Capital Market Update

February 10, 2011
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SALTASH PARTNERS LLC
investing in American ingenuity
A Brief Tour of the Capital Market

- What’s happened in the past year?
- Capital market conditions
- Property market conditions
- Outlook for 2011 and beyond
- Property sectors to watch
Treasury Liabilities have Doubled in Five Years

U.S. Treasury Liabilities Outstanding

Federal Reserve

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13.97%
Add in GSE and Agency Liabilities

Treasury Debt and GSE and Agency Liabilities

16.26%
Is Quantitative Easing Working?

St. Louis Adjusted Monetary Base (BASE), Billions of Dollars, Bi-Weekly, Seasonally Adjusted: January 26, 2011 vs London Gold Fixing & CPI

No Apparent Effect, Yet

Benign Liquidity Trap?

Federal Reserve; Bureau of Labor Statistics; Deutsche Bundesbank; Saltash Partners
Is Inflation around the Corner?

St. Louis Adjusted Monetary Base (BASE), Billions of Dollars, Bi-Weekly, Seasonally Adjusted: January 26, 2011 vs London Gold Fixing & Price Indices

- Monetary Base
- London Gold Fixing
- CPI x 10
- Commodity Index x 10

Federal Reserve; Bureau of Labor Statistics; Deutsche Bundesbank; IMF; Saltash Partners

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Is Quantitative Easing Working?

Treasury Yield Curve

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Has Inflation Begun?

- Wall Street Journal – yesterday
  - Inflation Worries Spread
    - China Raises Rates amid Hit to Wheat Crop
    - Treasury Yields at 9-Month High

- Paul Volcker on inflation
  - "won't be a problem next year, it won't be a problem for several years. “ October, 2010
When Will Demand Return?

Recent Post-Recession Employment Recovery

- 1990
- 2001
- 2008

- 98.6%
- 98.0%
- 90%
- 91%
- 92%
- 93%
- 94%
- 95%
- 96%
- 97%
- 98%
- 99%
- 100%

This is the sharpest employment decline in the modern era

February, 2010
93.8% of peak

December, 2010
94.7% of peak

Bureau of Labor Statistics; Saltash Partners LLC
Establishment Data

Signs of a bottom?

CENSUS

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FRB Senior Loan Officer Opinion Survey: Net Percentage of Domestic Respondents Tightening Standards for Commercial Real Estate Loans
Commercial Mortgage Demand Rising

FRB Senior Loan Officer Opinion Survey: Net Percentage of Domestic Respondents Reporting Stronger Demand for Commercial Real Estate Loans
Whither Cap Rates?

Core Property Spread = Cap Rate - 10 year Treasury

Real Capital Analytics; Federal Reserve; Saltash Partners LLC
Property Risk Premium Declining?

Core Property Risk Premium as Percent of Risk Free Rate
Caprate - 10 yr Treasury/10 yr Treasury

Real Capital Analytics; Saltash Partners LLC
Whither Cap Rates?

NCREIF Cap Rates Trailing Spread
1978 - 2006

High inflation years

Low inflation years

NCREIF; Federal Reserve; Saltash Partners LLC

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Recent Core Property Returns

NCREIF ODCE Total Return

-36.8%
Change including Income return
Overshoot?
Recent Core Property Returns

NCREIF ODCE Total Return

-42% in 2 years including Income return
Overshoot?

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Business Credit is Beginning to Come Back

Credit Market Borrowing

Small and Mid-Market Businesses are coming back to the window, slowly
Commercial and Multifamily Not So Much

![Graph showing Commercial and Multi-Family Mortgages Outstanding]

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Mortgage Portfolio Continued to Shrink

Commercial Mortgages Outstanding by Holder

- Commercial Banks
- Life Insurers
- CMBS
- REITs

$ Billions

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<th>Q1</th>
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Originators All Pulled Back

Change in Mortgage Assets by Holder

- GSE's
- Life Co.'s
- Credit Unions
- Savings Inst.'s
- Commercial Banks
- ABS Issuers

Federal Reserve

No meaningful volume but MBA reports Commercial up 63% over 2010Q3 in last quarter
The Scope of the Problem – Distress as a Share of Market

Distress as a Share of Market

Sales Volume 2005-2008

Distress as % of Volume

Real Capital Analytics

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The Scope of the Problem - a Closer Look

Distress as % of 2005-2008 Deal Volume: Selected Markets

- Las Vegas: 44%
- Miami: 22%
- Phoenix: 18%
- Philadelphia: 14%
- Manhattan: 12%
- Houston: 11%
- Boston: 11%
- Sacramento: 11%
- Dallas: 10%
- Atlanta: 9%
- Orange Co: 9%
- Los Angeles: 8%
- Hartford: 7%
- Chicago: 7%
- San Francisco: 6%
- San Jose: 6%
- Austin: 5%
- Seattle: 5%
- San Diego: 4%
- Stamford: 4%
- Westchester: 4%
- DC Metro: 4%

Real Capital Analytics
What’s Going on in The Institutional Market?

• Tax exempts chasing Core and Funds
• “Barbell” strategy, Core and Opportunistic
• Shift from Separate Accounts to Funds
• Premier markets
• Trophy properties
• Lots of firings
• Some hirings
Do These Numbers Look Familiar?

Recent Cap Rates in Active Markets

- **Apartment**
  - NY: 6.0%
  - DC: 6.3%
  - LA: 6.3%
  - SF: 5.9%
  - CHI: 6.0%

- **Office**
  - NY: 6.0%
  - DC: 7.1%
  - LA: 7.6%
  - SF: 6.2%
  - CHI: 6.9%

- **Retail**
  - NY: 6.8%
  - DC: 7.0%
  - LA: 6.9%
  - SF: 8.1%
  - CHI: 7.9%

Real Capital Analytics
What’s Wrong with the Current Strategy?

• “Corest of Core” office properties have gain to lease
  – Rents will be rolling down for some time
  – Tenants are demanding expensive TI’s and other concessions
  – Declining cash flow in early years will kill the IRR
  – Office will take the longest to recover fully
Where are the Best Opportunities?

• Multi-family development and rehab
  – Massive generation maturing into the work force
  – Huge pent-up demand from the recession
  – Continued shift to the “new urbanism”
  – Very low level of new supply in recent years
  – Rents are rising
  – Concessions are easing
Hotels are looking attractive

- Midweek January occupancy up 10% YoY
- Business travel is back
- Lots of room for occupancy growth
- Even more room for RevPAR Growth
- Pricing has not caught up with hotels as quickly as other property types
- Distressed assets are trading
Where are the Best Opportunities?

• Hurt Core office
  – Has been lightly traded as yet
  – Capital spent on tenants will be *increasing* revenue
  – Revenue will grow annually as market recovers
  – Rush to sustainability can be implemented with TI dollars
  – Retrofitting vacant space for sustainability will speed rent-up
Where are the Best Opportunities?

- Developable land (Yikes!)
  - Multi-family home sites
  - Single family pre-development
  - Homebuilders are acquiring again
  - Reduced supply will begin to tell in 2 to 3 years
  - Sustainability movement will require sites recycled from other uses now in low demand
Thanks for your time,
Have a great 2011.