed cash would be king, especially as the commercial market struggled with re-pricing and deleveraging of the sector. A key phrase was "distressed," which referred to properties, debt, sellers and any other forms. Some thought secondary and tertiary markets with limited competition for assets in the current market and few prospects for overbuilding due to tightening credit as good opportunities. I agreed, but with the caveat these were longer terms holds with the risk of limited exit strategies or options. In terms of property types, land was the most frequent response, although they recognized the best deals have already been transferred to new owners who will wait for the market to turn. Apartments were seen as an attractive sector, followed by industrial and niche properties including medical offices. Finally, respondents saw opportunities in "value creation" as hot money withdrew and that which stayed, seeking out partners, consultants and buyers who could help nurture assets to protect and/or create value.

Reflecting on the Future



In the current stage of the real estate cycle, many difficult decisions will have to be made. Some will be focused on expanding wealth, while others will be focused on damage control and survival. During this period, being connected to the rapidly changing markets and having solid on-going relationships will be more important than ever. To help, I will try to stay on top of the unfolding scene and, where possible, try to get ahead of the curve. I offer my personal website http://jrdelisle.com with more features to come including an AskDrD interactive element. My full text articles on Financial Views dating back 10 years are also available in the Market Watch section. Good luck and thanks for the opportunity to share my thoughts and to stay connected via the survey and audience feedback.