

February 5th, 2010

Commercial Real Estate & REITs 2010

REIT Strategy

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REIT Strategist

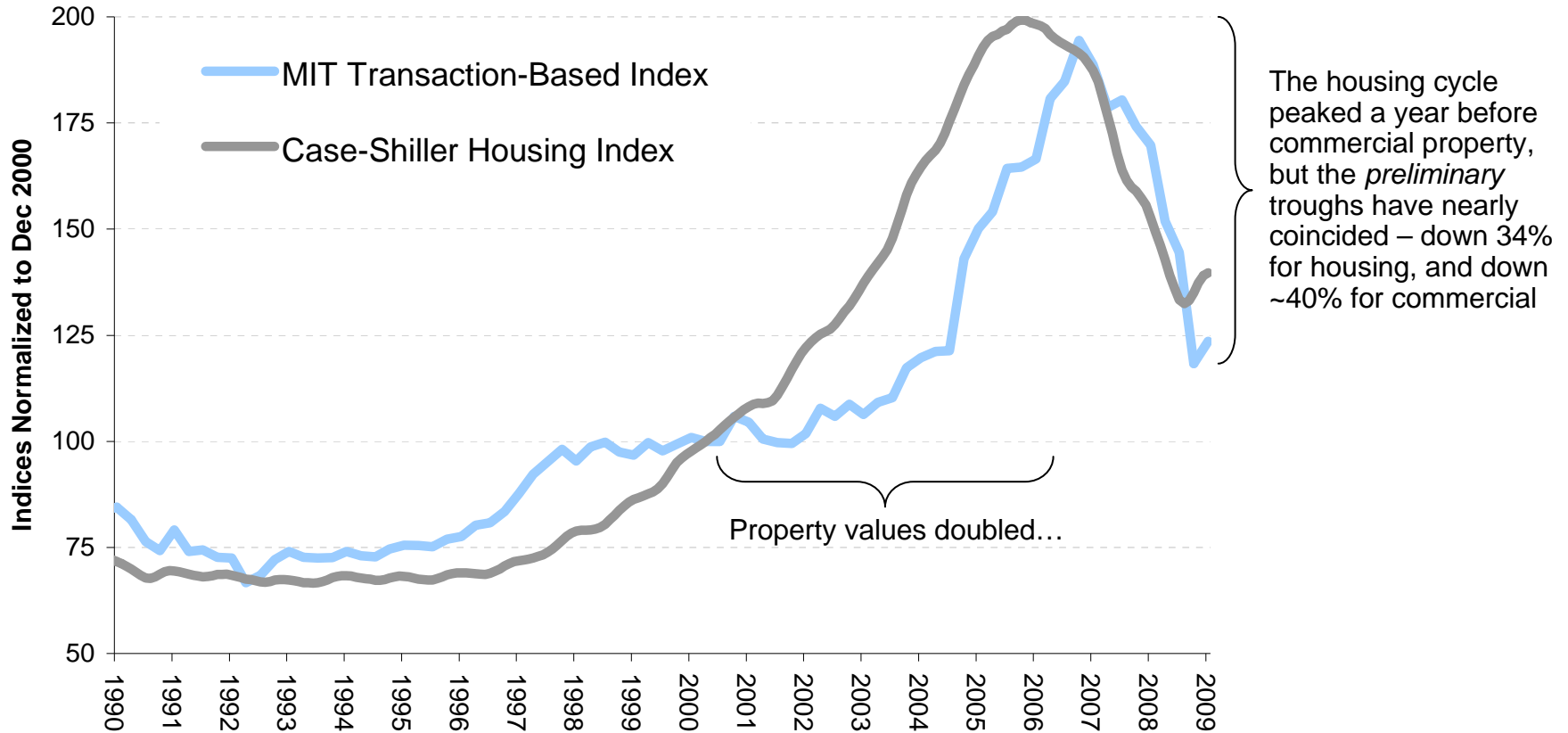
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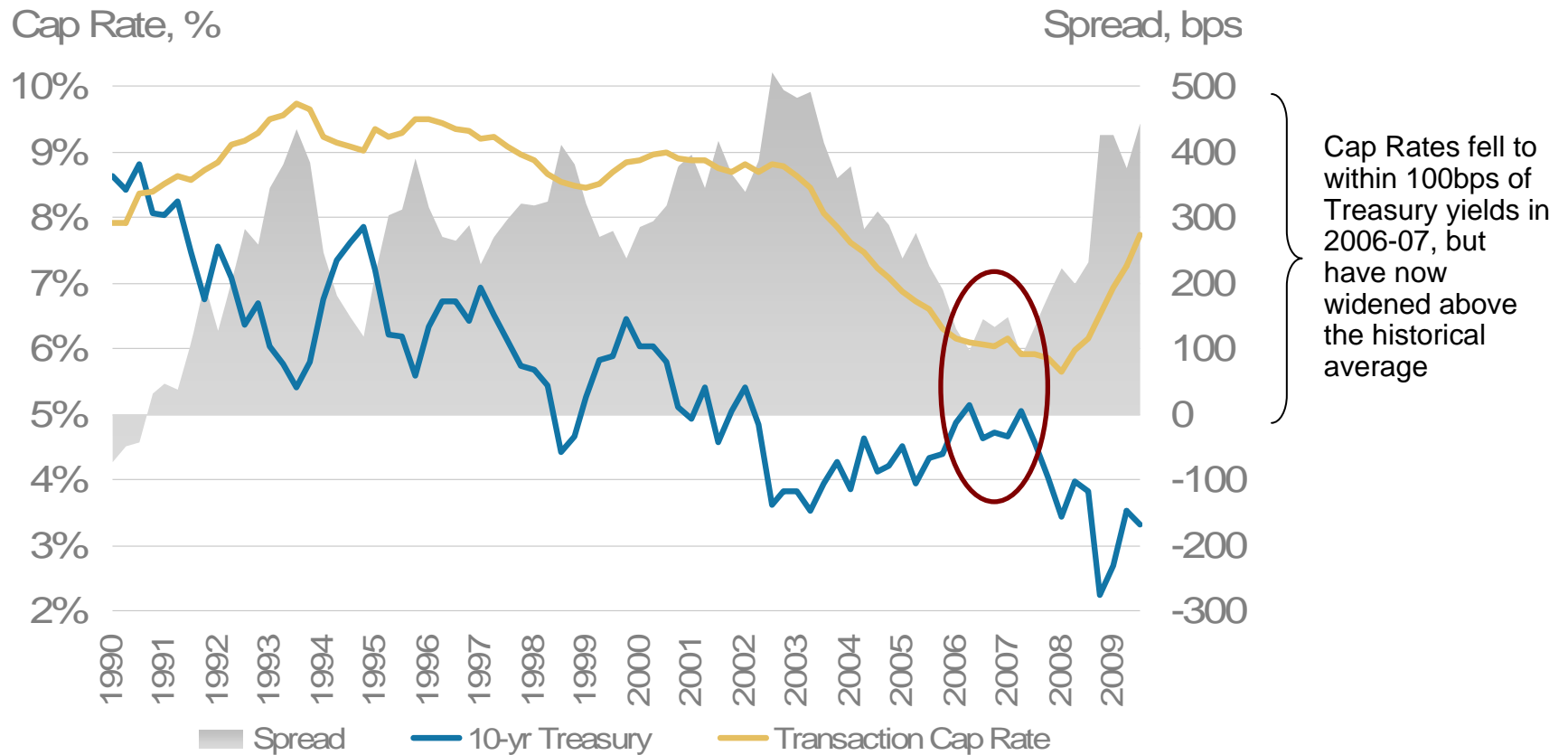
The Current Cycle in Perspective

- This commercial real estate cycle was driven by credit, not over-supply
- CRE appreciated 60% from 2004 to 2008 on easy, cheap credit, fueling a surge in transactions
- Values now stand at 2004 levels again, but all too often with 2007 debt burdens



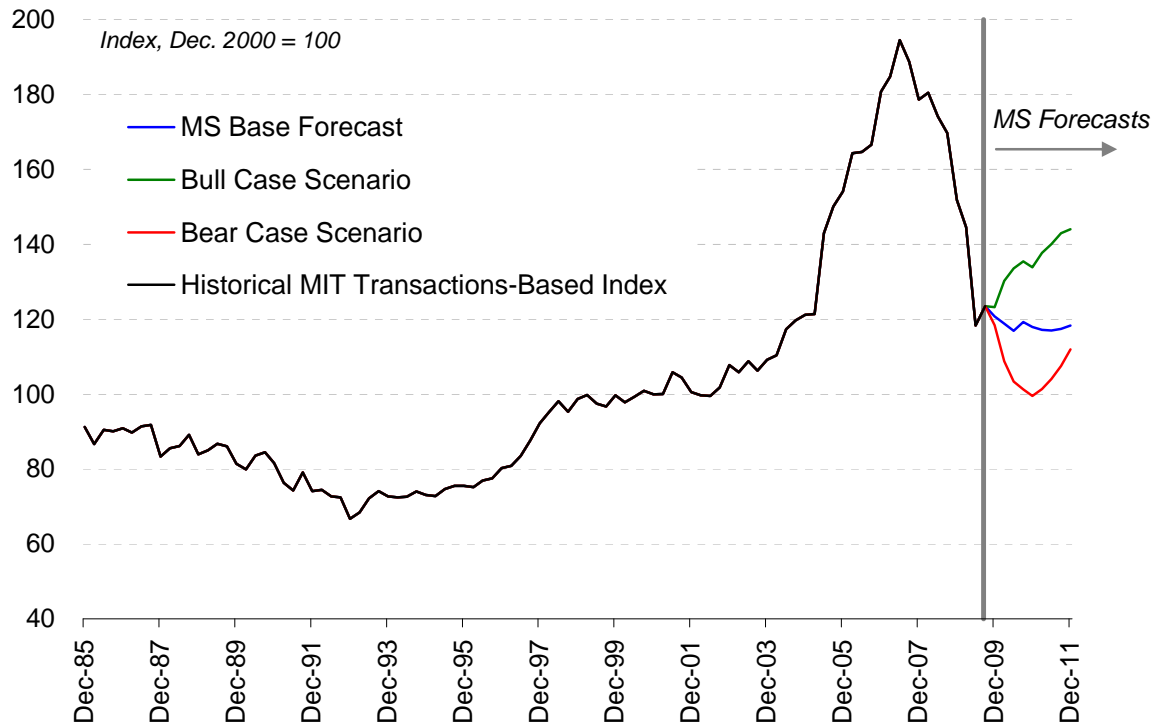
Fundamentals Did Not Support 2006-07 Pricing

- The spread between transaction yields (cap rates) for CRE and the 10yr Treasury rate dipped to +100bps
- The long-run average spread is +200bps, but the recent correction nearly doubled that figure



We Expect Values to Stabilize in 2010, Continuing a Recent Trend

The Outlook for Commercial Property Values



Source: MIT, Morgan Stanley Research.

Bull Case = V-Shaped Value Recovery

Spread compression more than offsets the impact of higher yields, spurring a sharp price reversal (+17% through 2011). Cash flows resume growth in 2011.

Base Forecast = Stabilization

Values stabilize, with CRE cap rates at around 7.5%, modestly below current levels. Higher yields and lower cash flows neutralize the impact of tighter credit spreads. Cash flow declines in 2010–11 reflect a sustainable but modest recovery.

Bear Case = Another Year of Declines

Disappointing growth keeps credit spreads high, while faster cash flow declines amplify the impact on asset values. Values recover in 2011, but still end another 10% below current levels.

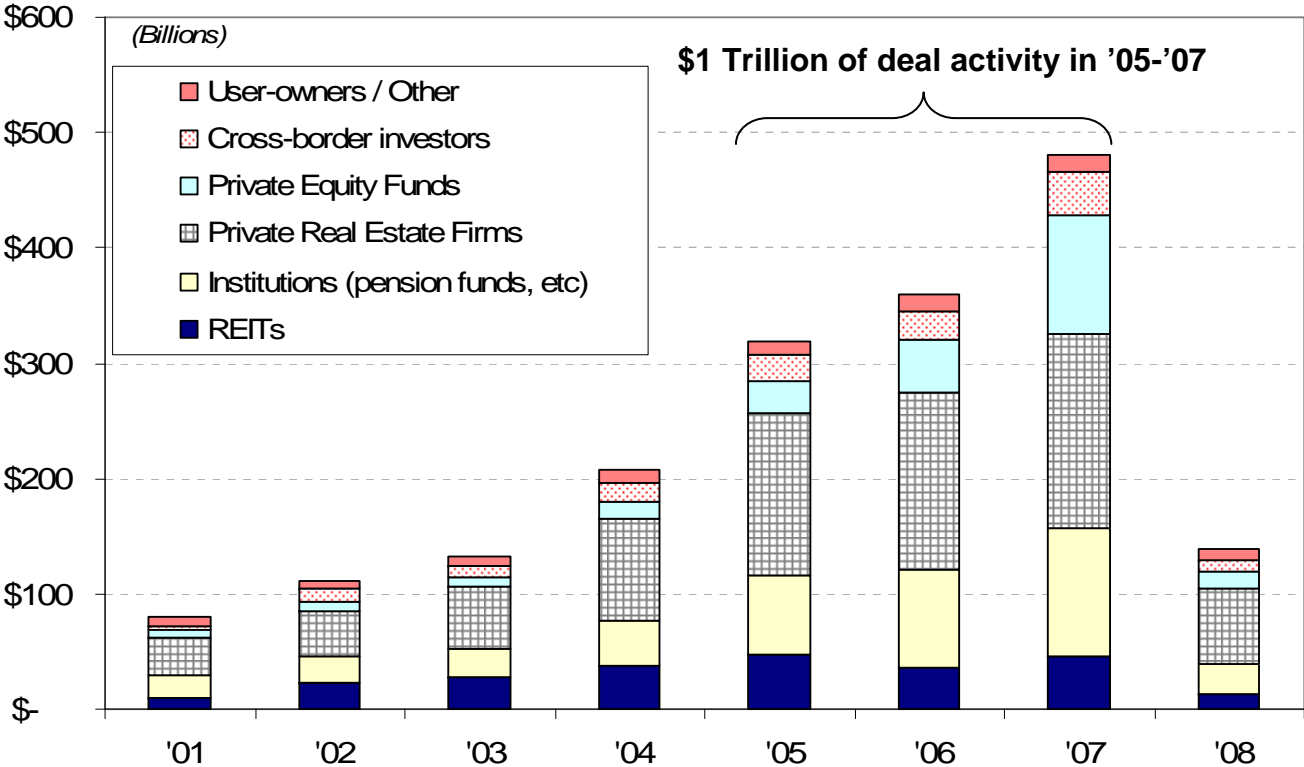
Key Drivers:

- The trajectory of rates & credit spreads
- The pace of distressed transactions
- Timing of the employment recovery

The Transactions Party & Debt Hangover

- Investors responded to low credit spreads by aggressively flipping properties, just as in housing
- Over \$1 trillion of acquisitions were completed near the top of the cycle in '05-'07, many now underwater
- Leading acquirers were private equity funds, with public REITs being much more conservative

Commercial Property Acquisitions by Type of Buyer



Source: Real Capital Analytics

How Deep is the Leverage Hole With Values Off 40%?

Current CRE debt outstanding is \$3 trillion, with scheduled maturities >\$300B/yr through 2012

Problem #1: Bank construction loans

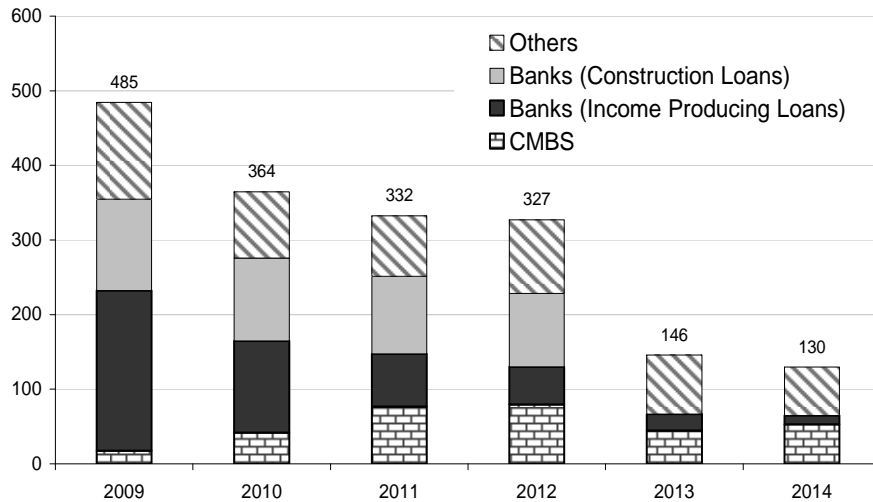
- Shorter duration means valuations underwritten at inflated 2006-08 prices, leaving no equity
- Lease-up is vulnerable to cash flow shortfalls, making extensions more problematic

Problem #2: Pro forma CMBS mortgages

- At the peak, securitized mortgage underwriting was based on frothy cash flow projections
- The recession meant that growth was rarely achieved, leaving interest coverage shortfalls

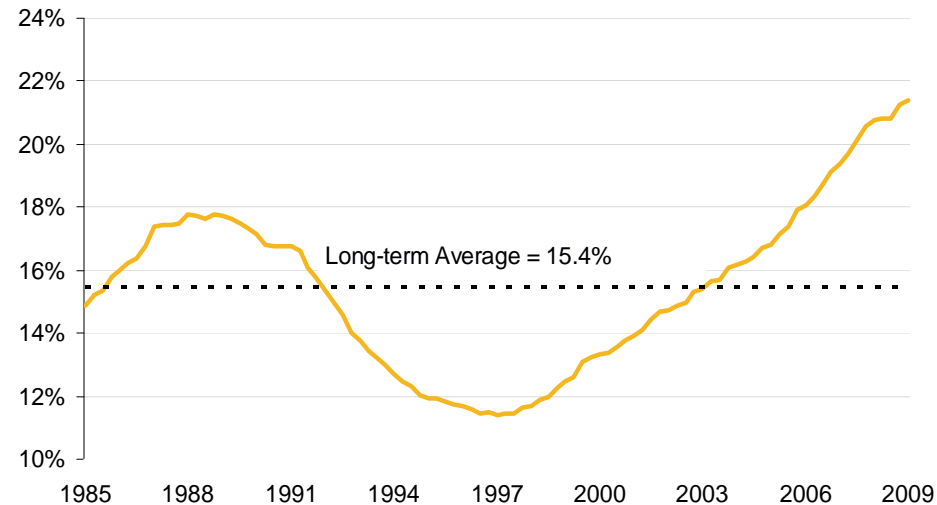
To achieve historical debt/GDP ratio, ~\$365B of debt would have to be shed by 2014 (~ \$70B per year)

Commercial Real Estate Debt Maturity Schedule (\$Bn)



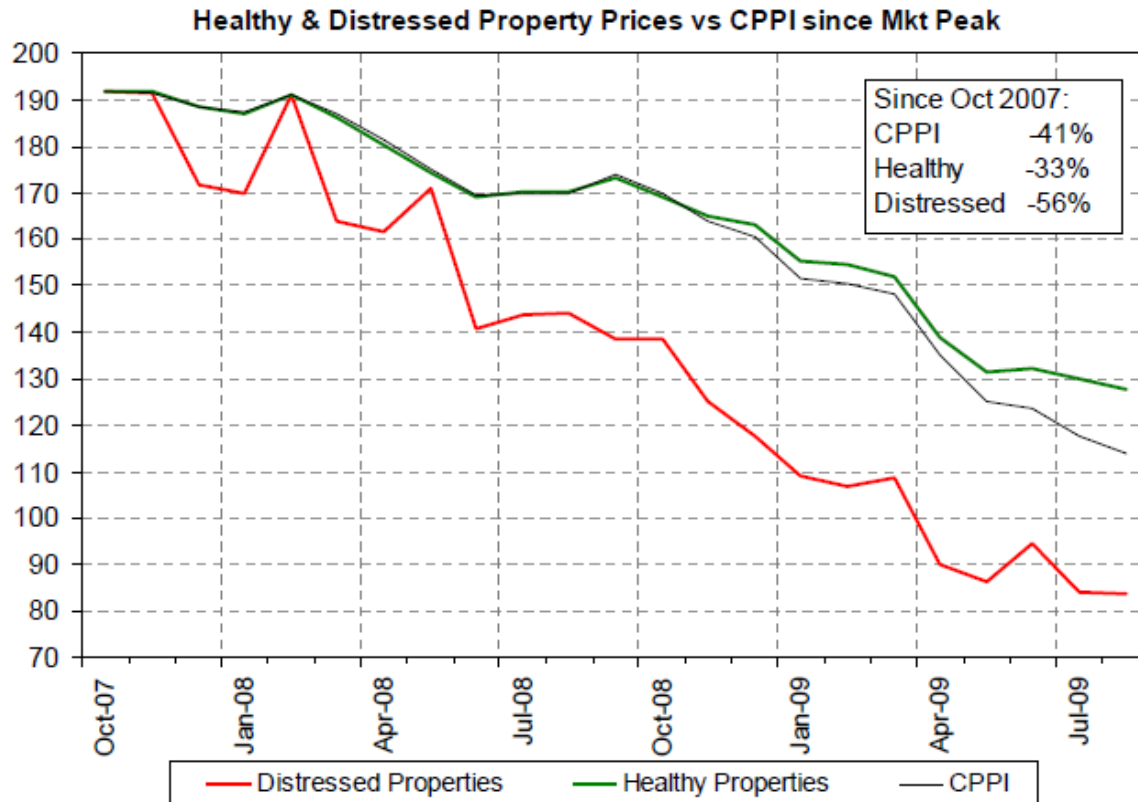
Source: Federal Reserve, FDIC, FFIEC, MBA, Trepp, Morgan Stanley Research

Ratio of Commercial Real Estate Debt to Nominal U.S. GDP



“Amend and Extend” Is a Rational Strategy

- The leverage hole hasn't translated to an avalanche of distressed sales/liquidations
- Pricing on distressed properties has declined >20% more than on “healthy” deals
- Peak to trough declines of 56% for distressed deals explains the logic of avoiding liquidation at all costs
- Regulators are encouraging bank and CMBS extensions/modifications, disappointing vulture investors

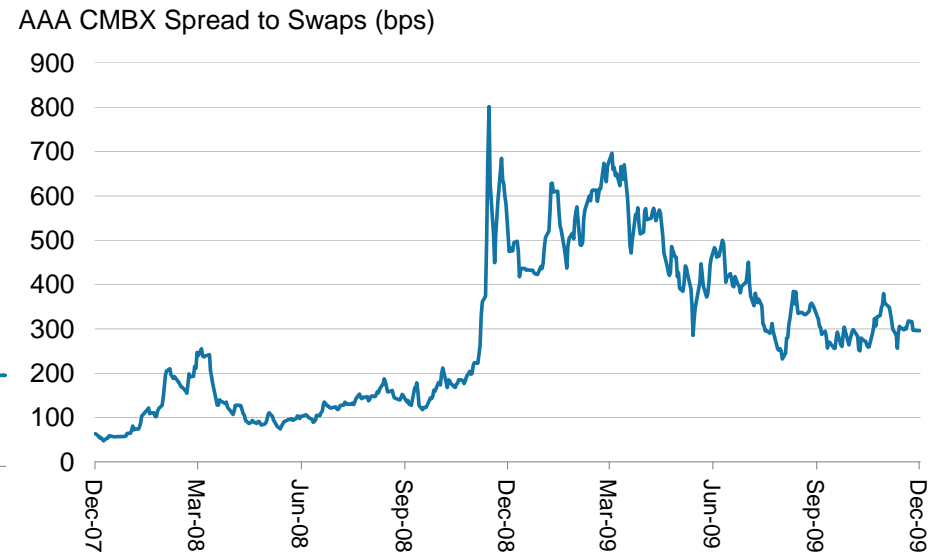
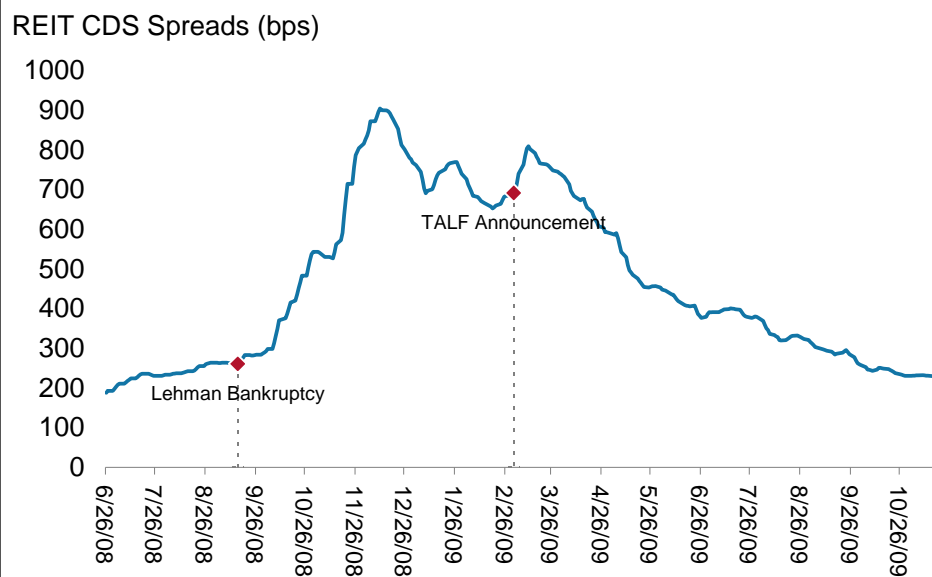


Asset pricing based on transactions by non-distressed sellers is down 33% from peak, versus a 56% decline for distressed sellers or assets

Source: Real Capital Analytics and MIT (Geltner).

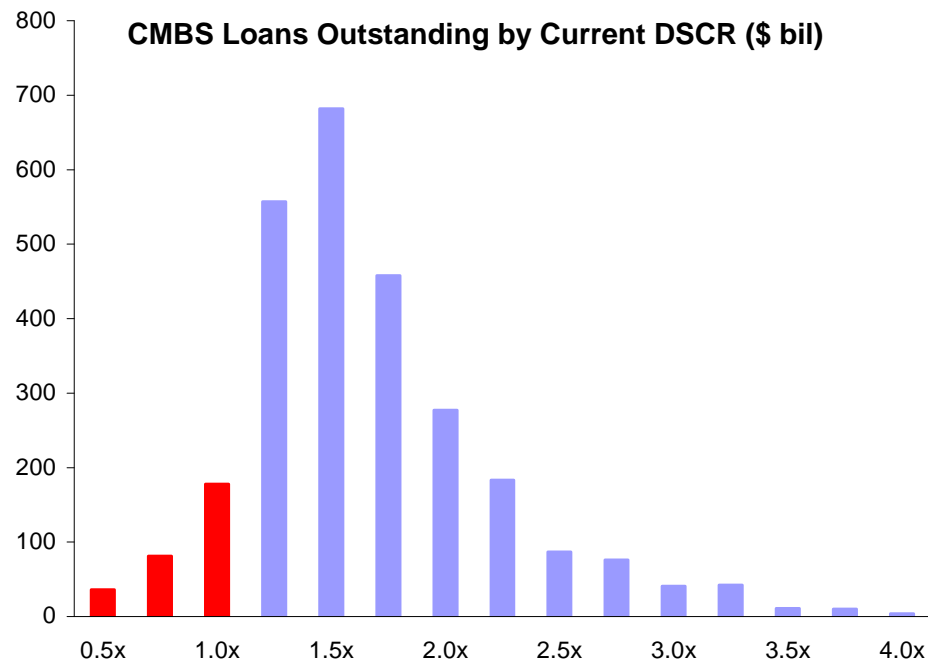
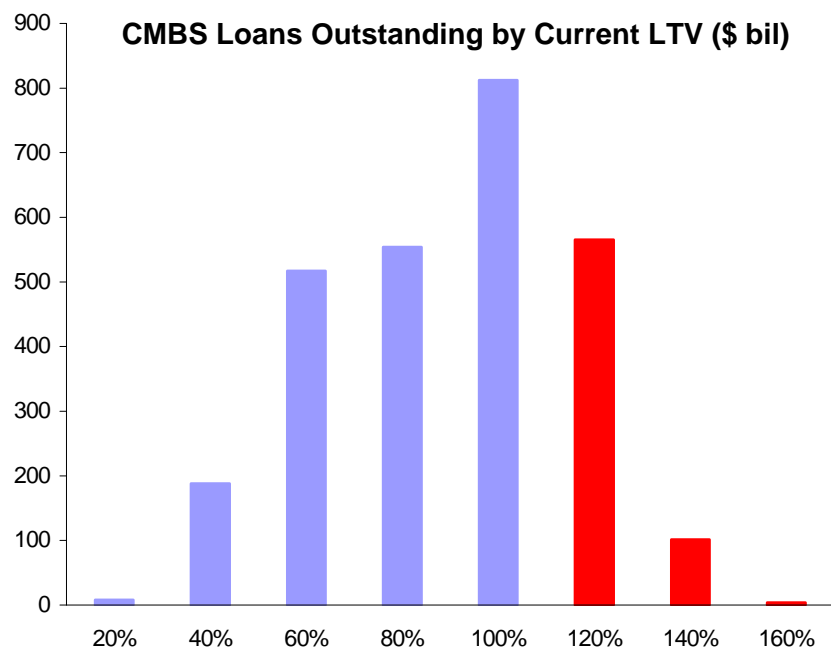
Bright Spots for the Recovery I – Debt Markets Have Thawed Considerably

- Spring has come early for commercial real estate debt, as the thaw is underway
 - CMBS spreads on legacy loans are down 400bps from peak (albeit still high vs. 2008)
 - CDS spreads for REIT unsecured debt are at pre-Lehman levels, with the market wide-open
 - Terms for bank lines of credit to REITs have eased considerably
 - Large mortgages are again available (>\$200M) in the past 90 days, and LTVs are rising
 - New CMBS offerings are possible, without TALF, and potentially via conduit deals in 2010
 - Spreads on new CMBS have been well inside of legacy deals, due to better underwriting
- Credit market healing helped property values to stabilize in 2H09 – we expect more of the same in 2010



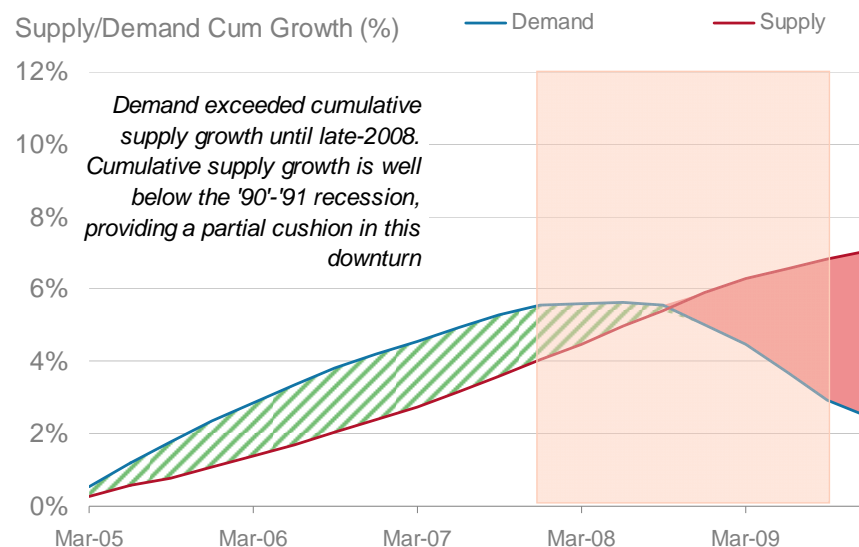
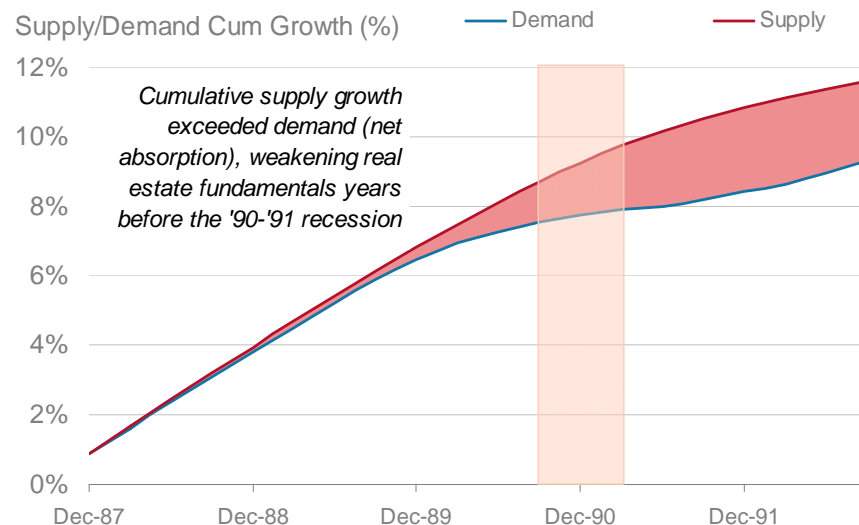
Bright Spots for the Recovery II – The CMBS Market Is A Longer Term Issue

- Many of the most aggressive large loans were securitized into CMBS pools, but the most problematic were 7-10 year deals at the market peak in 2006-07, which mature after 2012
- While ~\$700B in CMBS loans have negative equity, by our estimates, special servicers believe time is on their side, particularly for positive cash flow loans
- Close to \$300B of loans have negative cash flow (DSCR<1.0x), clearly a bigger problem, but modifications are increasingly common, as servicers have incentives to restructure



Bright Spots for the Recovery III – The Supply Side Stayed in Balance

- Despite obvious demand-side challenges poised by The Great Recession, the supply side of the equation is very benign
- In the lead-up to the RTC liquidation era, supply growth had exceeded demand for years, weakening fundamentals even before the 1990-91 recession
- Commercial real estate supply grew 8% in the 3 years prior to the 1990 recession, but only 4% in the lead-up to the current recession
- While demand has been more severely impaired, the supply picture should lead to a sharper 2011-12 recovery once the demand recovery reduces high market vacancy rates



Views on the REIT Sector – Upside Remains

Base Case – Acquisitions programs take shape, fundamentals approach a trough, and cap rates stabilize (RMZ target: 640 → 13% total return from today's levels)

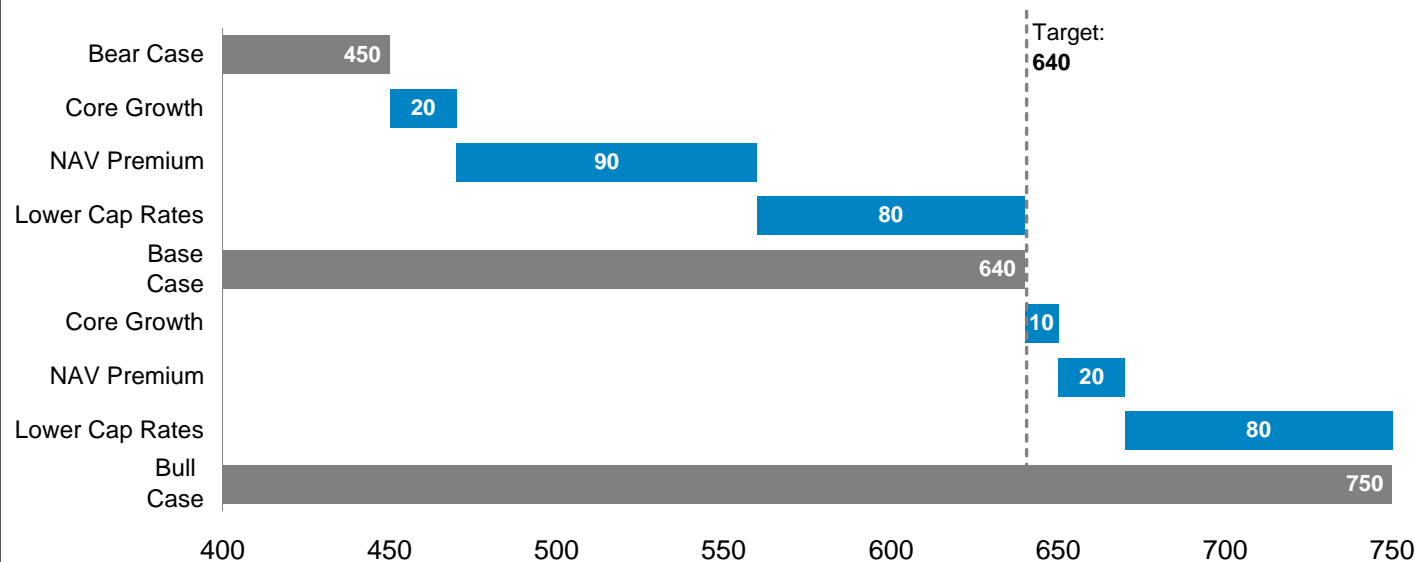
Bull Case – Spreads contract as credit heals sharply, economy recovers at pace (RMZ target: 750 → 32% total return)

Bear Case – Modest economic double-dip; credit spreads and cap rates rise (RMZ target: 450 → -18% return)

A Buyers Dozen for REIT Investors

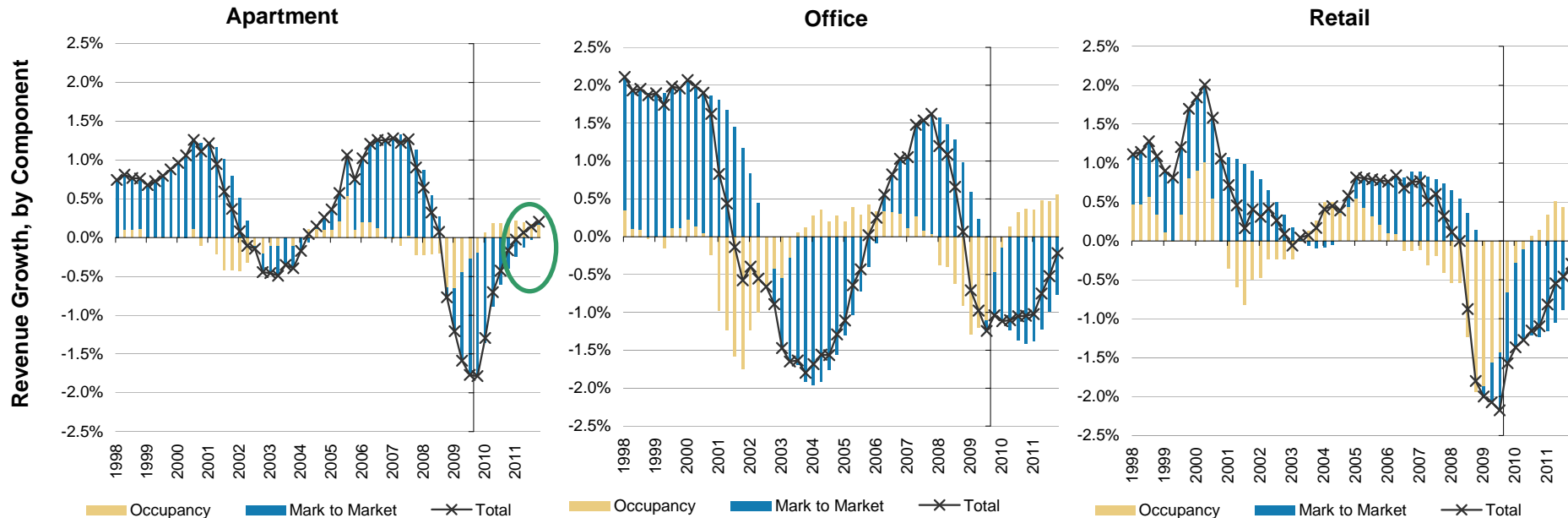
Company	Ticker	Property Subsector
AvalonBay Comm.	AVB	Multifamily
EastGroup Props	EGP	Industrial
Equity One	EQY	Shopping Centers
Essex Property	ESS	Multifamily
Federal Realty	FRT	Shopping Centers
Health Care REIT	HCN	Healthcare
HCP	HCP	Healthcare
Highwoods	HIW	Office
Home Properties	HME	Multifamily
Kilroy Realty	KRC	Office
Mack Cali Realty	CLI	Office
Mid-America Apt.	MAA	Multifamily

Source: Morgan Stanley Research



Operating Fundamentals – Scenarios for Major REIT Subsectors

- Apartments** – Well-positioned for a strong recovery, with Echo Boomers fueling a rebound in demand and short lease-terms accelerating the revenue impact. 2010 REIT guidance set the bar at an achievable height, if job growth resumes by mid-2010. *Favorites: ESS, MAA.*
- Retail** – Retailers can afford to pursue a flight to quality, given high market vacancy rates. Quality regional malls and in-fill strip centers are resilient, but we expect a subdued recovery, with limited upside to market rents. *Favorites: EQY, FRT.*
- Commercial** – Lease-terms will translate into a slow recovery, as in-place rents roll down to market. Acquisitions could materialize as a positive catalyst. *Favorite: KRC.*




Source: PPR, Company Filings, Morgan Stanley Research

Conclusion – Signs of Life Have Emerged

- Commercial property values are stabilizing, thanks to a rapidly recovering credit market
- Financing is increasingly available, but more selective
- The tentative reemergence of the CMBS market is an important positive development
- Public REITs are well-positioned to acquire assets because of access to public debt & equity markets
- Construction loans and *pro forma* CMBS loans will be at the forefront of distress in 2010
- Over-leveraged assets will largely remain so, as lenders amend & extend
- The transaction market is still sluggish due to ongoing workouts, but should accelerate through 2010 as investors become more confident in the cyclical bottom
- Supply is a bright spot, but won't be appreciated until 2011
- Retail remain overbuilt, but top properties benefit from a flight to quality
- Apartments are positioned for a strong recovery, as job growth resumes & Echo Boomers start to rent
- Hotels may suffer a head fake, as occupancy remains too low to generate rate growth

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