

“Professor’s Comments”

(For the January 2010 Moody’s/REAL Index returns.)

This is a periodic commentary which will generally be posted monthly on the “RealIndices” web site, offering the perspective on the indexes of Professor David Geltner (or occasional guest commentators). Geltner was a leader of the team at MIT that developed the methodology for the Moody’s/REAL Indexes.

January Continues the Positive Results...

The January 2010 All-property return continued the CPPI’s positive streak to three months in a row, with a moderate (but “we’ll take it”) one percent gain over December. This now places the CPPI at 114.7, which is 6.25% above its October 2009 nadir of 108, and 40.2% below its October 2007 peak value of 192. Volume, at \$4.3 billion, was off sharply from December (\$8.3 billion), but that could be a normal December-to-January relationship. Year over year, this January’s volume was some 10% above that of January 2009 as measured by RCA closings dollar value for “major” (greater than \$5,000,000) core assets (apartments, industrial, office, & retail). While this still leaves trading volume at a very depressed level by recent historical standards (e.g., January 2008 was \$15.6 billion and January 2007 at the height of the boom was \$29.5 billion), there continue to be important indications that a bottom has been placed in private market pricing (with always the caveat: “*at least for now...*”).

One indication in favor of this is the continued strength in the REIT market, where share prices reflect the informational efficiency and leading nature of the stock market. As I write this in mid-March, REIT prices have continued to climb significantly since the end of January, and the discrepancy between REIT yields and the private property market yields reflected in January’s transaction prices suggests that the stock market perceives the private market to be priced in significant “bargain territory”. REIT yields by mid-March were below 4%, while average RCA closings cap rates in January were generally above 8% (a bit less for apartments).*

* Of course we need to be careful drawing a direct pricing inference; REIT yields are levered and net of both capital expenditures on in-place assets and earnings plowback for entity-level investment, which should imply greater share price appreciation (but also greater risk) in the REIT market compared to prices in a static portfolio of private market valued properties. Nevertheless, these differences have tended to imply a pretty stable relationship between REIT and private market yields with property cap rates in recent years typically trading between 100 and 300 basis-points above REIT dividend yields (based on RCA and NAREIT reports). If this yield spread moves significantly below 100 bps, that may suggest a “buy REITs, sell private property” strategy. (In February 2009 this spread reached a record low more than 200 bps *below zero*, and REITs have since rebounded more than 100% while private properties fell at least 20%.) Similarly, if the private market cap rate minus REIT dividend yield spread moves significantly above 300 bps, that may suggest a “buy private property, sell REITs” strategy. The spread is presently well over 400 basis-points, two standard deviations beyond its 10-year average. Of course, it should be noted that this is a two-sided tactic; the spread may be high not because private properties are under-valued and will rise, but because REITs are over-valued and will fall (such as late 2006 when the spread crested 300 bps). However, if the high positive Private-minus-REIT spread prevails at a time when private cap rates are also relatively

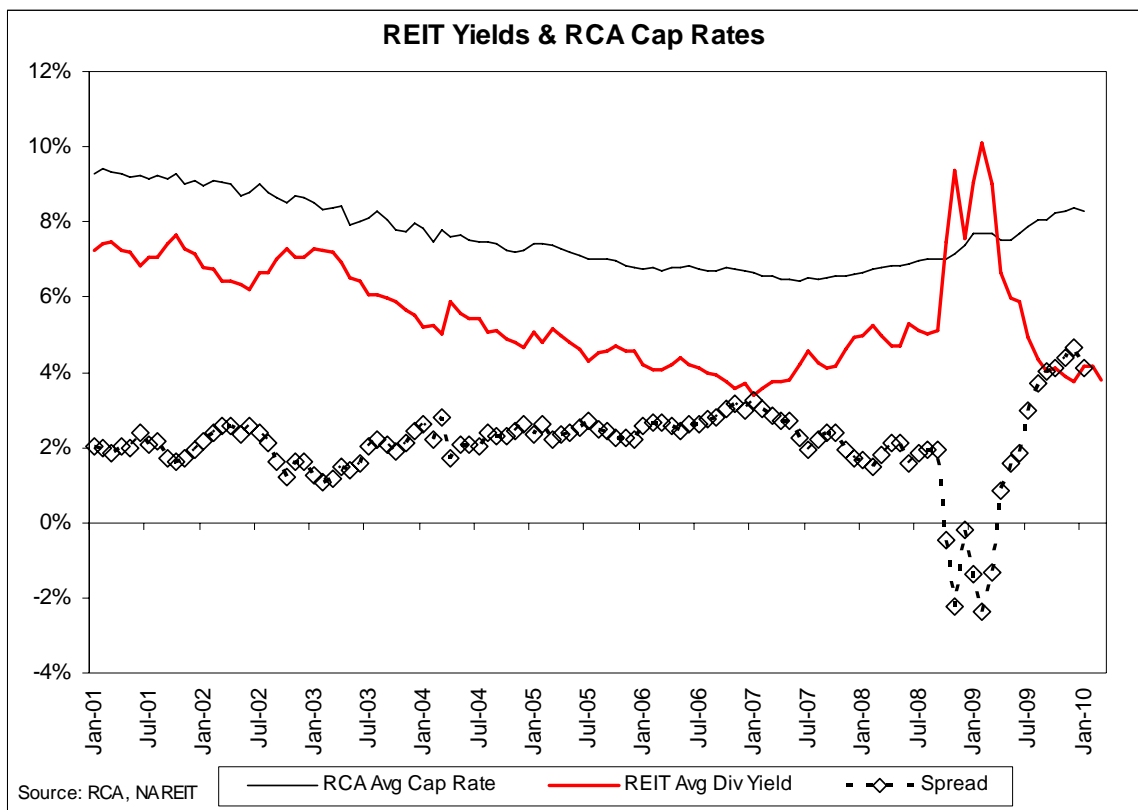


Exhibit 1

There is another very positive sign in the January CPPI numbers that are “behind the scenes”. The chart in Exhibit 2 (next page) updates our breakout of the price changes among properties falling into distress since the market peak (indicated by the RCA “troubled asset” flag) versus those remaining “healthy”. January saw an extremely strong uptick in the *distressed* properties sale prices (up over 7% even as “healthy” properties slipped a little). In other words, what was driving the +1% return in the January CPPI was actually the prices obtained by the sales of RCA-labeled *troubled assets*. While we must place a big caveat around the +7% result for distressed because the sample size of distressed properties is small (which means that the noise in the distressed property index can make it spiky), the January uptick is a very positive sign (if it can persist). This is because distressed property sale prices probably tend to reflect buyers’ “bid” prices more directly than those of “healthy” properties (presumably, as sellers of “troubled assets” generally are under more pressure). Thus, the upturn in the distressed properties index suggests that the *demand side* of the property investment market is beginning to revive. It suggests that the “vultures” are finally starting to “pounce”.*

high in absolute terms (or at least not at an historical low), then this may provide a clearer signal of an impending private market price increase (although not of nearly the magnitude as the REIT gain of the past year, and not necessarily a permanent private price increase).

* Such an upturn in potential buyers’ willingness-to-pay prices is also confirmed by another transaction price based index, the so-called “TBI” published by the MIT Center for Real Estate based on NCREIF property sales, in which the demand-side index turned up strongly in 3Q2009, only to fall back again in 4Q but still ending the year 7% above its bottom.

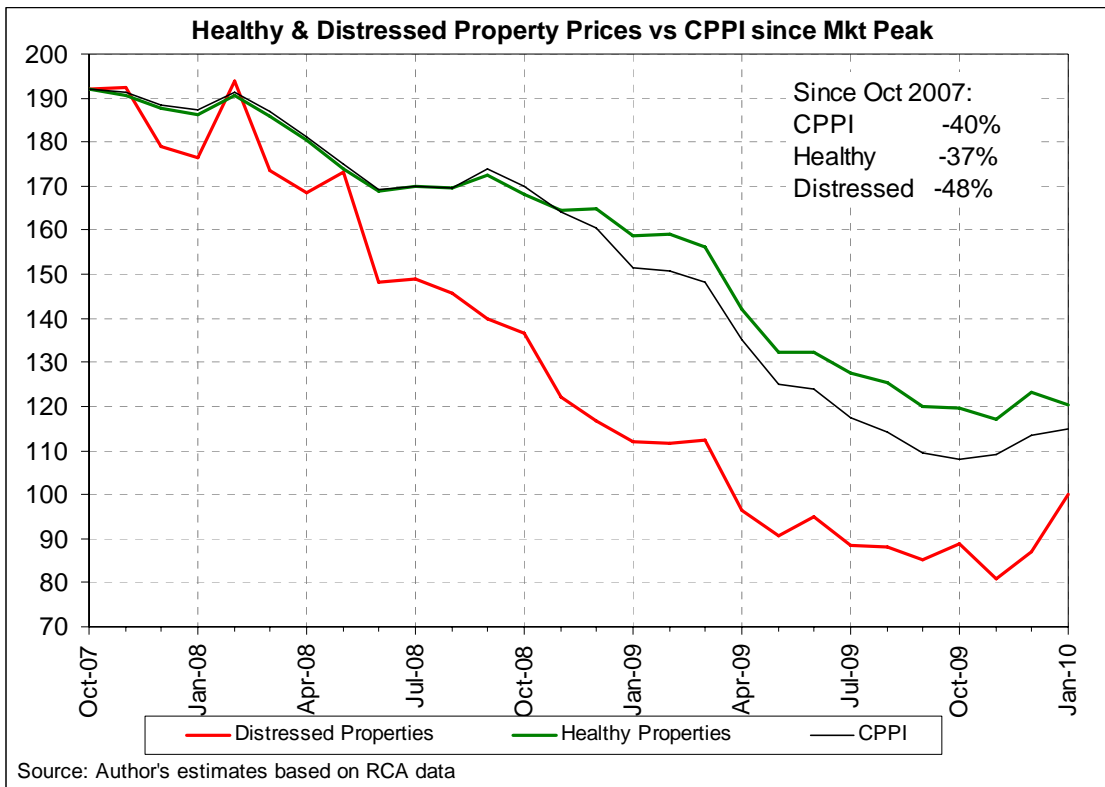


Exhibit 2

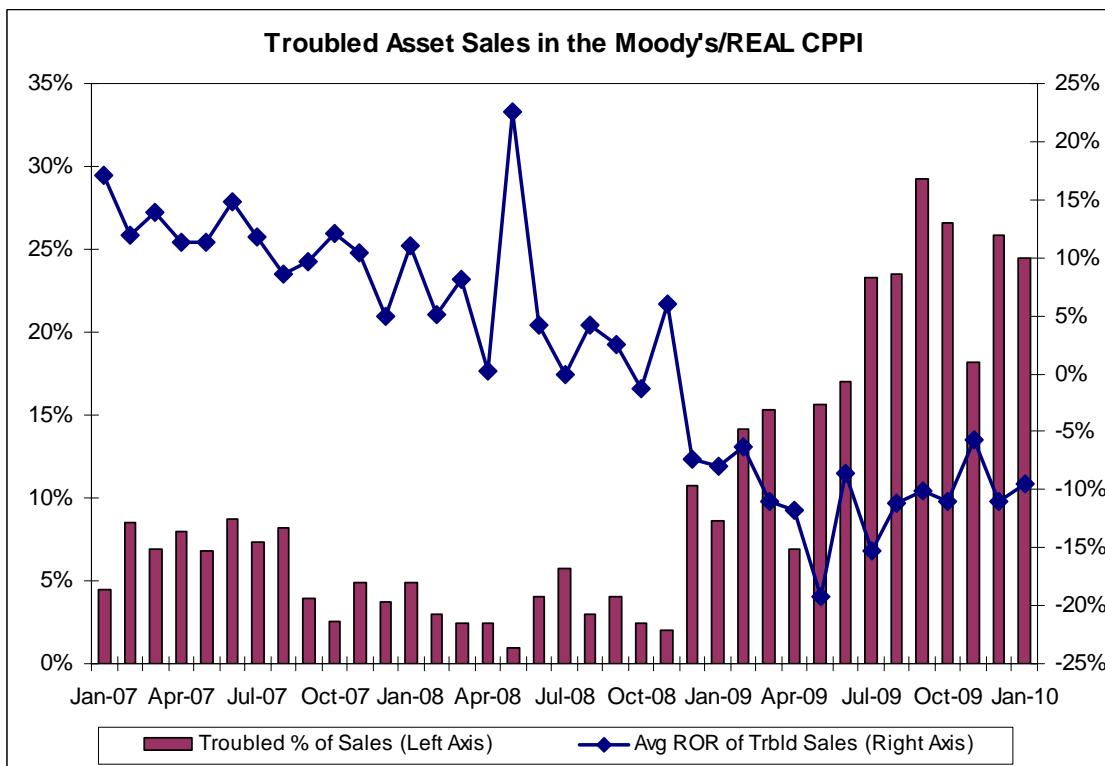


Exhibit 3

This pricing result no doubt reflects the fact that distressed property sales are continuing to remain in balance, not swamping the market.* As shown in Exhibit 3, sales of RCA “troubled assets” held nearly constant at approximately 25% of the repeat-sales used to compute the CPPI.† Indeed, one begins to hear complaints in the marketplace that investors are having trouble finding as many properties for sale as they would like to buy. The index numbers are confirming these anecdotal stories. Of course, the extent and permanency of any turnaround or bottoming in private market asset prices, even in the context of a recovering economy, may depend on the ability of owners and their lenders and servicers to continue to deftly manage the necessary de-leveraging that the bursting of the great property price bubble of 2005-07 still requires. The debt overhang is still there, and will be for quite some time, and for a huge magnitude of property asset value (with perhaps a trillion dollars or more of commercial mortgages still underwater).

These are indeed “interesting times”, in which one can plausibly imagine commercial property prices going in any direction from here: up with continued economic recovery and vulture-pouncing in the presence of distressed-sale discipline; down if that discipline can’t hold in the face of the weight of refinancing needs or if the economic recovery stalls; or essentially flat (probably with some modest bouncing) if these two forces equal out. With such multiple possibilities, this would be a great time for speculators to liquefy a property derivatives market (if there were one in the U.S.).

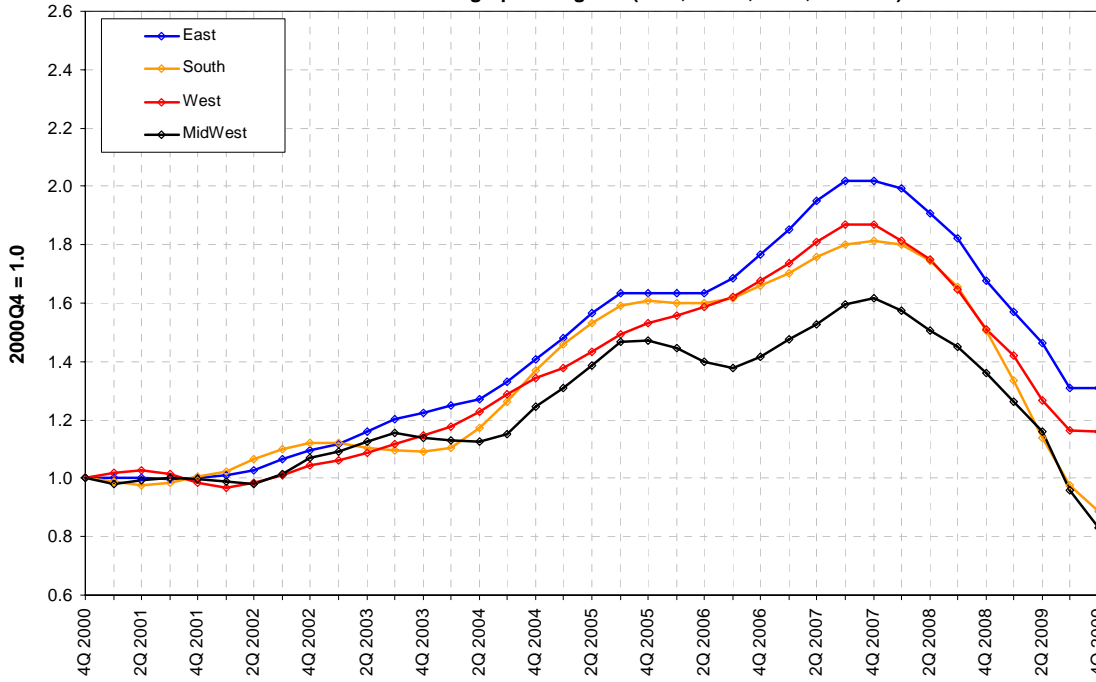
Updating our real estate economics perspectives on the CPPI...

In my “Professor’s Corner” commentary of last January, I introduced some break-outs of the CPPI that take a different perspective from the traditional contiguous multi-state region-by-sector breakouts that most analysts track. The new breakouts are motivated by fundamental real estate and urban economic principles about land value dynamics and economic base. They combine all property usage type sectors together, and define locational definitions based not only on contiguous geographical political boundaries, but alternatively on fundamental spatial economics and economic base considerations: “all-

* Part of this distressed property sales discipline is not just the quantity of distressed properties put on the market but *which* such properties. Not all distressed properties are alike. Sellers of distressed properties are becoming more adept at selecting the more appealing such properties to put up for sale, and they are finding more ability on the part of buyers to distinguish that fact and to pay higher prices for such properties. This may be a big part of the explanation for the January uptick in the distressed property index. (This doesn’t negate the “good news” aspect of that uptick, but it does nuance it.)

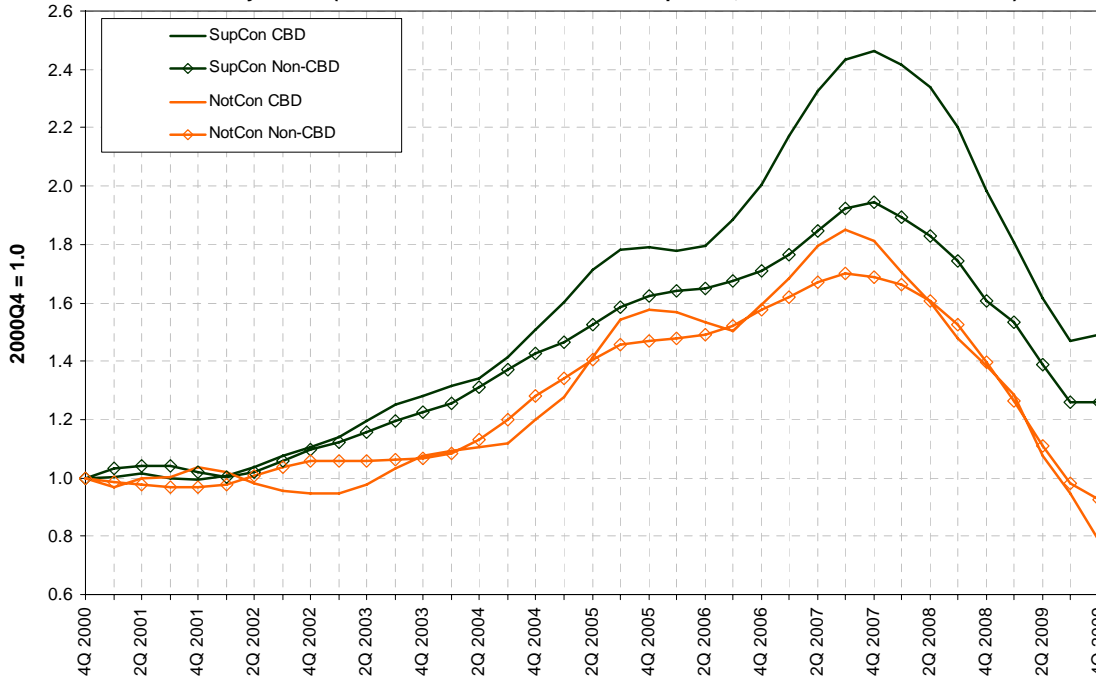
† The CPPI is computed using *all* valid RCA sales price observations for which there is a valid prior sale price, except those failing to pass the index data filters. An observation is “valid” if its price is confirmed by at least two independent and authoritative sources (on average there are four confirmations). The filters eliminate repeat-sales observations with less than 18 months between sales (“flips”), or with extreme price changes greater than 50% (or less than -50%) per annum, or with changes in indicated size, age, or usage between the two sales. Observations are also filtered out if they are portfolio deals (more than one property sold at once, in which case individual asset pricing may be problematical), or if there are other flags suggesting a non “arms-length” price (such as foreclosure sales). The result is that typically the CPPI is able to use about one-quarter of the total RCA transaction observations (e.g., 90 out of 376 in January 2010).

**Exhibit 4: Commercial Real Estate Same-Property Price Evolution (CPPI-based), 2001-2009:
NCREIF Multi-State Geographic Regions (East, South, West, MidWest)**



Note: All core property sectors aggregated. Source: Authors' estimates based on RCA repeat-sales transaction price data.

**Exhibit 5: Commercial Real Estate Same-Property Price Evolution (CPPI-based), 2001-2009:
Land Value Dynamics (Constrained vs Unconstrained Dvlpt Mkts, CBD vs Non-CBD Locations)**



Note: All core property sectors aggregated. Source: Authors' estimates based on RCA repeat-sales transaction price data.

property” indices of transactions prices in supply-constrained versus non-constrained markets; in CBD or non-CBD locations.*

With this in mind, have a look at Exhibits 4 and 5 on the preceding page. (The exhibits have the same vertical scale, and are summarized statistically in the table below.†) Note that the overall nine-year (2001-09) differential in price change performance has now widened to over 700 bps/year between the supply-constrained CBD properties and the not-constrained CBD properties, and to over 500 bps/year between the East and Midwest NCREIF regions. These differentials are clearly too great to be offset by yield differences, suggesting substantial total return investment performance differentials during the 2001-09 period.‡

| | Mean/Yr | Rise | Fall |
|----------------|---------|--------|--------|
| SupCon CBD | 4.5% | 146.1% | -40.3% |
| SupCon Non-CBD | 2.6% | 94.5% | -35.2% |
| NotCon CBD | -2.7% | 85.1% | -57.7% |
| NotCon Non-DBD | -0.9% | 70.0% | -45.6% |
| | Mean/Yr | Rise | Fall |
| East | 3.1% | 101.8% | -35.1% |
| South | -1.3% | 81.3% | -51.0% |
| West | 1.6% | 87.1% | -38.1% |
| MidWest | -2.0% | 61.9% | -48.6% |

-David Geltner, March 2010.

(See www.realindices.com for an archive of past issues of “Professor’s Corner”.)

* Bob White (President of RCA) has suggested that this break-out should be further refined by separating out multi-family properties from the other three core usage type sectors. Such a refinement would be very interesting, and we hope to examine it in future issues of this commentary.

† Our plan is to update these break-outs quarterly, possibly enhanced by separating out multi-family properties. See the January 2010 “Professor’s Corner” commentary for a detailed description of the definition of these breakout indices. Also note that these indices are computed using a two-stage frequency conversion procedure (we call “ATQ” – for “annual-to-quarterly” – similar to the “QTM” procedure used to compute the monthly All-property Moody’s/REAL CPPI). The indices are quarterly, but they are computed from underlying quarterly-staggered annual-frequency indices. This technique is very effective at reducing spurious noise in the indices, but it may result in a slight tendency to “over-smooth” the indices, and also a slight lag bias in picking up turning points, generally no more than a quarter, but this could explain why these break-outs don’t pick up as much of the upturn that the monthly CPPI captured in the fourth quarter of 2009. (The smoothing and bias is because annual-frequency indices have difficulty fully reflecting price movements that have not – or not yet – spanned a good part of the year.)

‡ As noted in January, the SupCon-CBD index is substantially influenced by New York City properties (particularly office and apartments, in both Manhattan and the outer boroughs). Note also that excess total return investment performance does not necessarily imply super-normal returns, as we are not controlling for differences in investment risk, and of course the difference portrayed is an *ex post* result over a particular span of history (not necessarily an *ex ante* expectation).