

# HEITMAN

*Presentation for:*

**Lambda Alpha**

February 20, 2012



There is a difference – Experience.

# Positives Outweigh Negatives, Positioning U.S. Economy for Accelerating Growth

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## U.S. Economy -- Positives and Negatives, February 2013

### Positives

- Housing now a positive force
- 5.8 million jobs created since trough
- Unemployment at 7.9% and wages growing
- Low inflation allowing central banks to ease
- State budget positions improving
- U.S. banking sector healthy and lending
- Retail sales showing strength, as are auto sales
- U.S. manufacturing competitiveness rising
- Low-cost energy a boost for business and consumers; on path to energy independence
- China growing again

***U.S. economic expansion will continue***

### Negatives

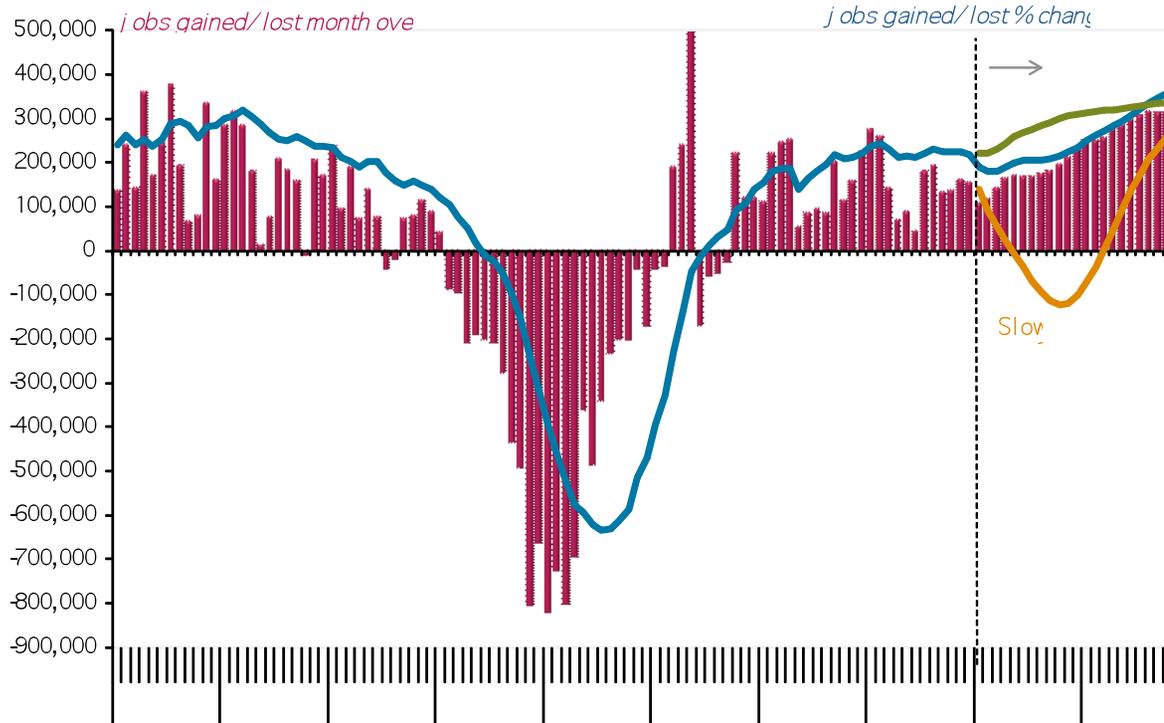
- Foreclosures still happening but rate lessening
- But we lost 8.5 million jobs
- Europe, Europe, Europe
- Fiscal cliff – Part behind us. Huge challenges remain
- Higher payroll taxes in place, likely to affect consumer confidence and spending

***Downside risks are high but will lessen with deals on debt ceiling and sequester***

# While Job Growth has been Slow Relative to Past Recoveries, It has Persisted and Should Accelerate

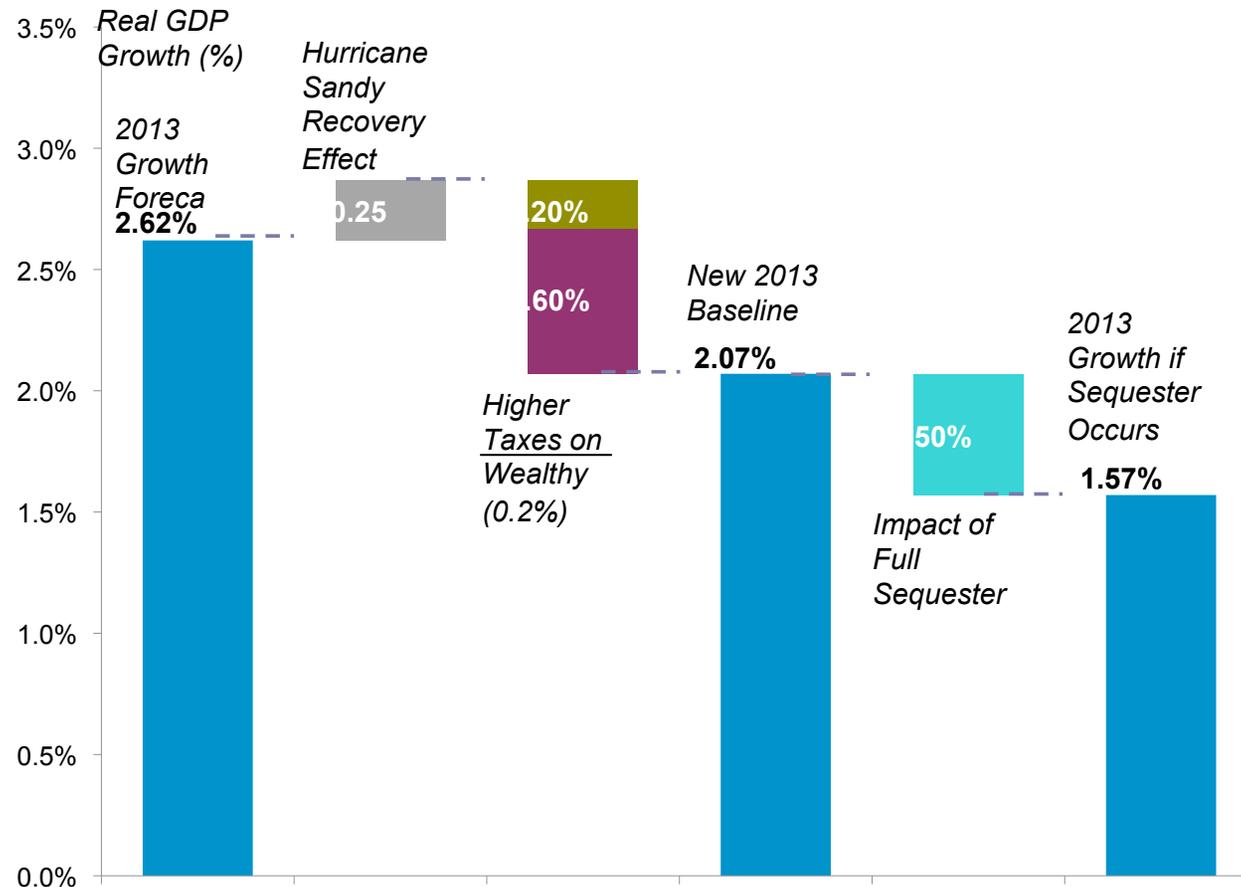
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Historical and Forecast Employment Growth  
U.S. 2005-2014



- Job growth averaged 181,000 per month during 2012
- That represents a slight increase from the average of 175,000 in 2011.
- Manufacturing jobs are increasing as companies bring production closer to the end user
- Construction employment finally rising as single-family housing development begins again

## Forecasted GDP Growth Effects U.S. 2013



Source: Moody's Analytics;  
Heitman Research

- Politics could and will affect the rate at which U.S. GDP grows during 2013
- Republicans are pushing for major deficit reduction
- Some are arguing for the full \$1.1 trillion cuts entailed in Sequester
- The Sequester conversation comes on top of the expiration of the payroll tax and raising of taxes on wealthiest households

# Wage Growth – One Key to Healthy Retail Sales Increases

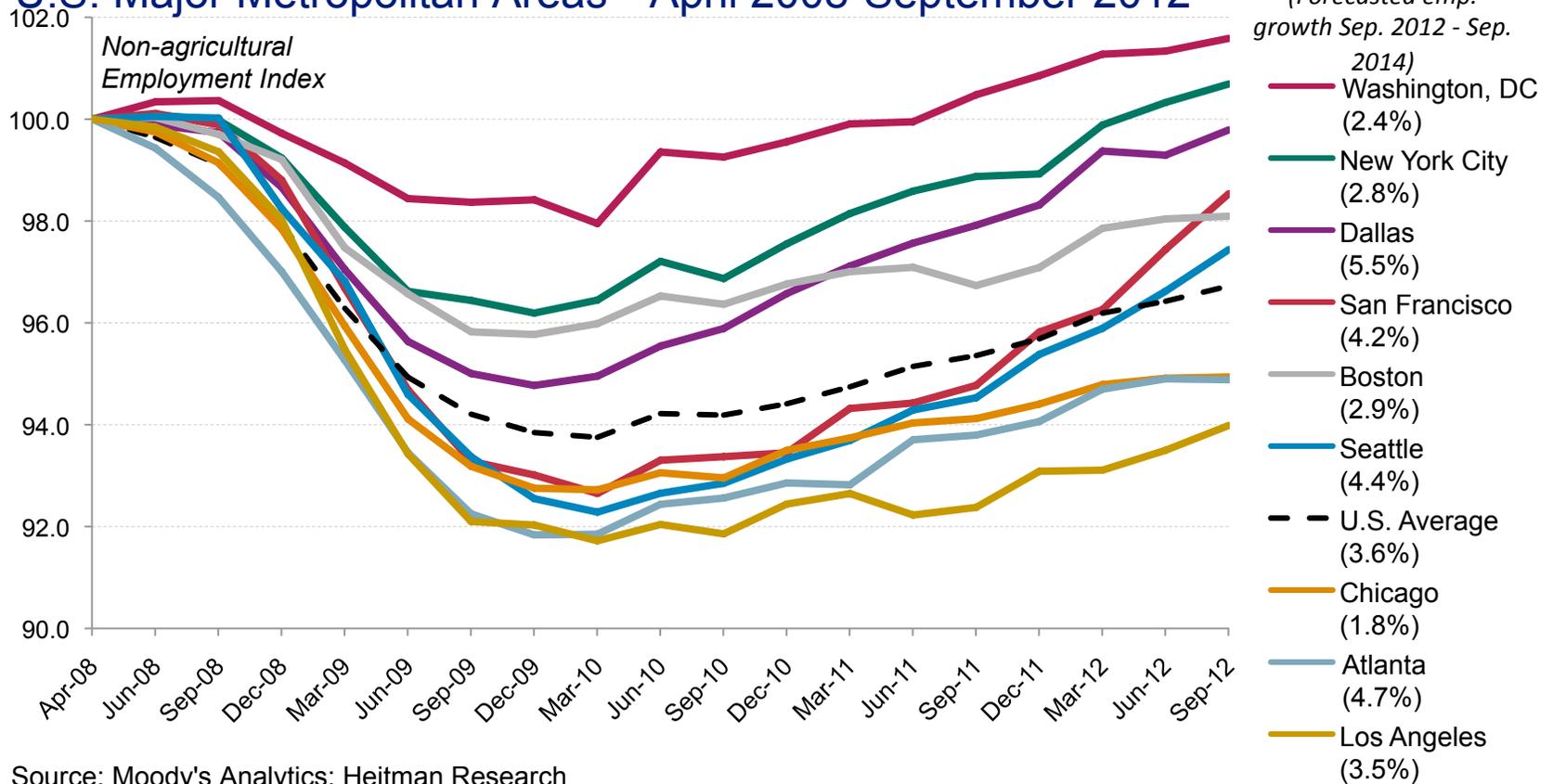
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Private Sector Aggregate Wage Growth  
U.S. 2007 - 2012



# But Recession's Grip Continues: Only a Handful of Metros in Expansion

Total Non-Agricultural Employment Performance  
U.S. Major Metropolitan Areas\* April 2008-September 2012

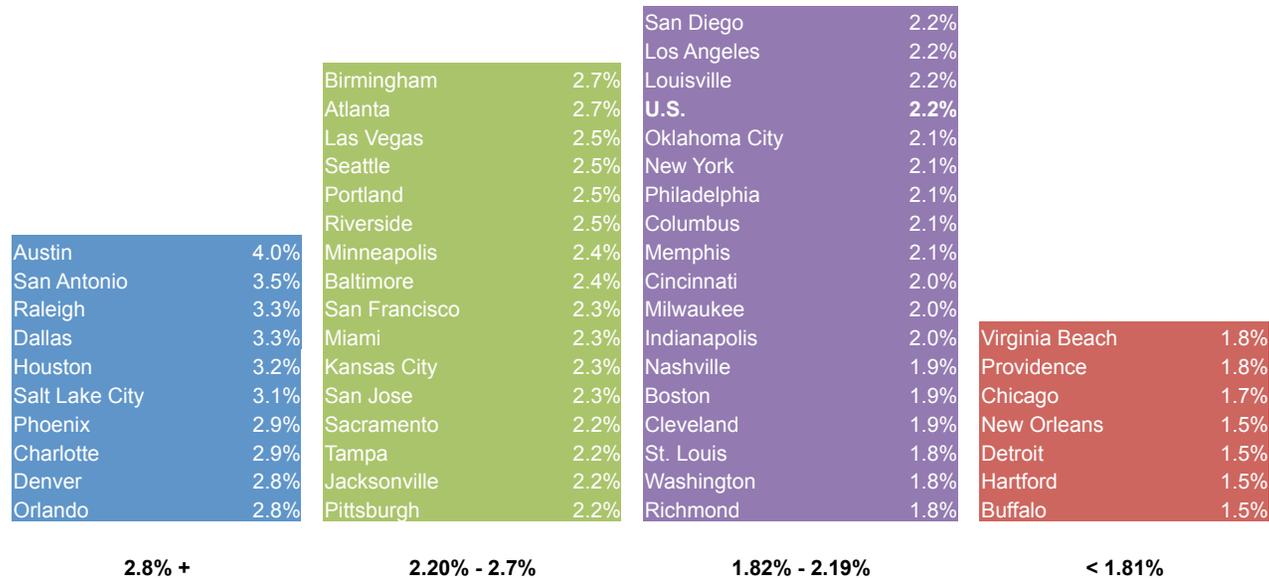


While coastal metros led in growth immediately following GFC, other metros are seeing strong growth now

# Looking Ahead: Fastest Growth in Tech and Energy Markets

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Job Growth by Metropolitan Area  
Q4 2012-Q4 2015



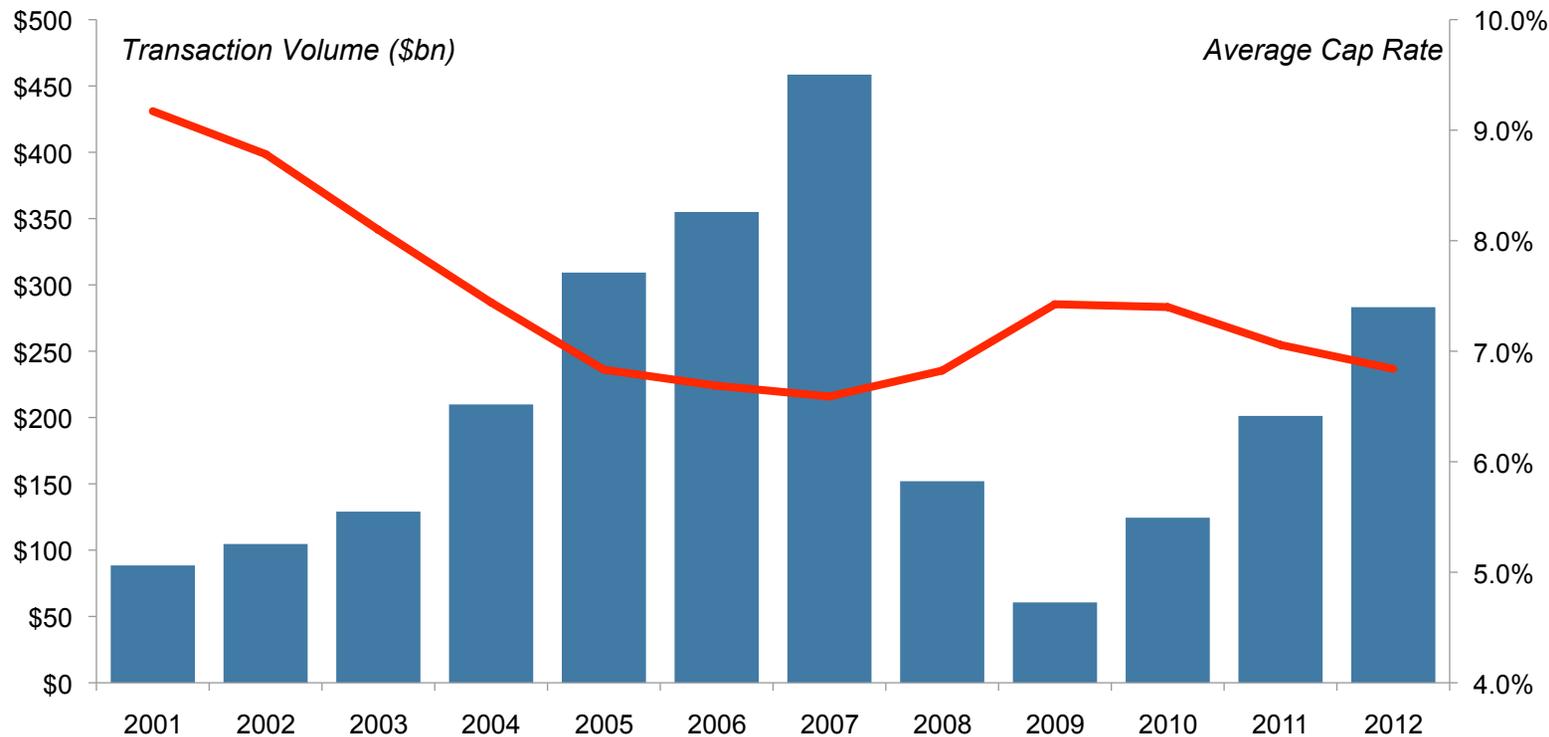
Source: Moody's Economy.com; Heitman Research

- We emphasize job growth in identifying markets for real estate investment because job growth is highly correlated with space demand
- Looking ahead, energy and tech markets should continue to dominate
- Manufacturing centers should see improvement as well, including Birmingham, Milwaukee, Cincinnati
- Housing bust markets should enjoy strong rebounds

# Transaction Volume Up Significantly in 2013; Yields Close to Pre-Crash Lows

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## Transaction Volume and Capitalization Rates All Property Types 2001-2012



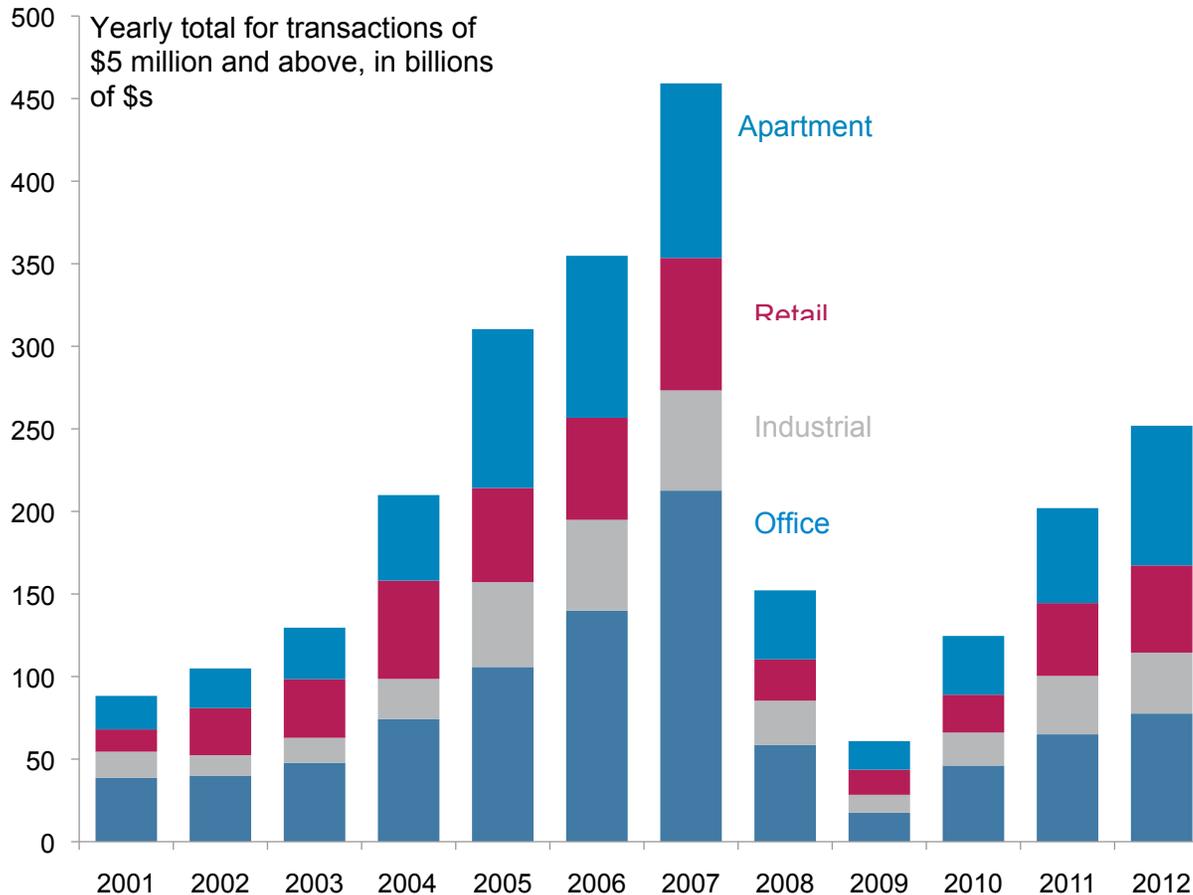
Source: Real Capital Analytics; Heitman Research

Real estate transaction volume rose by 24% in 2012 as domestic and off-shore investors sought yield. Capitalization rates are back close to 2007 lows but the income being capitalized reflects rents and occupancies that remain below peak levels

# Apartments Were the Most Sought-After Property Type in 2012

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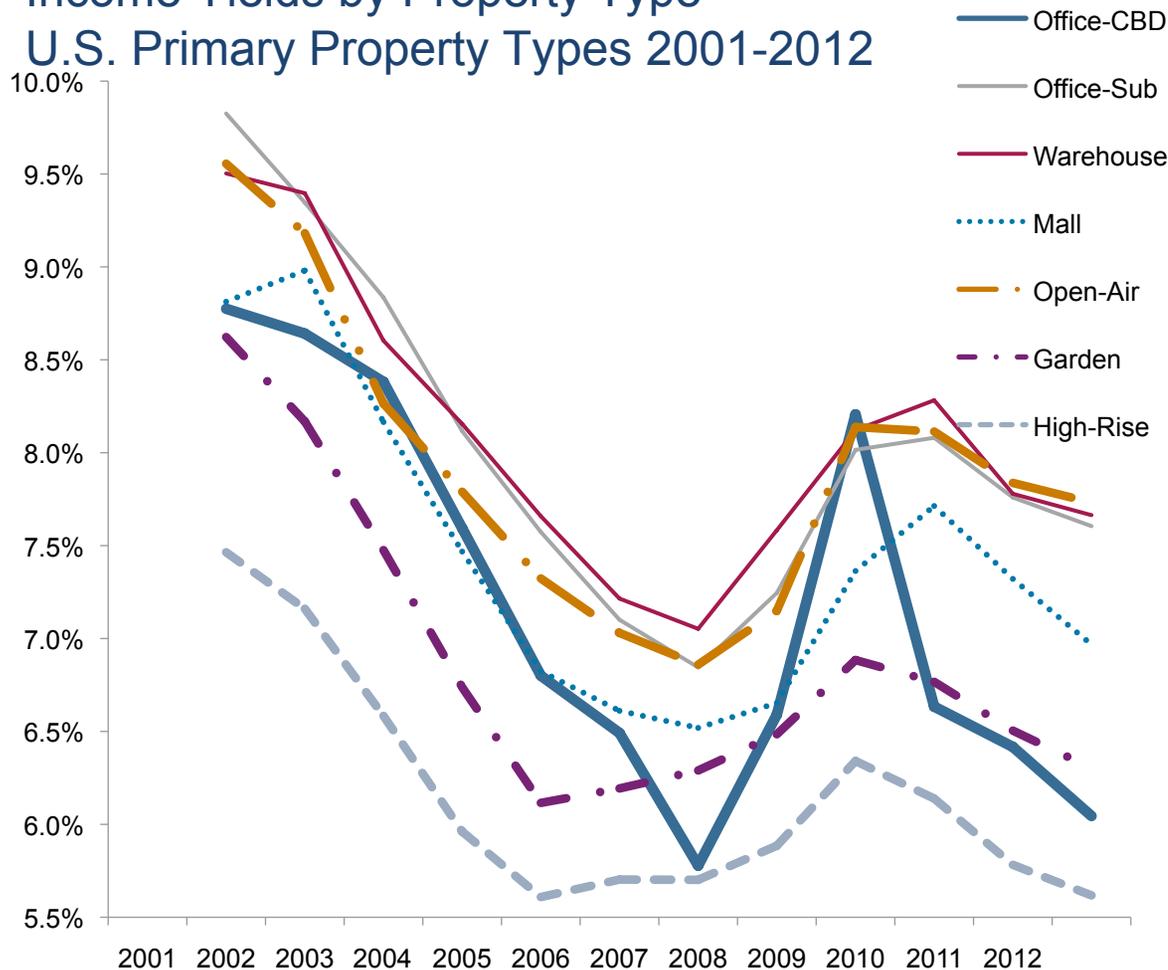
## Transaction Volume by Property Type U.S. Primary Property Types 2001-2012



Source: Real Capital Analytics; Heitman

- Apartments ranked first in total acquisition volume in 2012 at 33.6%. Their share of total volume has been trending up since the GFC
- Office ranked second with a 30.8% share of transaction volume, well under their long-term average of 36.7%
- Retail came in third at 21.0%, matching their long-term average
- Industrial represented 14.6% of total transaction volume, down slightly from their 15.2% historical share

Income Yields by Property Type  
U.S. Primary Property Types 2001-2012



Source: Real Capital Analytics; Heitman Research

- Income yields (capitalization rates) have fallen across all property types since the end of the GFC
- High-rise apartments have the lowest income yield, reflecting expectations of strong income growth
- Income yields for CBD office have fallen sharply and are close to pre-GFC lows
- Income yields remain elevated for open-air retail and warehouse

## Core:

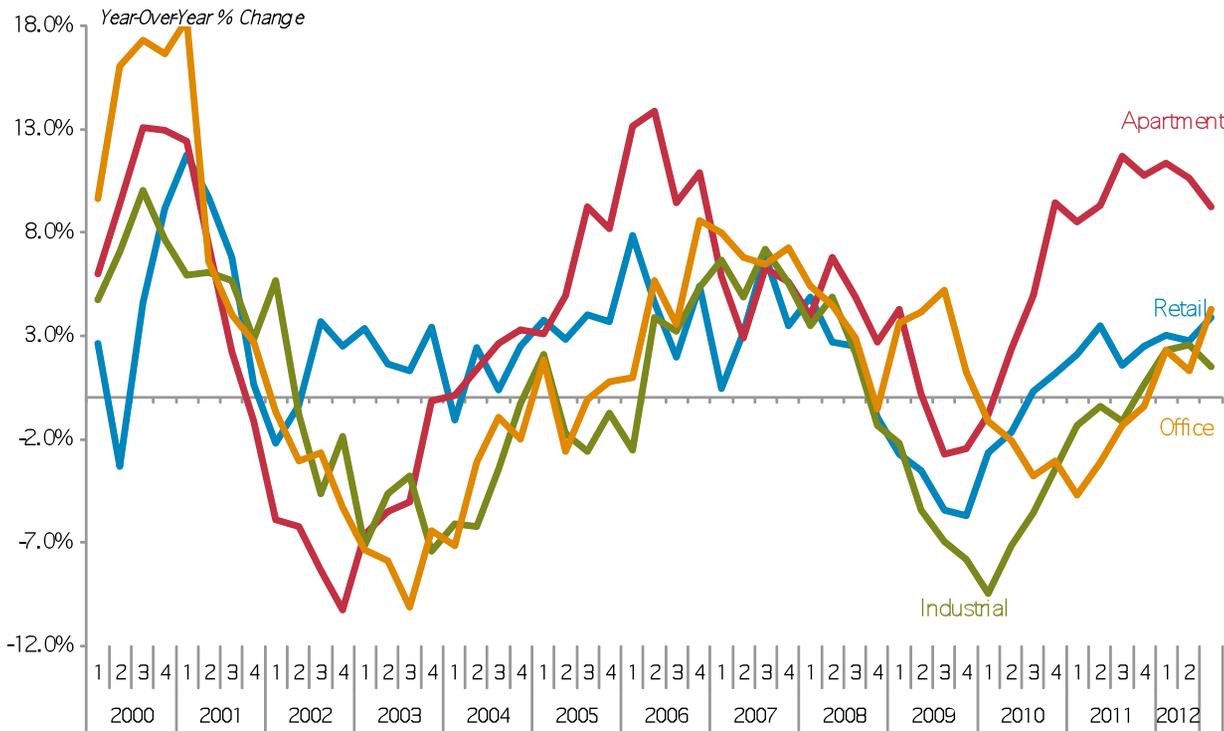
- Though investment market for core is competitive, acquisitions can be made at yields that offer a wide spread to treasuries and with attractive income growth potential
- Limited construction for this point in the cycle sets up a sustained period of rising occupancy and rents across the primary property types
- Pricing in the gateway markets (Boston, Los Angeles, New York, San Francisco and Washington, D.C.) is highest
- We recommend mixing investment in gateway markets with acquisitions in the next tier, where income yields are 50 to 100 basis points higher and income growth potential is as high or higher

## Value-Add and Opportunistic

- The combination of property market improvement and low levels of construction activity set up execution of multiple value or opportunistic strategies
- These include development of Class A apartment, warehouse, medical office, student housing and senior housing
- Acquisition of existing assets with high vacancy or near-term rollover. Office and warehouse are particularly suited for this
- Take advantage of high income yields and inexpensive debt for execution of strategies like investment in Class B regional malls

# All Major Property Types Seeing NOI Growth

Same-Store NOI Trends by Property Type  
U.S. NCREIF Properties 2000-2012 (Q3)



Source: NCREIF; Heitman Research

- All property types are seeing gains in net operating income
- Occupancy is rising across all property types
- Rents have bottomed and are growing across all property types as well

# Modest Levels of Construction Should Extend the Property Market Recovery

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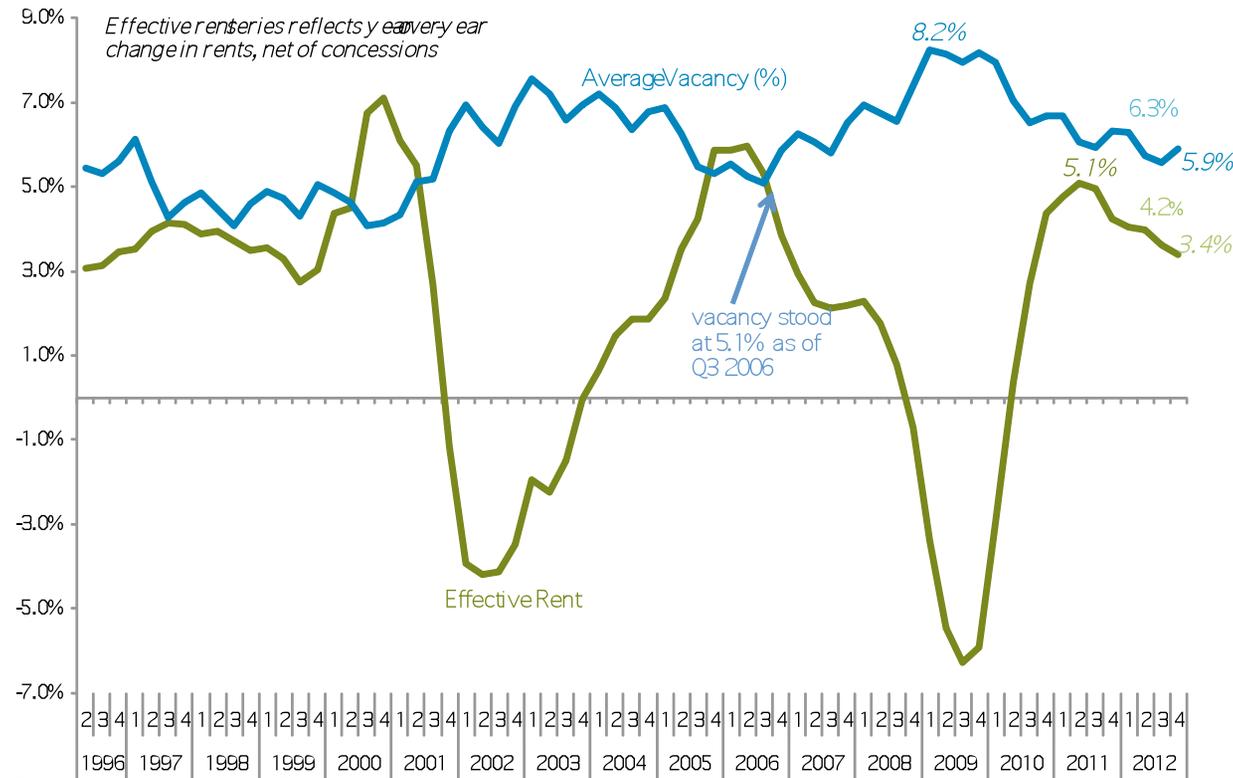
## Construction Volume: Major Property Types 2012 Deliveries Compared to Three Years after End of Prior Recessions

	2012	2004	1994	2012 as % of 2004	2012 as % of 1994
Apartments	105,154	153,700	188,000	68.4%	55.9%
Industrial	27.5	132.7	86.9	20.7%	31.6%
Office	7.8	35.3	9.1	22.1%	85.7%
Retail	30.9	216	145.2	14.3%	21.3%

Construction activity is extremely modest for this point in the economic cycle, outside the apartment sector. Depressed construction volumes should serve to extend the period of rising rents and occupancies for existing properties.

Source: Co-Star (retail); CBRE-EA (office and industrial); U.S. Census Bureau (apartments) Apartments expressed in units, industrial, office and retail in millions of square feet.

Apartment Effective Rent vs Vacancy  
U.S. 1996-2012 Q4

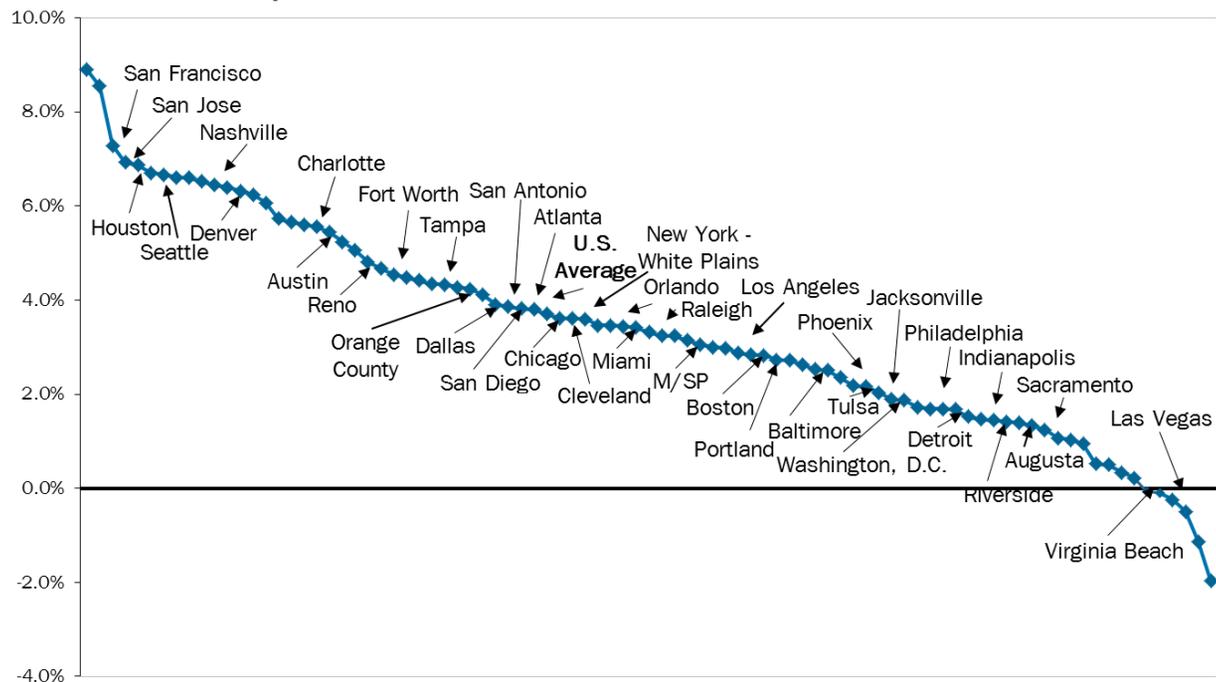


- Apartments continue to see improvement
- Vacancy is back down to within 50 basis points of the pre-recession level
- Effective rents continue to grow
- But their growth is capped by the fact that the national average apartment rent now exceeds pre-recession levels

# Effective Rent Growth Exceeds Inflation in Majority of Major Markets

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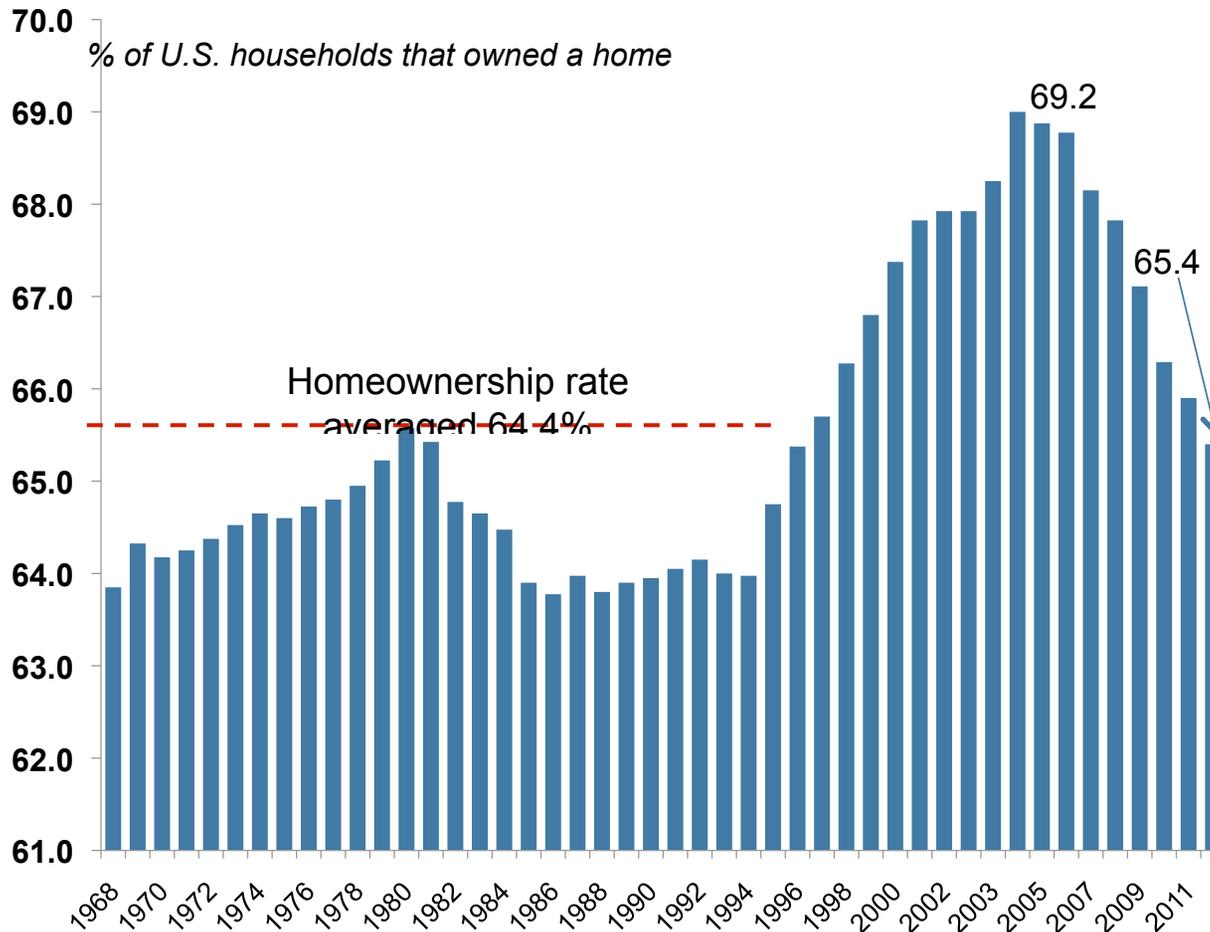
Effective Rent Growth  
Selected U.S. Metropolitan Areas December 2011-December 2012



Source: Axiometrics; Heitman Research

- Apartment rent growth exceeds the rate of inflation in the majority of major U.S. metros
- It is occurring at a rapid rate in metros seeing the strongest job growth and high rates of household formation
- While some of these are coastal metros, others are inland metros like Houston, Denver, Charlotte and Nashville

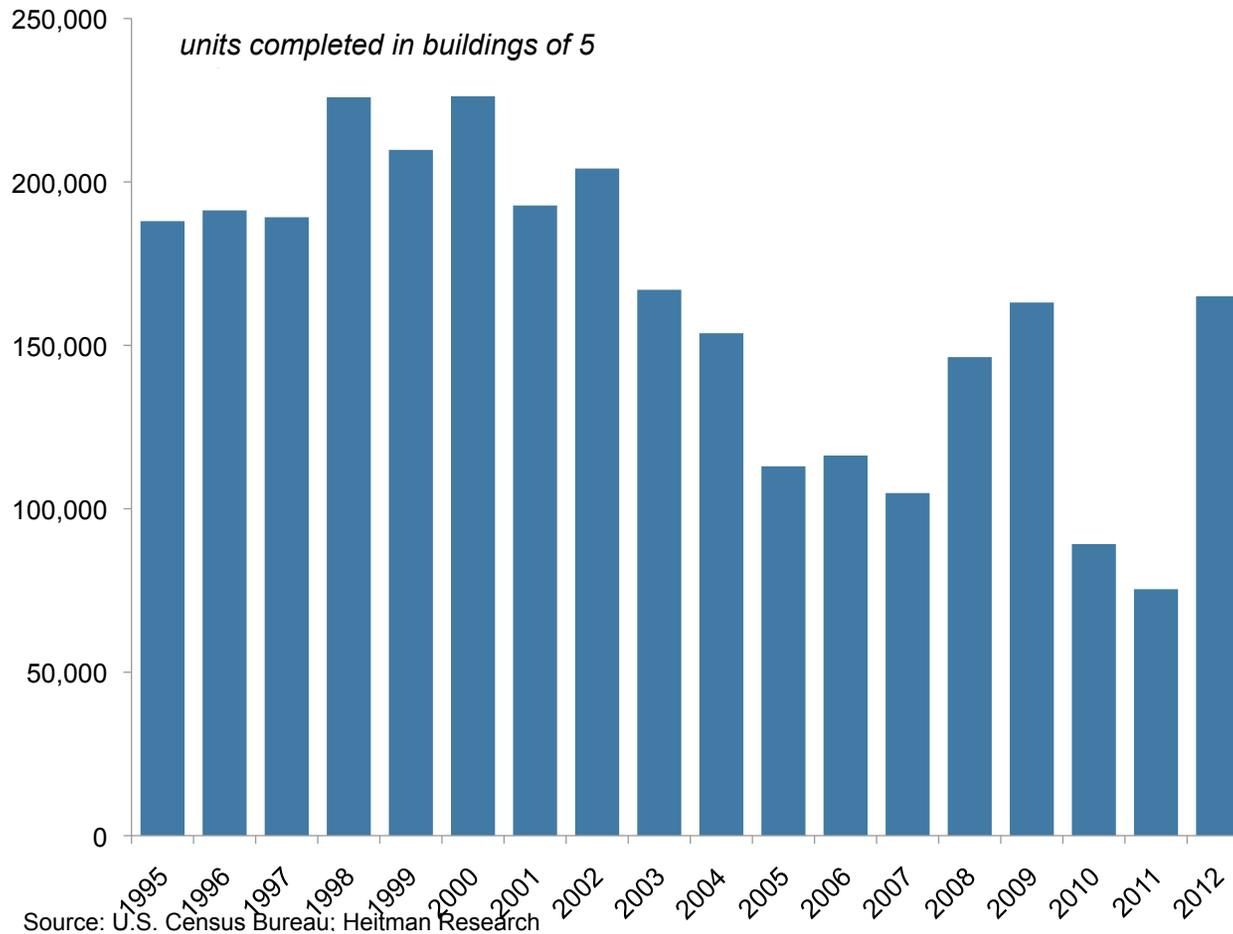
## Homeownership Rate U.S. 1968-2012



Source: U.S. Census Bureau; Heitman

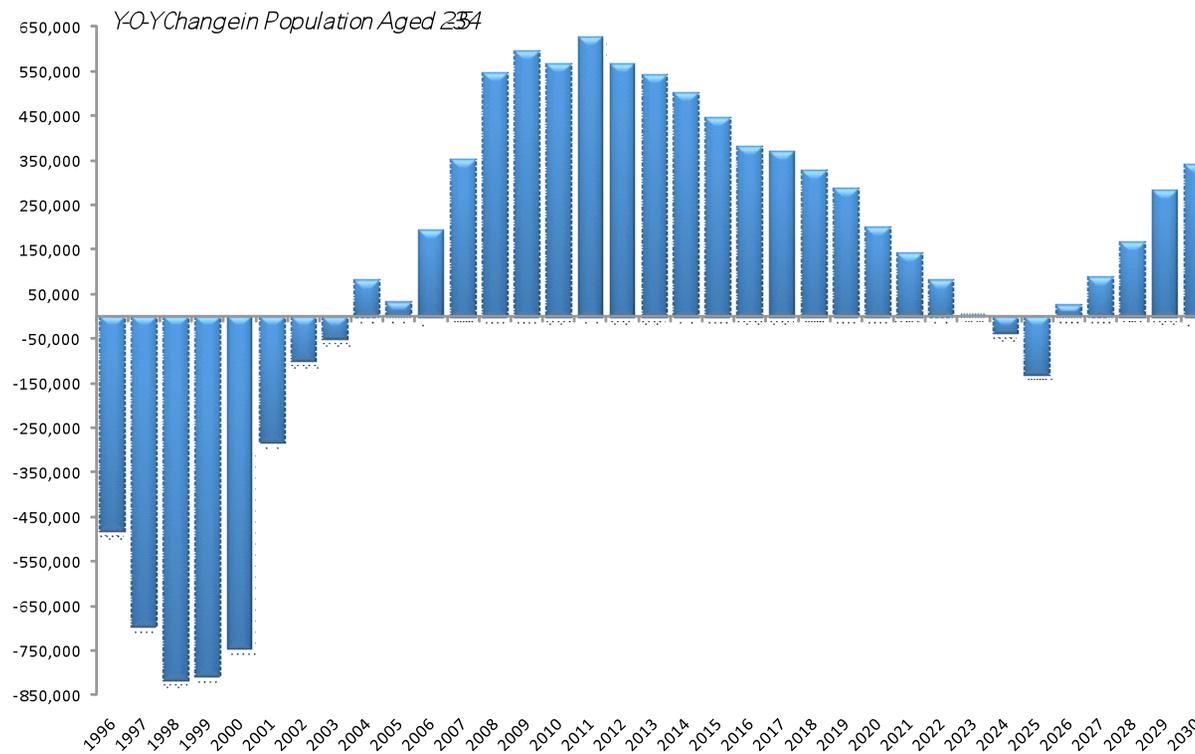
- The homeownership rate has fallen 380 basis points since its pre-recession peak
- The share of U.S. households that own their home has reverted back to the long-term average
- The movement from ownership to renting has expanded the pool of renters for market-rate apartments
- We expect the homeownership rate to stabilize at its current level before rising slightly
- Offsetting this will be expansion in the total number of households

## Apartment Completions U.S. 1995-2012



- Apartment construction dropped sharply following the GFC
- It resumed in 2012, when the inventory of market rate apartments expanded by 0.7%
- Units under construction will expand the inventory by 1.0% in 2013
- Construction is highly concentrated, with six metros accounting for 33% of U.S. apartment unit additions in 2013, led by Washington, D.C., Dallas, New York, Seattle, Austin and Houston

Annual Change in the Age Group Most Likely to Rent Apartments  
1995-2030



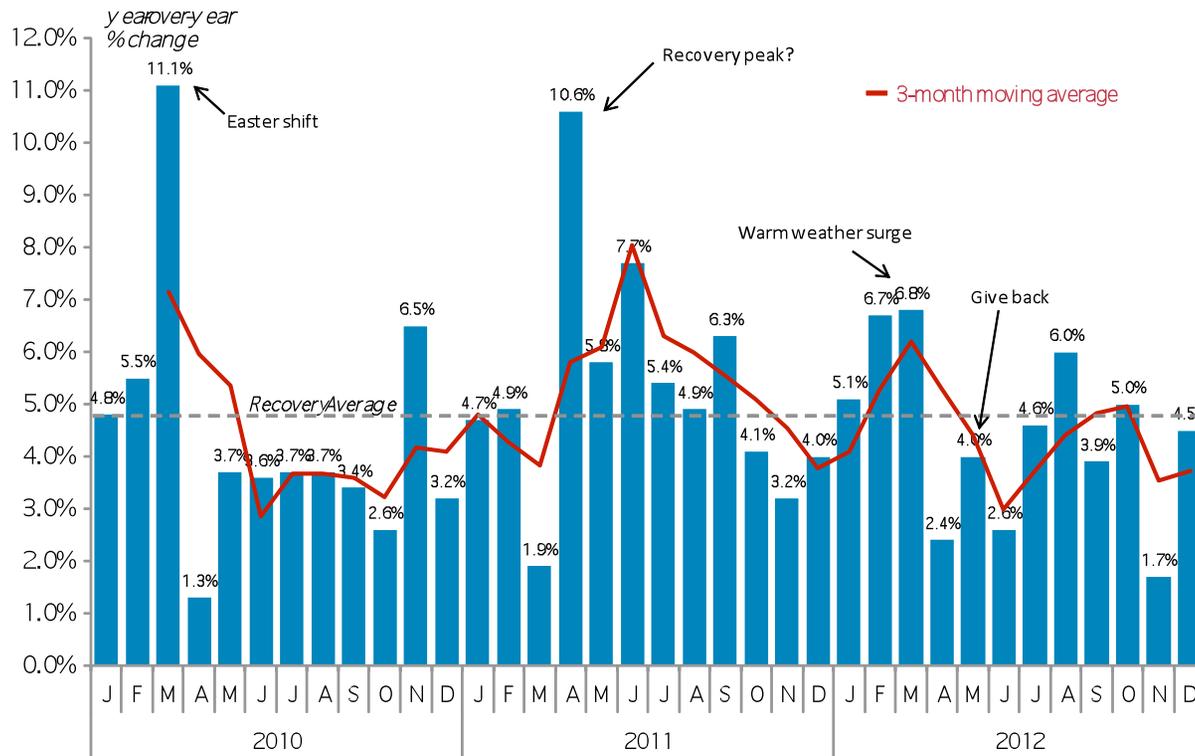
Source: U.S. Bureau of the Census; Heitman Research

- The number of people in the age group most likely to rent apartments (ages 25-34) is rising.
- In 2013, about 550,000 people will age into this demographic category. An overwhelming share of this age group will rent market-rate rental apartments
- In addition, household formation is favorable. The GFC kept many young people living at home. As job creation accelerates, many are young people are moving out from their parents' homes into apartments

# U.S. Retail Sales Defying Expectations

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ICSC Same-Store Sales Trends\*  
U.S. January 2010 - December 2012



Source: ICSC; Heitman Research

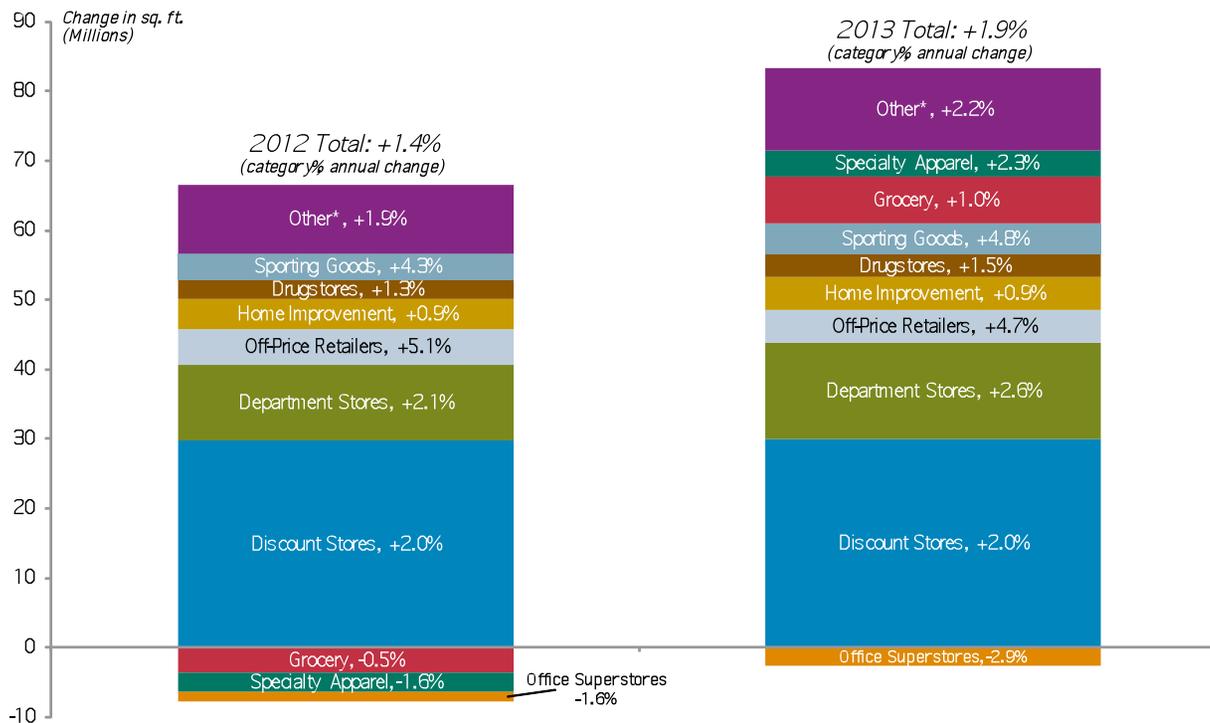
\* Excludes drug stores

- Retail sales growth, which supports rent growth for retail tenants, has stayed strong
- This led to high profitability for the majority of retailers during 2012
- Recent tax changes will suppress spending, particularly among moderate-income households
- For higher-income households, tax changes are offset by the rising stock market and home value increases

# Store Openings Exceed Store Closings

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Projected U.S. Chain Retailer Growth\*  
Square Footage Growth, 2011-2013



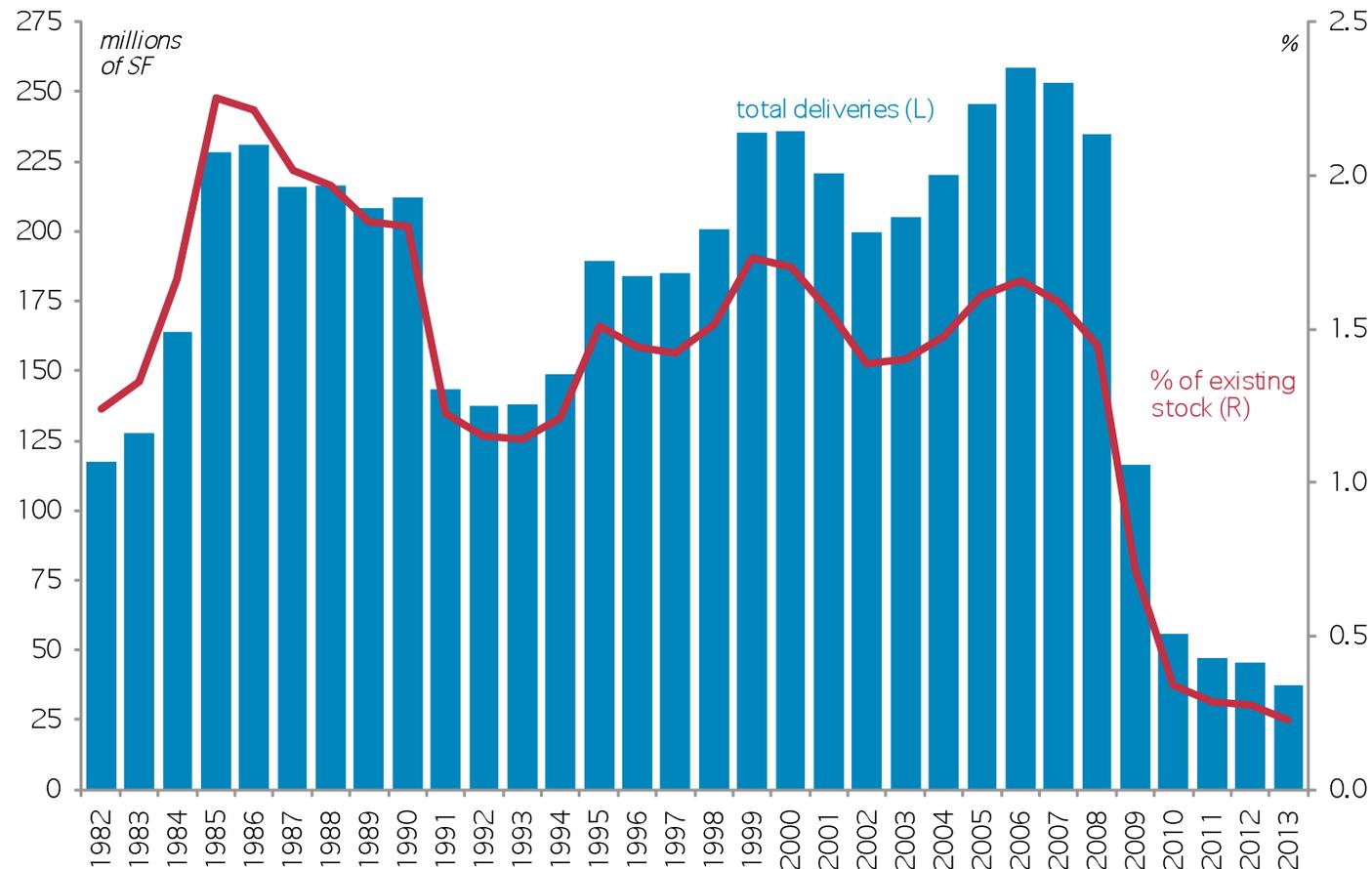
Note\*: "Chain Retailers" defined as 205 of the largest retailers, which constitute 67% of total retail square footage;

"Other" consists of categories with <2M sq. ft. change in both years

Source: Telsey Group; Heitman Research

- While some retailers are closing stores, store openings far outnumbered store closings in 2012
- That trend will continue in 2013, resulting in net expansion in retail space demand among regional mall tenants as well as those that prefer open-air centers

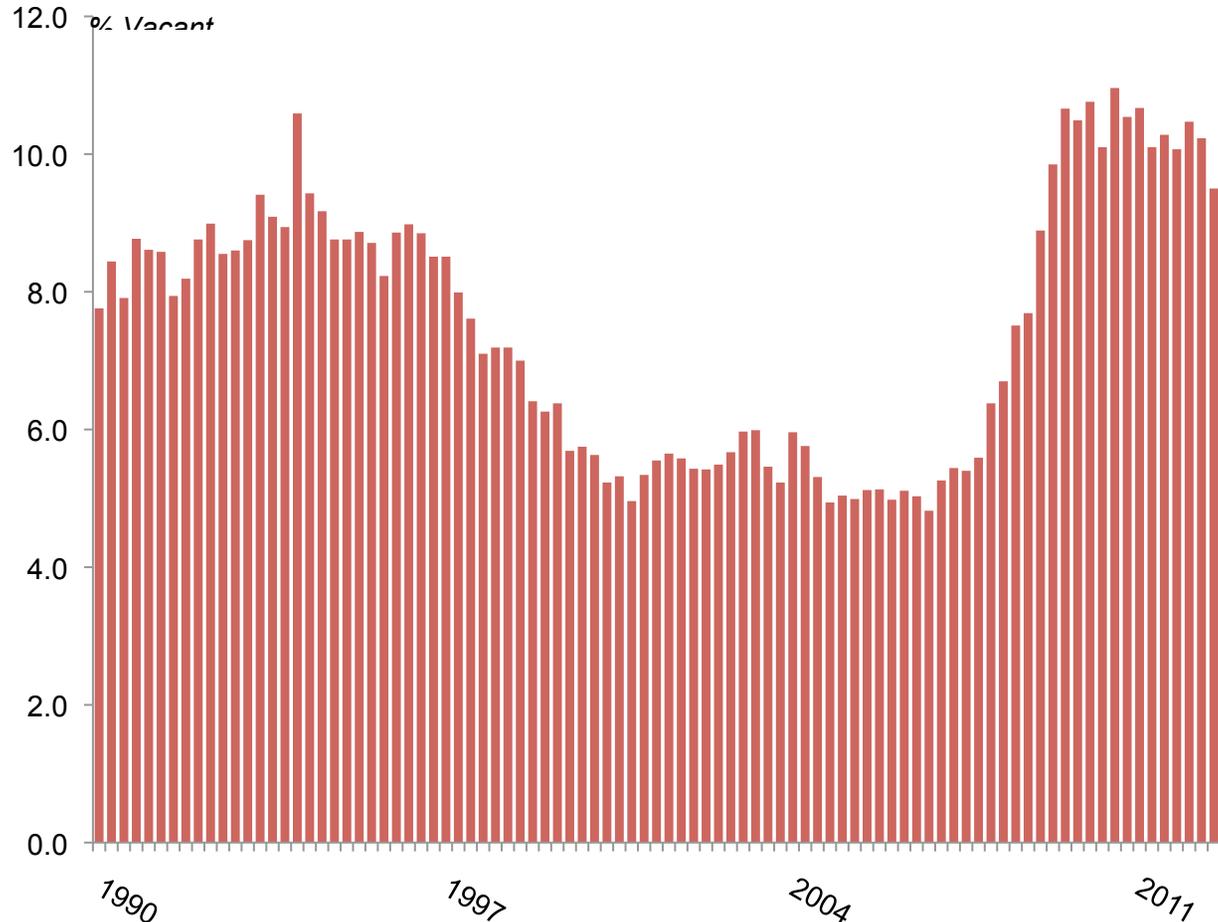
**Retail Deliveries**  
 U.S. 1982-2013 (projected based on data through Q3 2012)



Retail construction is at 30-year lows. Both the amount of retail space being built and the rate at which the retail inventory are expanding are minimal.

Source: Co-Star; Heitman Research

## Vacancy Rate U.S. Retail Properties 1990-2012 (Q4)



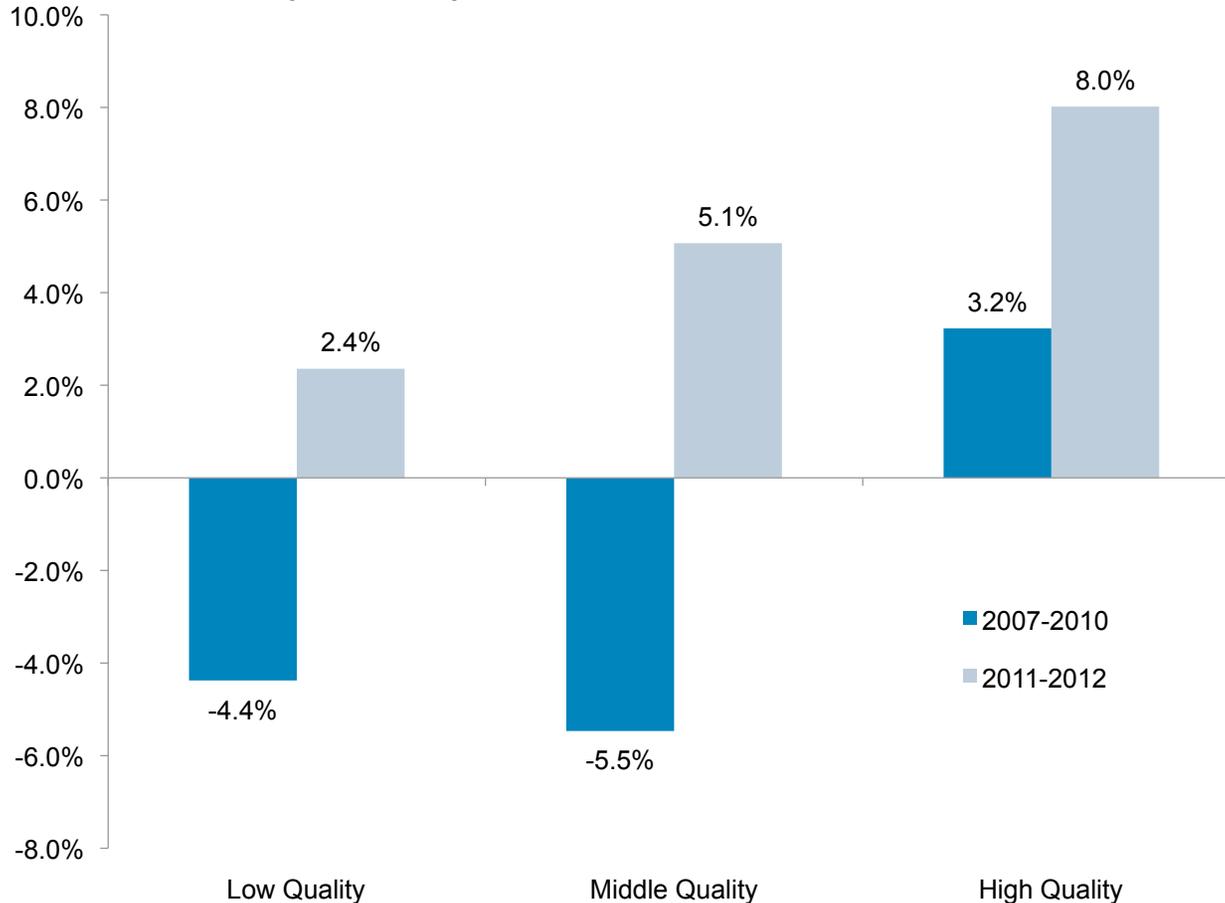
Source: NCREIF: Heitman Research

- As a result of the net expansion of retail tenants and the lack of retail construction, the vacancy rate is coming down
- The improvement in vacancy is greatest for the properties with the highest sales volume per square foot across all retail formats
- As those centers get filled, space demand is rising for moderate-quality retail properties

# Within Regional Malls, the Best Get Better

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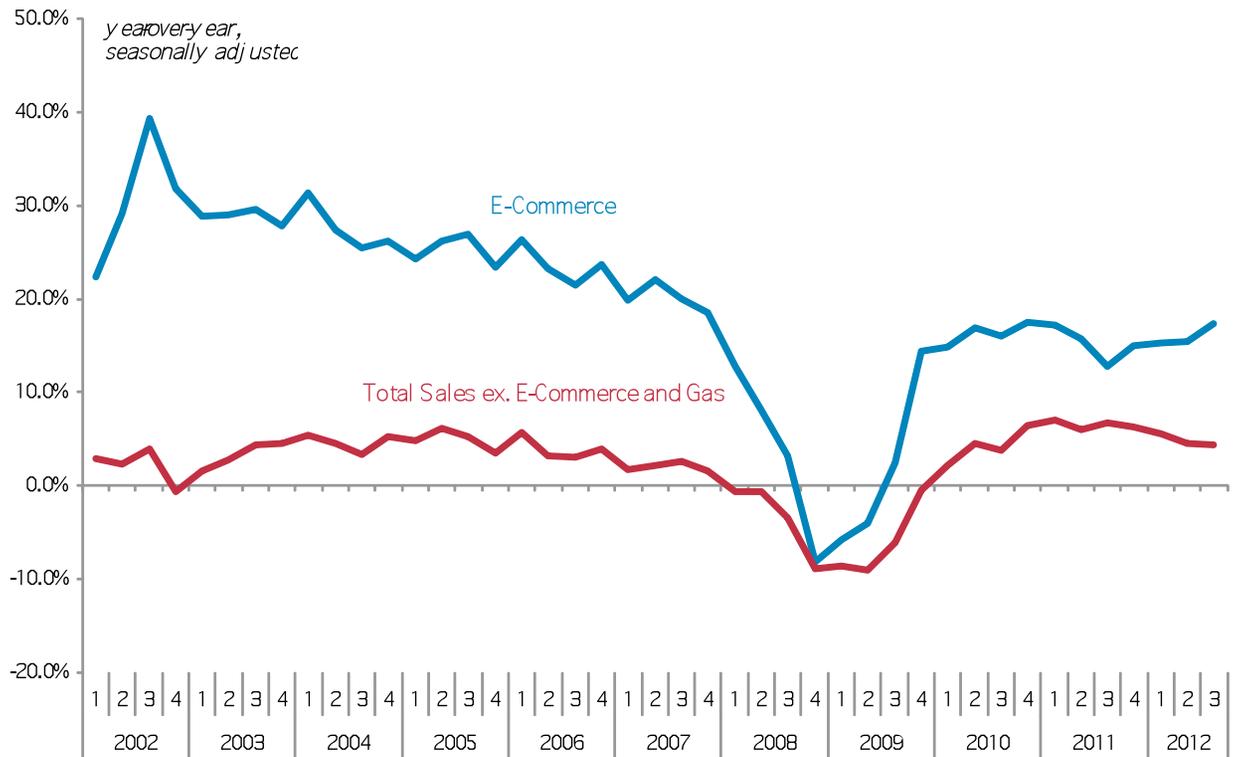
## % Change in Regional Mall NOI Mall REITs by Quality Level 2007-2012\*



\* FY 2012 estimated based on reports through Q3  
Source: Company Reports; Heitman Research

- In U.S. retail, tenants are willing to pay higher rent to gain a place in a center where the other tenants are achieving the highest sales per square foot in the market
- As a result, these high-quality centers can see an increase in occupancy and rents during recessions, even as lower-quality centers are experiencing declining occupancy and rents

E-Commerce Sales Growth vs. Total Sales Growth  
U.S. 2002-2012 (Q3)

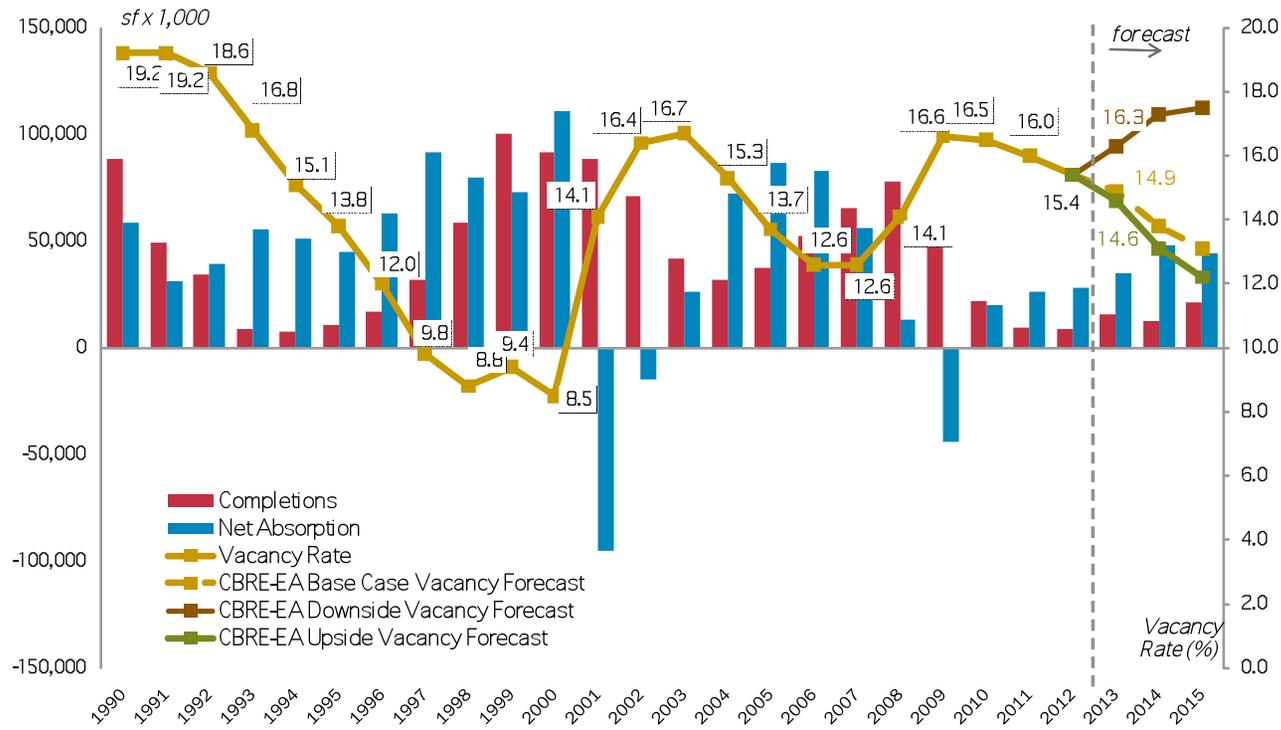


Source: U.S Census Bureau; Heitman Research

- E-commerce is an important and growing option for U.S. households
- It has transformed whole categories, taking them on line (books, music, games)
- But in many categories, on line and on-the-ground work well together, as indicated by Apple's decision to have a major presence in traditional retail settings
- But some centers will be hurt as the Internet reduces the number of shopping trips, especially low and mid-quality regional malls

# Slow Office Recovery Continues

Office Completions, Net Absorption, and Vacancy  
U.S. 1990-2015 Years Ending Q4



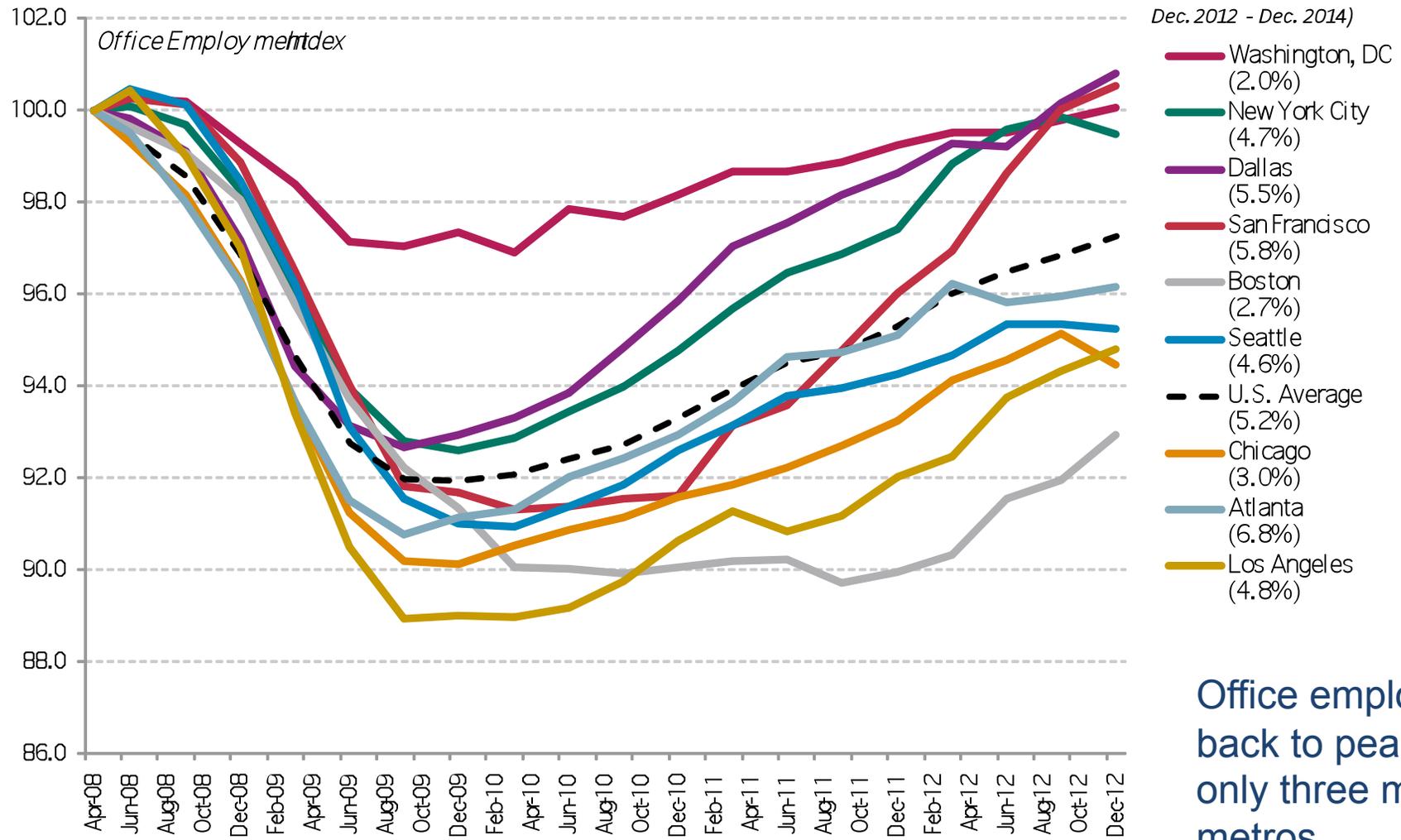
Source: CBRE Econometric Advisors; Heitman Research

- Three years after office vacancy peaked, it remains high, having dropped only 120 basis points. In prior economic recoveries, the rate of improvement for office vacancy was much higher
- Factors holding back the recovery include muted office job gains and a secular reduction in the amount of office space per worker

# Recovery Held Back by Office Employment That's Well Below Peak in Most Metros

## Office Employment Performance

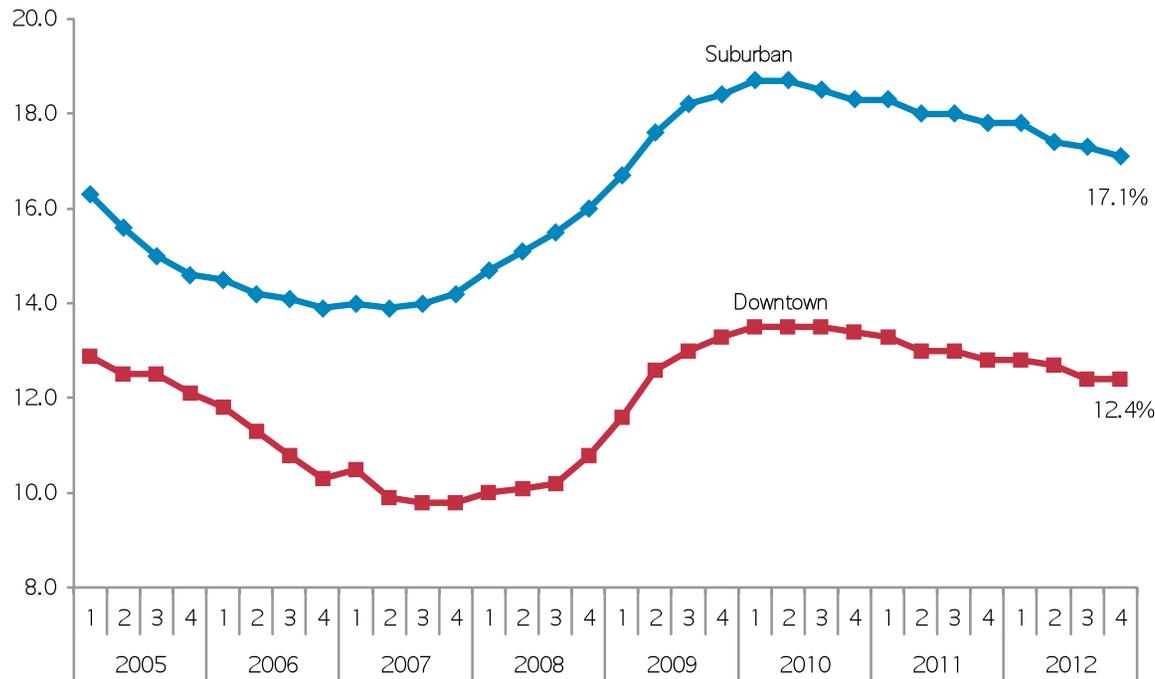
U.S. Major Metropolitan Areas\* April 2008 - December 2012



Note: "Metropolitan Area" defined as the core metropolitan division in all cases except ATL, which has no divisions  
 Source: Moody's Analytics; Heitman Research

Office employment is back to peak levels in only three major metros

Office Vacancy: Downtown vs. Suburbs  
U.S. 2005-2012



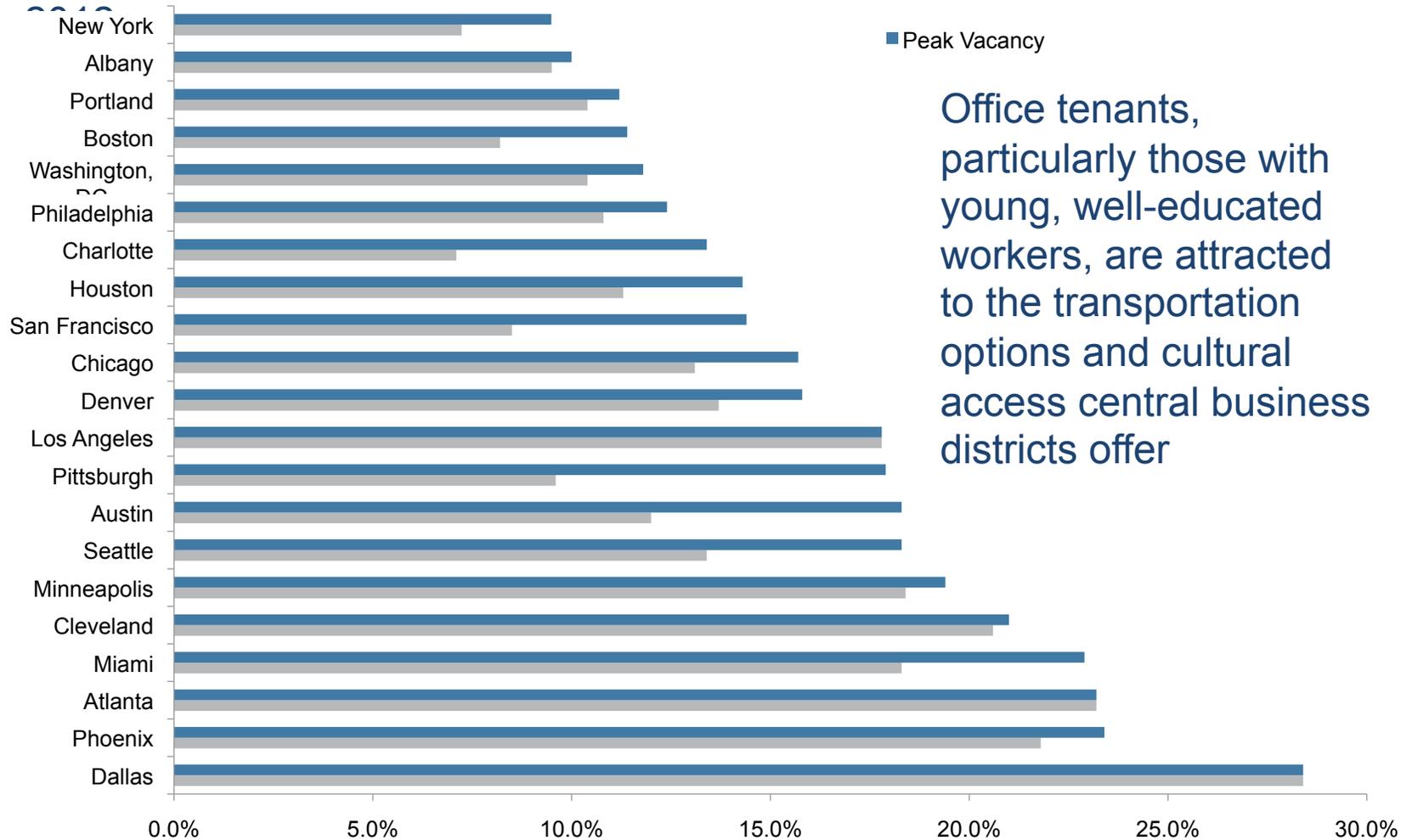
Source: CBRE Econometric Advisors; HeitmanResearch

- Downtowns are significantly healthier than suburban markets
- While suburban office remains an attractive option for tenants in many sunbelt markets, downtown markets are grabbing market share in some metros
- In Chicago, the central business district, which represents just over 50% of the metro office inventory, was the location of 85% of the demand over the past five years

# Many Downtowns are Much Improved from Peak Vacancy, Led by Tech and Energy Markets

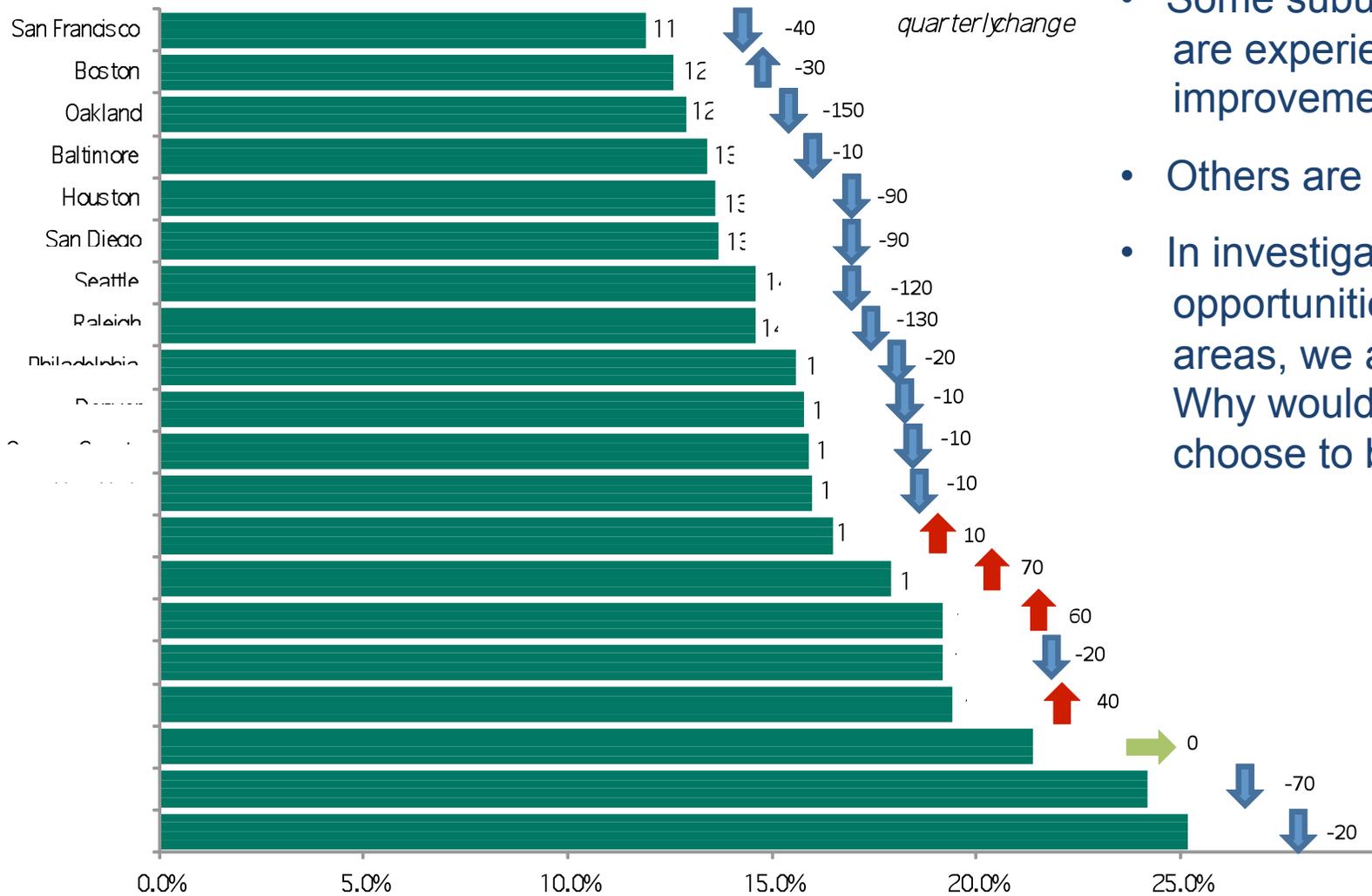
## Office Vacancy

### Recovery from Peak Vacancy, Downtown Markets Q4



Source: CBRE Econometric Advisors; Heitman Research

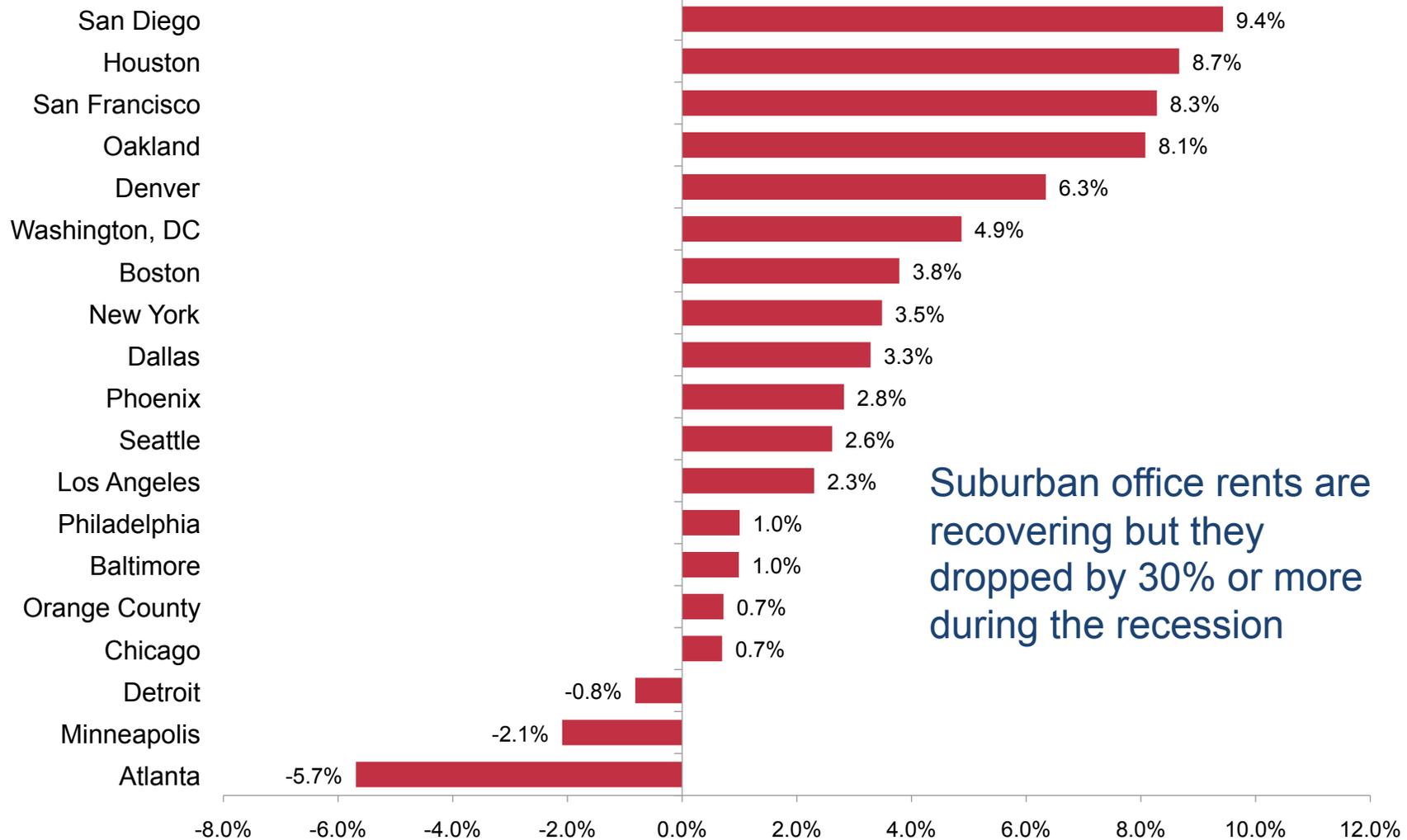
## Office Vacancy Selected Suburban Markets Q4 2012



- Some suburban markets are experiencing rapid improvement
- Others are stagnant
- In investigating investment opportunities in suburban areas, we always ask, Why would a tenant choose to be here?

## Office Rent Growth

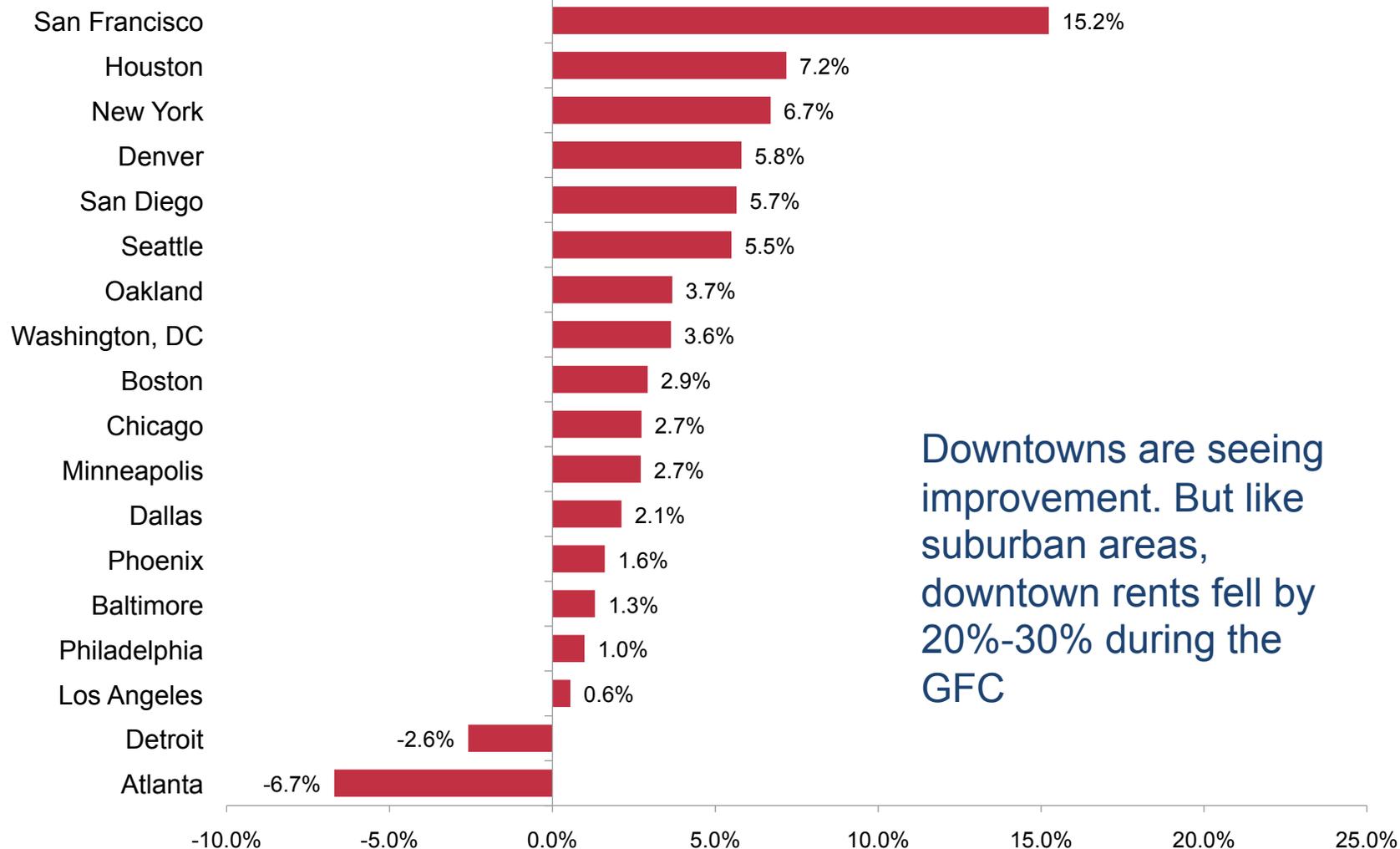
### Selected Suburban Office Markets, Q4 2012 vs Q4 2011



Source: CBRE Econometric Advisors; Heitman Research

## Office Rent Growth

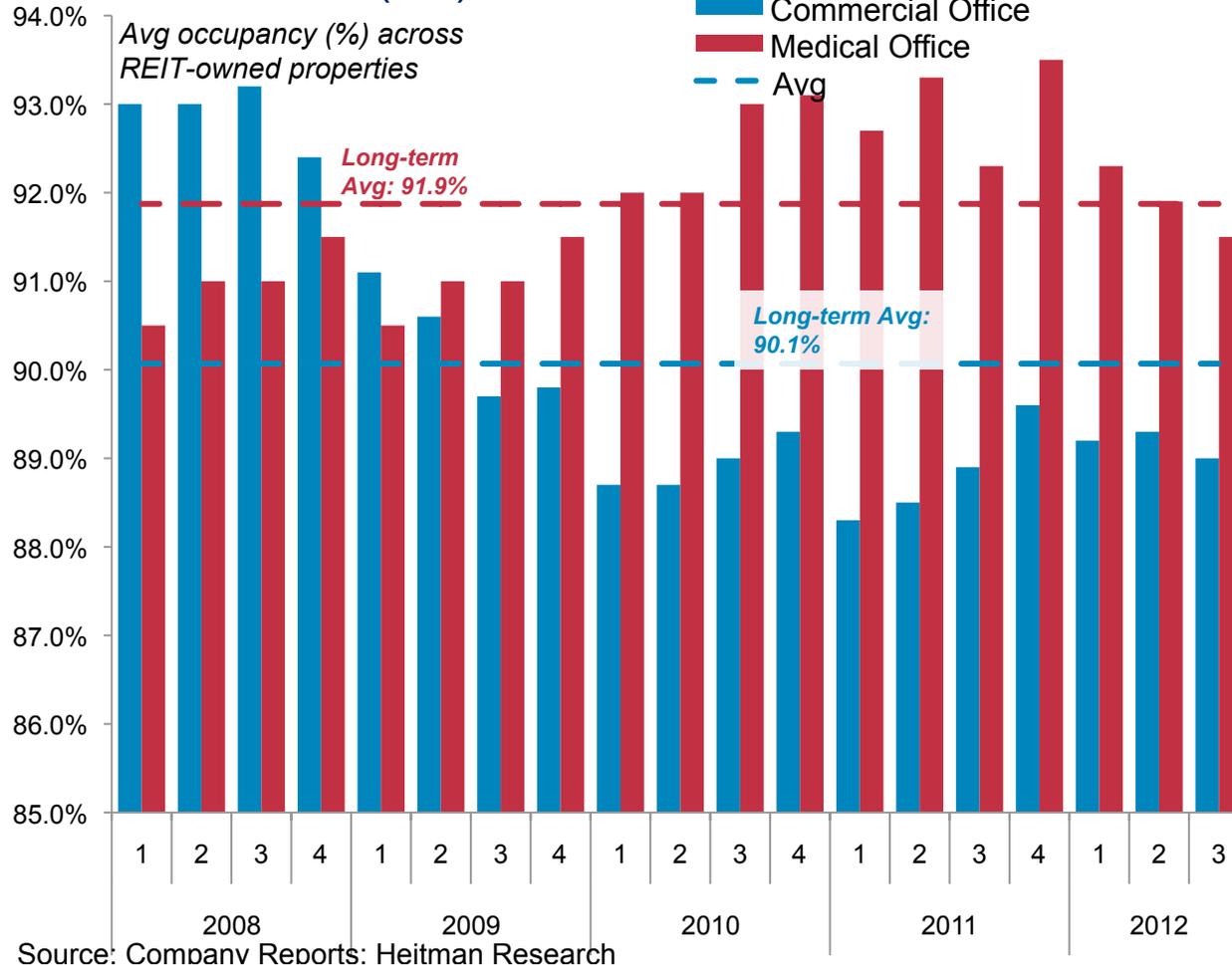
### Selected Downtown Office Markets, Q4 2012 vs Q4 2011



Downtowns are seeing improvement. But like suburban areas, downtown rents fell by 20%-30% during the GFC

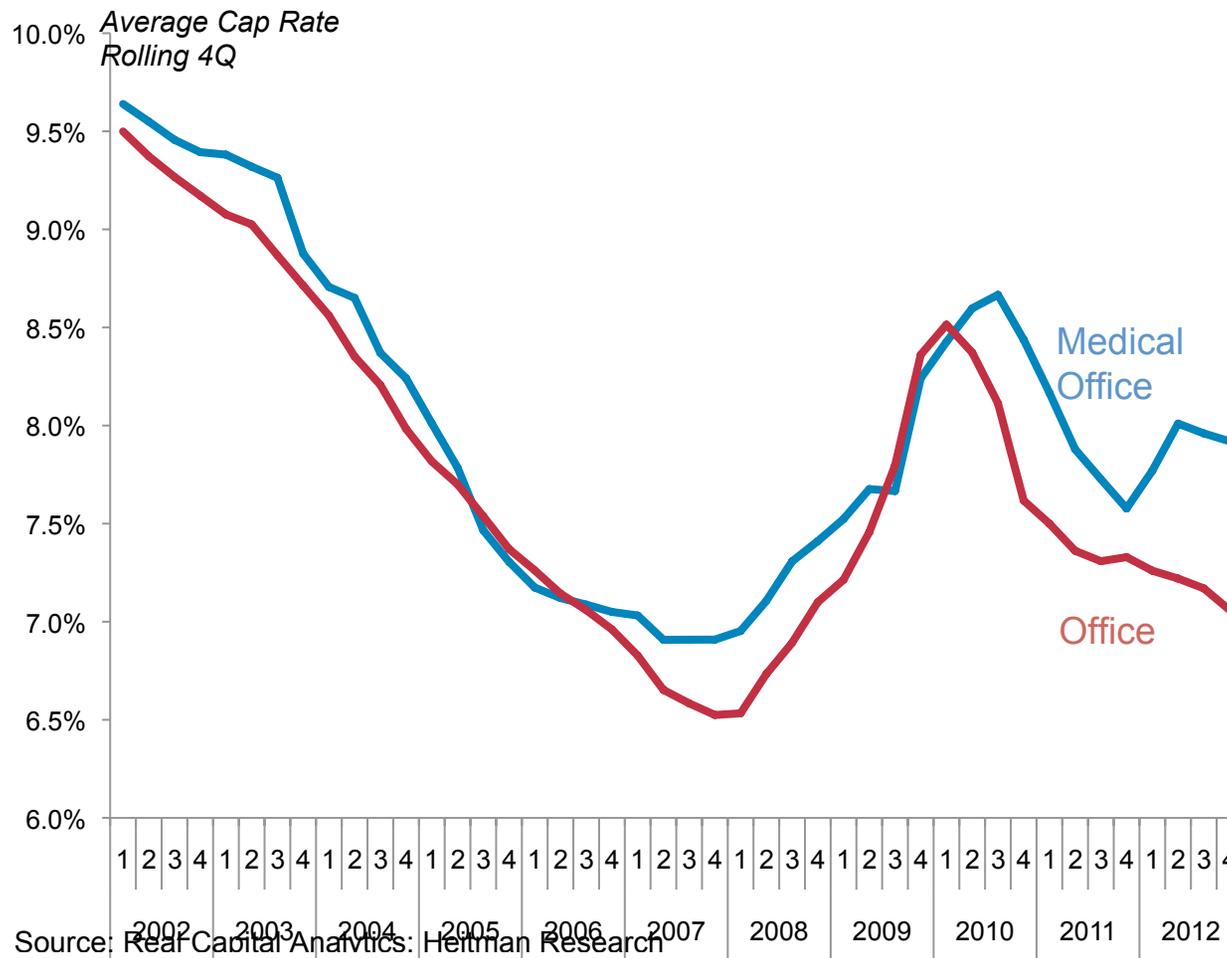
Source: CBRE Econometric Advisors; Heitman Research

## Medical Office vs. Commercial Office Occupancy U.S. 2008-2012 (Q3)



- Medical office has a higher long-term occupancy average than commercial office
- Demand by medical office tenants tends not to move in concert with the economic cycle
- By contrast, office moves with the economic cycle, with a lag

## Capitalization Rates: Medical Office vs. Office U.S. 2002-2012

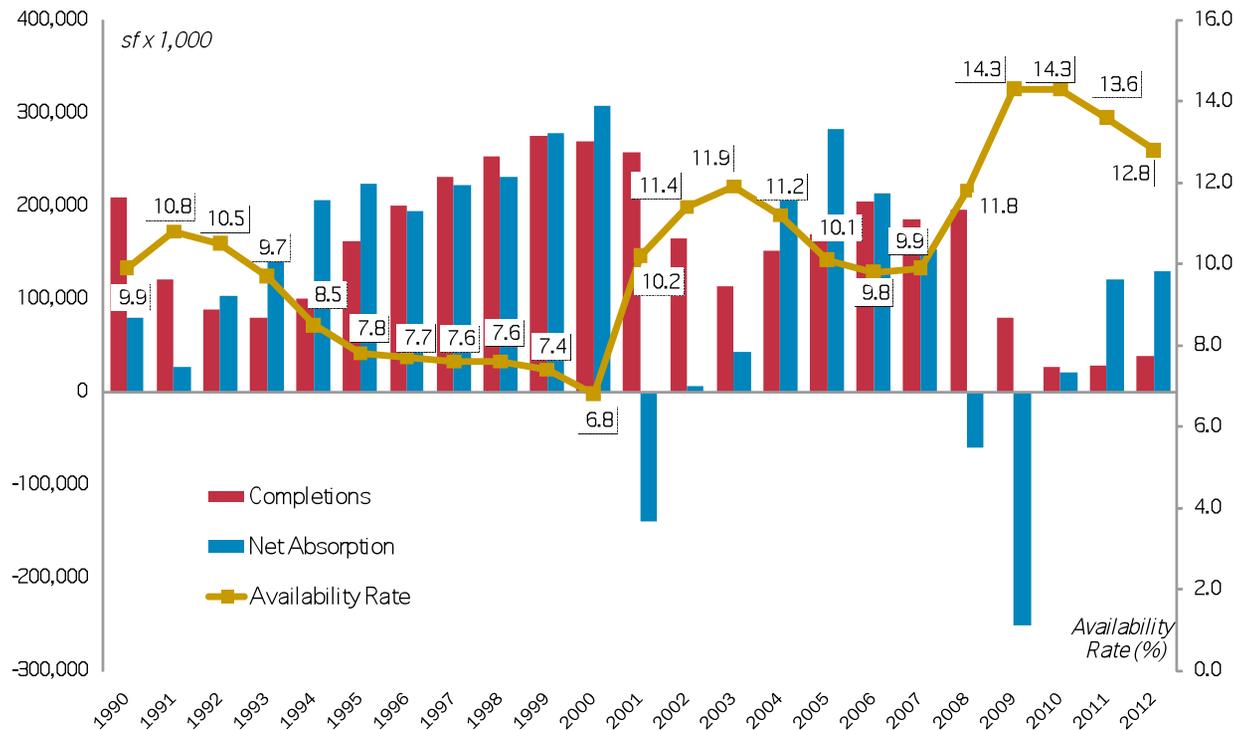


- The spread between commercial office income yields and those for medical office is wide today
- We expect pricing to converge over time
- Medical office is an increasingly common element of core and value-add portfolios

# The Industrial Recovery is Gaining Steam

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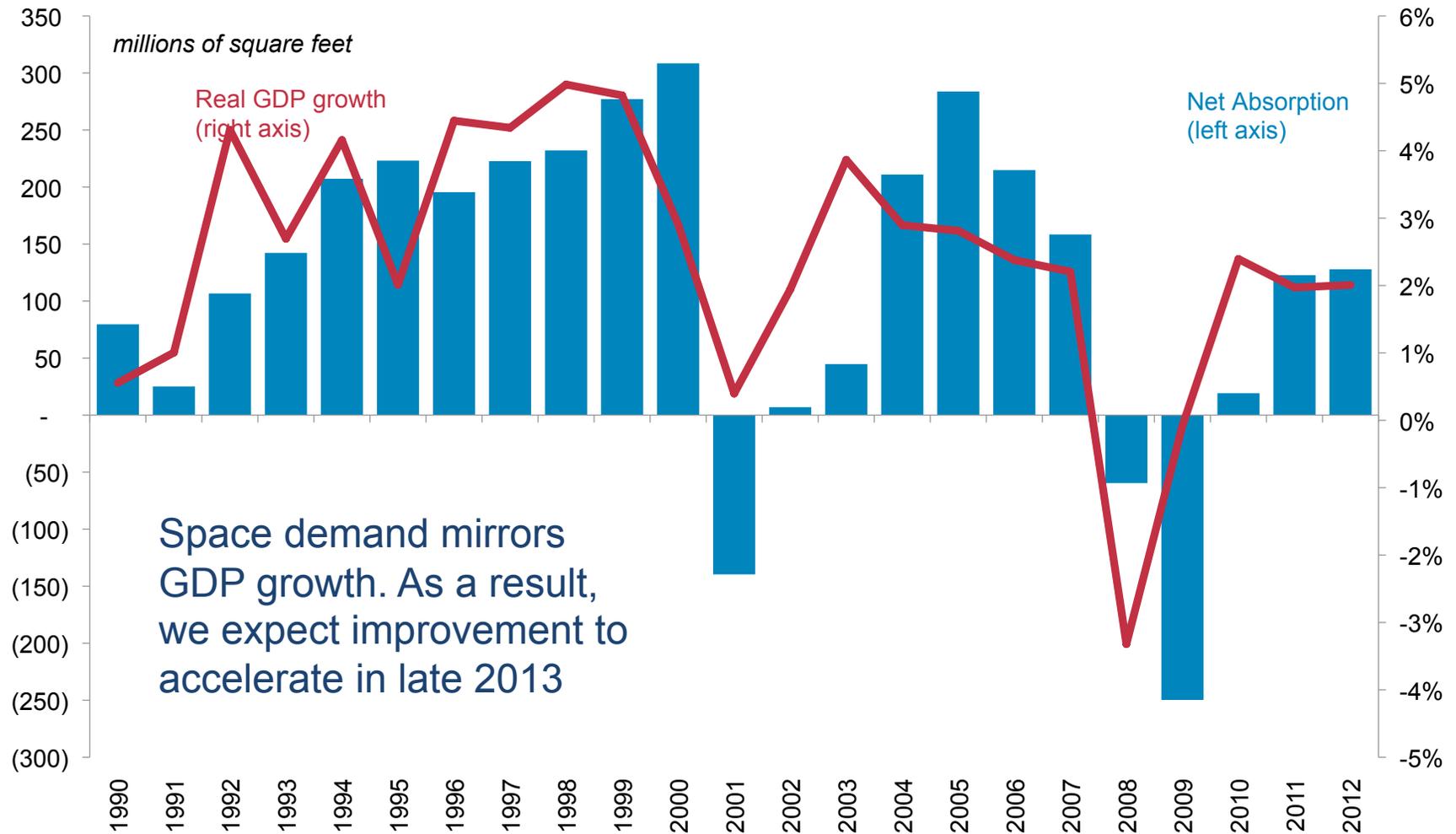
Industrial Completions, Net Absorption, and Availability  
U.S. 1990-2015 Years Ending Q4



Source: CBRE Econometric Advisors; Heitman Research

- Industrial market conditions are improving. The amount of available space has come down 150 basis points from an all-time high in 2009
- Two solid years of space absorption combined with modest construction has helped markets improve

## Industrial Net Absorption and GDP Growth Years Ending Third Quarter 1990-2012

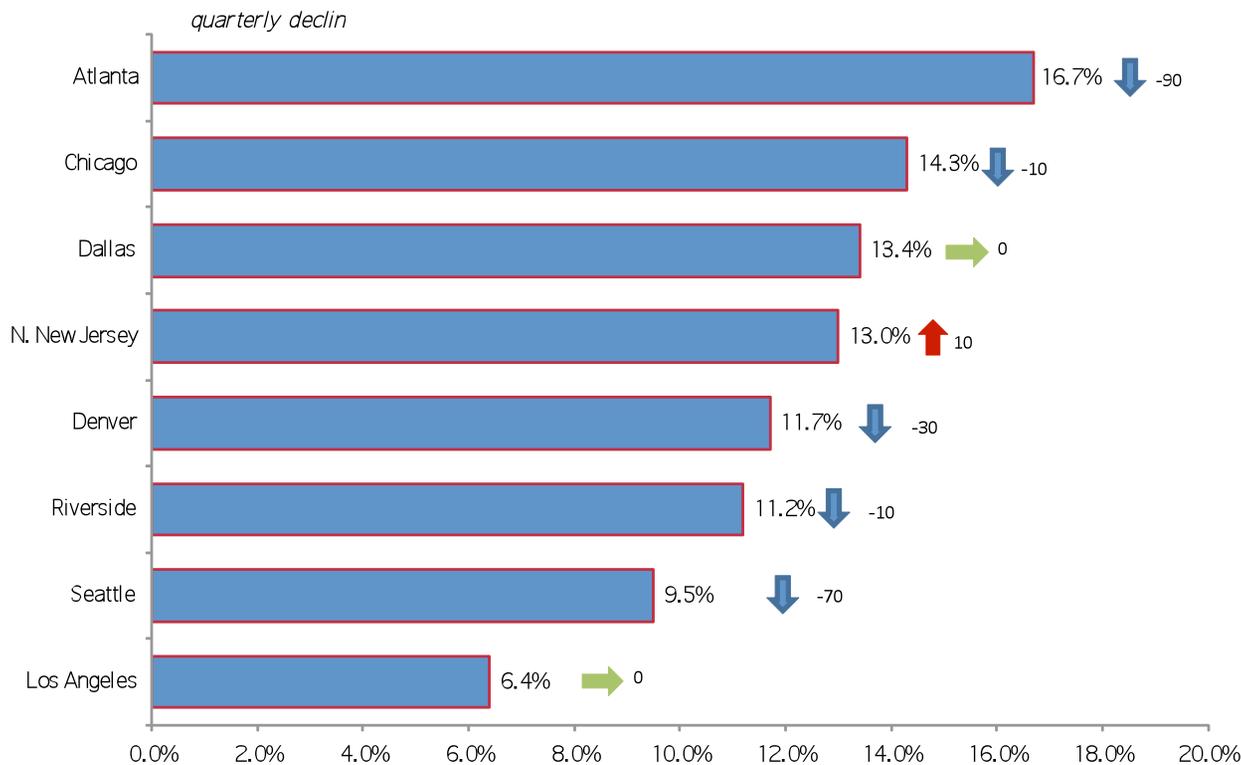


Source: CBRE Econometric Advisors; Moody's Economy.com; Heitman Research

# Major Industrial Markets are Getting Healthier

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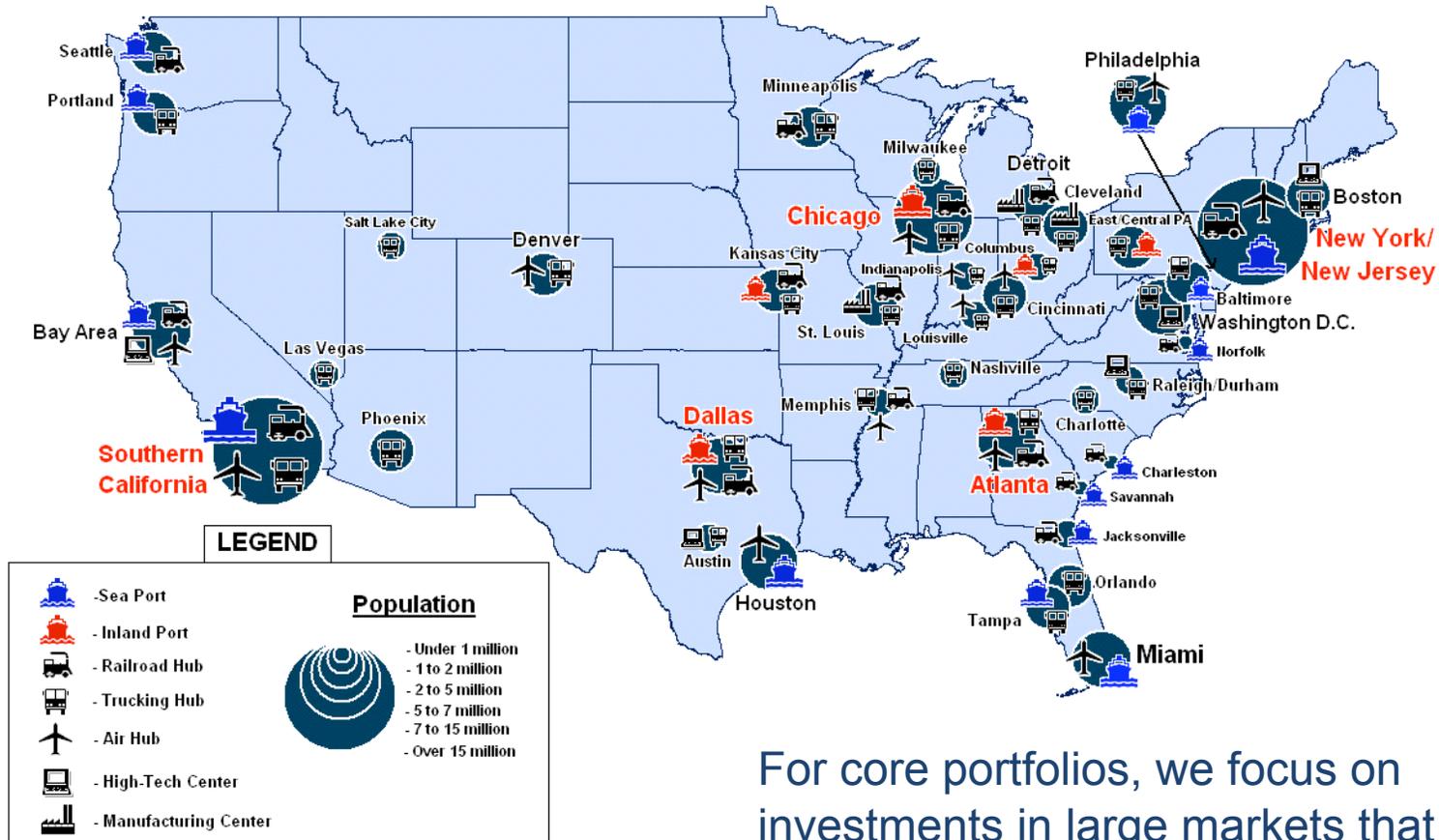
Industrial Availability  
Selected Markets 2012 Q4



Source: CBRE Econometric Advisors; Heitman Research

- Availability is coming down in virtually all of the nation's major industrial markets
- Southern California and Seattle, the major entry points for goods from Asia, are the nation's tightest industrial markets

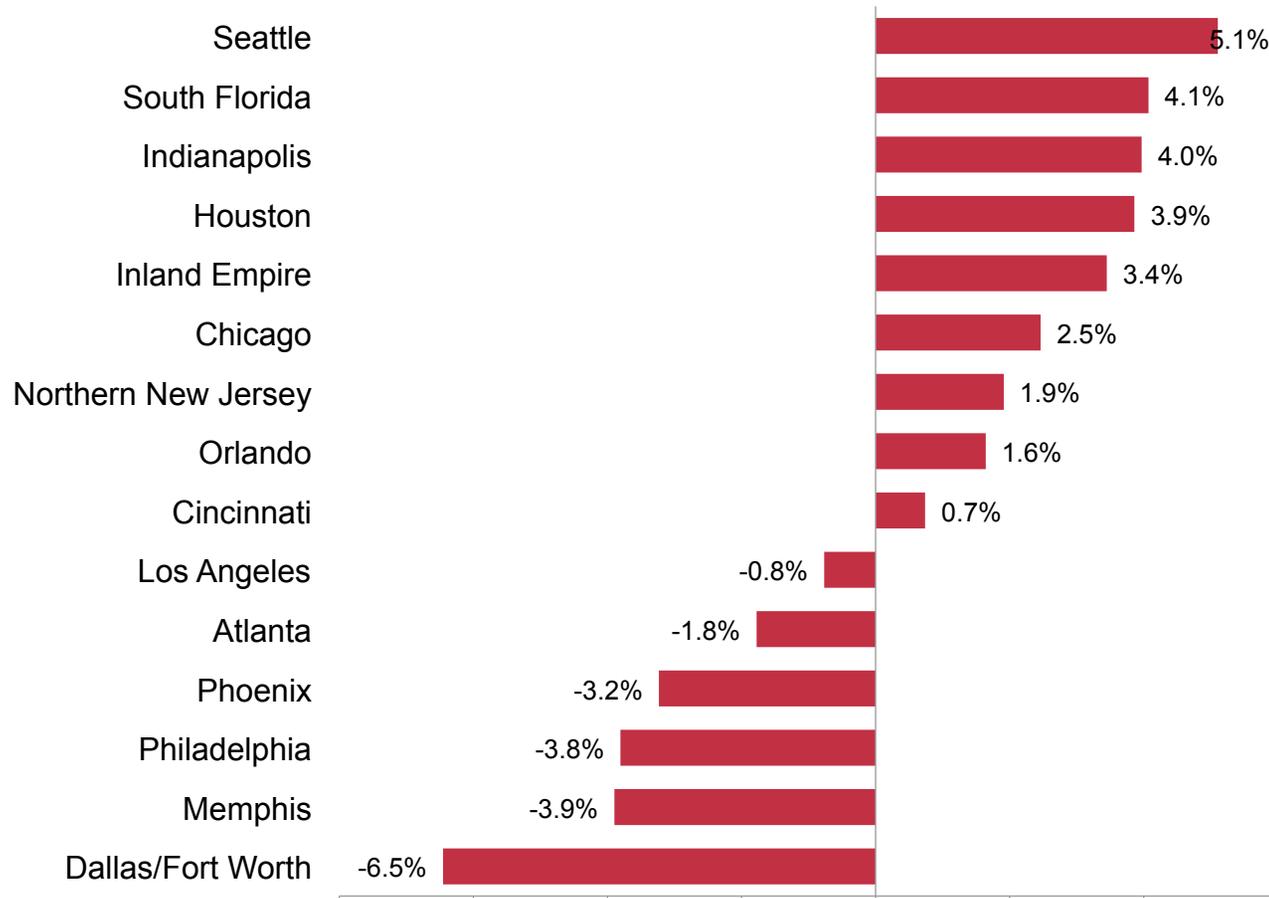
## US Industrial Markets



For core portfolios, we focus on investments in large markets that are centers for the four main ways goods are transported

# Rent Growth Now Happening Across Most Major Industrial Markets

## Industrial Rent Growth Selected Industrial Markets Q4 2012 vs Q4 2011



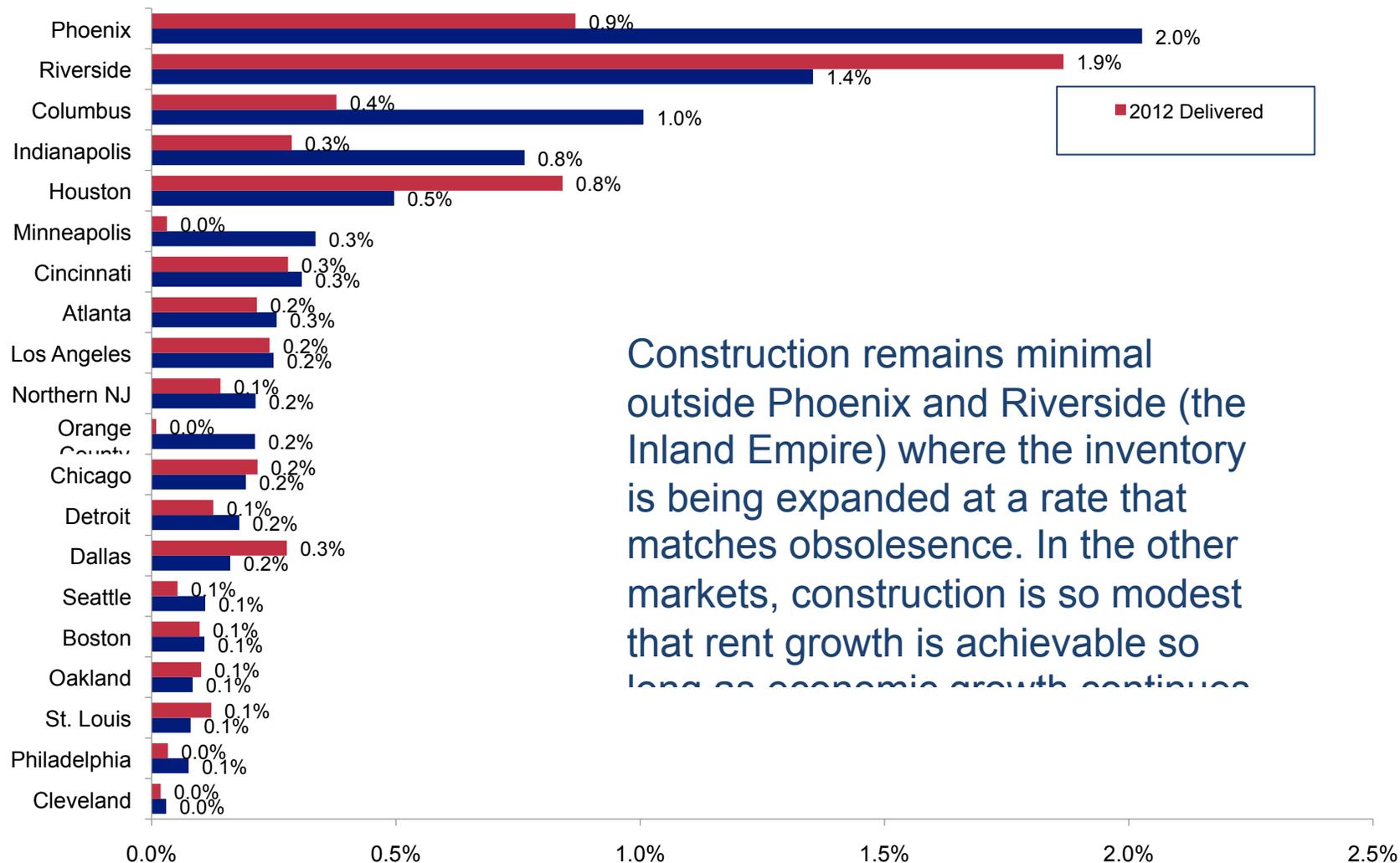
Source: CBRE Econometric Advisors; Heitman Research

- While industrial rents are still falling in some markets, the trend is positive
- Major distribution hubs are generally achieving rent growth

# Muted Levels of Construction Should Sustain Vacancy Declines/Rent Increases

## 20 Largest Industrial Markets

### 2012 Delivered & Under Construction as a % of Total Stock Q4 2012



Construction remains minimal outside Phoenix and Riverside (the Inland Empire) where the inventory is being expanded at a rate that matches obsolescence. In the other markets, construction is so modest that rent growth is achievable so long as economic growth continues.

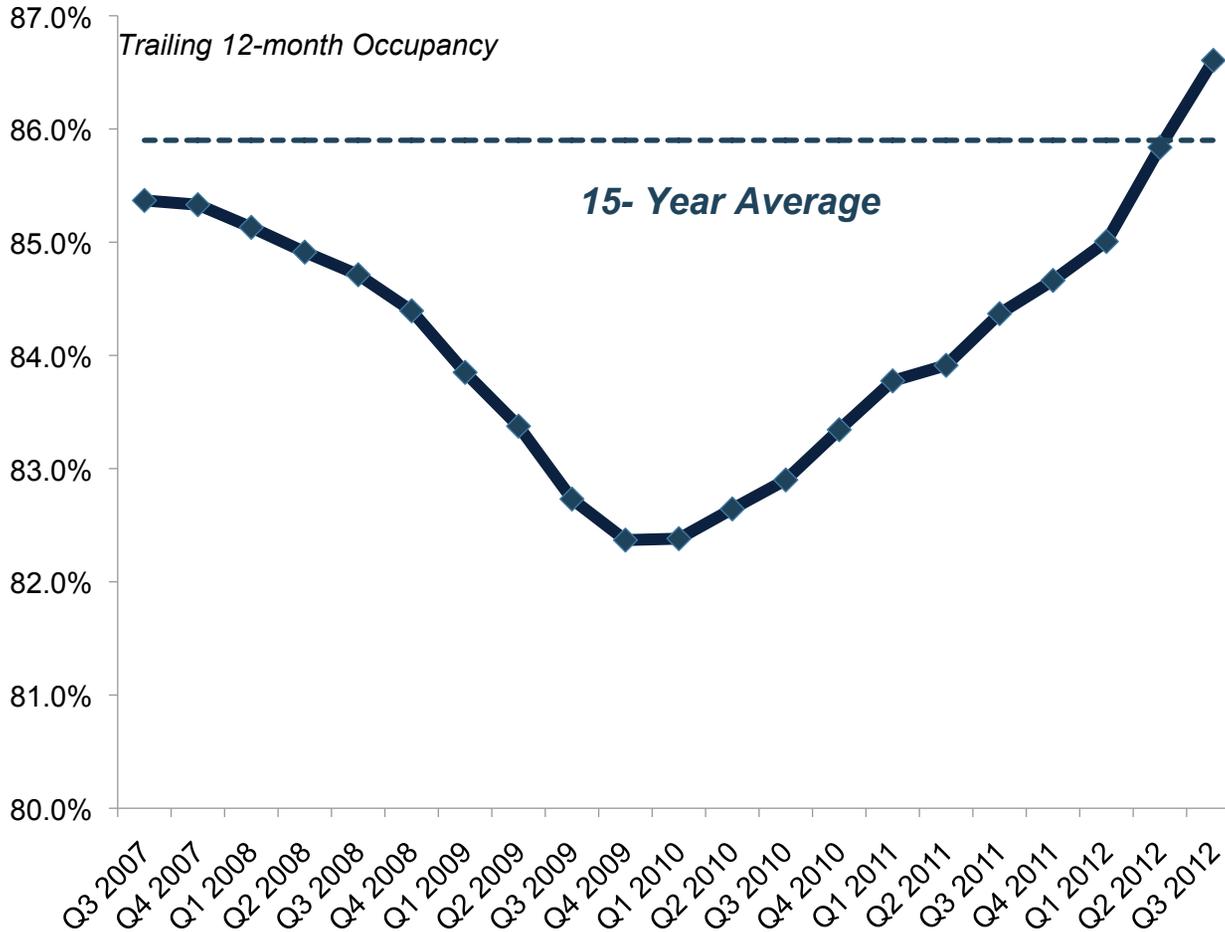
Source: CBRE Econometric Advisors; Heitman Research

# Self-Storage Occupancy Now Exceeds its 15-Year Average

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## Self-Storage Occupancy Trends

U.S. 2007-2012



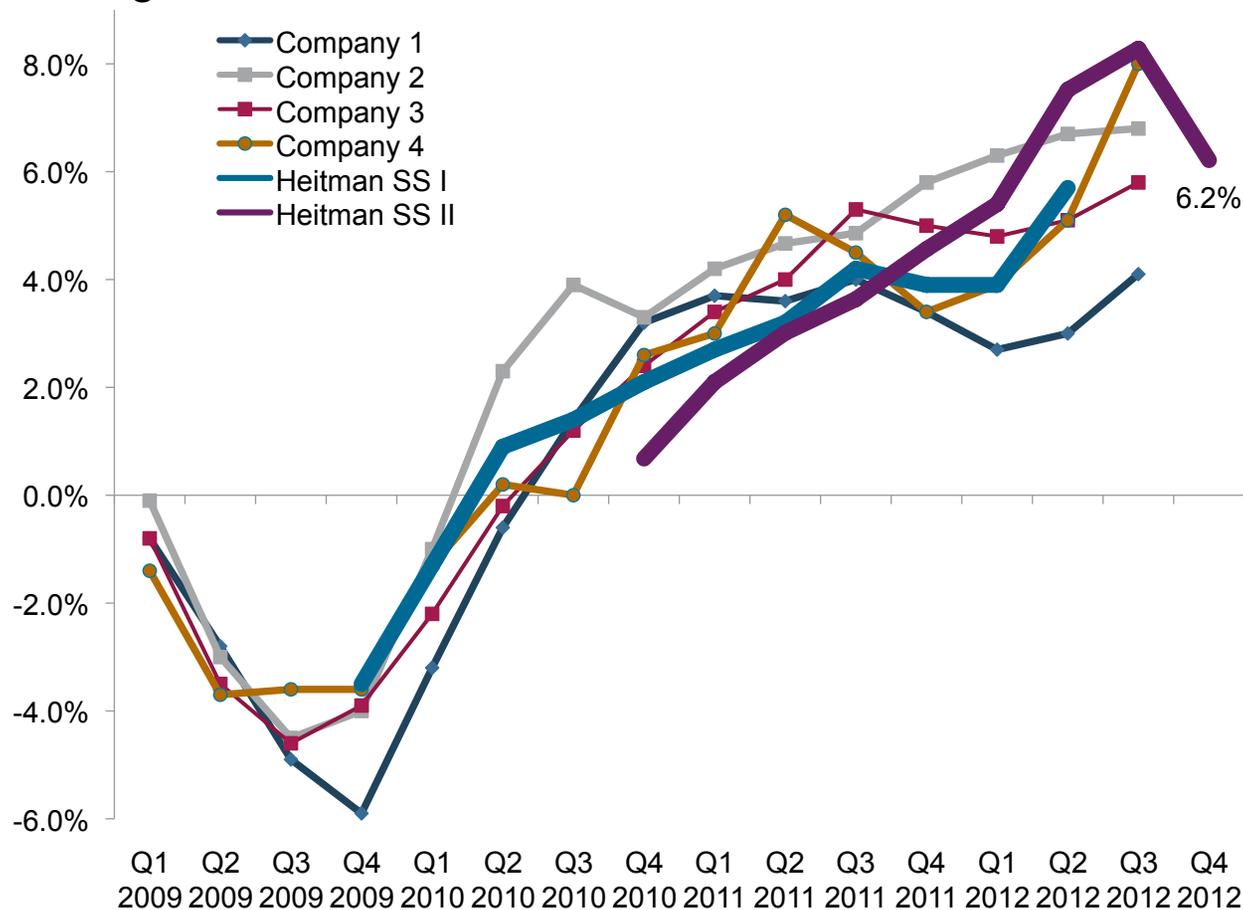
Source: Company Reports; Heitman Research

- Demand for storage tends to be triggered by change, such as death, divorce, a relocation, home renovation, business start up, or a military deployment
- While the short lease terms for self storage (30 days) don't provide protection during economic recessions, occupancy can improve quickly given the limited amount of construction activity in the sector

# Storage is Seeing Strong Revenue Growth

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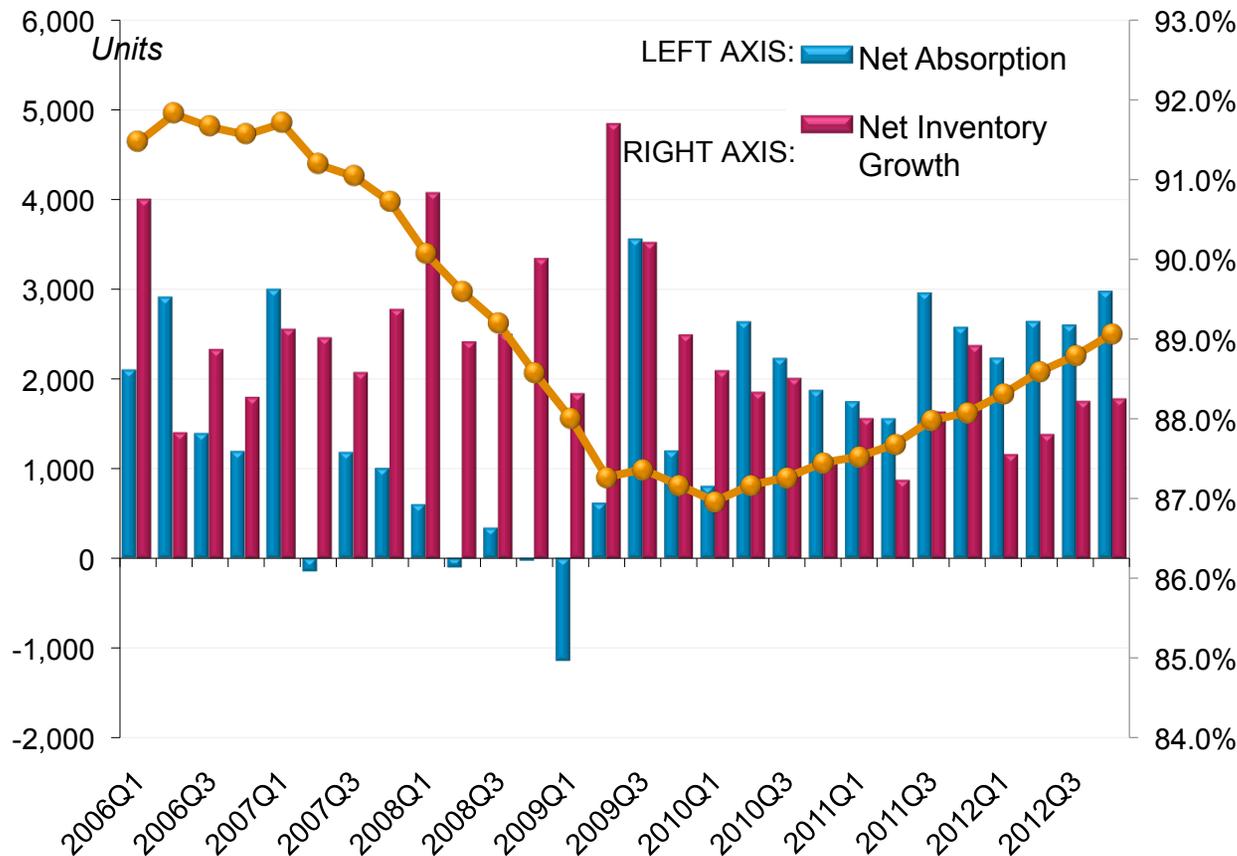
Self Storage Revenue Growth (Y-O-Y)  
Storage REITs vs Heitman Same-Store Pools



Source: Company Reports; Heitman

- Self storage properties have experienced a strong rebound
- Revenue growth has trended up consistently since early 2010
- Most of the growth reflects occupancy gains. But some operators are achieving rent growth on new leases
- All storage operators are benefitting from the ability to raise rents on existing tenants so times as often as twice annually

## Senior Housing Market Trends 2006-2012 Q3



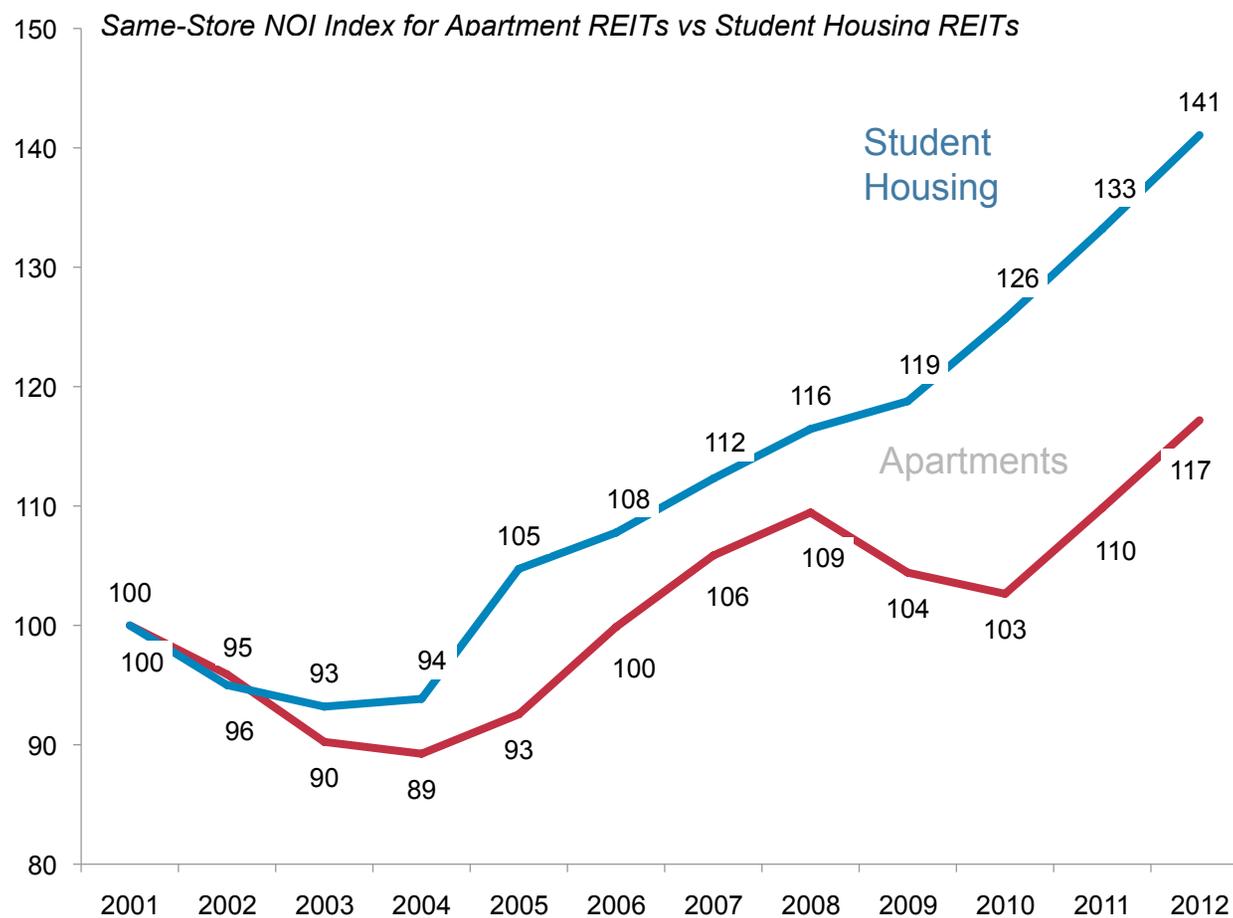
Source: NIC, Heitman Research

- Senior housing is experiencing a moderate recovery
- Vacancy has declined as construction has diminished and demand has increased
- Independent living has experienced a stronger recovery than assisted living
- Independent living costs less than assisted living. Many senior are opting for independent living and augmenting their care with outside services

# Student Housing has Delivered Better NOI Growth than Apartments

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## Student Housing NOI Growth vs Apartments U.S. 2001-2012



- Student housing net operating income has increased steadily since the early 2000s
- Its growth has outpaced that for apartments, given that net operating income grew during the GFC for student housing while it declined for apartments
- Because student housing demand does not move in lock step with the economy, it plays a defensive role in a mixed-asset portfolio

# Student Housing Trades on Higher Income than Apartments

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Capitalization Rates: Student Housing vs Apartments  
U.S. 2002-2011



Source: CBRE Campus Advantage and Heitman Research

- Student housing is more management intensive than apartments
- The leasing season is shorter and demand is concentrated, coming typically from a single source (the college or university)
- As a result, it trades on higher yields than apartments