

Private Real Estate

Conference Call Highlights

BELOW IS A SYNOPSIS OF A BAILARD PRIVATE REAL ESTATE CONFERENCE CALL THAT TOOK PLACE IN FEBRUARY 2010, SUPPLEMENTED WITH QUESTIONS BASED ON THE THEMES OF THE CALL.

2009 RECAP

Commercial real estate experienced its worst year on record during 2009. Values were driven sharply lower first by a repricing of the asset class and subsequently by the impact of declining rents and occupancies on property cash flows. While the first half of the year was exceptionally bleak, by year end there were some encouraging signs of hope and a resurgence of investor interest in the asset class.

CAPITAL MARKETS

The absence of debt financing in commercial real estate and a significant bid-ask spread resulted in record low transaction volume in 2009. Property sales totaled just \$52 billion across the entire U.S. during the year, off 64% from 2008's relatively low volume. In addition, cap rates rose a further 83 basis points (0.83%) during the year according to recent Real Capital Analytics data. The number of properties offered for sale significantly exceeded closed transactions in 2009, and distress—as measured by loan delinquencies and foreclosures—continued to rise. These negative factors culminated in a 44% drop in commercial real estate pricing from its 2007 peak (as measured by the Moody's CPPI Index), sending property prices back to levels last seen in 2002.

The credit markets remained largely frozen during 2009, although there were

signs of life as the year drew to a close. The high volume of maturing loans over the coming years remains a worry; the lending community's "extend and pretend" philosophy, while possibly forestalling asset "fire sales," may ultimately result in lingering distress that could hamper the commercial real estate recovery.

FUNDAMENTALS

During 2009, commercial real estate, as a lagging asset class, finally began to catch up with the deteriorating U.S. economy. The second quarter in particular proved a turning point for U.S. real estate fundamentals. Rents in some markets declined by 25 – 40% as tenants became scarce and vacancy rates soared. By the end of the year, vacancies in most property types were near record highs—surpassing even the early 1990's peaks. As expected, increasing vacancies and declining rents began eroding property level net operating income; properties in the NCREIF NPI experienced a 3% decline in net operating income during 2009, the fourth worst year on record. Further evidence of weak property fundamentals was reflected in current loan delinquency rates, which began the year at 1.18% but spiked to 5.61% by the end of 2009. However, as the economy continues to strengthen, the deterioration in fundamentals should also begin to slow and eventually stabilize.

Q What is the outlook for commercial real estate?

Despite 2009's challenging environment, as we begin 2010, it appears that the worst may be behind us. Public REITs, a possible leading indicator, rallied 111% from their March lows.¹ Property transaction volumes in the third and fourth quarters trended upward from the paltry numbers seen in the first two quarters of the year, a possible indication that volume may have bottomed. The recent Moody's CPPI data showing a slight increase in pricing for November may also suggest a stabilization of pricing. And lastly, there are even signs of a thawing in the credit markets. While the commercial mortgage-backed securities market remains essentially closed, there were three single-borrower CMBS transactions that occurred toward the end of 2009; strong investor demand for the securities may serve to encourage lenders to re-enter that market. There is also anecdotal evidence that life insurance companies are coming off the sidelines to resume lending in 2010 with new allocations for originating commercial mortgages.

The outlook for the economy is also improving. The recent moderation in jobless claims, lower unemployment rate and strong fourth quarter GDP are positives for commercial real estate fundamentals and a hopeful sign that a sustainable economic recovery is on the way—a necessity for stabilizing market rents and occupancies. The rapid adjustment in commercial

Bailard

INVESTING. REDEFINED.®

real estate values occurred in part due to the deteriorating outlook for real estate occupancies and rents. With much bad news now priced into the asset class, the stage may be set for positive “earnings surprises” and stabilization in values.

Q What sectors are likely to recover first during this cycle?

Apartments are typically the first major property sector to recover from a downturn due to the relatively short (one year) lease terms. Expect office and retail to lag, for the same reason—these property types usually have much longer lease terms (five to 10+ years), so it takes longer for the impact of a recession to be felt at the property and thus to recover. Apartments should also benefit from broad demographic trends, and they have historically provided the best risk-adjusted returns of the four major property types.²

Q Where are the opportunities?

Investors, still reeling from commercial real estate losses, have become extremely risk averse—perhaps overly so. This climate of fear has generated a herd mentality, where many investors are clamoring after the same types of investments such as apartments and other properties offering “durable income.”

In this environment, we believe it is important to look at capital flows within the asset class and that investors are best served by seeking returns in areas where capital is relatively scarce. With apartment properties in coastal markets and well-leased core properties in strong demand—and generating multiple offers—interesting opportunities abound elsewhere. The value-added sector, in particular, may offer attractive acquisitions and a scarcity of competing buyers. Areas of interest may include office buildings with some vacancy and apartment properties in battered housing bust markets.

Q Leverage on real estate accelerates returns in both up markets and down markets. What are prudent policy considerations, and how can real estate investors avoid too much leverage going forward?

Overleverage has certainly contributed to commercial real estate’s woes in this downturn. Many investors sought to maximize their use of cheap debt just because it was easily available; others thought they had employed relatively conservative leverage at loan-to-value ratios of 60–65% as rising property values masked the true risk of leverage. While loan-to-value ratios are an important factor in determining an optimal level of leverage, they are not the only consideration. Debt service coverage ratios (a measure of the income available to service debt) are also important. Unfortunately, in the days of easy credit, many loans were often originated without adequate income in place to service debt.

In addition, it is important to actively manage a debt maturity schedule so that significant concentrations of debt do not mature in a single year. While the overall interest rate on the debt is important, it is not paramount—investors should be careful not to sacrifice flexibility for the last basis point in rate. Lastly, it is helpful to maintain a pool of assets that are completely unencumbered by debt to maintain future financial flexibility.

Q What attributes should I look for when making an investment in an existing private real estate portfolio?

Many commercial real estate investors today are hampered by decisions made during the boom years. Overleverage has resulted in inflexible capital structures where all properties are encumbered with debt and few traditional liquidity sources are available. Some investors’ lack of access to liquidity has been exacerbated by large single-property acquisitions made at the top of the market in order

to put money to work quickly. However, large property size limits the universe of potential buyers and lenders to have the balance sheet capacity or appetite to absorb large investments. Lastly, the lack of access to liquidity and inflexible capital structures have paralyzed many investors, leaving them unable to cope with deteriorating fundamentals and distracted from the blocking and tackling basics of portfolio operations.

Look for portfolios with a strong balance sheet—a flexible capital structure, access to liquidity and the ability to cope with deteriorating fundamentals. Leverage should be at manageable levels with a staggered maturity schedule. Low exposure to volatile property types such as office is also crucial. The portfolio should be small enough so that investors can understand each investment—a portfolio consisting of hundreds of properties does not lend itself to transparency and problems can be difficult for investors to ferret out. Similarly, a relatively small portfolio allows each subsequent investment to have a meaningful impact on portfolio performance going forward.

Having said that, diversification is important. However, be sure to look beyond the common measures of diversification (style, property type, geography) to the economic drivers of the portfolio—a map may seem to illustrate a diversified portfolio, but high exposure to, say, financial services markets across the country, could result in significant portfolio challenges in this cycle.

Also, fresh valuations are important. You want to be buying into portfolios that reflect today’s values—not the values of one year ago.

Fresh valuations are important—you want to buy into portfolios that reflect today’s values.



Michelle L. Foss, CFA
Senior Vice President, Real Estate Research

Private Real Estate

Q What should I look for in a real estate investment manager?

Target managers who have navigated multiple market cycles and who have the experience in real estate to potentially generate solid performance going forward. Focus on managers who



Thomas E. Bailard
Chairman

Target managers who have navigated multiple market cycles and who are not distracted by damage control within their firm or portfolios.

have not been distracted by damage control within their firm or portfolios—and similarly those who have not had to resort to draconian actions to “save” their portfolios.

A key consideration should be a manager’s actions at the top of the market: was the manager patient in putting money to work in new acquisitions? Or did the manager acquire larger and larger deals in order to invest the money? Was the manager willing to sell assets at the top of the market? Did the manager resist the temptation to overuse easy leverage? Did the manager stick to its investment strategy?

Similarly, how has the manager responded to the down cycle? Has the manager buried its head in the sand on valuations, or accelerated valuations to better reflect the changing market conditions? Has communication and information transparency increased or decreased?

Adversity shines a light on the good managers—poor stewards of real estate capital may not survive this cycle.

Q What should I be concerned about with the asset class?

We have two primary concerns about commercial real estate at this point in the cycle. The key driver of commercial real estate fundamentals is job growth; it impacts office-using employment, retail spending, imports and household formation. In order for occupancies and rents to recover, we need job creation and a sustainable economic recovery. While much bad news is already baked into commercial real estate values, today’s values are predicated upon a 2010 economic recovery. Negative surprises could result in additional value declines, and further deterioration in fundamentals could negatively impact property operations.

In the capital markets, the concern remains looming debt maturities in the asset class. Over \$1 trillion in commercial real estate loans are coming due over the next few years—many of them with high loan-to-value ratios and low debt service coverage ratios creating a significant equity gap. While lenders have so far been reluctant to foreclose on assets and sell (the “extend and pretend” philosophy), eventually this debt must be recapitalized, possibly prolonging the downward pressure on asset values while the financing gap awaits a solution.

Q What steps can commercial real estate investors take to protect against the negative economic environment?

We believe active asset management is critical in a down market. While it is impossible to completely insulate properties from the effects of deteriorating rents and occupancies, steps can be taken to actively reduce their impact. In order to mitigate the impact of future lease expirations, landlords can offer early lease

renewals for key tenants at a blend of the existing rent and today’s market rent. While the income stream from the asset may decline in the near term, the extended lease term may be preferable to losing the tenant to another landlord willing to buyout the lease term. Building owners can also pursue short-term leases to provide additional income support at the property. While it may not be desirable to lock in today’s low rates for the long term, short-term leases can provide a welcome enhancement to income and cash flow during a challenging market. For properties with existing vacancy, it is critical to meet the market on rents—otherwise ownership will be playing catch up with other landlords who recognize where the market is. A down market can also provide a competitive advantage for well-capitalized landlords, who can attract tenants with their willingness and financial ability to fit out space for prospective tenants.

A diversified tenant base is always important, but concentration can be especially problematic in a market downturn. Look for portfolios with a staggered lease expiration schedule, no concentration of large tenant leases expiring in a single year, no large exposure to a single tenant and a variety of tenants whose businesses depend on differing economic drivers.

Q Why is commercial real estate an attractive investment now?

Commercial real estate can play an important role in a multi-asset portfolio. Despite a tumultuous 2009, the asset class (as measured by the NCREIF NPI) retains its three key benefits: low correlation with other asset classes, relatively low volatility and a competitive earnings yield compared with other assets. The events of the last two years haven’t changed those positive attributes. Its correlation remains low (0.20 with the S&P 500 and -0.13 with bonds as measured by

Private Real Estate

the Barclays Capital U.S. Aggregate Bond index over the last 10 years); it remains significantly less volatile than stocks (as measured by the S&P 500), despite recent performance; and real estate offers



Ronald W. Kaiser, CRE
Co-Founder, Director,
Real Estate Research

Over the last 10 years, real estate has outperformed both stocks and bonds despite its worst year of performance on record.

an earnings yield of over 6%. In fact, over the last 10 years, real estate has outperformed both stocks and bonds despite its worst year of performance on record.³ Further, historically real estate has typically outperformed other asset classes in periods of high inflation.

Q Is it true that vintage years matter? If so, is now a good time to invest?

While it is impossible to time a “bottom” in the market precisely, with unleveraged commercial real estate values down 30 – 40%, today is certainly a better entry point into the asset class than a couple of years ago. In past cycles, some of the best returns were often generated from investments made coming out of the cycle—vintage year matters! Furthermore, historically, apartments or retail have consistently led the sector’s recovery.

¹Source: NAREIT, through 12/31/09.

²Source: NCREIF, through 12/31/08.

³Sources: NCREIF, Bloomberg, Morningstar, DataStream. NCREIF NPI Index: The National Council of Real Estate Investment Fiduciaries (NCREIF) National Property Index (“NPI”), consisting of returns on all unleveraged and deleveraged properties reported by NCREIF’s data-contributing members, had a total market value of over \$238 billion as of the fourth quarter 2009. It represented 6,211 properties in the U.S. The NCREIF NPI is unmanaged and is not available to investors. S&P 500 earnings are based on five-year trailing operating earnings. The Barclays Capital U.S. Aggregate Bond Index (formerly Lehman Brothers U.S. Aggregate Bond Index) is an unmanaged, market-value-weighted index of taxable investment-grade fixed-rate debt issues, including government, corporate, asset-backed and mortgage-backed securities, with maturities of one year or more.

RISKS

Investing in private real estate entails significant risks that are customarily associated with the development and ownership of income-producing real estate, including illiquidity, changes in supply and demand, and inexact valuation. Fees and expenses may offset the return on investments. An investor may lose all or a substantial portion of the investment.

DISCLOSURES

These Conference Call Highlights are confidential and proprietary. These highlights may not be reproduced in whole or in part and may not be delivered to any person without the prior written consent of Bailard.

These highlights have been distributed for informational purposes only and are not a recommendation of, or an offer to sell or solicitation of an offer to buy, any particular security, strategy or investment product. These highlights do not take into account the particular investment objectives, financial situations or needs of individual clients. Performance information portrayed in these highlights is not indicative of the past or future performance of any Bailard product.

Past performance is no indication of future results.

These highlights contain the current opinions of the author(s) and such opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Bailard

INVESTING. REDEFINED.®

Published March 15, 2010

For more information, please call 800. BAILARD (800.224.5273) or visit www.bailard.com.

Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404