The State of the U.S. Real Estate Market - Spring 2015

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"The Train Has Left the Station"

INTRODUCTION

Boys Love Trains

When my sons were little, they both loved trains. Thomas the Tank Engine, Lionel Trains, anything that ran on a track and made that unmistakable chugging sound. My oldest son in particular loved the story of the Little Engine That Could. Not a night would go by that he would not dig out that tattered book from his pile of favorites, climb into my lap and insist that I read it to him at least twice before he would go to bed. "Puff, puff, chug, chug…I think I can, I think I can."

Having lived in the Northeast for the majority of my life, and having traveled broadly, I have grown to have a strong affinity for trains myself. Amtrak, the Metro, the Tube, the Subway, Freight trains, Bullet trains, Maglev trains, all kinds of trains (excepting maybe those carrying volatile Bakken Shale oil). My admiration stems largely from the fact that trains are a much more relaxed and efficient form of transportation than commercial flight in our post 9/11 world. Generally speaking, trains are highly predictable, and, though they can be delayed from time to time, they generally run with reasonably measured precision. They start at a certain point, they make calculated stops along the way, and they complete their journey by arriving at a pre-specified destination at a pre-determined time.

Trains Are Like Development

This measured and deliberate process of moving people and goods by rail is similar to the construction of a building, in that construction starts at a given point, it reaches milestones that are highly orchestrated along the way, and it arrives in the form of a completed building, hopefully on time and on budget. (At CenterSquare, we generally avoid speculative development given its relative risk and return profile, but we do track it closely as a gauge of market sentiment.) Like a train, the progress of construction can be followed and measured by casual observers – holes are excavated, foundations are poured, steel is erected, curtain walls are sealed and interiors are finished. Building a high rise office tower can take 36 months from start to finish, and anyone can watch the process unfold as they move along the street in their daily lives. This deliberate and methodical sequencing is much like the approach of a steam locomotive: the initial visual evidence of smoke from the stack, the faint sound of the whistle, the rumbling of steel wheels on rails, and finally the arrival announcement in the station. Lastly like a train, once a building starts its journey out of the ground, you know that it will ultimately arrive at a relatively certain point in the future.

In today's world of increasing new development, there are a number of "trains" that are seeking approval to charge out of the station in a race to be the first to reach stabilization. Capital is channeling into real estate development opportunities at a rapid clip, and, as in every development cycle, the question will be who reaches stabilization in time, and who gets left in the rail yard due to a lack of track. Success in development is almost always achieved by first movers, with those that are late out of the gate often finding insufficient demand to fill their projects upon completion.

The apparent predictability of the development cycle begs the question that if we can see these projects rising before our eyes, and we can measure their progress along the way, and we can predict with a high degree of certainty when they will arrive, then why do so many people continue to claim that you cannot time the real estate market? The market cannot hide the supply pipeline that it is delivering from a distance, as the data and the physical evidence are available to most anyone who takes the time to observe them. The reality is that you *can* time the cyclicality of the real estate market, and, more importantly, to be a superior investor, you actually *must* time the market. More on that idea to follow, but first let's set the stage...

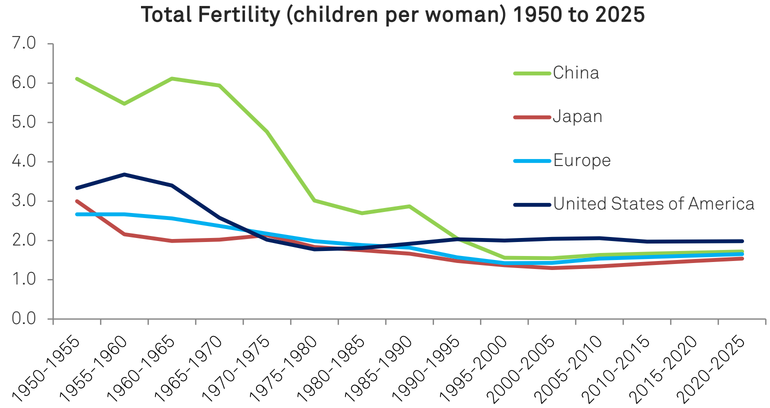
MACRO OVERVIEW

As an investor, it is critically important to always know where you stand in a financial world that has always been, and will always continue to be, highly cyclical. Generally speaking, the current investment vintage is a time for caution and discipline given the level of uncertainty that the Central Banks of the world have infused into our financial system. Unlike the 2009-2010 vintages, this is a time period where mistakes will have significant consequences, because margins are simply not as great as they were directly following the downturn.

Demographics: A Longevity Shift in the Population Pyramid

With all of the currency that has (and will continue to be) printed in the name of stimulus since the global financial crisis, the textbooks would advise you that we are certain to see a significant amount of inflation manifest in our global economy. That said, given the offsetting, and potentially overpowering, demographic force of the aging and shrinking of the developed world's population and workforce for the first time in history over the next 25 years, it is hard to see how we could be entering anything but a long term deflationary environment. The question is, which of these powerful forces will win out? The Central Bankers understand their demographic conundrum, and they have been working diligently to prevent us from falling into a deflationary spiral. They have been successful, at least in the U.S., in that inflation has been achieved, but it has not been an inflation of general wages, goods and services; instead it has been an inflation of asset prices. The Central Bankers have not been as successful in arresting the deflationary fears in markets such as the EU, where both sovereign and corporate debt of intermediate duration have begun to trade at negative yields for the first time in financial history; effectively undermining the foundation of modern finance theory. Clearly, market participants are betting that significant inflation is a high class problem that will not manifest in the near term.

Total Fertility (children per woman) 1950 to 2025

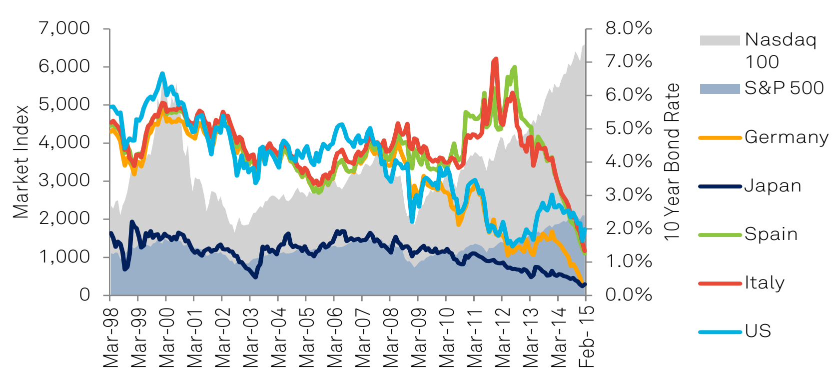


Source: United Nations, Department of Economic and Social Affairs, Population Division (2013). World Population Prospects: The 2012 Revision, DVD Edition.

Public Market Cycles: Peak to Trough and Back Again

I do not pretend to be a public markets expert, but I do believe in the simple statistical principle of reversion to the mean. That said, the S&P is up 216% since its lowest level, the NASDAQ is up 340%, and the sovereign debt of the major economies are trading at yields (or negative yields) that are hard to fathom from an historical perspective. Factor in the uncertainty that stems from accelerating technological advances (i.e. artificial intelligence) and their resulting impact on labor markets, the current debt fueled oversupply of fossil fuels, and an extended economic expansion now going on 70 months, and it is hard not to imagine that we might begin to run out of cheap money economic propulsion in the near term.

Market Indices & 10 Year Government Bond Rates



Source: Bloomberg, February 2015

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Geopolitical Concerns: Crimea as the Sudetenland?

When I think about what might serve as a catalyst to change the current investment environment, geopolitical uncertainty stands at the very top of the list. The political landscape is reminiscent of the post-Depression environment in which no world leader had the economic fortitude to oppose the rogue nations of the day. The current policy of appeasement in the Ukraine is reminiscent of German aggression in the late 1930's, the evolving and escalating tensions in the Middle East have tinderbox attributes, and the economic uncertainty of the EU all contribute to the potential looming clouds on the investment landscape.

All of this uncertainty makes it hard to clearly see the investment road ahead even though it is right in front of us. This is not a time to take significant risk in the hopes of generating the exceptional profits that can be earned in certain vintages, but it is instead a time to be prudent because capital can be easily lost if it is not properly protected from these shifting market forces. We are fortunate that, even against this backdrop, the U.S. real estate market continues to offer superior risk-adjusted opportunities for those willing to pick through today's out of favor assets in order to manufacture durable income streams to be sold into the yield-starved market.

TIMING OF MARKETS

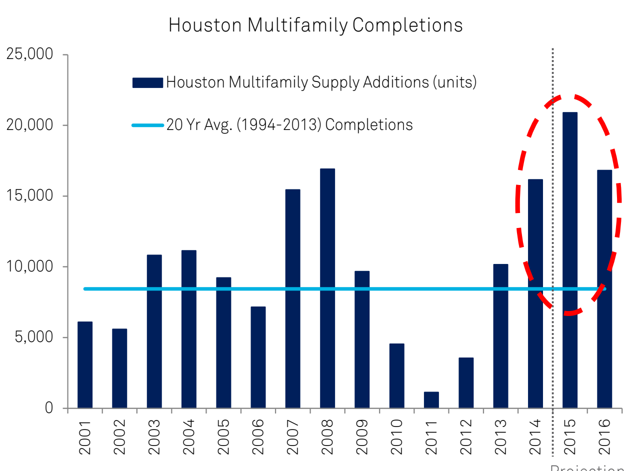
Supply Is Not a Sneaky Foe

Contrary to popular opinion and what they would teach you in some of our finest academic institutions, to succeed in investing in real estate it is essential that investors be able to time the cyclicality of the markets correctly. Identifying the catalyst that causes the capital markets to retrench is challenging to say the least, but understanding where you stand, at least on a relative basis, within the flow of the capital tide is mandatory for success. Conversely, the supply pipeline approaches like the train in the distance, and therefore allows itself to be anticipated, predicted and subsequently traded upon. Supply and demand are rather evident metrics to front run given the level of data available in today's marketplace.

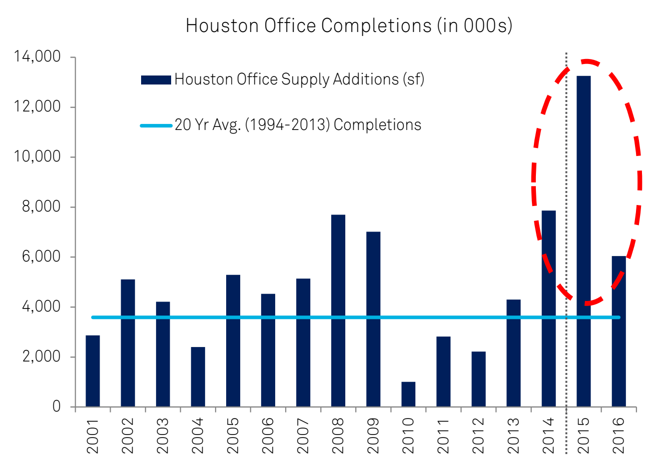
Houston: The Leopard Can't Change Its Spots

Over the course of the past ten years, CenterSquare made a conscious decision to overweight its investment activities in Texas in general, and in Houston in particular. In the fourth quarter of 2013 we discussed the new supply pipeline of office and multifamily property that was approaching, and we proactively decided to exit those asset classes completely in 2014.

With that objective, CenterSquare sold its last office asset in Houston with the sale of 1301 Fannin, a 784,000 square foot office and data center, which was the single largest investment in CenterSquare's second value-add fund. The market call to exit Houston was made based primarily upon the pending pipeline of new product entering the market, coupled with Houston's demonstrable history of boom and bust cycles.



Source: CoStar Portfolio Strategy, 4Q 2014



Source: CoStar Portfolio Strategy, 4Q 2014

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While we could not have projected the magnitude of the recent oil shock that is coinciding with the delivery of the abundant supply of office and multifamily property, its potential impact on Houston real estate demand was evident. The reliance on energy to drive the demand component of the fundamentals equation in Houston, coupled with the city's lack of barriers to entry for development, helped us to expedite our conclusion to exit.

It is unknown at this point whether the oil shock has caused the marginal projects in the pending pipeline to be stopped or not – only time will tell. Either way, we will be watching the Houston market closely to look for a proper re-entry point once the lagging trains have been denied access to the station and thrown the market more substantially off balance.

Source: Wall Street Journal, February 11, 2015

WHAT NOW?

Current Asset Class Observations

CenterSquare is a contrarian investor by nature, which means that we will often pursue opportunities that benefit from the good fortune of being out of favor with the majority of the investing community. We find these asset classes offer more attractive initial pricing, and therefore better downside protection, because their perceived risk is greater than their actual risk from our perspective.

Good Vintage Opportunities

Though every asset is unique in real estate, certain asset classes find themselves as either out of favor or overbought in today's environment. Currently, as we sift through the pool of potential opportunities, we find that the most attractively priced raw materials for our value-add strategies are generally suburban office and non-grocery anchored (or dark grocery anchored) retail properties. In addition, we are also attracted to the demographic tailwinds that will benefit senior housing for the next 35 years.

Suburban Office: Differentiated Parking Is the Key

Suburban office is the most categorically out of favor asset class today for many reasons. First, suburban growth which was so robust as baby boomers moved to the suburbs, is now viewed as a challenge in the age of the urban focused millennials. Given that growth is going to be more scarce in suburban markets, it is important to target markets with true absorption potential as evidenced by population growth and job creation.

Second, parking is the great differentiator in the marketplace for suburban office properties. Office parking ratios of 4 spaces per 1,000 sf were sufficient in the 1980's when architects were allocating 250 sf for each occupant. Now that occupant density has doubled (often 125 sf or less per occupant today) due to corporate cost cutting, it is imperative that potential tenants are able to squeeze more value out of every inch of their occupied real estate. Therefore, legacy suburban office product must be able to change its existing parking capacity (as well as its capacity to heat/cool/circulate air, etc.) to be able to satisfy this changing dynamic, or it will become physically obsolete as tenant leases roll over. The ability to modify/grow/enhance the parking capacity of an asset will prove the ultimate differentiator in the marketplace and drive the success or failure of the legacy inventory of this product type.

Retail: Anchors Are Often Owners

Non-anchored retail is largely out of favor, as investors worry about the over-retailed marketplace, the credit of many of the national chains, and the specter of online shopping. Retail properties are positioned to become a tale of binary performance with winners driving strong sales per square foot, and losers being redeveloped into updated formats or alternative uses. Some of the best areas for value creation in retail today stem from

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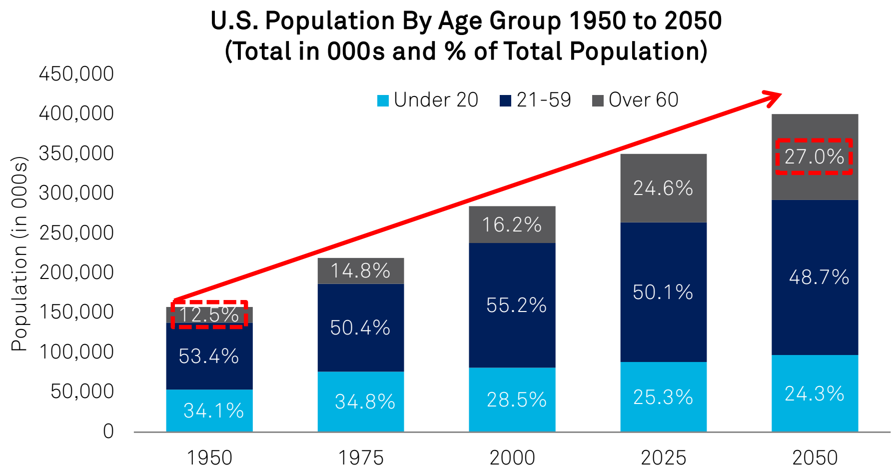
creating outparcel opportunities at existing centers. The most interesting opportunities may exist in controlling the redevelopment rights embedded in anchor leases and reciprocal easement agreements to leverage control of a center's redevelopment away from the existing owner. In some cases, these contractual rights may be worth more than the actual real estate square footage itself.

Senior Housing: Demographic Tailwinds



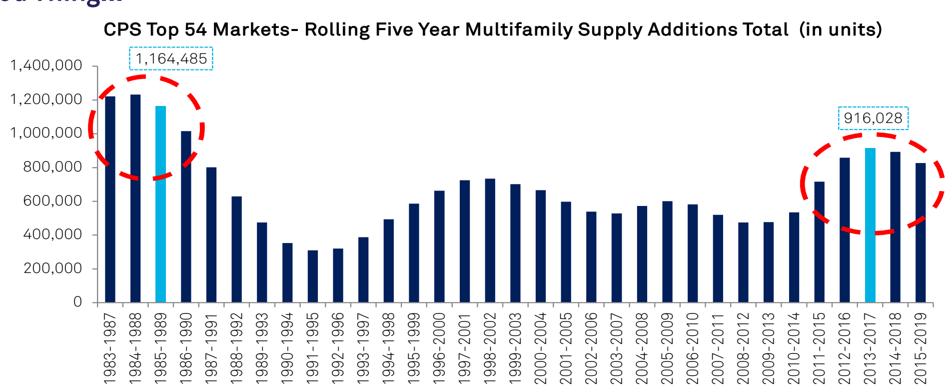
Source: United Nations, Department of Economic and Social Affairs, Population Division (2013). World Population Prospects: The 2012 Revision, DVD Edition.

Senior housing will benefit from the convergence of four trends that should result in opportunity. First, senior housing appears to be the only real estate asset class where the current demographic forces will create a tailwind for investment performance. The senior population is anticipated to double from 2015 to 2050, and this does not even take into consideration the increased longevity that will clearly result from advances in medical technology that will manifest during that timeframe. Second, this increased longevity will result in increased demand for senior housing in all levels of acuity especially at the assisted end of the spectrum. Third, the entrance fee component of senior housing is largely out of favor with the capital markets due to the lumpy nature of this revenue stream and its high correlation with the housing market. Finally, many of these assets have traditionally been operated as not-for-profits with significant subsidies provided by affiliated religious organizations to cover operating shortfalls. Given the increasing inability to fund shortfalls and capital improvements going forward, these owners will provide a significant inventory of capital starved assets in need of operational conversion to for-profit status. This trend will be most evident in the aging stock in the Northeast, and we will keep our eyes keenly on the supply pipeline, because marginal product will be delivered to compete with better located, historical infill assets.

Bad Vintage Opportunities

Solid investing involves avoiding the assets or situations in which the actual risk has become greater than the perceived risk. That may seem obvious, but it is often forgotten. It is hard to make money buying assets which the market perceives as relatively risk-free, because investors bid up pricing to reflect their need to be paid a de minimis risk premium. Risk premiums are a form of margin and safety, and when margins get thin and pricing gets full, then it is often prudent to find a new place in which to make investments. With that in mind, there are a few asset classes and markets in which risk premiums have eroded to uncomfortably thin levels.

Multifamily: Too Much of a Good Thing...



Source: CoStar Portfolio Strategy, 4Q 2014

Multifamily values are historically high in the current environment, with assets trading at record low cap rates as well as all-time highs on a price per unit basis. These rich values, coupled with the fact that multifamily was the only asset class that could attract construction financing coming out of the downturn, have resulted in a

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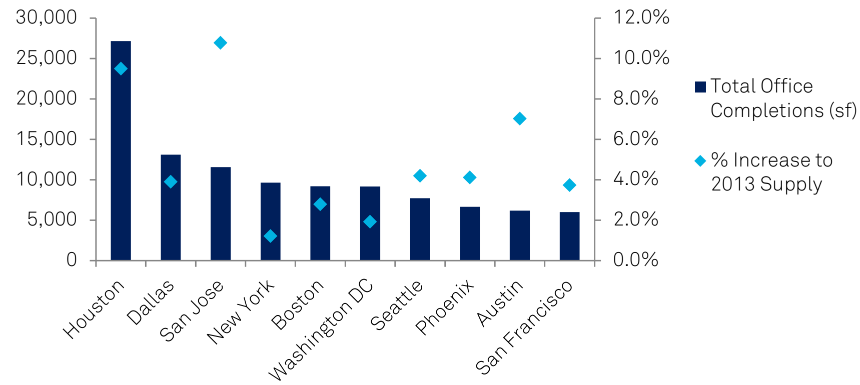
significant wave of new supply that is delivering in many major markets. This may result in the most significant overbuilding in this asset class since the late 1980's. From 2013 to 2017, in the top 54 metros tracked by CoStar Portfolio Strategy, over 916,000 units are projected to be delivered. This is the largest projected increase in multifamily supply in over 25 years for a consecutive five year period. 2015 is anticipated to be the peak of that five year period, and the result may be future buying opportunities in select markets.

CBD Office: It Comes in Bunches...

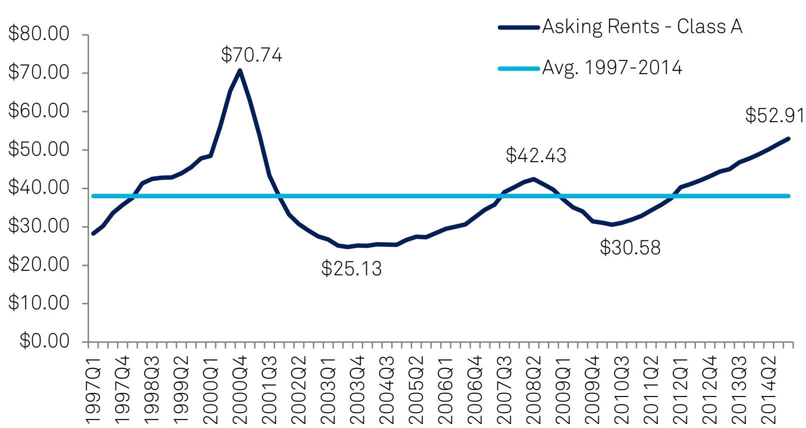
While CBD office has not experienced the same level of across the board supply increase as multifamily, it appears to be getting overbuilt in a few select markets. Given the long lead times and lumpy delivery of office towers, it is easy for these assets to deliver a significant level of oversupply as they tend to break ground at the same time, and arrive en masse at the station resulting in significant overcapacity.

Top Projected Office Completions (in 000s) by MSA - 2014 to 2016



Source: CoStar Portfolio Strategy, 4Q 2014

San Francisco Class A Office Asking Rents ($/PSF FSG) 1Q 1997 to 4Q 2014



Source: CoStar Portfolio Strategy, 4Q 2014

We have already touched upon the Houston market, but the Bay Area (San Francisco and San Jose) and New York represent additional markets in which capital has become enamored with the environment and significant pipelines of supply are moving towards delivery. Over the past 30 years in particular, the Bay Area has experienced at least three cycles of significant volatility in which rents have spiked before reverting back to longer term averages. Most recently these have been collapses brought about by a pullback in demand, but this time around it appears as though the market will have significantly more new supply to add gas to the demand fire should the current technology boom run out of steam.

This fact highlights an important point that differentiates the current environment from that of the last few cycles. The past few real estate downturns generally resulted from the pull back of demand from the marketplace. These were economic or capital market driven corrections that stopped the growing supply pipeline from getting out of hand in each case. Not since the 1980's have we experienced a true supply led shock, and for those that remember, the memory is that supply gluts can be much more challenging to work through than capital market retrenchments. The question for today is whether the economy and the current interest rate environment will continue in a manner that will allow for the current supply pipeline to fully manifest, or whether an increase in rates or some external shock will stop the construction before it gets out of hand. Either way, the first to deliver the highest quality assets with the least amount of debt should be able to find their way through the aftermath. The later arriving marginal assets built with maximum leverage will result in distressed opportunities for those willing to wade back into the market when the perception of risk again exceeds the risk itself.

CONCLUSION

Dare to Be Different

Given this world of global yield compression and geopolitical uncertainty, the U.S. will continue to attract foreign capital seeking the safety and security of our shores. Investors need to recognize that ours is a cyclical business, even when awash in capital, and that timing of entry and exit are still critical to delivering superior investment performance. Therefore, focusing on assets and/or markets that are currently out of favor represents the best chance of delivering stabilized income streams at a competitive cost advantage, which translates into profits for investor capital. Following the herd in chasing the most sought after investment opportunities of the day is almost always a recipe for underperformance. Sometimes it is better to go it alone, and pursue opportunities that others think are too menial or labor intensive to warrant their attention and effort. It seemed to work for the Little Engine That Could..............

P. J. Yeatman
Head of Private Real Estate

P. J. Yeatman

Mr. Yeatman is the Head of Private Real Estate at CenterSquare Investment Management and a member of CenterSquare's Management Committee. Mr. Yeatman is primarily responsible for leading the Private Real Estate business, including his role as Chair of the Private Real Estate Investment Committee, while retaining day-to-day responsibilities for the existing fund and separate account assets. He has over 20 years of real estate investment, redevelopment and restructuring experience in all property types and most major U.S. markets. Prior to joining CenterSquare in 2012, Mr. Yeatman founded CoveredBridge Ventures in 2011. Previously, he spent 11 years at Lubert-Adler partners, last serving as its Senior Managing Principal. At Lubert-Adler, Mr. Yeatman participated in the raising of $6 billion of equity, and led the firm's activities in distressed and public to private transactions. Mr. Yeatman earned a Bachelor of Science in Economics and Marketing from Babson College and a Masters of Science in Real Estate from Massachusetts Institute of Technology. Mr. Yeatman was published in the Journal of Real Estate Economics and has been a guest lecturer at the Wharton School of the University of Pennsylvania. Mr. Yeatman served on the Board of Directors of both Mervyns and Central Parking Corporation.

Definition of Indices

The following indices were included in the commentary for illustrative purposes only and have been selected as they are well known and are easily recognizable by investors. The indices have volatility and other material characteristics that may differ from actual investments, are unmanaged, are not available for direct investment, and are not subject to management fees. Because of these differences, benchmarks should not be relied upon as an accurate measure of comparison.

S&P 500 *The S&P 500 is an index that is considered to be a gauge of the U.S. equities market. The index includes 500 leading companies spread across the major sectors of the U.S. economy. The index focuses on the larger cap segment of the U.S. market and represents approximately 75% of the market capitalization of U.S. securities.*

NASDAQ *100 The NASDAQ 100 is an index composed of the 100 largest stocks based on market capitalization traded on the Nasdaq (National Association of Securities Dealers Automated Quotation system). The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies including investment companies.*