THE NCREIF TRENDS REPORT: THE STATE OF THE INSTITUTIONAL REAL ESTATE MARKET

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Most participants in institutional, private equity real estate have focused predominantly on the NCREIF Property Index (NPI) return data released quarterly. Quarterly total returns are provided for the NPI on an unleveraged basis, covering both the appreciation and income return components. The NPI has also been used as a standard to compare private equity real estate returns, to returns on other broad asset classes.

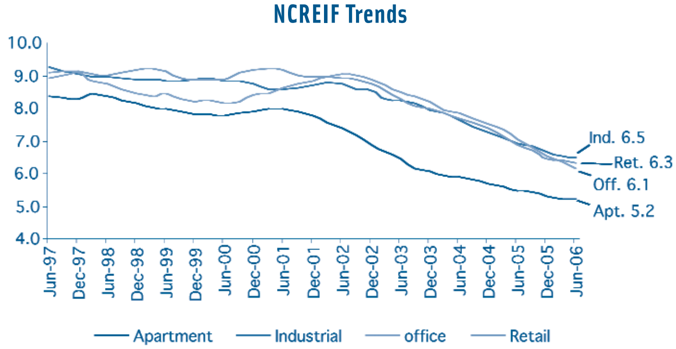
Within the NCREIF database, however, there exists a rich selection of much more detailed information across all the properties included in the Index. A less widely known supplement to the NPI is the NPI Trend data. This data set details transaction activity in the NPI and reports transaction cap rates for the overall index. It also includes current value cap rates, which are cap rates for only those properties revalued in the current quarter. It also reports detailed time series on vacancy rates and same store net operating income growth disaggregated by region and by property type.

So what does the NCREIF Trend Report reveal about the fundamentals and investment market conditions of US commercial real estate? Are the trends different than what is currently being reported by outside third party vendors such as Real Capital Analytics, Torto-Wheaton, or REIS? The analysis of the NCREIF Trend data first covers investment market conditions and follows up with an assessment of the fundamentals across the NPI assets.

Cap Rate Trends and Investment Market Conditions

One of the most important data series from the trend report is the current value cap rates. Exhibit 1 graphs the current value cap rates across the four broad property types, covering the period 1997 through the second quarter of 2006 on a 4-quarter trailing basis. Yield compression is evident across all sectors.

Exhibit 1
Current Value Cap Rates
NCREIF Trends



Source: NCREIF, data through Second Quarter 2006

Real Capital Analytics
Average Transaction Cap Rates

	2006:Q1	2006:Q2
Apartment	5.9%	6.1%
Industrial	7.2%	7.0%
Office	7.0%	7.1%
Retail	7.0%	6.9%

Source: RCA

Apartment cap rates, at 5.2%, were the lowest among the four property types, and the highest was for industrial, at 6.5%.

Average transaction cap rates as reported by Real Capital Analytics (RCA) for the past two quarters are also provided for comparative purposes. RCA reports higher cap rates than the current value cap rates in NCREIF. This discrepancy is a function of differences in both coverage and methodology. RCA covers a much broader universe of properties, all properties valued over $5 million and located in primary, secondary, and tertiary markets. Properties in the NPI, however, represent institutional grade properties or the best properties, in the best markets. These are newer, Class A properties in each sector which have garnered the largest portion of institutional capital. Cap rate compression has been greatest among these properties.

In addition, the NCREIF Cap Rate methodology uses a trailing net operating income (NOI) which is actual accounting data from properties, while the RCA data is based on a one-year forward forecast NOI. The NCREIF Cap Rate should be lower than the RCA cap rate in a time period when fundamentals are improving.

Current value cap rates in the apartment market appear to be stabilizing. After rising to 8.0% in 2001, apartment cap rates have declined to 5.2% over the past four quarters. There is some evidence that the apartment investment market is cooling, however. Higher interest rates and the disappearance of positive leverage have resulted in a slowdown in condo conversion activity. This is taking some of the froth away from apartment market pricing.

Industrial cap rates also continue their downward trend, averaging 6.5% over the past four quarters. In line with the apartment market, current value industrial cap rates have been stabilizing in recent quarters. Most of the industrial investment activity has been composed of large portfolio transactions this year. With the Centrepoint privatization earlier this year, industrial transaction volume has been the strongest among the four property sectors. Average cap rates continue to trend lower for properties in the better submarkets.

The office sector was the only property type to report further cap rate compression. Capital values on a nominal basis are at an all time high for office real estate. A prime property in Midtown Manhattan recently traded in excess of $1,000 per square foot. These prices reflect the top of the market for core, Class A property. Reflecting such higher pricing, current value cap rates for office averaged 6.1% in the past year, trending down from 6.4%. Similar to industrial, investment activity in the office market has been led by a few large transactions. Cap rates continue to compress for larger, newer properties, located in the primary markets.

The downward trend in cap rates is also evident in the NCREIF retail properties. Current value retail cap rates averaged 6.3% over the past four quarters, yet sales volumes are reportedly lower this year as compared to year-ago levels.

Of the four property types, retail was the most out of favor during the late 1990s. Historically, current value cap rates for retail have been the highest among all four property sectors. During the boom years of the late 1990s, retail's stable but slow growth performance was viewed as a negative. More recently, retail has received renewed respect from the capital markets,

Exhibit 2
NCREIF Current Value Cap Rates by Region

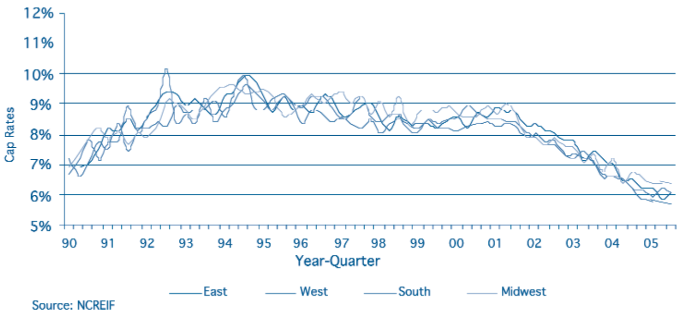
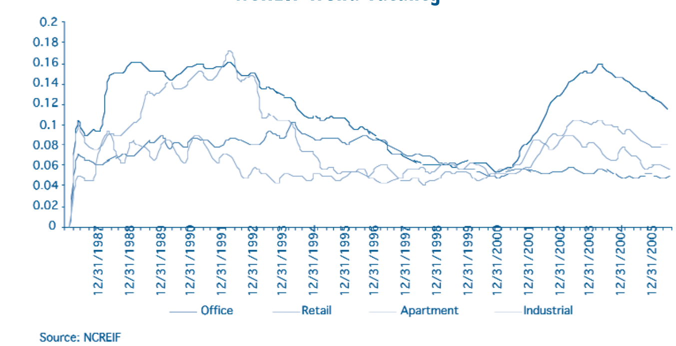


Exhibit 3
NCREIF Trend Vacancy



especially since the 2001 downturn. Its relative stability was embraced as a virtue. Retail properties in the NPI have seen the greatest cap rate compression, almost 300 basis points, as compared to the other property sectors.

Regional variations in current value cap rate trends are captured in Exhibit 2. All regions report declining cap rates, with the West reporting the lowest cap rates. Not surprisingly, the slow-growing Midwest reports the highest cap rates as compared to other regions. These regional variations are also confirmed by recent transactions where spot cap rates remain the lowest on average in the West followed by the East. High-barrier to supply real estate markets continue to attract a larger proportion of institutional capital.

NPI Vacancy Rates and Fundamentals

Property market fundamentals have been in recovery over the past two years, as reflected in the vacancy rate trends in the NPI. (Please see Exhibit 3) Vacancy in the NPI retail properties has been the lowest, averaging 5% over the past year. By contrast, the office market continues to exhibit the greatest degree of disequilibrium, with vacancy rates close to 11.5%. Across the board, however, real estate fundamentals of properties in the NPI have improved, buoyed by an expanding economy and relatively robust job creation over the past four years.

Based on the NPI reported vacancy rates, the US apartment market enjoyed a 110 basis point drop to 5.8% year ending second quarter 2006. This trend is in line with what REIS is reporting for the same time period. The apartment vacancy rate has hovered within a narrow band of 40 basis points over the past year. Steady absorption paired with restrained construction activity of "for-rent" housing has allowed the apartment market to gain traction. On a regional basis, the tightest apartment markets are located in the South.

Net operating income (NOI) of apartment properties in the NPI increased 13.8% in the last four quarters. This resulted from both a burn off in concessions and also higher face rents. Apartment NOI growth was strongest in the West (20.4%) and South (11.9%), followed by the East (11.4%) and Midwest (8.0%).

Industrial vacancy rates continue to improve across all regions as well. Near-record demand, paired with a relatively modest supply pipeline, resulted in tightening market conditions. NPI industrial vacancy rates averaged 8.0% over the past four quarters (year-ending second quarter 2006). The NPI industrial properties are reporting better supply-demand characteristics than those captured in the larger Torto-Wheaton universe. While Torto-Wheaton reports the same improving trend in industrial vacancy rates, their reported vacancy rates averaged a much higher 10.4% for the same period. On average, properties in the NPI are stabilized, newer assets located in the better markets. This may partially explain the divergence in reported vacancy rates.

Industrial NOI has recovered, averaging a modest but positive 2.6% over the past four quarters. All regions reported positive NOI growth with above-average increases accruing to the fast-growing South (8.6%) and relatively supply-constrained East (5.8%).

The recovery in office is now firmly established at a national level. Office vacancy rates from the NPI show continued improvement in fundamentals with an 11.4% vacancy rate. Similar to the industrial sector, Torto-Wheaton reports a higher national office vacancy rate of 13.2% for the comparable period. Again, the NPI covers the universe of properties which are predominantly stabilized and, hence, should report better operating performance.

Over the past two years, existing office supply has been absorbed at a healthy pace leading to healthy NOI growth. Office NOI growth in the NPI has increased over the last four quarters, averaging an impressive 5.3%. NOI growth in the East (7.6%) leads all regions. Money and financial services centers are the leading office markets in the US. New York and Washington, DC remain among the top two office markets in the nation.

Retail markets have been exceedingly strong during the past four years. Retail vacancy rates in the NPI have been steady over the past four quarters, averaging 5.0%. REIS reports a higher 6.6% national retail vacancy rate for the same period. Looking at the volatility in vacancy rates, it appears that the office, industrial, and apartment markets were severely impacted by the 2001 economic downturn. Retail markets were moderately impacted and have continued to see healthy rent growth.

Retail NOI grew an average 4.6% over the past four quarters, after growing fairly steadily at 2-3% in the prior four quarters. Retail NOI growth was substantially different across the regions, with the South (10.7%) leading and the Midwest (-0.1) trailing. The East (4.9%) and the West (2.8%) were average performers.