Real Estate Insights, Forecasts & Strategies
Strategic Advantage
Editor: Christopher Lee
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2012…A Year Of *Dubitare*

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Friends & Colleagues:

"We made it!" These three words truly describe the emotional state of the real estate industry as it enters 2012. For some, that statement means arriving at the finish line after a financially challenging recession and tepid recovery. For others, these three words mean arriving at the starting line for a new real estate cycle about to begin. **The contrast between those who are ending their journey and those who are eager to start is manifest throughout the real estate industry**. However, for both groups, the eventual outcome and determinant of success over the next 12 months can be described in one word…*dubitare*.

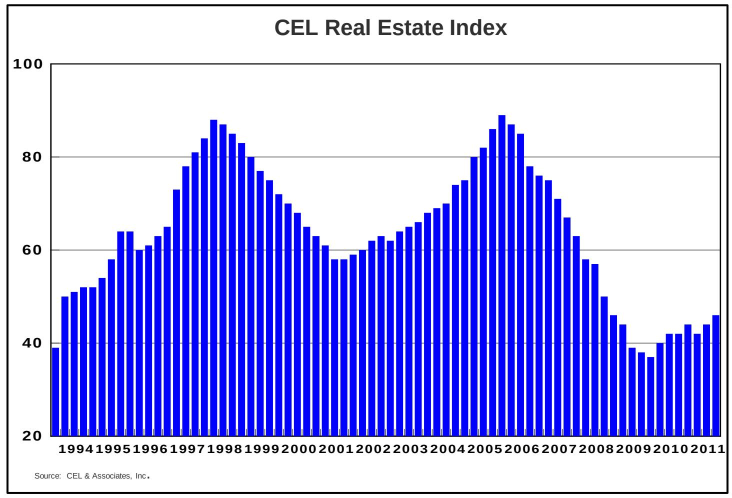
In the last year of an ending and soon-to-be first year (2013) of a new real estate cycle, exactly the time frame in which we find ourselves today, the best word to describe the actions and behaviors of many real estate leaders and companies is the Latin word *dubitare*. The definition of *dubitare* is "to doubt or hesitate." **In 2012 far too many real estate firms will be reluctant to try something new, engage or consider new opportunities, hire new talent or embrace strategies considered to be either out-of-the-norm or too-far-from-our-comfort-zone.** Many real estate leaders have become *de facto* adherents to Kierkegaard's philosophy of "de omnibus dubitandum," or "doubt everything."

The real estate industry enters 2012 in a tsunami of doubt amid a sea of opportunity. Every positive statement or action seems to be followed by the word "but." **The element of fear and/or *dubitare* is paralyzing decisions on growth, investment and strategic change**. Many cannot see the forest for the trees or as Montaigne said, **"no wind favors he who has no destined port."**

It is crystal clear that those who wait, hesitate, defer, delay and painfully over-analyze every decision will finish second or lower. Inaction breeds doubt and fear of the unknown. However, **2012 offers a unique opportunity to shed the anchors holding you and/or your firm from achieving success**. **Now is the time to shift from being a protector of value to a creator of value** -- to get something done rather than waiting for others to pass you by – to create and implement a plan to win. Yes, change can be difficult and daunting. But now is the time to toss out the old and bring in the new (new thoughts, new ideas, new strategies, new business practices, new priorities and new talent). **In the Age of Consequence and Restructuring, if you wait for the ship of opportunity, you soon will discover that the boat has already left the dock.**

The following pages highlight and forecast what is likely to occur in 2012, and where to find incredible opportunities for growth. However, to capture tomorrow's opportunities, this issue of *Strategic Advantage* should be read without the debilitating disease of *dubitare*.

Global Confusion, Conflict & Contraction



Unfortunately modest improvements within the U.S. economy will be tempered and impacted by global events and a potential global recession in 2012. Global equity markets lost $6.3 trillion in 2011, with more losses expected over the next 12 months. Governments of the world's leading economies have more than $7.6 trillion in debt maturing in 2012. **Borrowing costs for G-7 nations could rise as much as 39% from 2011.** The U.S. should not have a problem attracting demand, but several other countries will struggle. The repeated attempts to address fiscal responsibility and deleveraging are caught in a Rubik's Cube of sovereign, legacy and political constraints. Several countries are statistically bankrupt or teetering on economic collapse (Greece, Spain, Italy, Portugal and Ireland, with Belgium, the UK and France not far behind). **Banks throughout Europe are deleveraging, shedding toxic assets and dramatically curtailing new lending**. Economic growth was only 0.6% during 3Q11 in the 17-country Eurozone. On January 13, Standard & Poor downgraded the credit ratings of France, Italy and Spain, as well as six other European nations. What happens to Italy and Spain could determine the future of the European Union and the euro.

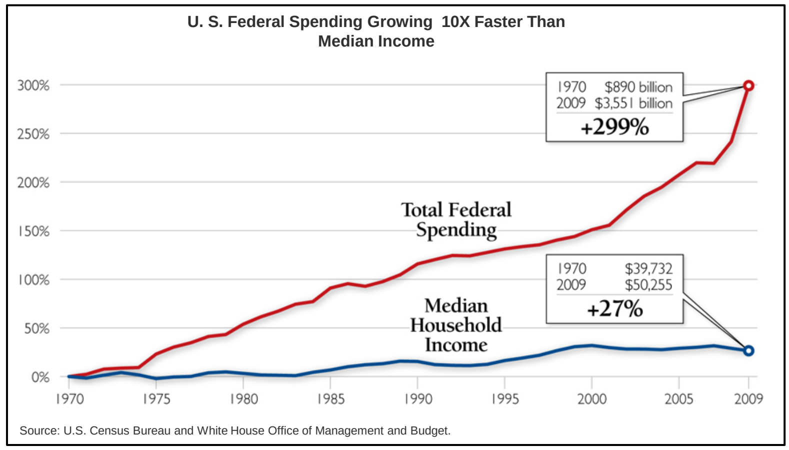
Despite some European governments' attempts to rein in spending, bond yields are rising rapidly as investors continue to lose confidence in "real reform." European banks are more under-capitalized than their U.S. counterparts, and the ongoing political squabbles, which debate but do not resolve the problem, will continue throughout 2012. The bottom line is **an 80% chance Europe (except perhaps Germany and Sweden) will fall into a recession within the next 12 months**…a recession that could be far worse than what the U.S. just experienced. The U.S. dollar will continue to appreciate against the euro in 2012.

Germany is increasingly likely to become the transfer agent for select European countries (e.g., Spain and Italy), but will not bail out Europe. **The euro will continue to fall, and European imports (15% of U.S. exports) will decline.** A European Finance Minister (appointed by Germany) is a strong likelihood to oversee a predicted decade of negative to low economic growth, rising civil unrest, the printing of money and the restructuring of bloated entitlement programs.

The uncertainty regarding the euro and unlikely chance of getting so many diverse countries to sign over their sovereignty to another country will create more *dubitare* in corporate boardrooms, bank lending officers and investment managers. **The U.S. stock market will continue its rollercoaster ups and downs, depending on the plans and outcomes of Europe's financial woes**.

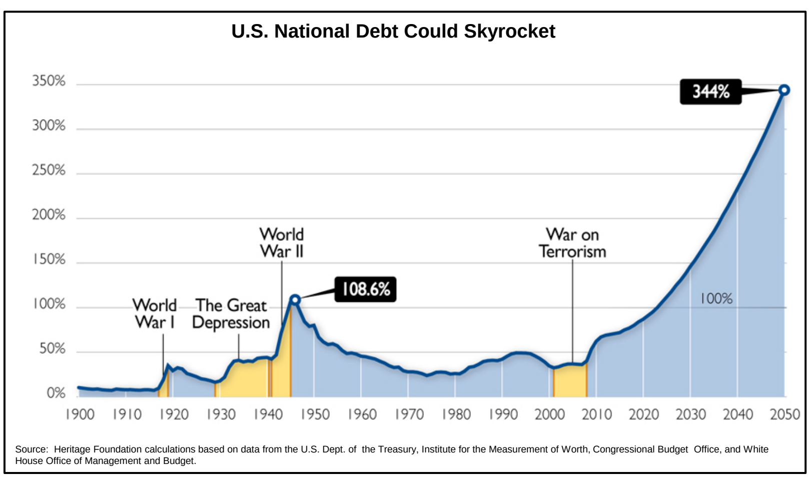
The unrest and turmoil in the Middle East will continue. **The Arab Spring will shift from an earthquake to a long bumpy ride of bloody aftershocks, with little likelihood of resolution over the next 12 months**. Ghosts of the past and future will create a decades-long struggle toward a to-be-determined form of independence. This *dubitare*-induced concern probably will cause oil to jump to $118 or more a barrel (the cost of a barrel is around $100 today), adding 15% – 20% or more to the current price of a gallon of gas (currently nearly $3.40 per gallon). **China is unlikely to continue its double-digit growth**, and its reliance on exports and a controlled currency will continue to feel the impact of a deleveraging, savings-focused U.S. consumer. I expect China's real GDP growth rate to rise only 5% - 6%. China's real estate bubble is about to burst, and the government's attempt to shift to a domestic-driven economy will take years. With a cheap labor workforce expected to peak in 2014, an economy at around 40% of the U.S. economy and a per capita GDP at only 9% of that in the U.S**., the fear of an economic shift toward China is vastly over-stated**. For the real estate industry, China's slow economic restructuring means growing opportunities for services and intellectual capital providers. Watch for China to continue to invest in or acquire controlling interest in U.S. companies during 2012.

U.S. Economy…Is There An Adult In The Room?



A polarized Congress, a recalcitrant and politically vulnerable President and a dissatisfied public in an election year spell gridlock, movement politics, blame-game sound bites and a stark reminder that kicking the can down the road only creates bigger problems later. **The 2012 election year will be a time for critical thinking…a year of choices along our path dependency.** *Dubitare* is most appropriate when examined within the context of politics as usual. Consumer Confidence ("Present Situation") lingers around record lows (now 46.7). The Conference Board's Measurement of CEO Confidence (now 42) is at a two-year low. **The U.S. now has a record $15.2 trillion in debt, making America's debt officially over 100% of GDP** (in 2010 Greece's debt was 120% of GDP), and President Obama is considering another request to raise the debt ceiling another $1.2 trillion. The U.S. Senate's leadership has not brought forth a budget for the U.S. in over 900 days. No wonder the American consumer is in *dubitare* mode…and shifting from a borrow-and-spend to a save-and-conserve pattern of consumption.

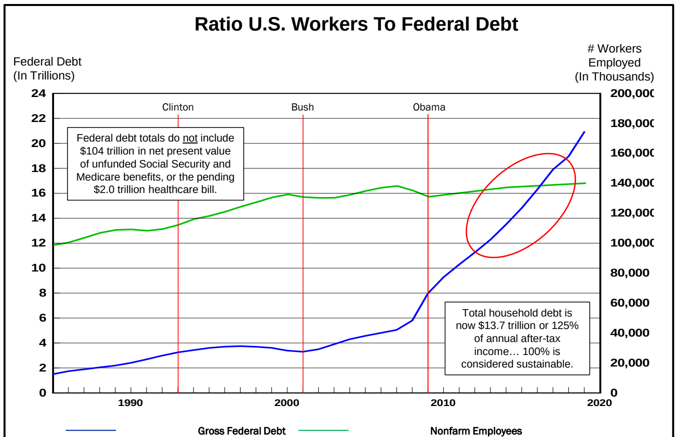
Only 24% of small business owners surveyed by the National Federation of Independent Business, indicated they were planning capital outlays over the next six months, and small businesses account for 52% of all U.S. workers. The Business Roundtable's 3Q11 survey of its members (an association of CEOs with total annual revenues over $6 trillion) found the **CEO Economic Outlook Index dropped to its lowest level (77.6) since 4Q09.** After a tumultuous ride throughout 2011, the S&P 500 ended the year only 0.3% above its close in 2010.



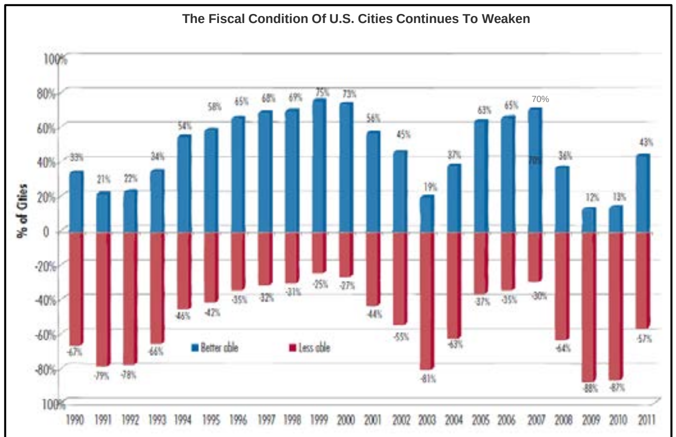
Home prices continue to fall, according to the latest S&P/Case-Shiller report. There are 1.6 million residential REOs or soon-to-be REOs, and combined with 5.4 million visible homes for sale creates a massive inventory to sell in challenging economic times. A more troubling statistic is that nearly **50% of residential loan modifications fall back into delinquency**. According to Zillow, home values have declined 23.7% since May 2007 and are expected to decline another 2% - 4% in 2012. In 2011, U.S. homes lost more than $681 billion in value, which was 35% less than the $1.1 trillion lost in 2010. **Only nine out of 128 markets in the U.S., according to Zillow, gained value in 2011**. I expect home sales to be around 5.3 – 5.5 million in 2012…30% or more of those buyers will be investors. According to CoreLogic, 10.7 million residential properties have negative equity. Moody's Investors Service estimates that more than 50%

of all jumbo loan borrowers are underwater. The states of Nevada, Florida, Michigan and Georgia have an average negative equity of 41.4%.

Since January 2009, new Federal government regulations have added billions of dollars in new costs to consumers, more than any other period on record. According to the U.S. General Accounting Office, between October 1, 2010, and March 31, 2011, the Federal government added 1,827 new regulations, with the annual cost estimated at $38 billion. MSNBC reports that some 40,000 new laws will take effect in 2012. The vast majority could **reduce/restrict consumer spending, add further regulatory controls and dis-incentivize job creation**. This annual cost to consumers could increase dramatically in 2012 and beyond as hundreds of new regulations stemming from the Dodd-Frank financial regulation law, Obamacare and the EPA work through the system.



Source: U.S. Department Of Treasury, U.S. Office Of Management And Budget, Heritage Foundation and Congressional Budget Office.



Source: National League Of Cities.

The repercussions of these new regulations on U.S. consumers, who are historically responsible for 70% of the U.S. economy, will be reduced spending, a lower standard of living and an overall decrease in consumption. **This lower level of consumer spending in 2012 will be a major contributor to an anemic GDP growth rate of 1.7% - 1.9%,** or far below what is needed (3% - 4%) to create an employment rebound and a robust economy. Inflation will likely remain around 2.5% - 3.1%. Rising global protectionism will grow in 2012.

In 2012, public dissatisfaction regarding perceived "generous" pensions, benefits and wages for public sector employees will intensify. According to the U.S. Department of Labor Statistics, public sector employees make 26.5% more than private sector employees. When overall benefits are added, according to the most recent analysis of the Department of Labor Statistics, **Federal civil servants earned average pay and benefits of $123,049 in 2009, while private sector workers made $61,051 in total compensation** (*USA Today* 8/31/10). What occurred in Wisconsin, Ohio and Indiana during 2011 may be a harbinger of events to unfold in 2012 - 2013.

In California, according to CALPERS, 9,111 retired California government workers receive pensions in excess of $100,000 annually. When local government workers are added, according to the California Center for Public Policy, that total exceeds 12,000. And California is not alone…Illinois, New Jersey, Ohio, West Virginia, New Hampshire and Pennsylvania are experiencing major unfunded liabilities. During the 2012 – 2014 period, **I expect a continued exodus of major employers from "too expensive, too many regulations and too many taxes and fees" states like California and Illinois to more private-sector, employer-friendly states like Texas, Virginia and Utah.**

Most stimuli enacted in 2009 and 2010 will be gone by year-end 2011. The Federal Reserve is out or nearly out of solutions to cure the country's economic woes. While **I expect interest rates to remain low through 2012**, the process of financing and refinancing will be increasingly burdensome, exacerbated by "low" valuations given by "gun-shy" appraisers. However, as readers of *Strategic Advantage* know, **now is the time to restructure one's balance sheet, secure new or extended lines of credit, refinance and lock in seven- to 10-year loans at today's lower rates** and restructure potentially challenging loans.

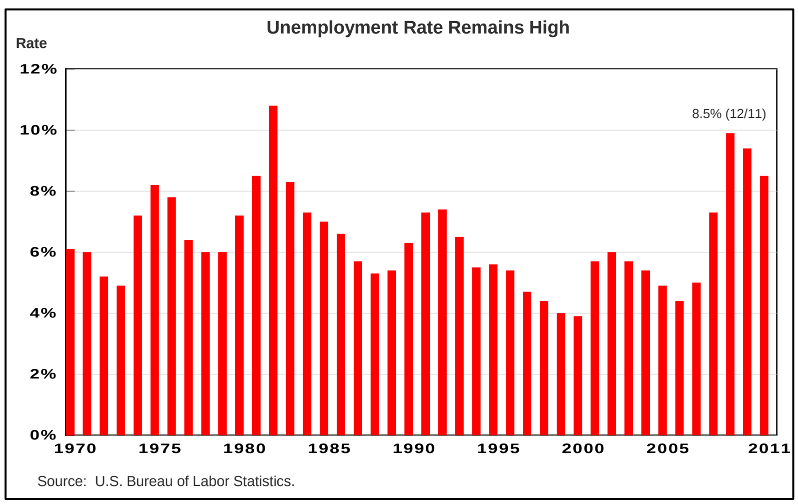
Because 2012 is an election year, the political rhetoric could reach the highest level of voter disdain. Unfortunately, the needed debate and discourse on how to solve the seemingly uncontrollable Federal deficit spending and growing entitlement programs will give way to personal attacks and distractions. But the facts are what they are…the U.S. needs to change its approach to fiscal responsibility, or it will resemble other "entitlement-based" countries on the verge of financial collapse. The August S&P downgrade was an early warning of what may come.

According to the *Wall Street Journal*, **nearly 50% of all Americans now receive some form of government benefit, and 45% of all U.S. households do not pay income tax.** In the 1980s, only 30% of U.S. households received some form of government benefit. Today 45.8 million Americans receive food stamps (15% of the country), up from 17.2 million in 2000. According to the U.S. Census Bureau, over 46.2 million Americans live below the official poverty level…the highest number in 52 years. Kiplinger reports that **student loan defaults are soaring. Only 40% of all loans are being repaid**, and **by 2014, 15% of graduates will walk away from their loans.** By the end of 2012, $1.1 trillion will be outstanding in student loans. Taxpayers are on the hook for 70% of all student loans made by the government. The impact of this increasingly entitlement-based, limited-accountability, societal shift over the past three years is the cornerstone of *dubitare* among the private sector to invest, hire or create new opportunities due to a fear of rising taxes, increased regulation and added employer-based employment taxes and benefits costs.

The good news amid a sea of bad and conflicting economic news and policy, is that 2012 and 2013 should be the bottoming-out years. We hope the absence of political will and leadership in both parties to address the significant national challenges in the U.S. will change. For the real estate industry in 2012, **brace yourself for a mild recession (now around a 30% chance)**, increased fees, taxes, green mandates, more regulations, attacks on the carried interest provisions and a growing shift of employers away from "high cost, employer-unfriendly states" to states that are "fiscally sound, employer-friendly" and have a lower overall cost of doing business. The best states to be in during 2012 and beyond are Texas, Colorado, Virginia, Utah and North Carolina.

Jobs…The Myths & the Reality

Unfortunately, as Robert Anton Wilson stated, "Humans live through their myths and only endure their realities." With an avalanche of data on employment and unemployment being released daily, confusion over a "job saved" vs. a "job created" and a declining unemployment rate and high jobless claims, what is really happening?



First…the "official unemployment rate" is not a reflection of true unemployment. Today's unemployment rate of 8.5% includes only the 13 - 14 million "officially unemployed" workers and does not include:

- ❑ 8.9 million part-time workers who want full-time jobs.
- ❑ 2.6 million workers who are no longer counted as unemployed because they no longer receive unemployment benefits.
- ❑ Millions of self-employed workers who are not fully employed or who have returned to school to learn a new trade.

While job growth appears to be gaining some traction, the **real unemployment rate is around 15% - 17%.** The U6 unemployment rate is 15.2%. Some analysts believe that number could be as high as

21%. Whichever number is used, true unemployment in the U.S. is around twice the "official" unemployment figure released by the U.S. Department of Labor. In addition, the decline in the unemployment rate to 8.5% was not totally due to a growth in jobs, but also a **decline in the workforce participation rate to a 25-year low of 64.2%.** The December nonfarm employment gain of 200,000 jobs is encouraging, but 42,000 job gains came from "messengers and couriers" who are expected to be laid off in January/February. The number of Americans applying for unemployment is now 372,000…for the eighth time over the past nine weeks. The most important number is the 5.8 million jobs not recovered from the 2007 peak. **I expect the U.S. will average around 150,000 jobs per month through 2012**; however, total payroll will still be over 3.0 million jobs below the 2007 peak.

Second…approximately 11 million undocumented immigrants are in the U.S., millions who are working but their employment status is not counted in the Department of Labor statistics. It has been estimated that illegal workers compose up to 5% of the U.S. workforce.

Third…median income of U.S. households declined 2.3% in 2010 to the lowest level since 1996 on an inflation-adjusted level according to the U.S. Census Bureau. Since the recession began in December 2007, median household income has declined 6.8%. It all comes back to jobs and the lack of job creation policies at the Federal and many State levels.

Fourth…boomers are not retiring, so opportunities for younger workers are limited in the hierarchical chain of employment progression. In a recent Associated Press poll, 73% of Baby Boomers plan on working past traditional retirement age. In this same survey, 53% of Boomers polled say they do not feel secure in being able to retire comfortably, and 31% of Boomers believe they will struggle financially in retirement.

Fifth…there are available jobs but the qualifications, skills and experience do not match the unemployed. According to a recent survey by the Manpower Group, more than 50% of employers surveyed indicated that they were having trouble filling jobs because they could not find qualified workers. The **talent shortage is real** and with continued *dubitare* regarding the recovery, **looking for the "perfect" candidate will continue**.

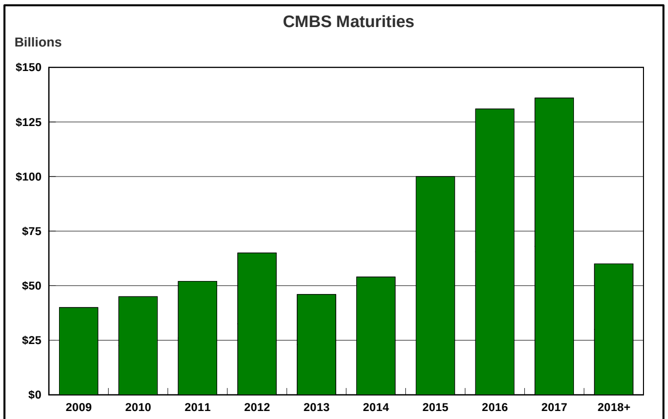
Sixth…while private sector job creation jumped toward year-end 2011, jobless claims remain high, and the anticipated layoffs "after the holidays and year-end" could negate any modest growth in jobs. I am encouraged by the uptick in new factory orders. The ISM Index, now at 53.9, is having its best showing since June.

Seventh…in 2012 women will compose over 50% of the U.S. workforce. Women now hold 52% of all managerial and professional jobs, compared to 26% in 1980. Over the past few years, women have earned 60% of all bachelor's and master's degrees.

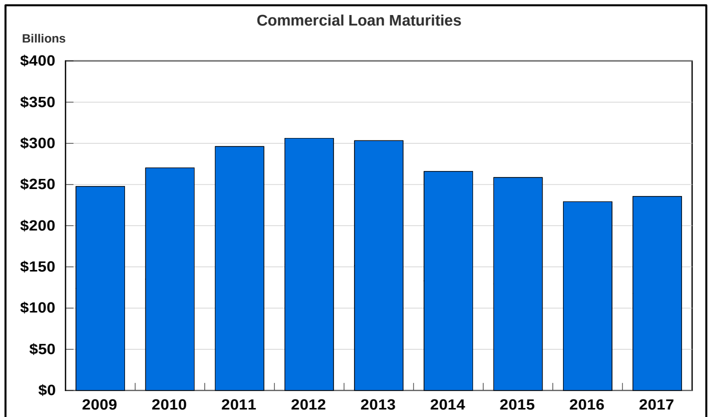
While the list of myths and realities could go on *ad infinitum*, the impact on the real estate industry resulting from high unemployment and a lack of job creation has not been positive. In 2012, there will be far more "debate" and "political sound bites" on jobs and job creation, resulting in no fundamental changes to the current malaise. **Change will not occur until the deadlock in Washington DC is altered.** If change does occur, there could be a tsunami of new job openings as belief in American entrepreneurism is re-established. For real estate firms in 2012, the primary thrust should be on relationships, CRM initiatives, adopting a client-centric business focus, industry specialization, niche marketing, brand enhancement, joint ventures, strategic partnering and emphasis on those conventional emerging "growth" sectors of the economy. **Now is the time to increase, not decrease, new customer/client activities**.

Capital Outlook

The real estate industry is now faced with a plethora of capital seeking a limited supply of opportunities, a lack of debt capital, a continued slow drip of troubled asset dispositions, increased underwriting standards and appraisers who prefer to undervalue true asset amounts. **Equity isn't the problem, but finding deals that work and sellers who recognize that fundamentals will not improve is the challenge.**



Source: Goldman Sachs.



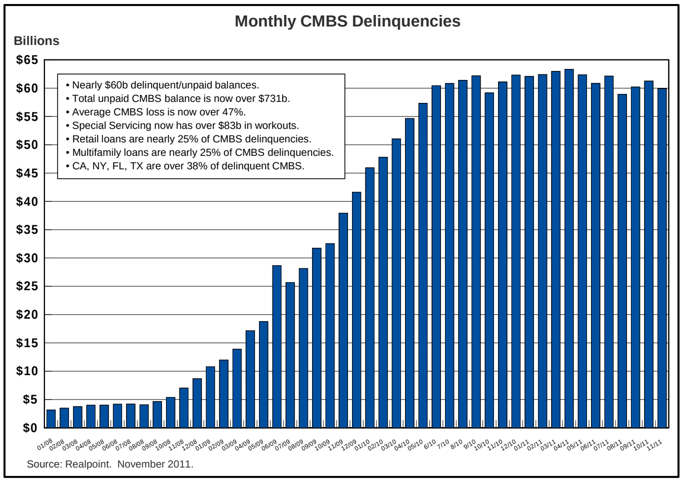
Source: U.S. Federal Reserve.

Compounding these capital challenges are lenders, who prefer to pretend and extend billions of dollars in troublesome CMBS loans that soon will face refinancing problems, and Federal gamesmanship regarding the pace of resolving the 844 U.S. "problem" banks (3Q11). **The combination of too much equity and limited quality assets to acquire has driven cap rates down in several core markets and along both coasts.** With money center banks demonstrating little incentive to lend, insurance companies are now increasing their lending pace. Today the 10 largest U.S. banks hold 84% of all assets held by all 7,830 FDIC insured institutions. In 1995 that figure was only 42%. **Between 2010 and 2014, approximately $800 billion in mortgage debt is maturing, and around 66% may be underwater.** Many mid-sized banks are at risk.

Credit card debt increased an estimated $64 billion in 2011, far more than the previous two years. In 3Q11, U.S. consumers ran up 154% more credit card debt than during the same period a year earlier. While the current credit card debt is not at pre-recession levels**, I remain concerned that irrational or irresponsible exuberance will re-enter our lexicon again during the 2012 – 2013 period.**

And then there are current and pending debt maturities. **Over the next 12 months, approximately $100 billion in CMBS loans are maturing**. Around $32.5 billion of these loans (2,600 properties) were underwritten in 2007. According to Morningstar, in November 2011, the delinquent unpaid balance of CMBS loans totaled $731.5 billion. CMBS delinquency was also impacted by $1.6 billion in liquidations reported for November 2011 at an average severity of 50.5%.

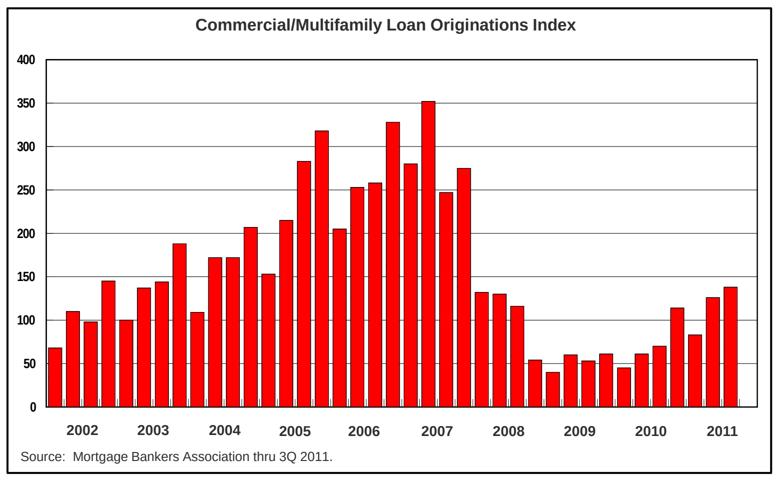
My biggest concern for 2012 is the continued denial of loan modifications or debt restructuring by special servicers. **The delinquency rate for CMBS loans could reach 9.5% in 2012 as the pressure on 12,636 loans on CMBS watch lists exceeds the potential for resolution**. Office buildings (27%), retail assets (24%) and multifamily (24%) are the main delinquency concern categories. California (15%), New York (10%), Florida (7%) and Texas (6%) are the states with the largest pending CMBS problems.



I expect the capital markets to muddle through 2012 and not resolve all their problem loans until 2015 - 2016. In 2012, watch for consolidation among the active conduit lenders and around $50 billion in new CMBS loans to be originated. REITs will continue to have access to capital, insurance companies will increase their lending activity and pension funds will probably begin a gradual shift to secondary markets. **I expect non-traded REITs to continue as active buyers in 2012 and an increase in foreign capital.** Fund capital could revise return expectations to avoid losing capital management fees and an opportunity to earn backend promotes.

I expect overall transaction volume for real estate assets in 2012 will exceed $325 billion. This would be a dramatic increase over 2011 totals (around $200 billion). However there are several factors that will contribute to a robust year for investment sales. These include but are not limited to:

- ❑ Billions of dollars of troubled bank and CMBS mortgages.
- ❑ $360 billion of maturing mortgages, many of which will require significant equity to refinance.
- ❑ A banking industry with $1.5 trillion in commercial debt on their books with a 2012 forecast for declining profits.
- ❑ Increased regulatory pressure (75 – 80 banks could fail in 2012).
- ❑ A likely significant jump in foreign acquisitions due to the global financial crisis.
- ❑ A REIT sector with ready capital to deploy.
- ❑ Billions of dollars in funds with pressure to invest (261 private equity funds in the U.S. alone).



And **remember all those 5-year leases that were signed at the peak in 2007 will roll over this year…most at lower lease rates**.

For the real estate industry, **2012 is the time to**:

1. Lock in 7 – 10 year debt at historically low interest rates.
2. Seek entity-level transactions/investments to secure a long-term pipeline of deal flow.
3. Secure long-term capital relationships.
4. Focus on niche markets and growth sector tenants.
5. Pursue value add and troubled assets (portfolios and single properties).

It is clear that capital, lacking a secure pipeline of investment opportunities, will make investment errors. If you are a capital provider, **drop the one-off investment strategy and shift to a strategic investment model.** If you are a real estate entrepreneur, your best asset is your knowledge and boots-on-the-ground experience, so leverage it by securing a long-term capital source.

Office Sector Outlook

The year 2012 will continue to be a tenant's market as existing and prospective leases keep lease rates down and terms shorter. However, signs show that in core markets and core assets, the prospects for pushing rents are improving. Corporate America will not dramatically increase hiring over the next 12 months, and efforts will continue to consolidate, increase worker productivity, maximize existing space, reduce operating expenditures and lower occupancy costs. Corporate profits appear to be moderating as we go into 2012. U.S. multinationals are returning home as companies discover they can cut costs by reducing the supply chain, and stable labor costs are emerging positive signs. According to Reis, the amount of space occupied by businesses fell during 2008 – 2010. Employers occupied just an additional 20.7 million square feet in 2011. However, the **2012 byline for the office sector is a contrast between the have and have-not markets.** The "have" markets (San Francisco, New York and Washington DC) will do well…others will continue to be a challenge. Suburban office property will struggle with the impact of limited demand. **I expect to see more pure office building owners/operators move into multifamily, select retail-based mixed-use, unique corporate build-to-suits and green conversions over the next 12 - 36 months**.

Tenants have leasing/property choices:

- ❑ "Going Green" will shift leasing preferences to more energy-efficient buildings.
- ❑ Trophy properties will continue to attract investor interest.
- ❑ Corporations will look to consolidate operations and downsize.
- ❑ Throughout 2012, tenants will continue their "wait-and-see" attitude regarding hiring.

The office sector, unfortunately, is going to be in a no- to slow-growth mode for several years. Watch for teardowns of B and C office buildings for mixed-use opportunities. New opportunities will be created from corporate build-to-suits. Identifying and implementing strategies to capitalize on this certainty is a must in 2012. In addition to San Francisco and New York, I like Houston, Silicon Valley (tech hiring is up), Austin, Chicago suburbs, select areas in greater Southern California, Pittsburgh, Baltimore, Seattle, Dallas, Boston, Denver, Charlotte, select submarkets of Atlanta, and Indianapolis. However, **success will be tenant/industry focused (e.g. energy, high tech, R & D).** Watch for the impact of new oil and natural gas discoveries in Ohio, Texas, Colorado, North Dakota and Louisiana on the demand for direct and indirect jobs and space requirements. **Moving to a client-centric business model is a must**.

The best strategies for the office sector are:

1. Focus on tenant satisfaction, retention and building relationships.
2. Shift to establishing a strategic advantage within select growing industry sectors including:

❑ Energy	❑ 24/7 cities that attract Gen Ys
❑ Waste management	❑ Life sciences
❑ R & D	❑ Legal
❑ Intellectual-based service industries	❑ Technology
❑ Healthcare	❑ Software development
❑ Medical devices	❑ Emerging technologies
❑ Alternative energy	❑ Pharmaceutical

3. Consider a diversification strategy (MOBs, Corporate BTS and strategic investing).

Office Sector Facts & Observations

- ✓ According to Real Capital Analytics, office property sales in 3Q11 were $14.8 billion…a 40% increase from a year earlier.
- ✓ Through 3Q11, sales of significant office building totaled nearly $41 billion (1,403 properties sold).
- ✓ While year-over-year cap rates have dropped to around 7.3%, the cap rates for premier properties in the upper quartile have appeared to top out, resulting in a narrowing of cap rates between premier and all other office assets sold.
- ✓ CBD office assets will continue to garner investor interest in 2012, while suburban assets will struggle to address weak fundamentals.
- ✓ Effective office rents are likely to be slightly better (0.1% to 0.3%). NOIs will feel the impact of lower rents and limited lease-up opportunities.
- ✓ Vacancy rates will decline slightly (60 bsp – 70 bsp), and speculative development activity will be very limited.
- ✓ Net absorption could range from 40m – 45m square feet in 2012.
- ✓ Class B markets will still need to offer commissions to keep and attract tenants…at lower rents.
- ✓ In 2011, only 12.3 million square feet of new space was completed…the lowest level in 15 years.
- ✓ 2012 will be another year of hoping-things-will-get-better, but weak demand will persist.

Industrial Sector Outlook

For the first time in years, I expect the national vacancy rate for industrial properties to drop below 10%. However, resist the sudden urge to applaud…I expect effective rent growth to be below 1% and renewal rental rates to put pressure on operating fundamentals. Demand for industrial real estate could exceed 125 million square feet. **The best years for industrial real estate probably will be 2014 and 2015**. Drivers in this slow-yet-steady recovery include: (1) just-in-time inventory storage; (2) improving global trade; (3) e-commerce (direct to the consumer); and (4) improved warehouse and distribution logistics. With current pricing above replacement costs, cap rates are likely to stay about the same through 2012. **There has been little change to the preferred hub markets,** which will continue to benefit from "preferred" proximity to ports, international airports and rail lines. Among these markets are:

❑ Atlanta	❑ Lehigh Valley	❑ Norfolk
❑ Beaumont	❑ Los Angeles	❑ Oakland
❑ Chicago	❑ Memphis	❑ Philadelphia
❑ Dallas	❑ Miami	❑ Phoenix
❑ Duluth	❑ Newark	❑ Seattle
❑ Houston	❑ New Orleans	❑ Tampa

The widening of the Panama Canal will bring added investor/developer attention to ports along the eastern seaboard (Charleston, Jacksonville and Savannah). The ports of Los Angeles and Long Beach lost market share to east coast ports in 2011 (200,000 fewer containers). However, the current economic malaise in many global regions, rising fuel prices, investor and corporate *dubitare* regarding expansion and uncertainty regarding the adopting/embracing of Public Private Partnerships (P3s) will make 2012 a transition year for many in the industrial sector.

I am seeing encouraging trends in rail-based intermodal facilities, infrastructure improvements to road capacity around port areas and an accelerated rise in corporate build-to-suits for cold storage and state-of-the-art distribution facilities. In 2012 and beyond, there will be acceleration in upgrading and replacement of old or obsolete space to keep pace with new storage and distribution business models.

Industrial Sector Facts & Observations

- ✓ According to Real Capital Analytics, industrial sales activity through 3Q11 saw a 57% increase from a year earlier.
- ✓ In 3Q11 alone, seven portfolios of $100 million or more in value were sold.
- ✓ The AREA/Adler portfolio sales were done at a reported 6.1% cap rate.
- ✓ Overall cap rates for warehouse (around 7.5%) and flex space (around 7.9%) are likely to remain the same for 2012.
- ✓ The national vacancy rate will drop to 8.6% - 8.8%.
- ✓ Approximately 35m – 40m square feet could be added to supply in 2012.

For owners, operators and service providers in this sector, **I have the following recommendations**:

1. Focus on capturing a growing volume of corporate build-to-suits, remodels/upgrades and corporate consolidations/repositioning.
2. Renew a high priority for building/growing valued customer relationships.
3. Create collaborative business models to appeal to increasing highly specialized users.
4. Lock in a secured source of capital for growth initiatives.
5. Gain a greater understanding and application of robotics; e-commerce distribution logistics; new stacking systems; improved facility design to reduce turnaround time; new energy saving technologies; and new technology-based inventory tracking systems.

Retail Sector Outlook

Bottom line for this sector is to understand and create/deploy strategies that will capture the new and emerging consumer buying habits. Other than grocery, pharmacies, select "quick shop" retail and food outlets and well-branded retailers, the remaining **70% or so retail tenant base is under significant pressure as it struggles to remain relevant during a period of accelerated retail transformation**. As an example, box office receipts and attendance at movie theaters fell to a 16-year low in 2011. Consumers have less money to spend, and credit card debt remains an issue. Americans are deleveraging, and consumer confidence, while improving slightly, continues to be low by historical standards. A renewed focus on quality, price and service is a welcome trend for Big Box retailers and department stores. **But weak job growth and *dubitare* will contribute to another "lost" year for retailers and retail tenants.** Best opportunity will be in value added.

I expect overall vacancy levels within the retail sector to go over 11% in 2012…a level last reached in 1990. Rents will likely decline 1.0% - 1.3%. According to Reis, only 4.9 million square feet of retail space came online in 2011, slightly higher than the 4.5 million square feet that came online in 2010 (the lowest figure in 31 years). **There is still demand for high-quality malls, strategically-located grocery-anchored community centers and specialty retail outlets**.

Retail Sector Facts & Observations

- ✓ Overall retail sales in the U.S. were $4.7 trillion, an 8% gain over 2010.
- ✓ Food expenditures are now around 9.4% of disposable income.
- ✓ Over the 56-day 2011 holiday season, e-commerce retailers reported $35.3 billion in sales (15% over 2010 totals).
- ✓ Amazon reported a per-week Kindle sales figure of 1 million units during December.
- ✓ Consumers continue to shop or search online before going to brick-and-mortar retailers.
- ✓ E-commerce could become 10% of retail sales in 2012.
- ✓ Non-retail tenants will continue to grow their share of occupancy within retail properties.
- ✓ Larger retail tenants will continue to consider smaller configurations.
- ✓ Likely closing of up to 5,000 stores in 2012.
- ✓ In the first 3 months of 2011, Apple's sales were 20% of all sales by publicly traded retailers in the U.S.
- ✓ December 2011 retail sales increased by only 0.1% (-0.2% if auto sales are excluded)…the weakest increase in 7 months.

Apartment Sector Outlook

What's not to like? With a current atmosphere of strong demographics (around 78 million Gen Ys, a growing population of seniors and millions of displaced homeowners), limited additions to supply, available financing, a tepid market for home buying, a societal shift to a renter-based population, declining vacancies and rising rents, the apartment industry is poised for growth. The darling of investors, the preferred choice for urban communities seeking to revitalize their downtowns and the benefactor of a stagnant economy, **the apartment industry will continue its Cinderella-like journey through 2012 and likely through 2016**.

The problem for apartments is not demand (there is a great deal) or supply (there isn't enough); the problem is the potential impact of a herd mentality. When fundamentals are robust, when pent-up demand for apartments is in the millions and when favorable financing is available, everyone moves to that sector and becomes an "expert," regardless of capability or experience. ***Overheated, highly competitive* and *too many players* are phrases you should expect to hear in 2012; however, that will not stop investor interest in this sector**.

Apartment Sector Facts & Observations

- ✓ With trophy assets trading below a 5.0% cap rate, the focus on long-term market presence becomes a high priority.
- ✓ Around 2% - 3% of the total U.S. apartment buildings become obsolete each year. An increase in "green standards" may drive that to 5% or more over the next decade.
- ✓ According to Real Capital Analytics, through 3Q11 asset sales of significant apartment properties totaled $36.2 billion or a 65% - 70% gain over the same period in 2010.
- ✓ Cap rates have declined to 6.4%, and could drop another 20 – 40 bsp in 2012.
- ✓ Expect overall vacancy levels to drop below 10%, and the vacancy level for institutional assets to decline to 5% - 5.2%.
- ✓ Rents should increase 4.8% - 5.1% nationally.
- ✓ Multifamily permits could approach 200,000, while starts could top 245,000.
- ✓ Pay close attention to the U.S. Supreme Court's decision on rent control.
- ✓ While modest, overall returns will be steady. Over the next five years, apartments should be a safe or best bet for investors, owners and operators.

The challenge for those in the apartment industry is not when but where. There will be significant opportunities throughout the country, and while some of the best markets are highlighted below, the list could go on.

❑ Austin	❑ Houston	❑ San Antonio
❑ Boston	❑ No. Virginia	❑ San Diego
❑ Charlotte	❑ Portland	❑ San Francisco
❑ Denver	❑ Raleigh-Durham	❑ Seattle
❑ Dallas	❑ Salt Lake City	❑ Silicon Valley

The best strategy for investors is to find and secure an entity that can assure a pipeline of development and acquisition opportunities. The best strategies for apartment operators are to lock in a long-term capital source as well as 7 to 10-year debt at today's low interest rates, improve branding activities, invest in future leaders and technology, and plan for a rollercoaster ride of incredible opportunities.

Service Company Outlook

The next 12 months will reward those who excel in client service, valued client relationships, brand equity, leadership, diversification and specialization, and talent recruitment/retention. Property management, finance, appraisal, corporate services and investment sales should expect an increase of 10% or greater in revenue during 2012. Specialty practices, niche services and industry-specific services will do well. Investment sales activity could reach pre-recession levels.

There is no real trouble on the horizon for service providers in 2012 except that which is internally created. Lack of motivated young talent, adherence to old ways of conducting business, poor or no training, lack of a robust research platform, perceived difficult-to-use technology, aging leadership, lack of a commitment to innovation and aim-to-please commission and compensation structures are all performance killers. **What is most needed in 2012 and beyond is a carefully considered strategic and long-range business and growth plan**. Status quo and waiting for all boats to rise with the tide is not an option.

REITs Shift To Growth Mode

✓ Watch for further REIT consolidation, entity acquisitions and an increase in portfolio investments throughout 2012.

Core Strategies For 2012

In a year of transition, uncertainty, political debate and discourse, recalibration, change and *dubitare*, the best option is a combination of offensive and defensive strategies. Real estate leaders must become offensive and defensive realists…and understand that **all great real estate organizations are in a perpetual battle for relevance, opportunity and brand dominance**. While there are specific market, property and operational strategies, **the following is an overriding list of twelve core strategies which should become priorities during 2012**.

Offensive Strategies

- ❑ Set a clear vision, reset your priorities…have a one-, two- and three-plan.
- ❑ Identify, target and pursue only select customer-centric opportunities where you have a competitive edge.
- ❑ Implement a robust branding campaign to create a differentiating story.
- ❑ Revise your compensation plan, lock up your next-generation stars and reward based upon bottom-line results.
- ❑ Enhance your knowledge by creating/supporting a proactive, internal research capability.

- ❑ Take time to perfect sources of recurring income.

<u>Defensive Strategies</u>

- ❑ Secure long-term capital for growth.
- ❑ Lock in all debt at today's historically low interest rates.
- ❑ Disengage from properties, markets and personnel that prohibit the active pursuit and realization of future opportunities.
- ❑ Take advantage of competitors' difficulties (grow via entity acquisitions).
- ❑ Diversify products and services…don't put all your eggs in one basket.
- ❑ Have a plan for succession and sustained governance.

Closing Comments

There is indeed a lot to think about regarding 2012 and beyond. The solutions and opportunities for the real estate industry are endless. However, to remove the shackles of historical precedents, current trending data and *dubitare*, you must envision what can be rather than what once was. Now is not the time to hesitate, doubt or deny the inevitable. **Now is the time to take control of your destiny before the events of the future determine your fate**.

To share your comments, insights or ideas, please email them to newsletter@celassociates.com.

Regards,

Christopher Lee

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