



Research

US Investment Update

**Is the Real Estate Investment Market Recovering?
Mid-Year 2010**



Corporate Overview

Rockwood Real Estate Advisors (“Rockwood”) is a full-service real estate investment banking firm headquartered in New York with offices in Dallas, Miami, Orlando, and Mexico City. Formed in 1991, the firm provides a broad range of research-driven real estate investment banking services and business solutions to institutional and private investor clients on a national and global basis.

Committed to providing best-in-class client service, Rockwood has established a unique position in the marketplace by redefining real estate investment banking as a seamless blend of advisory and transactional services. Over the past three years, Rockwood has executed assignments involving approximately \$20 billion of real estate assets.

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Is the Real Estate Investment Market Recovering? Making Sense of the Market's Turn Using Imperfect Data

As headlines are focused on the fledgling recovery in the real estate capital markets – Transaction volumes are up! Cap rates are down! Vacancy rates are stabilizing! – we again feel the need to remind our readers of the limitations of available real estate data as a tool for making sense of the market's condition.

In particular, we have heard from a number of clients, seeking independent quantitative evidentiary support for the decline in cap rates that they are experiencing, that they are frustrated by the lack of data to support this drop, which many claim to be in the 100-200 bp range. There is good reason they cannot find such evidence, and that is because it does not exist. To understand why, read on.

No Clearing House or Exchange in Real Estate to Disseminate “Basic” Information: Real Estate Still Sold in the Equivalent of a 1920s Regulatory Environment

In commercial real estate, as in most asset or commodity markets, information is the lifeblood of the industry. Investors, lenders, and occupiers craft decisions based on where the market has been, where it is today, and where it is headed. This process of gauging the market requires data, which allows us to determine if our specific, experienced-based sense of the current market's health is consistent with a broader reality.

In the public financial (non-real estate) markets, despite recent structural woes, there is an institutionally-accepted faith that certain pieces of baseline market information are correct: how many shares of a certain stock traded today? How many shares traded on all the exchanges today? How much new corporate debt was issued? How were the shares priced in relation to recent and projected earnings? How many bps above the relevant risk-free benchmark was corporate debt priced? With a few clicks of a mouse, this information can be ascertained with absolute surety of its accuracy.

Indeed, US financial securities markets' great liquidity and mercurial momentum presuppose the accuracy of this

basic information. Regulations require that the information be passed through the various exchanges and associated clearing houses, and it is the availability of such information that has enabled ever-more sophisticated financial products, instruments and devices to find success: in fact, one might argue that this lack of basic clearing house information was one of the key causes behind the tremendous failure in the CDS market which operated outside the formally regulated trading system, and was the undoing of AIG, among others.

Nonetheless, in countless other markets both general and specific – from basic equities trading to commodity derivatives and municipal bonds – the availability of such information supports highly sophisticated hedging, trading and arbitrage techniques. Such techniques would not be consistently possible without this baseline information. A trading program that uses algorithms to attempt to detect and anticipate patterns in other investors' simple buy-sell orders, for example, must assume that the information it receives regarding the pricing, volume, and timing of the targeted trades is perfectly accurate. If this information were only vaguely accurate and useful as a general gauge, the trading algorithms would not function as designed.

Real estate markets, however, lack such basic information. We can tell you with perfect certainty the number of shares traded on the NYSE in the first half of 2010, the average price per share, and the average P/E multiple for a family of stocks. We can know all of this information with certainty because of trading and disclosure regulations imposed on public financial markets in the wake of the Crash of 1929 and the Great Depression, specifically the Securities Exchange Acts of 1933 and 1934 (and subsequent Maloney Act), which also resulted in the creation of the SEC.

There is no such equivalent regulation governing the trading of real estate. How many buildings were sold in the first half of 2010? Thanks to very good private market data sources, we have a general sense as to the answer. But the reality is that, even at this writing, there are sales in the first half of 2010 which have not yet been captured by these or other data sources. Why? Because there is no central clearing house, exchange, or regulatory processes governing where,

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when or how such information must be recorded, as there has been for securities for nearly eight decades. Instead, **real estate investment remains forever in the world of 1929.**

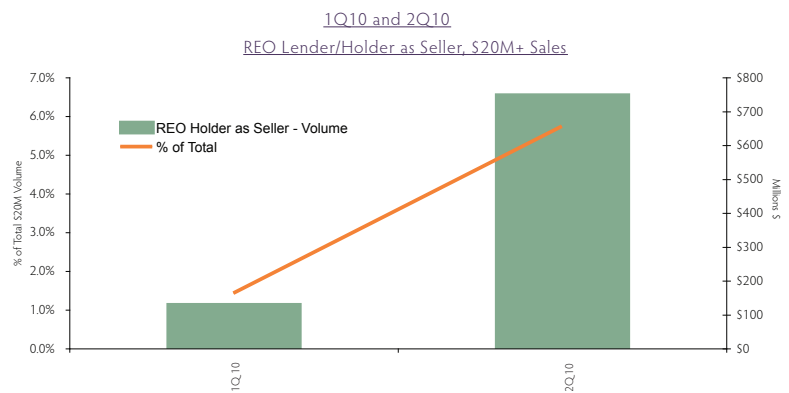
True, when a property is sold, a deed is exchanged, and such transfers are recorded everywhere. But in roughly a dozen “non-disclosure” states⁽¹⁾, the price (let alone the income) is either not recorded on the transfer, or if it is recorded, it cannot be disclosed. In addition, not only is there often a delay in deed recordings, but many types of what are, in effect, building sales, can be structured as not to trigger an official deed transfer – the sale of a partial interest, the sale of the holding company or a special-purpose vehicle which owns only the building, the sale of the ground lease, the creation and sale of a master lease. For anyone wishing to keep their building sale private, there are many ways to conceal or “structure” around the release of even the most basic data, such as price. As for the most important data – the income needed to calculate an NOI cap rate based on a sales price – it is very easy to keep such information from ever being made public in a venue where it can be definitively and independently confirmed.

Volume Is Up...Or Has It Merely Shifted From Other Forms?

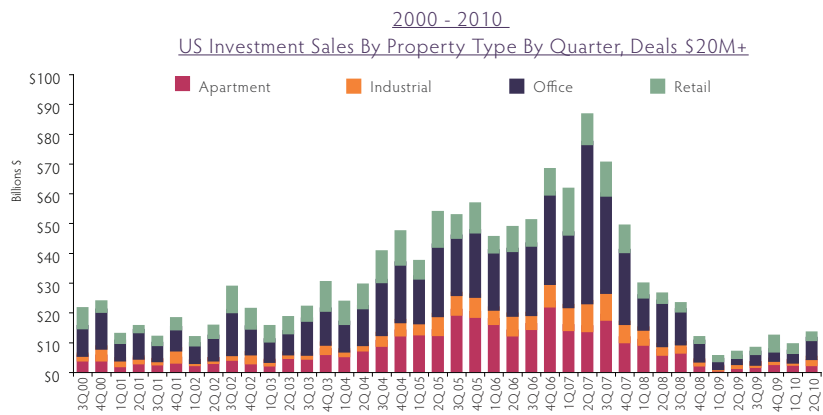
To wit, in abnormal market periods, like that which we are exiting, there can be a tremendous substitution between traditional building sales (which during normal market conditions are a good measure of broad “investment market activity”) and other means of investment, such as note sales, preferred equity raises, and joint venture and recapitalization structures. Detailed data on the amount of such other types of investment activity is rarely available from independent sources, as so many transactions are conducted without publicity.

Similarly, real estate capital-raising data from various independent sources, while good as a general gauge of market capital raising, are also not necessarily complete. Public pension funds and other heavily regulated investors must disclose their capital commitments, but many private and foreign institutions do not, and operate in secrecy. Even consultants and placement agents on large funds may often not know who all of the investors are, or the details of silent investors’ commitments.

So, while it is tempting to simply report that significant (\$20M+) investment sales transactions rose in the first half of 2010 by nearly 50% over the first half of 2009, we ask: what does this actually mean? How much of an increase in investment activity does this represent? Is some of this increase merely a shift from recapitalization, preferred equity and note sale activity?



In our view, **we actually believe the increase is legitimate, because we are also anecdotally seeing sustained amounts, if not outright increases, in other non-traditional investments, alongside the uptick in sales.** But without exhaustive data, we can’t ever be sure. What we do know is that counterparties who have found themselves being forced to foreclose or take back real estate collateral are no longer universally holding the assets, and are beginning to



¹ The largest of these is Texas, but the list includes a wide range of other states, such as Kansas, as well as parts of Missouri and Utah.

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dispose of them: by our estimation, after accounting for just 1% of sales in the first quarter of 2010, dispositions by Special Servicers and Foreclosing Lenders accounted for nearly 7% of total significant US sales in the second quarter of 2010. While we cannot predict whether or not this share will rise higher, we do believe that the absolute level of REO dispositions from such entities will continue to rise.

Cap Rates Are Down Dramatically, Or Not Much? Price Discovery Processes At Work.

Similarly, different data measures seem to show that cap rates peaked at the end of 2009 or at the very beginning of 2010. The best known data source⁽²⁾ shows that market-wide, all property-type cap rates have declined about 10-20 bps since.

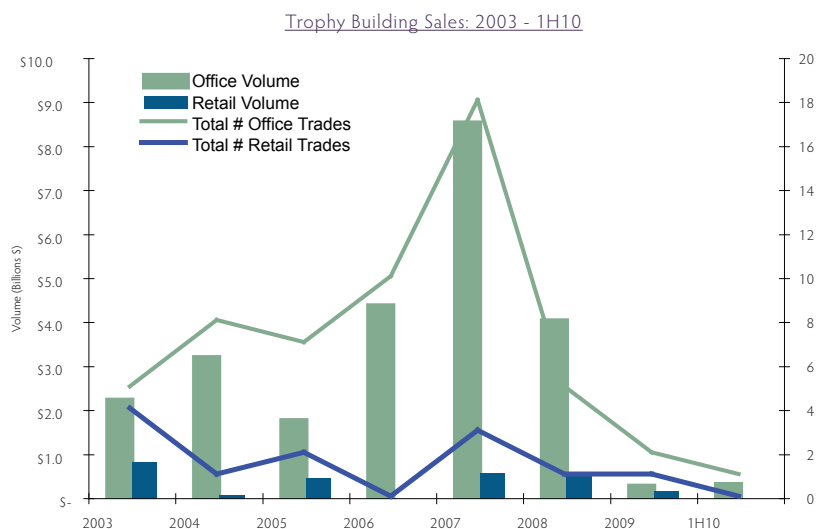
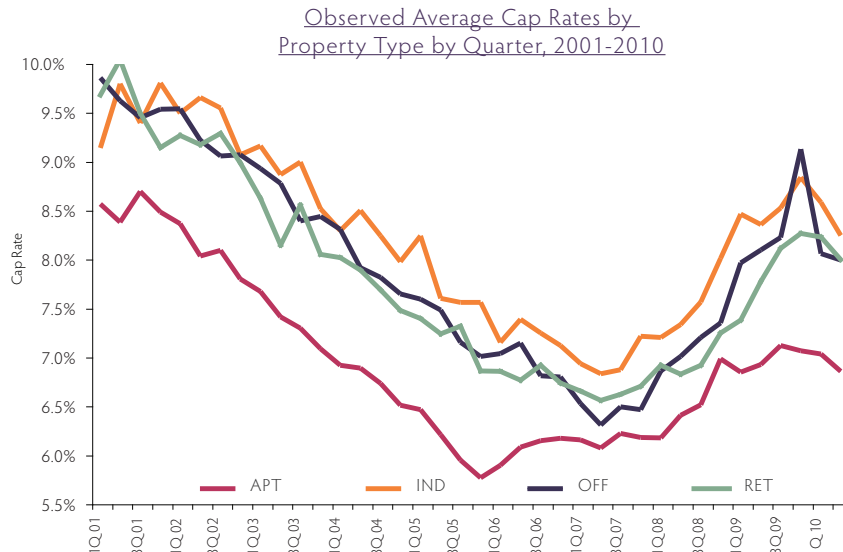
To ensure that this decline has not been skewed by a change in the share of trades accounted for by different property types (with their differing cap rates levels), it would be wiser to look at property-type specific time series, but these also reveal generally a 20-30 bp decline, except for the office sector, which shows a sharp jump up in the fourth quarter of 2009 before registering a 100 bp drop in early 2010. Examining this office sector jump, however, reveals the broader challenge in dealing with transactional data.

In the fourth quarter of 2009, this data source recorded a mere \$4 billion of office trades, for which cap rates were ascertained for \$1.2 billion. Not only can we not be certain that reported cap rates represent the same concept⁽³⁾, but of this \$1.2 billion, more than half was accounted for by just

five transactions, three of which involved a distressed seller, and two of which involved single-tenanted properties. Such thin data is unlikely to be representative of a wider consensus of values for the office sector overall, and explains why the recorded average cap rate displayed such unusual volatility: after all, it would seem remarkable that office cap rates jumped up by 100 bp for a single quarter, then dropped down again to where they were before.

This example in the office sector is representative of a broader issue for all the property types: in periods of extreme volume and pricing movements for an opaque, high transaction cost, and exchange-unregulated asset class, various forms of sample and selection bias⁽⁴⁾ make it difficult to draw any meaningful conclusions regarding

directional trending from general market pricing/cap rate data based on transactions.



² Which we will not name as we very much appreciate the products of this data source, and do not wish to appear to be critical of their products, which we think are great.

³ i.e. Is the cap rate based on trailing 12 months NOI? Pro forma year 1? NOI Inclusive or Exclusive of replacement reserves, etc? This varies by region and owner.

⁴ Which, given the thinness of the data and inconsistency of trading patterns/volumes, are difficult to statistically correct or adjust for via an "indexed" figure.

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Few true trophies, for example, have traded over the past year, and only one asset in either of Rockwood's Trophy Indices for the Office and Retail Sectors traded in the first half of 2010. Clearly transactional cap rates are not capturing pricing trends for this component of the market.

The most obvious general issue, however, is the data bias resulting from the overall thin volumes of trades coupled with cap rate tracking for roughly only +/- 30% of all trades.

This is part of the reason why the stated market-wide declines in cap rates do not dovetail with the experience of many market participants, who claim to have witnessed 100-200 bp declines over the last six months.

While it is tempting for those who want quantitative support of dramatic cap rate declines to use this as their "aha!" moment and blame the data, there is another, far more important component to the story: those market participants who claim to have observed a dramatic tightening in cap rates readily admit that the "higher cap rates" they "observed" 6-9 months ago were either:

- (a) on assets which are not similar in characteristic to those they are valuing today; or,
- (b) on assets which were slated for sale but **which did not trade**.

If the asset did not trade at the higher cap rate due to buyer-seller disconnect, then that higher cap rate does not show up in the data, as only those deals priced to clear will register. **Further, if deals did not trade because they did not meet a certain cap rate expectation, then that cap rate expectation did not reflect a market-clearing price.** This is part of the reason why deal volume has been so depressed, as market-clearing pricing has not readily been apparent for most assets, reducing their saleability. It is also a reason why the market data does not reflect market participants' experience of cap rate compression, because they are comparing an apple

(an asset which did not sell in 2009) with an orange (one that does in 2010).

It is our belief, then, that to claim "cap rates have dropped dramatically" is too simple to reflect a complex reality. Based on our recent book of business coupled with market-wide data, **we believe that credible buyers' bids have tightened by 100-200 bps since year-end 2009, while at the same time, sellers' ranges for acceptable disposition cap rates have risen 25-50 bps from where they were, effectively erasing much of what was a 200-300 bp bid-ask spread in the market. Note that we do not say that "cap rates"**

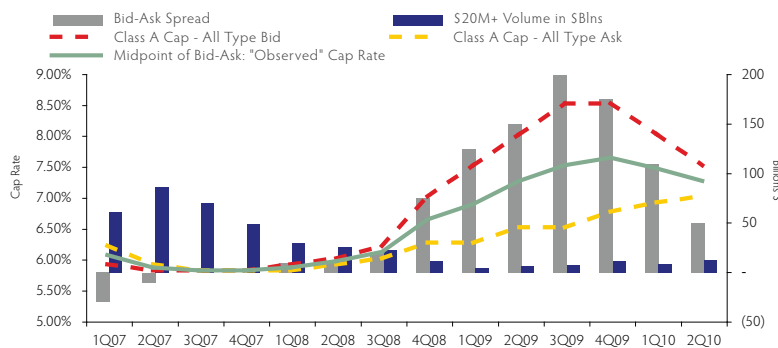
dropped 100-200 bps. We say that "buyers' bids" have dropped that much, and there is a difference, which reflects a nuanced understanding of how real estate markets "clear".

We believe that the inefficient and opaque nature of the private real estate capital markets increases its susceptibility to failures in the price discovery process, and that 2009's severe decline

in traditional volume and associated recovery in early 2010 reflects an extreme breakdown and subsequent repair in the price discovery mechanism.

In 2009, the discrepancy between buyers and sellers remained so persistent and wide as to reduce transaction volume to involve only those assets where there was a clearly understood concept of value: last year, that largely consisted of single-tenanted office or industrial buildings, where credit risks were readily understood and could be objectively priced vis a vis tenants' corporate debt pricing, treasuries and borrowing costs. For all other assets, there was no such pricing consensus between buyers and sellers, as anyone who has recently ordered a certified appraisal can attest: many such valuations now contain a standard value along with a "discounted liquidation value" figure.

Cap Rates, Bid-Ask Spreads, and Volumes:
US Investment Sales, 2007 - 2010



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The diminishing disconnect between buyers' and sellers' perceptions of value in 2010 has enabled the price discovery function to begin working normally again, enabling successful sales of "typical", commodity-like real estate assets to occur again with increased frequency. **The movement in observed cap rates for actual transactions reflect the fact that buyers and sellers have both moved off their positions to meet somewhere in the middle; the resulting recorded drop in actual cap rates, therefore, understates the decline in buyers' bids.** As these normalized conditions reassert themselves for all but the riskiest (e.g. development land, 0% occupied buildings) properties, we expect the difference between appraisers' standard values and discounted liquidation values to diminish.

In the public financial markets, such prolonged price discovery breakdowns are rarer, because stocks are fungible and their markets, by nature of regulation, are more transparent: if you want to sell your shares in a Company X, you simply place a sell order (with the requisite stop/limit parameters), and they are instantly sold at the market-clearing price. This is why publicly-traded stocks are considered to be a Level 1 asset for accounting purposes – prices for identical assets are readily observable and quoted in an open exchange. Commercial real estate, however, is at best a Level 2 asset, and in 2009, was moving into Level 3 territory, with few meaningful cap rates available.⁽⁵⁾

Accordingly, data series which measure actual transaction cap rates miss the point, as do data series which measure holders/sellers' perceived or appraised perceptions of value, **because**

3-year IRR Comparison Using Two Different Independent Forecasts for Vacancy/Rent:			
		Source A	Source B
Rent Growth:	Year 1	-5%	-2%
	Year 2	2%	0%
	Year 3	5%	2%
Occupancy:	Year 1	80%	78%
	Year 2	85%	81%
	Year 3	90%	86%
Three-Year IRR:		10.7%	8.3%

the chief driver of the market recently has not been the levels or marginal movement of direction in either value concept, but rather the size of the discrepancy between the two. Of course, without definitive data, we can't be sure, but this is our working theory of the market.

Data Shopping and Gaming the System: Implications for Fiduciaries

The structural opacity in the real estate market has, of course, broader implications beyond a discussion of the current momentum of cap rates, and as investors gear up for a new cycle of investing, we note the obstinate persistence of a related trend - regarding "data shopping" in the use of vacancy and rent data and forecasts - that we had hoped would be consigned to the trash heap of history as merely an anomaly of the boom.

Many seem to assume that all independent market data is equally precise and accurate, as is the quality of exchange-published data relating to regulated securities, and that all market data sources are equivalently applicable to valuation and underwriting exercises. As such, this leads many to "data shop" for the "best" data and associated forecasts to suit their purposes at hand, with little attention given to how the data has been made, what exactly the data is measuring, and how applicable it is to the asset in question. Were this just an issue among some less-experienced individuals⁽⁶⁾, this might not be worth mentioning, but this practice appears to be widespread.

We recently reviewed an asset for a client in which a relevant counterparty insisted that their sense of value reflected rigorously-utilized "objective" third-party data sources and forecasts to inform underwriting assumptions and parameters, including but not limited to the rent level, rent growth, stabilized pro forma vacancy rate, and cap rate.

Focusing only on the vacancy and rent growth components of the underwriting, data "shopping" produced a swing in the three-year IRR by roughly 25%, from 8.3% to 10.7%⁽⁷⁾. The data source which was likely most appropriate for and applicable to this asset – that is, data for which the history and

⁵ While level 2 assets involve observable prices in a less active market involving similar, not necessarily identical, assets, level 3 assets utilize valuation techniques which rely on some inputs which are not readily observed.

⁶ Who can be forgiven for such errors given that their formative professional years do not pre-date the internet era and the digital spread of easily accessible data.

⁷ Note that the data for occupancy in the IRR chart reflects moving the specific asset's occupancy to a "stabilized" average market vacancy over three years. It is not the forecasted market vacancy from an independent data source.

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the projections were based on multi-tenanted, rental office properties over a minimum size threshold – yielded the lowest value. Utilizing a source which included owner-occupied and single-tenanted properties (which will often skew the vacancy rates lower) and had higher rent growth expectations based on an average asking rent forecast, yielded a far higher – but less relevant – value. Note that the reversion cap rate and going-in cap rate were held constant in this example, and that we did not use rent growth forecasts from one source combined with occupancy levels from a different source, another dubious practice that nonetheless seems to have become acceptable to more than a few investors.

While it is easy to ferret out such practices when operating alongside professionals dealing with individual assets, the implications for those dealing at the fund level – such as in secondaries market fund trades - are troubling, given that many of the individuals operating at this level are not focused on asset-specific peculiarities and associated issues regarding the limitations and nuances of the market data they are using.

To be sure, for those not beholden to regulated fiduciaries, such liberties with information and “data shopping” may not be troublesome. But to those who are, such issues raise serious questions regarding the appropriateness and thoroughness of their due diligence processes.

Conclusions

No matter how messy the data is, the US real estate capital markets are clearly recovering. We would remind readers not to get too obsessed with jumping to extreme conclusions in one direction or another on the basis of the granular details of the market data, however, because the data lacks the precision required for such analyses.

Many thought that the technology revolution would finally usher in a long-anticipated era of perfect real estate market information, but this is not to be: the US real estate markets will not see more exhaustive data until and unless:

- (a) large and powerful industry interests demand information disclosures of all participants; or
- (b) the industry is forced to such disclosures by the government.

Indeed, the production of more exhaustive and accurate market information could be readily achieved if the regulators of the largest investor and lender groups – banks, insurers, ABS issuers, pension funds, REITs – required detailed, standardized disclosures of property-level information for all debt and equity investments made.

To assuage privacy concerns, such data could, like NCREIF's data, be restricted in its manipulation as to prohibit individual property information from being disclosed unless part of an index with a minimum number of records. The availability of such information could potentially reduce the opacity and resulting volatility that produces real estate's dramatic booms and busts.

In some other nations, more transparent conditions akin to this already exist: in one of the largest Western European countries, the significant brokerage houses and market-makers co-operate to produce industry-wide data which reflects the total sum of their knowledge.

We do not, however, believe that the political will among investors exists for such a proposition in the US, because truth be told, the real estate industry likes its market opacity, for it is in opacity and illiquidity that access to privileged information can yield opportunity for outsized returns. Information is power, and for those with access to it, there is little short-term incentive to share it, for in real estate's booms, many fortunes are made. In its busts, a few such fortunes are lost, but generally by those who are, in hindsight, often cast as having been naive, late, or overreaching in their approach in coming to the party.

In sum, unless imposed by regulators, we doubt that real estate market information and data standards will improve much beyond their current state, and investors will need to make do with the data that we have, which, truth be told, is as good as we want it to be. Meanwhile, the market goes on, and despite its structural flaws, investors have sufficient confidence in its opportunities to return to a semblance of normal activity.

Which brings us back to the beginning: cap rates for transactions have indeed begun to drop and transaction volume has returned, largely as a result of a dramatic tightening in buyers' return expectations from their temporarily elevated levels in 2009. For those screaming “we've missed the brief opening to buy real estate cheap!”, we would point out that – based on the unbelievably low transaction volumes which transpired through 2009 into early 2010 – most everyone else seems to have

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missed the opening, too. As normal sales conditions continue to reassert themselves, opportunities for off-price or mis-priced bargains will remain, but will likely be concentrated in the foreclosure, note sale and preferred/JV market spaces, where opacity, transaction costs, and other market inefficiencies bring the potential for great reward, but at even greater levels of risk.

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