Real Estate Insights, Forecasts & Strategies

Strategic Advantage

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2013…A Time To Ascend

In This Issue

- *The Economy…Far Below Expectations & Trend Lines*
- *Jobs…A Game Board Of Opportunities & Risks*
- *Capital Outlook*
- *Office Sector Outlook*
- *Industrial Sector Outlook*
- *Retail Sector Outlook*
- *Apartment Sector Outlook*
- *Closing Comments*

Friends & Colleagues:

Today isn't anything like yesterday, and tomorrow will not look anything like today. I think Albert Einstein said it best when he stated we need to "learn from yesterday, live for today and hope for tomorrow." In fact, no one knows what will happen tomorrow, and nothing in life or real estate is guaranteed. In this Rubik's cube of economic, financial and governance uncertainty, mixed messages, conflicting opinions, confusing sound bites and can't-believe-it surprises, the outlook for 2013 becomes quite clear.

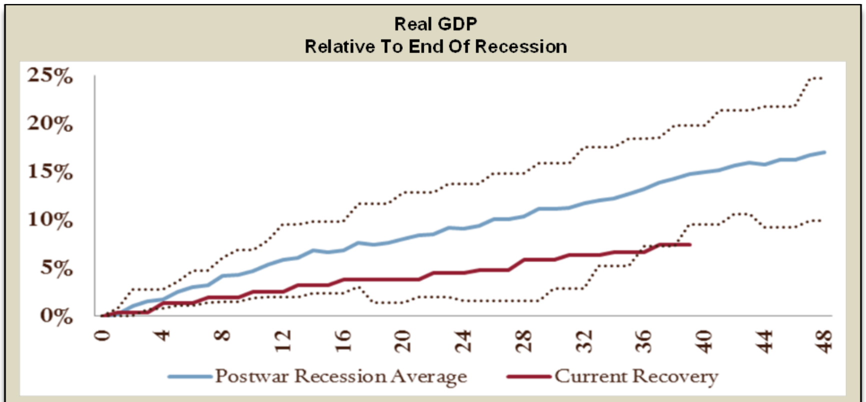
The fiscal cliff has turned into a never-ending slippery slope of debates, disagreements, denials, deferrals and debt…absent practical discourse, rational thought and realistic, long-term solutions. In this what-is-best-for-America's-future debate, **the real estate industry must attend to the business at hand while laying the foundation for future relevance and prosperity**.

It is quite clear from analyzing the trends, **2013 will be a turning point for nearly everyone and a tipping point year for the rest**. Today the real estate industry is at the precipice of historical shifts…from uniformity to differentiating…from full-service to specialization…from more-of-the-same to an aspirational workforce…and from reactive to transformational leaders. **This is no longer a Founder's industry…it is becoming a Successor's industry**. The next-generation leaders are poised and beginning to assume the leadership mantle.

The industry is ending its 50-year run of government and regulatory preference and will soon begin an era of customer-centric, knowledge-based, relationship-driven, talent-focused business practices I would collectively label "Integrative Relevance."

It is within the context of this transformational vibrancy that we enter 2013. While the facts and **some prevailing trends will not favor the real estate industry over the next 12 months**, we are at the tip of an iceberg of opportunities…far greater than what you see or hear. In 2013, the overall theme will be what rock climbers call *grauncy*…"a route requiring the use of unconventional and uncomfortable techniques." Yes, **2013 will be a year of boulders, bumps, cliffs, headwalls, chimneys and overhangs**. However, if you change the way you approach business opportunities and the way you think, and interpret those opportunities and the way you are able to let go of the past, then success can be realized. Now is the time to shift from a protector of value to a creator of value. Now is the time to toss out the old and embrace the new. **This is the Age of Consequence during which controlling your destiny must become the mission, and Integrative Relevance must become the preferred value proposition**.

The Economy…Far Below Expectations & Trend Lines



Source: www.cfr.org/cgs. Data Source: BEA

The current economic recovery following the 2008 recession has been the weakest since the post-WW II era. **Calendar year 2013 will mirror 2012, feel like 2011 and appear, at times, to be 2010.** While the economic policies enacted and the extraordinary costs incurred may have avoided a depression, they have not contributed to a "normal" economic recovery and have clearly changed the relationship between government, private enterprise and the citizens they serve. The Federal debt ceiling debate only weeks away means another long period of uncertainty. Domestic uncertainty will combine with significant global solvency challenges, and the financial markets will exhibit increased volatility over the next 12 months.

In 2013 an increasing number of Americans are realizing that a robust economy is not likely for several years, and when it occurs, they will not reap the benefits. According to a recent study by Towers Watson, only 41% of Americans are satisfied with their financial situation. A study by Pew Research showed that 85% of those who identify themselves as Middle Class say it is "more difficult to maintain their standard of living." In a recent Gallup poll, 50% of adults believe the "best years for the U.S. are behind us." Sixty-nine percent of Americans are more optimistic about their situation in 2013 than they are about the country's fate. Only 26% of Americans, according to Gallup, are satisfied with the way things are going in the U.S.

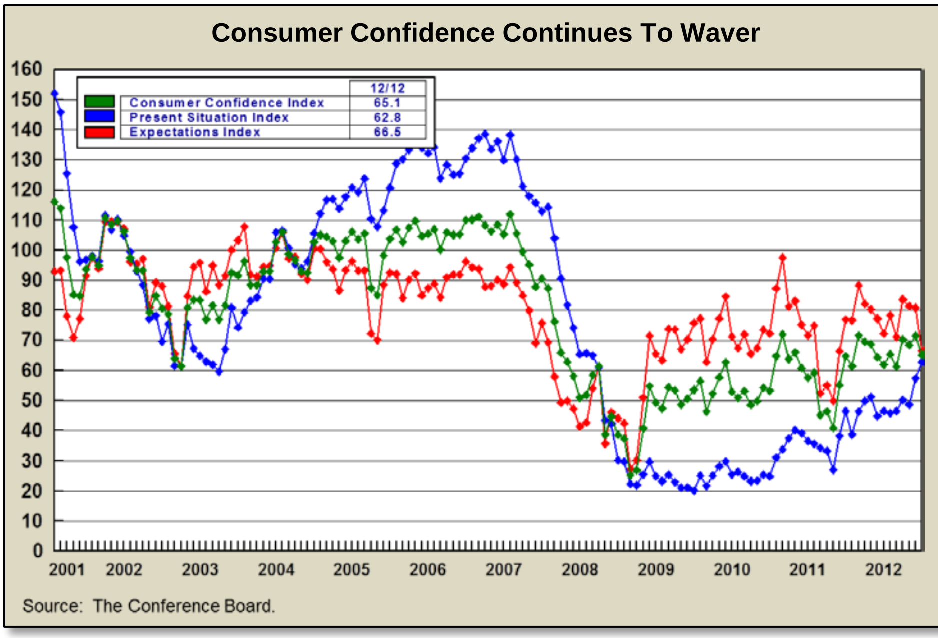
Nearly 47 million Americans are in the Supplemental Nutrition Assistance Program ("SNAP"), formerly known as Food Stamps. This figure is up 47% since January 2009. By any standard, the U.S. should have real GDP growth of 230 bsp to 300 bsp above today's level. **The relative weakness of this recovery is clearly visible in the historically very high number of under- and unemployed**. Nearly 40 months after the start of the economic recovery, GDP is only 7.4% higher than when the recovery officially began. In every previous post-war recovery, the stock of household debt has risen, but not so in this recovery, because the collapse in home prices has caused consumers to reduce or avoid taking on new debt. If the U.S. were in a normal recovery, we would have 15 million to 17 million more jobs.

Looming Economic Threats To The Future Of The Real Estate Industry

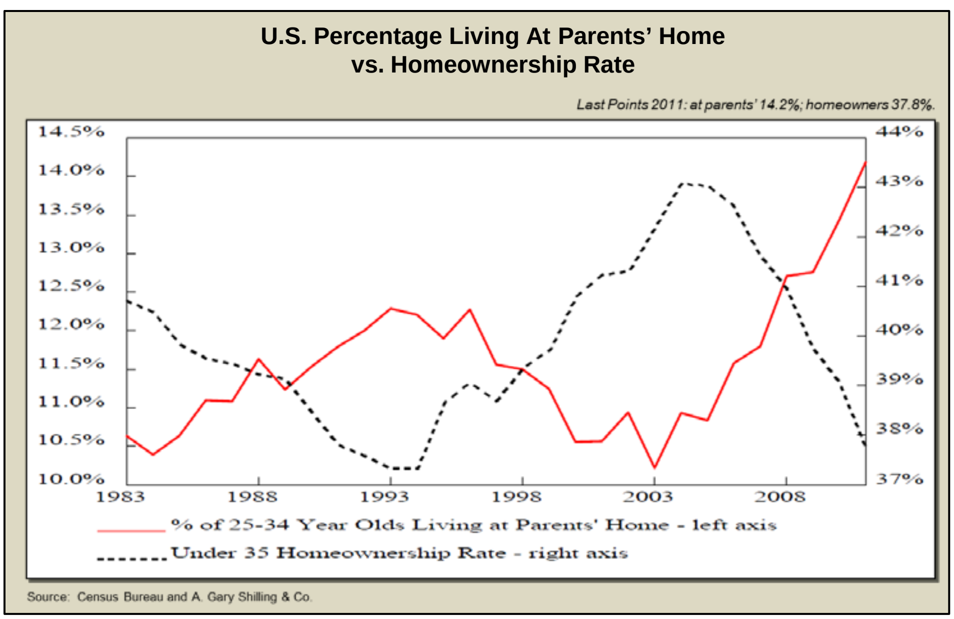
- Social Security…needs $3.7 trillion today to meet future liabilities.
- Medicare…needs $22.1 trillion to fund future liabilities.
- Global restructuring (Europe) and Middle East tensions/conflicts.
- Infrastructure…needs over $1.0 trillion to keep up with demand and decay.
- State Pension Funds…need $2.5-$3.0 trillion to fund future liabilities.
- Health Care…needs $2.0 trillion to fund future liabilities.
- Roaring inflation when the money multiplier rises.
- Federal Debt…now $16.4 trillion projected to rise to over $20.0 trillion by 2020.
- Household Wealth…still $8.0 trillion below pre-recession level.
- Approximately 88 million working-age Americans do not work.

Source: CEL & Associates, Inc. and various news sources.

According to The Conference Board, consumer confidence in December fell to its lowest level (65.1) since August. The Expectations Index declined sharply to 66.5, down from 80.9 in November. Aging consumers say they will not add to their existing debt burden. The cornucopia of economic policies (TARP, Cash for Clunkers, American Recovery and Reinvestment Act, HARP and numerous bailouts) has added to the national debt, created more dependents and delayed the inevitable day of reckoning without creating a normal recession recovery. **Low interest rates have removed the pressure on Congress or the President to act**. That could change by 2015 -2016, just in time for the next Presidential election. **The U.S. economic outlook is murky at best in 2013, with no upside momentum or confidence that "things will get better."**

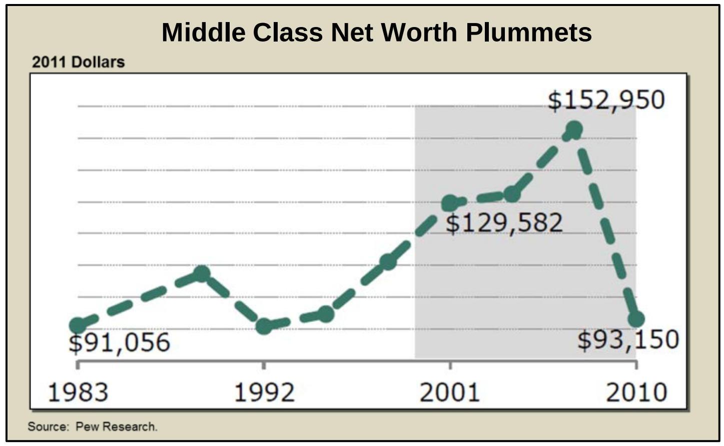


The U.S. is now in its third year of economic recovery, and the real economic growth rate is around 2%. **In an Age of Consequence, U.S. consumers are deleveraging, a process that could take eight – 10 years before a return to normal**. According to the CBO, the recent "fiscal cliff" agreement will add $4 trillion to the U.S. deficit. It's hardly a move in the right direction, and the bond bubble could become the next fiscal crisis. **With a sub-2% real GDP growth rate very likely in 2013: unemployment will remain high,** while the overall workforce participation rate will remain at a historically very low level.



The burden of new and looming tax increases, consumer deleveraging and rising taxes keep many consumers on the sidelines. Stagnant household incomes will keep retail expenditures down. Increased regulations will drive prices up and/or keep job growth down, and a band-aid fix to burgeoning Federal debt will increase the likelihood for a patchwork of economic successes, challenges and failures. The current economic situation is not sustainable and will create significant challenges if not addressed. The uncertainty created by a Ponzi scheme of government dependency is a broken model of fiscal stability and that is not sustainable.

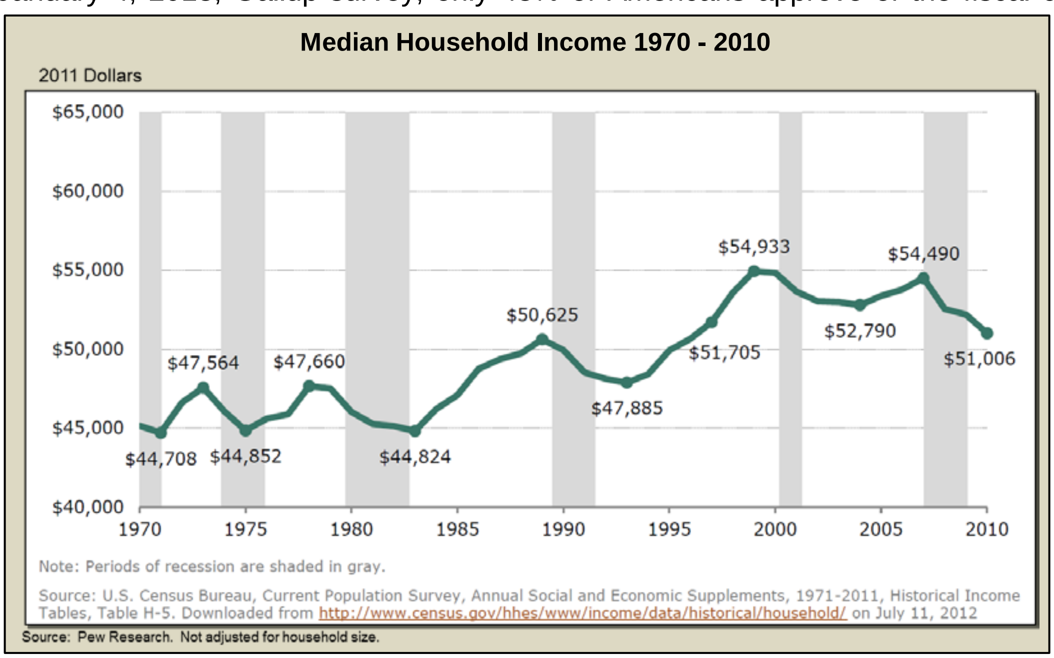
From a political perspective, I doubt Washington will demonstrate the political will to remove pork and earmarks, truly overhaul the tax code or enact relevant tax increases in combination with significant spending cuts. Consequently, the $16.4 trillion national debt will go higher. In 2013, I envision: a potpourri of modest tax increases; "promised" tax reforms and future expenditure cuts that will not materialize to the extent needed; an increase in the debt ceiling; and a flurry of political pronouncements that appeal to each respective voting block but lack any substantive changes necessary for a return to economic vitality. **I expect a credit downgrade by the 2Q if real action is not taken**. The Keynesian multiplier effect of government spending has not worked.



For real estate leaders, ascending the cliff of uncertainty mandates a different way of conducting business – not conducting business differently. Political discourse will continue, and ideologues will create a daily diet of advocacy sound bites. William Shakespeare described it best in Macbeth when he said it was a story "…full of sound and fury, signifying nothing." The solutions to structural deficits will not happen in 2013…thus the need to take control of your plan to ascend and secure future prosperity. **Look to your business model, not to Washington, D.C., for the winning strategies**. Take control of what you can control.

While Round 1 in a 10-Round battle over the fiscal cliff is now in the books, a new war is looming among an aging population (Social Security and healthcare), an entitlement society (SNAP, welfare and unemployment benefits) and the X and Y Generations ("Why should we have to pay for the mess you created?"). In 1960 the share of the U.S. population age 65 and older was 9%...by 2020 and 2030, it will be 16.1% and 19.6%, respectively. Life expectancy by 2020 will be 79.5 vs. 69.7 in 1960. **The battle for proper fiscal balance and economic future of the U.S. is now underway**.

The ratio of workers-to-retirees was 3:2 in 1980 and will drop to 2:1 by 2030. The next 10 years will be a time when trade-offs, sacrifices, give-backs and give-ups will be the daily debate. According to a January 4, 2013, Gallup survey, only 43% of Americans approve of the fiscal cliff agreement. **The best insurance policy for real estate firms facing Integrative Relevance will be talent (surround yourself with the best), capital (one-off trolling for dollars will not work) and leadership (next-generation and transformational leaders must take hold)**.

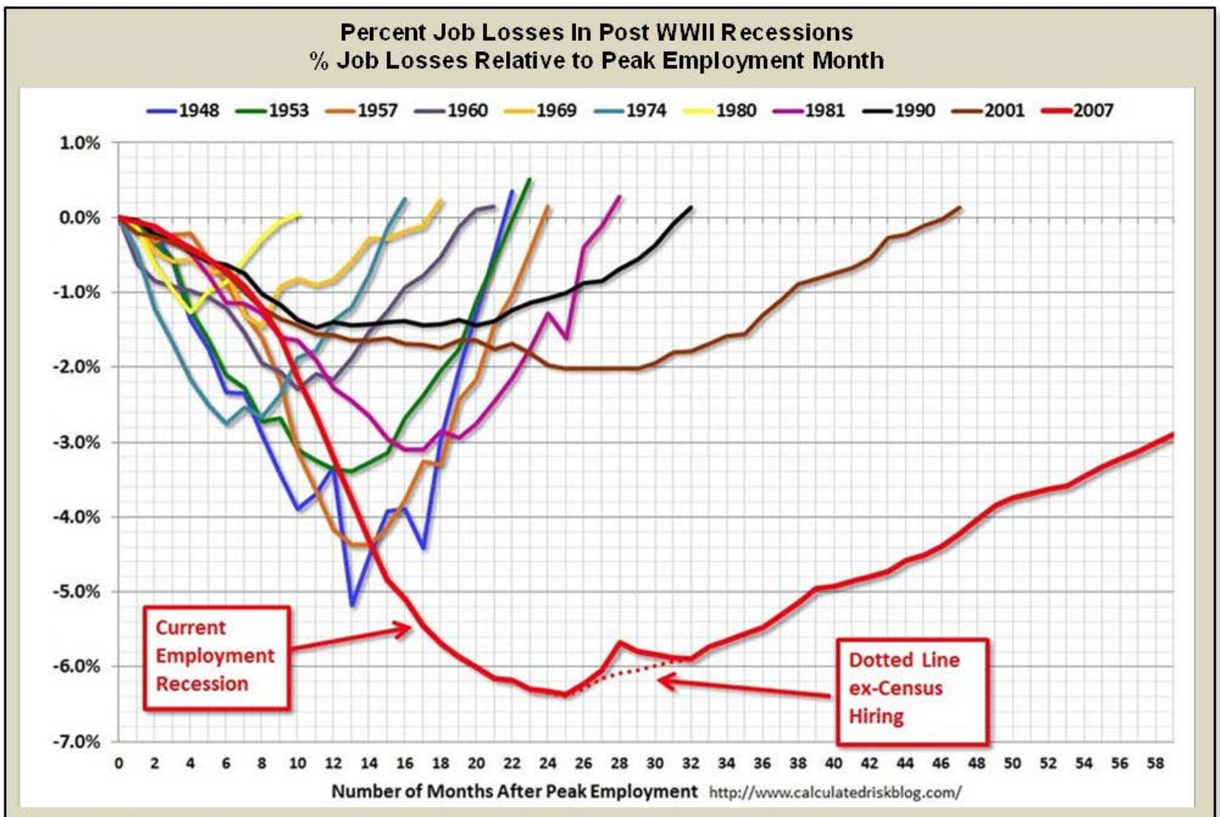


I expect real GDP to rise only 1.6% - 2.0% in 2013. The first two quarters will be much slower than the final two quarters. If there is no resolution to the debt ceiling/crisis and burgeoning deficits, real GDP could range from 0.7% - 1.2%, and the probability of a recession will increase dramatically. **Therefore, get used to mediocre growth, and plan accordingly.**

The key to a sustainable recovery is a dramatic reduction in government spending. The tax system is a Swiss cheese of loopholes, special interest benefits and unknowns with a need to return to a more growth/risk reward vs. penalty orientation. But changes are ahead for the real estate industry that will significantly alter how real estate assets are acquired and financed. These changes will be addressed in future issues of *Strategic Advantage*.

Jobs…A Game Board Of Opportunities & Risks

Based on a normal economic recovery and normal population growth, the U.S. should have 15 million to 17 million more jobs than it has today. The U6 seasonally-adjusted unemployment rate is now around 14.4%, the labor force participation rate (63.6%) is at a 30-year low and the number of part-time workers (many of whom would prefer full-time work) has risen to 7.9 million. According to an October 31, 2012, Bureau of Labor Statistics report, wages and salaries increased only 1.7% (9/11 – 9/12), essentially "unchanged" from a year ago. The higher tax rates enacted in early January will affect 750,000 small businesses. According to a WSJ/Vistage CEO poll in December, 29% of small businesses will hire fewer workers, and 32% will spend less on equipment in 2013.

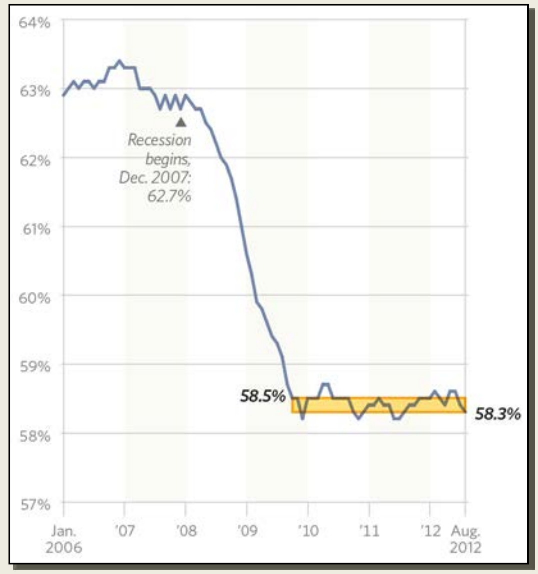


Source: Business Insider

The U.S. net job additions currently averages around 150,000 – 155,000 jobs per month…far below the 300,000 jobs per month needed to return to normal. In December only 155,000 jobs were added. September and October job total numbers were just revised downward from 145,000 and 171,000 to 132,000 and 138,000, respectively. With the lack of jobs, absence of long-term policies to create jobs and increasing disincentives to hire full-time workers, **the jobs outlook for 2013 is likely to be more of the same**.

In November 2007, the number of U.S. workers stood at 146.6 million. By December 2009, the number of U.S. workers had shrunk to 131 million, and today there are around 141.5 million workers, 19 million of whom are part-time. In December, according to the U.S. Department of Labor, 12.2 million persons were unemployed. The number of workers claiming SSDI has risen 22% over the past five years to nearly 9 million. There are 2.6 million "marginally attached" workers who are available to work but not counted in the labor force. The number of undocumented workers, according to Pew Research, is around 8 million (7 million work in nonfarm jobs). **So what we have is not a shortage of labor; we have a shortage of jobs, and many available jobs do not align with the available workforce**.

The Unemployment / Population Ratio Has Not Improved



Source: Heritage Foundation.

Interestingly, **nearly 54% of bachelor's degree holders age 25 or younger were unemployed or under-employed in 2011**. Many bright young adults coming out of college are holding jobs that do not require a degree. According to U.S. government figures, only three of the 30 occupations with the largest projected number of job openings between 2012 and 2020 will require a college degree. With nearly $1 trillion in student loan debt, and defaults on student loans rising rapidly (remember, student loans cannot be discharged in bankruptcy), **the financial outlook for those age 18 – 34 is far less robust than it was for their parents at the same age**.

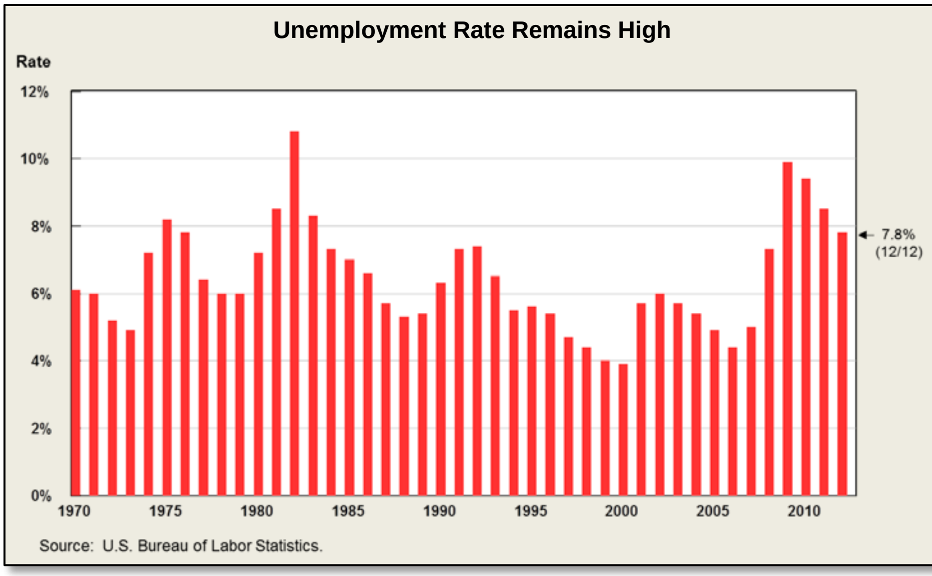
Over the past several years, readers of *Strategic Advantage* know that we are projecting a geographic quilt of regional job winners and job losers. I like economic freedom states such as Texas, Virginia, North Carolina, Tennessee (Nashville) and Colorado. **I like the tech, healthcare-related, energy and finance industry-based areas** such as the Silicon Valley (including San Francisco), Austin, Seattle, Oklahoma City, Denver, Raleigh-Durham, Houston and Boston. I like the gateway cities such as Miami and port cities (particularly on the east coast)…and if you want to place a 15-25 year bet, I like the manufacturing regions throughout the U.S. (particularly Ohio) that will flourish from robotics and improved automation that will make the price of U.S. goods comparable to the cost of goods made in China.

Best Cities / Areas For Jobs & Young People

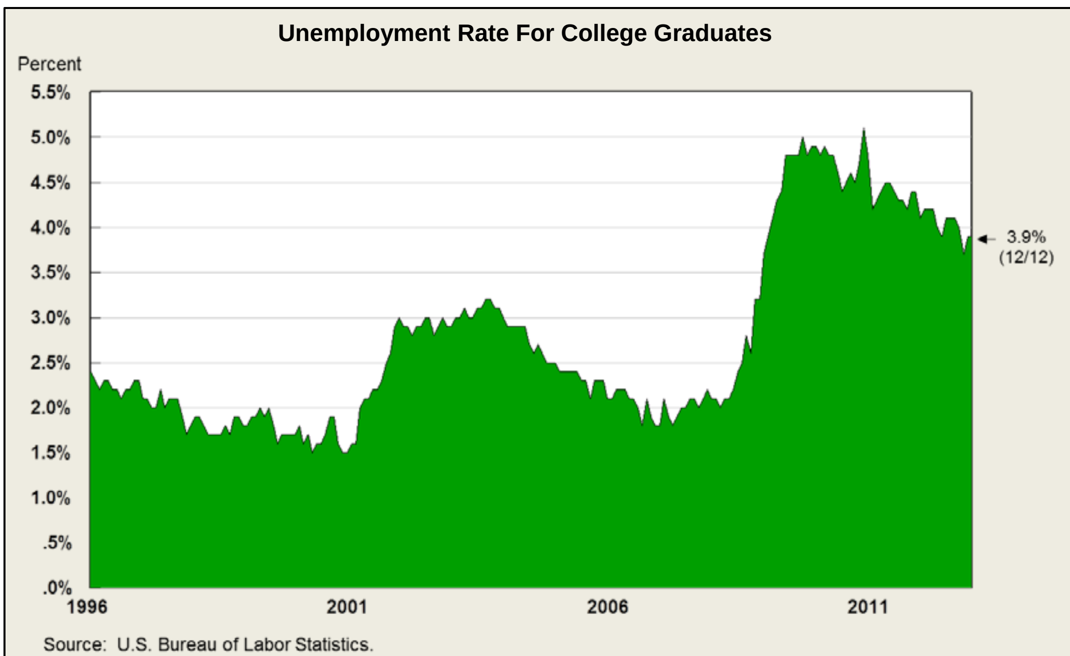
- ❑ Austin, Texas
- ❑ Denver, Colorado
- ❑ Dallas, Texas
- ❑ Washington, D.C.
- ❑ New York City, New York
- ❑ Seattle, Washington
- ❑ Houston, Texas
- ❑ Boston, Massachusetts
- ❑ Silicon Valley, California
- ❑ San Diego, California
- ❑ Raleigh, North Carolina
- ❑ Minneapolis, Minnesota

I also like several of the "tweeners" (too small…but not big enough) such as Minneapolis, San Diego, Charlotte, Richmond and Salt Lake City. My on-the-bubble markets (too risky today to recommend, as their economic futures are not clear) are markets such as Los Angeles, Phoenix, Philadelphia, Orlando and northern New Jersey. Economic vitality, job growth and demand for real estate will be confined to select areas. **Real estate companies must develop strategies that capitalize on the shifting demographics and job creators**. It will be far better to adopt a customer-centric vs. a geo-centric model over the 2013 – 2020 period.

I expect the U.S. will add around 2.1 million to 2.4 million jobs per year through 2015…thus keeping the number of unemployed or under-employed at historically high levels over the next 18 – 24 months. According to a November 2012 Wells Fargo/Gallup poll, U.S. small business



owners "expect to add fewer net new jobs over the next 12 months (2013) than at any time since the depths of the 2008 – 2009 recession." In the same survey, 61% of small business owners "expect no change in workforce size." Further, **20% of small business owners "expect to reduce the number of jobs at their company over the next 12 months."** Remember, small businesses generated 65% of the net new jobs over the past 17 years, according to the U.S. Small Business Administration.



A recent report by the Kaiser Family Foundation found that since 2009, **healthcare premiums have risen $2,370**. The Council for Affordable Health Insurance found that more than 2,200 state benefit mandates will add from 10% to 50% to the cost of coverage. Since the passage of the Affordable Care Act in 2010, healthcare premiums have jumped 9.5% in 2011 and 4.5% in 2012.

According to a recent study by Ernst & Young, if taxes are raised on those making over $250,000, this could cause 700,000 people to lose their jobs. Between June and November of 2012, 621,000 of the 847,000 new jobs created have been in government. As of December 2012, 1.1 million Americans were not counted as unemployed, since they have been classified as "no longer looking for work." **Older workers are not retiring. Around 20% of Americans over 65 years of age are either working or looking for work, a post-WW II high**. The impact on younger workers has been devastating. The number of workers age 25 to 54 (the prime working years) is now 94 million, the same level as in April 1997 when the U.S. had 46 million fewer people. Too many young Americans are working part time or under temporary government programs.

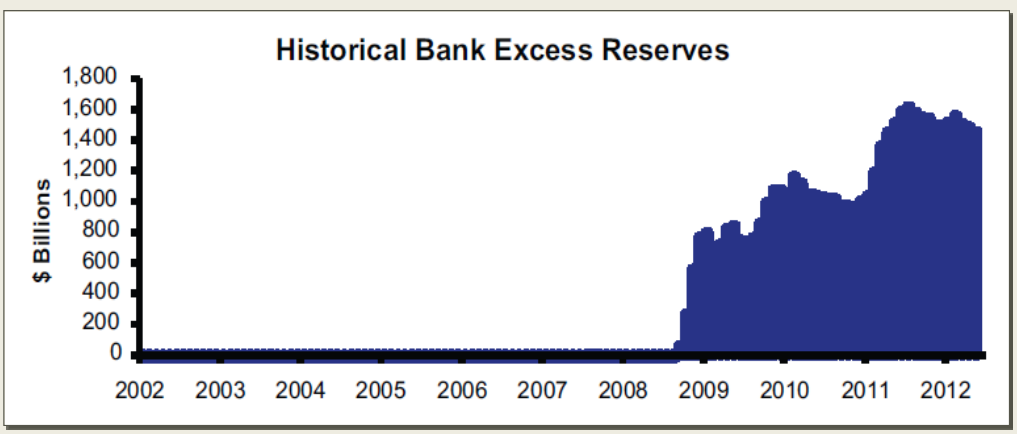
Since the economic "recovery" began in June 2009, household incomes are down 5.7%. The average inflation-adjusted income for households in the middle 20% of U.S. income earners is now lower than it has been since 1995. **Bottom line: The real estate industry must focus on avoiding areas of the country that are becoming far less appealing to job creators**.

According to several studies by the Tax Foundation and Chief Executive magazines, among the best states for business are Texas, Utah, Virginia, Tennessee, Florida and Washington. Among the worst states for business are California, New York, Illinois and New Jersey. Perhaps that is why Texas has accounted for nearly one-third of the jobs created in the U.S. since the economic recovery began. Over the past decade around 225,000 California residents (3.4 million since 1990) have left the state, and 254 California firms in 2011 "moved all or most of their work and jobs out-of-state."

The real estate industry is driven by the demand created by jobs. **In 2013 it would be wise to consider business and growth strategies that align with the opportunities, not the conditions, within today's quilt of economic recovery**. Real estate firms should pay more attention to the type, versus the number, of jobs in those markets in which they operate, own or intend to grow in 2013 and beyond.

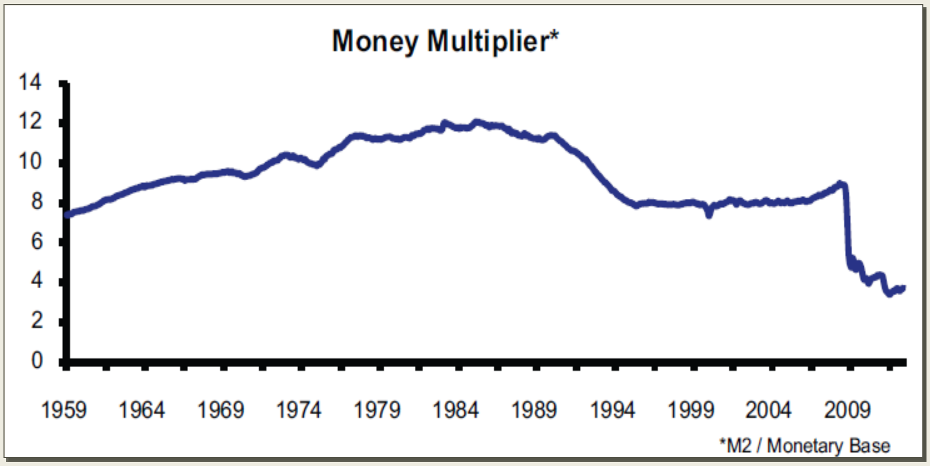
Capital Outlook

Let me be perfectly clear…there is no shortage of liquidity in the system. What we have is a lending and regulatory problem. The combination of the Fed's Quantitative easing (QE1, QE2 and QE3) and the passage of Dodd-Frank in July 2010, have combined to create a lending crisis. As Ludwig von Mises, a noted economist of the 20th century, said, **"For the naïve mind there is something miraculous in the issuance of fiat money**. A magic word spoken by the government creates out of nothing a thing which can be exchanged against any merchandise a man would like to get." Today the abundance of capital has resulted in money having no value at this time. Without open debate, the Federal Reserve has decided to transfer a trillion dollars of spending power from savers to debtors.



Source: The Linneman Letter, Summer 2012.

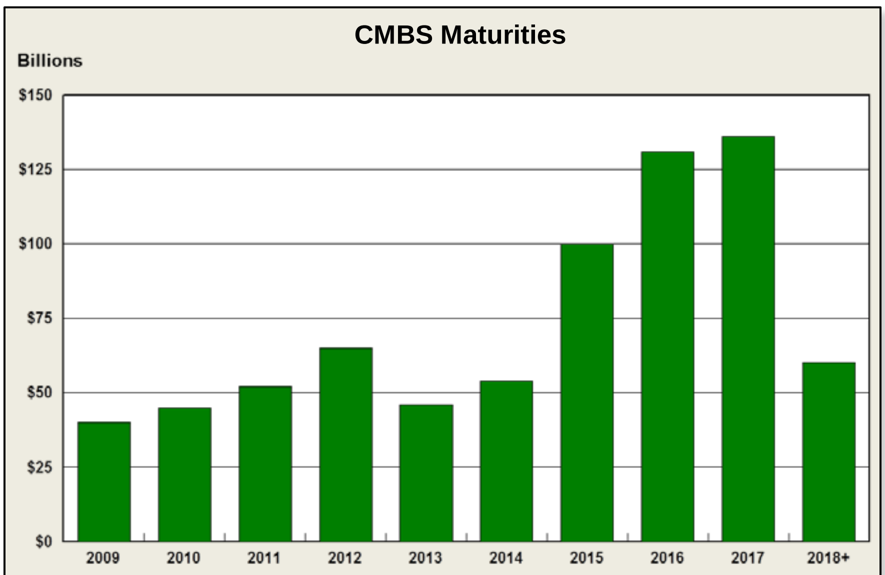
As of December 26, 2012, the seasonally-adjusted monetary base in the U.S. was around $2.63 trillion, up $861 billion from January 2009, and up $1.79 trillion since January 2008. According to the Federal Reserve, $1.45 trillion is in "excess reserves" (vs. only $1.5 billion in January 2007). **There are no incentives to lend, particularly if the Fed is paying $3.6 billion in interest on those reserves**. In this world of thin-air monies, the theory is simple: Take no risk and get paid for doing nothing. Excess reserves are now 93% of total reserves, vs. the 40-year average of around 2%. Thus, banks are utilizing (lending) only 7% of their total reserves. Plus the Fed stated that it will likely keep interest rates low until 2015. **The net result of the money multiplier at historical low levels is to keep inflation down**…but when this massive amount of liquidity is ultimately infused in the marketplace, inflation will accelerate dramatically.



Source: The Linneman Letter, Summer 2012.

The impact of the Dodd-Frank legislation on financial institutions with less than $10 billion in assets (98.6% of all banks) will be significant. The added fees and regulatory costs will cause many banks to struggle and seek a merger to survive. **This too-big-to-fail legislation has created a new category of banks: too-small-to-succeed.** The result of this consolidation will be the off-loading of redundant space and the likely compression of the square feet per employee within this tenant segment.

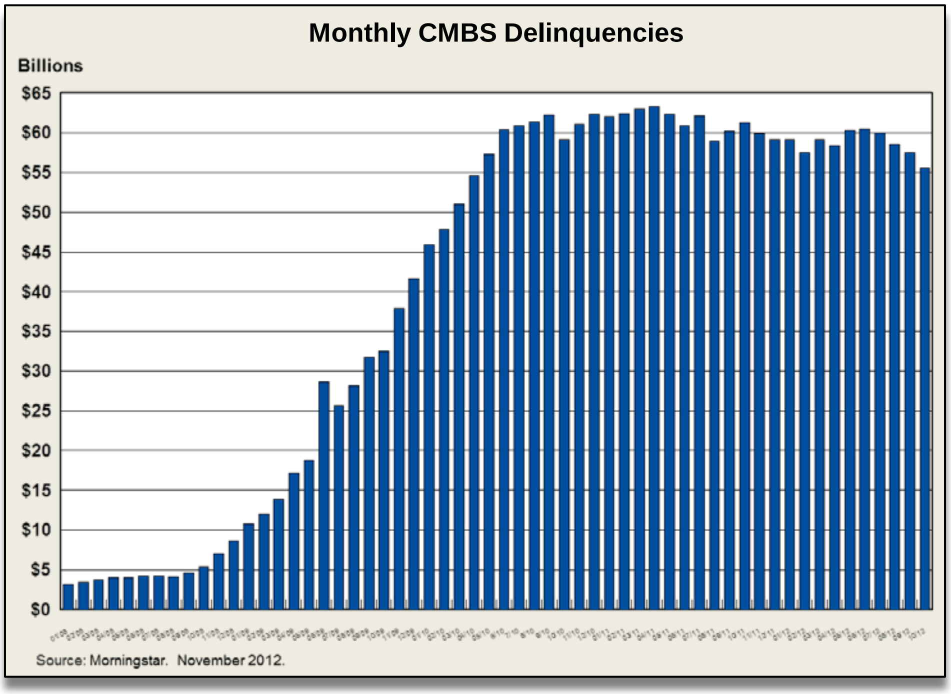
According to a November 2012 report by the Small Business Administration ("SBA"), bank lending to small businesses rose from $758 billion in 1994 to a peak of $2.14 trillion in June 2008, and then dropped to $1.96 trillion by June 2011. U.S. bank regulators injected more than $200 billion into more than 900 banks in hopes of stimulating lending to small businesses. But according to the SBA, the "TARP's Capital Purchase Program was largely a failure."



Source: Goldman Sachs.

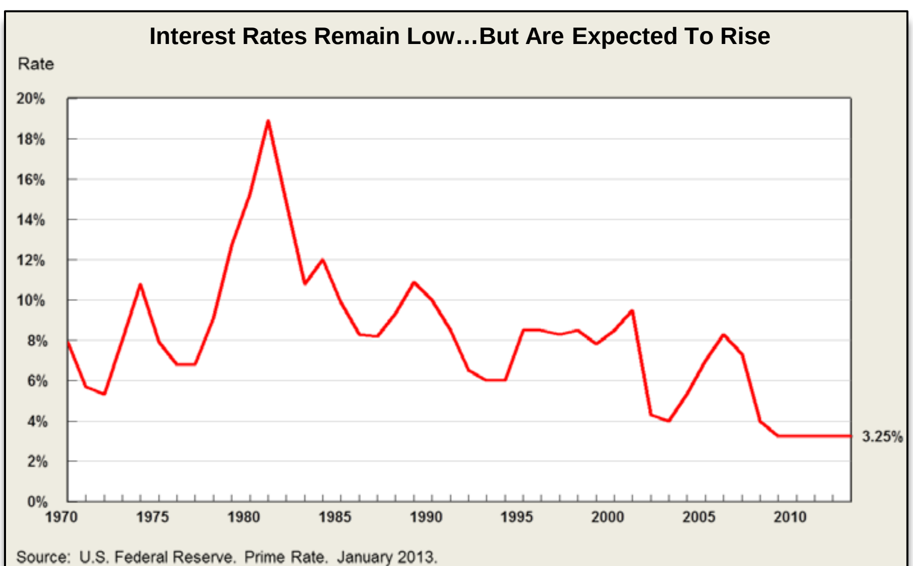
According to Trepp and others, approximately $2 trillion of real estate debt is expected to mature by 2017. While estimates vary, around 40% - 50% of those loans are or soon may be "underwater," and many will not be refinanced at existing debt levels. A perfect indicator of the emerging challenge is the 8.7% delinquency rate on CMBS loans. In November, Morningstar added 434 loans ($6.04 billion) to their Watchlist. In 2013 approximately $47 billion in CMBS loans will be maturing. The average loss severity on a CMBS liquidation is now averaging approximately 45%.

Another area to watch is state and local property taxes, which would significantly impact value and financing. Nationwide, according to data from the U.S. Census Bureau, state and local governments collected 44% of property tax revenue from residential property and 56% from non-residential property. However, **the U.S. Census Bureau also noted that commercial and industrial assets were less than 25% of assessed valuation (vs. 60% for residential properties)**.



U.S. consumer debt is now around $11.4 trillion ($8.2 trillion of which is mortgage debt). Credit card debt now stands at $852 billion, and student loan debt has increased to $914 billion. The average U.S. household credit card debt (of those who carry debt) is now $15,418. **Through October 2012, 46.7% of U.S. households had a credit card balance**. Over the past two years, investors have pulled $300 billion out of the equity markets.

One of my biggest concerns for 2013 is the impact/outcome of the uncertainty created by the "fiscal cliff" and debt ceiling debate and ultimate resolution. Whatever action is taken, I expect a disconsolate electorate will further entrench and lose hope that meaningful fiscal solutions will be realized. Psychologists have written reams of reporting tying the negative social impacts caused by environmental stress and lack of predictable outcomes to human well-being. **The current societal stress caused by a feeling that "things are not getting better" is having a negative impact on consumer expenditure and borrowing patterns**. In a USA Today/Gallup poll, 71% of Americans rate economic conditions as "poor." In a December 2012 Rasmussen poll, only 35% of U.S. voters believe that the country is headed in the "right direction." Around 54% of U.S. voters expect a recession in 2013.



From a capital markets perspective, **I expect we will see an increase in foreign capital investments in U.S. real estate and/or with U.S. real estate sponsors**. The safe-haven appeal, the uncertainty over the euro, Middle East unrest and perceived depressed values and safe returns are attracting foreign capital. Cross-border transactions could exceed 9% of all sales volume in 2013. Canada and China lead the way, but Norway, Korea, Germany, Brazil and other countries are becoming more active. Foreign entities now hold $5.5 trillion of U.S. Treasury securities.

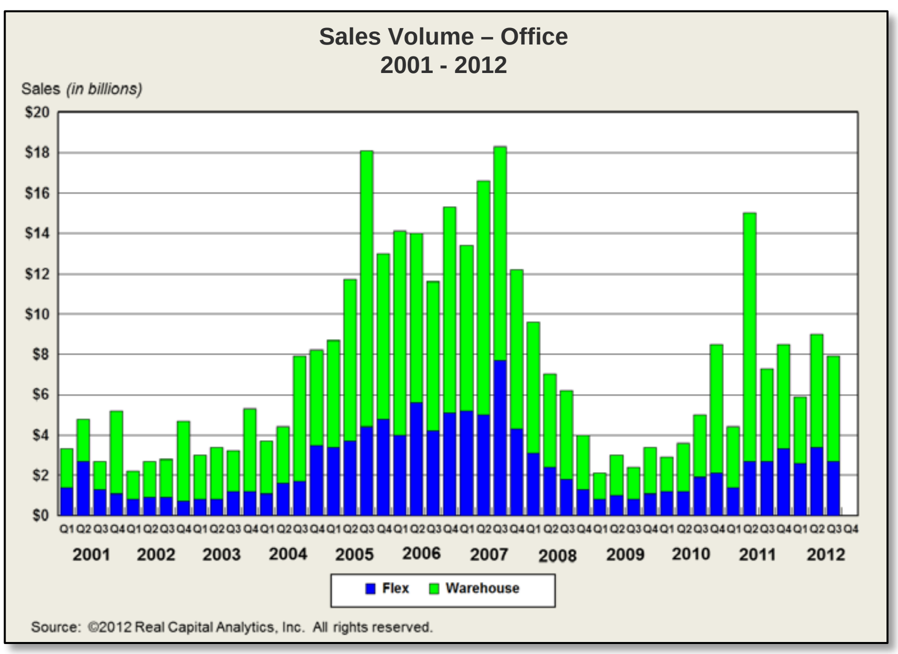
In 2013, I expect interest rates to remain low, transaction volume to increase to around $250 billion, an increase in separate accounts sponsored by pension funds, continued anemic bank lending, a rise in insurance company investments (equity and debt) and a shift from core to "as-good-as-core" secondary market inventory. Investment sales activity could rise 14% - 19% in 2013. I also expect a rise (6% - 8%) in entity-based transactions over the next 12 months. In a Time To Ascend, capital will remain priorities No. 1, 2 and 3 for many real estate companies.

Office Sector Outlook

The best words to describe the office outlook include: *dubitare, distazo* and *stochastic*. Uncertainty, doubt, retooling and cost-cutting are frequently mentioned by office tenants when asked to provide their perspectives on 2013. Driven by global and U.S. uncertainty, **office space occupants are shifting from leasing space to creating productive workplace environments within their existing footprint**. Popular strategies for office tenants include space planning efficiencies, alternative workplace options, increased use of Independent Contractors, leveraging new and existing technologies and the willingness to lease B space or in B locations.

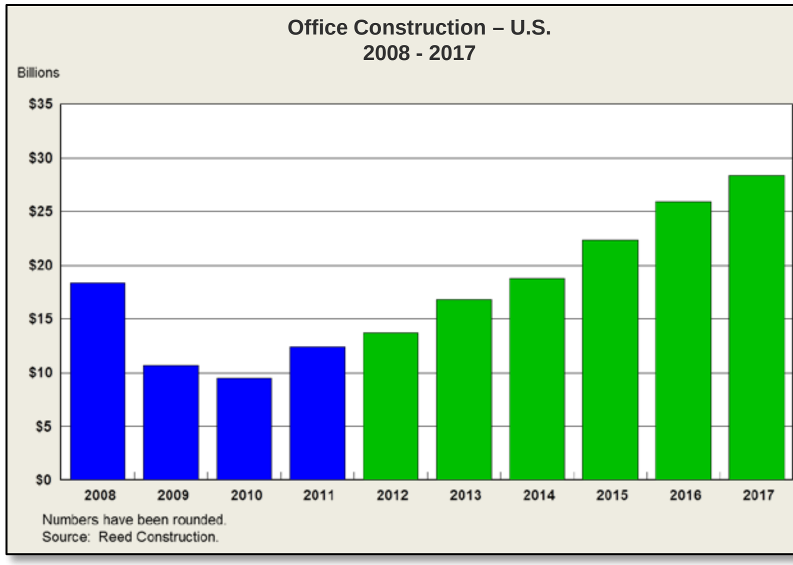
Because office space is directly related to the economy and job growth, **occupiers are reluctant to "lease for growth," preferring to stay where they are** and negotiate lower rents at renewal time. The more financially stable are embracing build-to-suit options. This is a tenants' market, where free rent, enhanced TIs and other concessions are commonplace in many markets. A growing number of tenants question paying premium rents when rates are 20%, 30%, even 50% less expensive in other locations. Watch for unique opportunities in nontraditional locations and properties. Mixed use projects will offer many development and redevelopment opportunities.

The one silver lining within the office sector is a growing trend by occupants to use space differently, rather than lease different space. According to research by CEL & Associates, Inc., occupants are: (1) using space to attract and retain employees; (2) embracing green technologies and sustainability programs offered by landlords; (3) rethinking space planning and the need for so many individual offices; and (4) making space more client-friendly, collaborative and contemporary.



Tenants are discovering that the time an Executive actually spends in his or her office is less than 30% of the work week. A shifting focus involves working from home, utilizing smartphones, leveraging Blue Tooth technology, working while traveling and setting up a home office. Today work increasingly follows the individual, rather than the individual going to work. Occupants are responding by converting static offices into dynamic, collaborative work spaces. Consequently the number of square feet per employee continues to shrink. The mobile, work-anywhere-at-any-time workforce has arrived.

Twelve months ago we predicted a no- to slow-growth outlook for the office sector for several years. We continue with that outlook for 2013, but see signs of improvement. Despite improving opportunities (11 consecutive quarters of occupancy and 8 quarters of rent growth), **I do not expect normalcy to return to the office sector until 2015 – 2016**. In 2013, I expect we will see more "green conversions," more mixed-use developments, and more efficiency-based re-leasing within the office sector. Beginning in 2013, I expect the high-tech, "fun" knowledge-worker workplace environments currently seen in San Francisco, Silicon Valley and other geographic locations with a concentration of tech companies will begin to be embraced by traditional tenants.



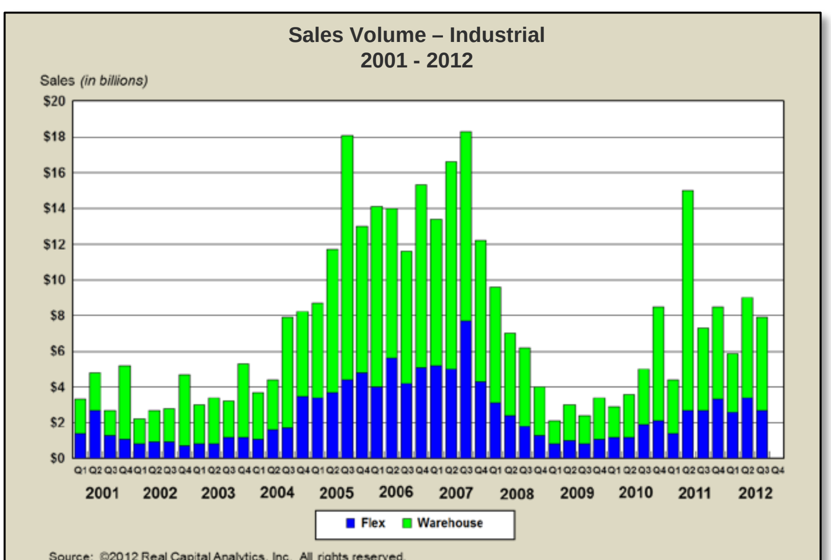
Numbers have been rounded.
Source: Reed Construction.

In 2013 I expect the national vacancy rate for office space to decline 60 bsp – 75 bsp. Rents will, unfortunately, be 10% - 18% below historical levels. New or value-add construction activity should increase 18% - 20% to around $16.5 billion. I expect the sale of office buildings will range from $70 billion to $80 billion in 2013, while cap rates will remain in the 6.7% - 7.6% range.

The best cities for landlords in 2013 will be Dallas, San Francisco, New York City, Boston, Silicon Valley, Seattle, Houston, Denver, Austin and Pittsburgh. Interestingly these markets are driven by energy, technology, emerging technologies, consulting, software development, regional financial services and gateway proximity. Many companies in those markets have cash to invest in growth-based initiatives. Be careful in Washington, D.C./Northern Virginia and several Florida markets. Some overlooked markets with select investor opportunities include New Jersey, Madison, Birmingham, Colorado Springs, Portland and Nashville.

Industrial Sector Outlook

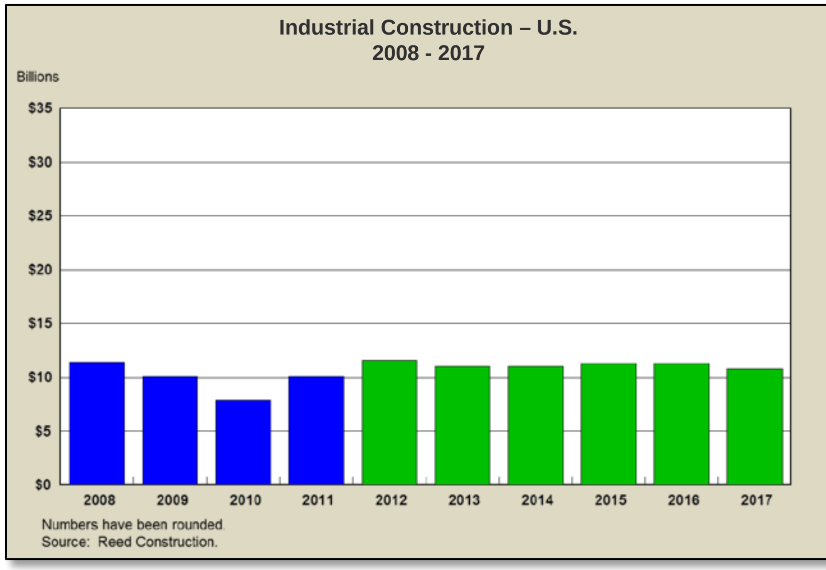
The industrial sector is experiencing a transition from old, inefficient, technology-challenged buildings to speed-of-delivery properties that reduce labor costs, embrace new stacking systems and robotics, which are energy efficient and more proximate to the end-users of products stored and distributed. While the industrial sector has been impacted by anemic economic growth, reduced global trade and the uncertainty emanating from Washington, users are using this time to re-engineer their supply chain process and just-in-time product delivery.



Source: ©2012 Real Capital Analytics, Inc. All rights reserved.

Net demand for industrial space was 27.5 million square feet in 3Q 2012, up from nearly 20 million square feet during the 2Q. While overall vacancy levels for industrial space are around 13.0% - 13.2%, the vacancy level in core markets ranges from 8.1% - 9%. The December ISM Index of 50.7 may signal that demand will begin to improve.

The best landlord cities entering 2013 include Los Angeles, Miami, Chicago, Philadelphia, Houston, Denver, Oakland, Dallas, Salt Lake City and Northern New Jersey. For those interested in niche markets, I like Nashville, Cincinnati, Cleveland, Indianapolis, Columbus, and Milwaukee. If you are a long-term investor, Seattle, San Bernardino/Riverside (Inland Empire) and Portland, Oregon, are worth investigating. Atlanta with its 18% - 19% vacancy level could take several years to rebalance.

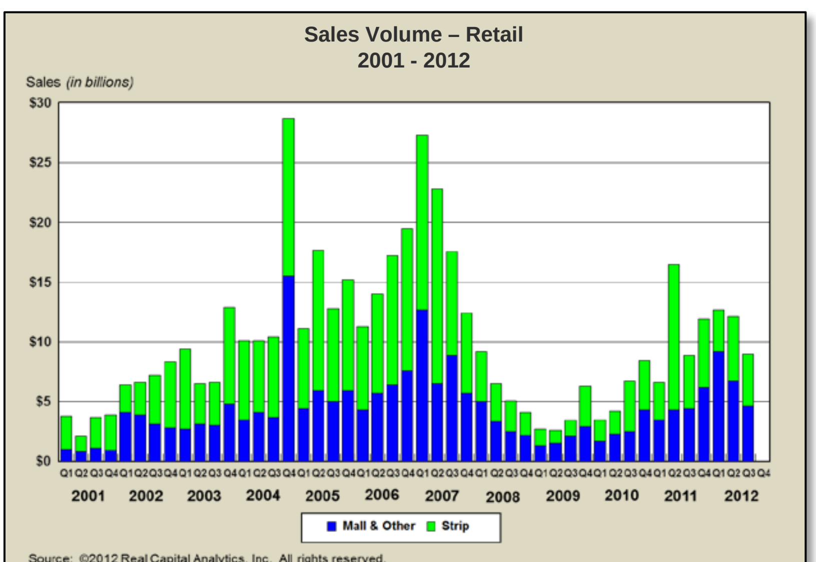


I expect cap rates for Flex space to drop 10 bsp – 30 bsp, Warehouse space to remain flat (perhaps rise 10 bsp – 20 bsp) and overall industrial space cap rates will likely remain around 7.7% -7.9% through 2013. I expect the sale of industrial buildings will range from $30 billion to $32 billion in 2013 and new construction to decline 5.0% - 5.3%. Rents could remain flat or increase slightly as vacancy levels decline 30 bsp – 60 bsp.

The real opportunities in this sector will be: build-to-suits, high-tech warehouses and assets located near major ports and distribution hubs. I am seeing emerging trends in rail-based intermodal facilities, cold storage facilities and activity in, around or as a result of the Panama Canal's widening. If fuel prices continue to rise, there will be demand for smaller distribution facilities. The declining availability of Class A assets should spur new development activity. **Long-term investors should closely monitor nanotechnology trends,** which will dramatically change how products are manufactured and used.

Retail Sector Outlook

Cautious optimism, encouraging signs, improving consumer sentiment and a steady recovery are terms now being applied to the retail sector. The bottoming out of retail vacancy levels and increasing demand for discretionary retail items (e.g., clothing, accessories, electronics and motor vehicles) indicate consumers are willing to spend for value and price. However, continued concerns regarding the economy and jobs are primary contributors to a poor holiday retail season (worst since 2008 according to MasterCard's Spending Pulse), and the increased sales activity at low-end and discount retailers reflects that reality.



Overall sales for stores which were open for at least one year were up 4.8% vs. a year ago; however, only 53% of chains beat forecast. Sales from e-commerce for the holiday season were $42.3 billion, up 14% from last year.

The impacts of Hurricane Sandy, the Newtown tragedy and unusual weather also contributed to a mixed year-end for retail sales. Improvements in the housing market probably kept retail sales from further declines.

Heading into 2013, **the normally positive consumer has become the prudent, vigilant and wary consumer**. The Consumer Confidence Index for December now stands at 65.1 down from 71.5 in November. Of more concern was the Consumer Expectations Index declining sharply from 80.9 in November to 66.5 in December. The rise in the payroll tax from 4.2% to 6.2% will affect millions of workers and could take up to $115 billion from disposable incomes.

The growing gap between the affluent and middle-income population is reflected in retail shopping. Whole Foods (high-end) plans to open 70 stores in 2013, while Family Dollar (discount) announced plan to open 500 stores in 2013. **The mid-price, in-between retailers continue to struggle. I estimate that 60% - 70% of today's retailers are battling to remain relevant in an age of e-commerce, m-commerce and digital retailing**.

The retail industry selling non-essential items is moving toward a try-in-store, shop online and pickup/return to store pattern of purchasing. Big Box retailers and many mall tenants will look more like Costco, Wal-Mart and Target but behave more like Amazon. According to my analysis, **it would not be surprising if Amazon becomes the No. 1 U.S. retailer** and sells more grocery products than the top grocery retailers. Amazon clearly owns the retail space, will soon own the publishing space and in the not-too-distant future will own the grocery space. Online purchases are now around 5% of retail sales, climbing to 10% in the years ahead.

In 2013 I expect overall vacancy levels to remain around 10.2% to 10.5%, while several markets will experience vacancy levels above 11%. **The best retail markets continue to be** New York City, San Francisco, San Jose, Orange County (CA), Long Island and Northern Virginia. Select **markets also attractive in 2013** include San Diego, Los Angeles, Austin, Boston, Denver, Houston, Miami, Nashville, Seattle and Washington, D.C. If you are a long-term investor (2015), Charlotte, Phoenix, Portland, (OR) and Tampa Bay are attractive. I like niche grocery, ethnic foods, discounters, drug stores, outlet malls, fast casual food, select theme restaurants and locations near higher-income demographics.

Cap rates for all retail property types could drop 10 bsp – 20 bsp in 2013, whether or not the consumer perceives that the fiscal cliff agreement is a short- or long-term solution. Sales of strip and community centers should exceed $1 billion in 2013, and I expect the sale of malls, core and value-add centers could reach $1.2 billion or more over the next 12 months. The key trend to monitor is the volume of sales in secondary and tertiary markets. Betting on the "sure thing" will be the mantra of 2013.

Retail construction activity should range from $18.8 billion to $19.5 billion as consolidation, upgrades, greening improvements and redevelopment activity continue. New home equity lines of credit should grow 22% in 2013 to $77 billion, a three-year high. This will add an available capital base not seen for several years.

What many retailers need to understand and integrate into their business model is that success is determined not by the products sold but by the caliber of the individual selling those products and how those products are presented/displayed. Too often retailers hire the "less experienced" or least qualified applicants to keep costs down and later wonder why their sales volume is below expectations. According to a recent study, **50% of holiday shoppers found their personal mobile device more efficient than store sales associates**.

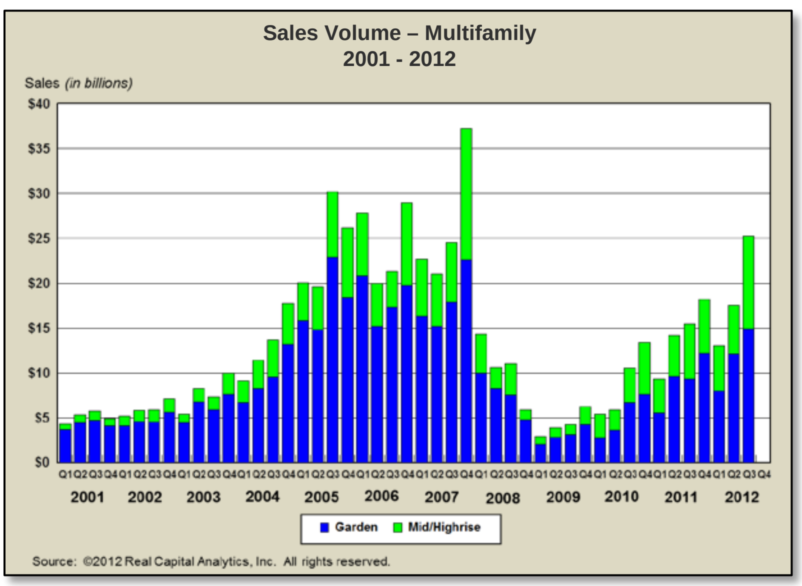
For retail real estate owners and operators, **I recommend more time spent on understanding the business model and practices of their prospective and existing tenants than on negotiating rent**. While retailers with a cost advantage similar to Amazon, or Apple with its distribution control, will prosper, we rapidly are approaching a tipping point where many fringe or adjacent retailers will go out of business. Retail real estate is not about space; it is about access and creating a relationship between the retailer and the consumer.

Apartment Sector Outlook

What is not to like about apartments? The combination of strong demographics (around 78 million Gen Ys and 79 million Baby Boomers), a poor economy with limited job growth and stagnant household incomes, delayed household formations (marriages) and birth of the first child, historically low consumer confidence, an increasing preference to rent and a growing supply/demand imbalance total a halcyon of good times for this sector. According to 2010 U.S. Census, almost 24% of men and 19% of women ages of 35-44 have never been married. For those age 20-34, 67% of men and 57% of women have never been married.

The U.S. is becoming a nation of singles, with cohabitation becoming the new family…all positive trends for the apartment industry. Declining vacancy levels, rising rents, a reduced ability to purchase a home and a frenzy of investor interest in apartment ownership are indicators of continued good times ahead for the multifamily industry. I expect the Cinderella-like journey for apartment owners and operators will continue through 2016.

The number and percentage of households where adults are "doubling up" is now around 22 million or 19.2% of all households. The percentage of adults age 18-24 living under the roof of another is 35.3%, and for those age 25-34 is now 30.5%. Most adults living with others are not married.

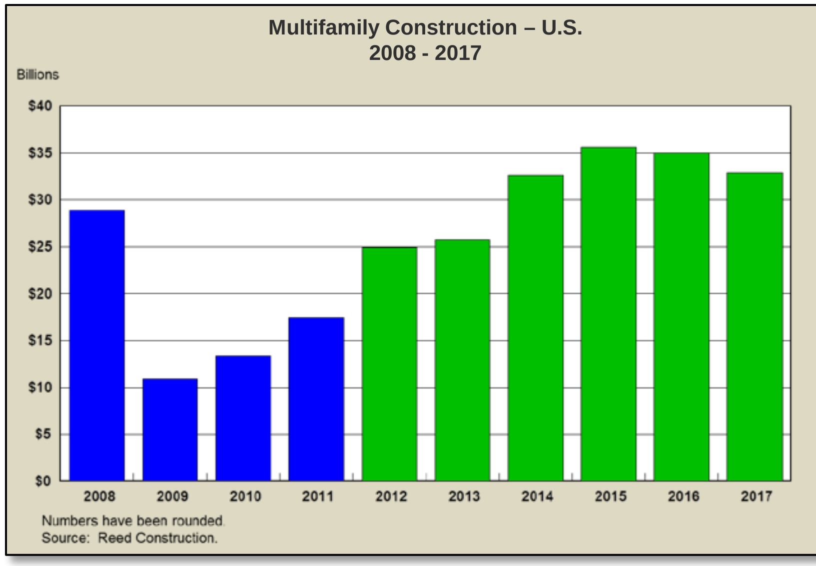


U.S. student loan debt stood at $956 billion at 3Q 2012, and in September 2012, 11% of student loan balances were 90 or more days behind. Since **93% of student loans are made by the government with little or no concern on how the loan will be repaid**, this looming next bubble of fiscal concern will mean a higher percentage of emerging college graduates will be renters for many years.

In 2013 I expect around 1.1 million to 1.2 million households will be formed, and nearly all newly formed households over the past five years have been renters. In 2011 the U.S birthrate was the lowest ever recorded (63.2 per 1,000). If the economy improves, new household formations could accelerate to 1.4 million to 1.6 million per year before returning to the norm (1.2 million to 1.4 million per year). As a result, **I expect homeownership to continue to decline possibly dropping to 64% by year-end**

2013. I expect the share of apartment renters to remain around 45% of all renters. Remember, among 18–24 year-olds, 77% are renters; and 59% of those age 25-34 also rent.

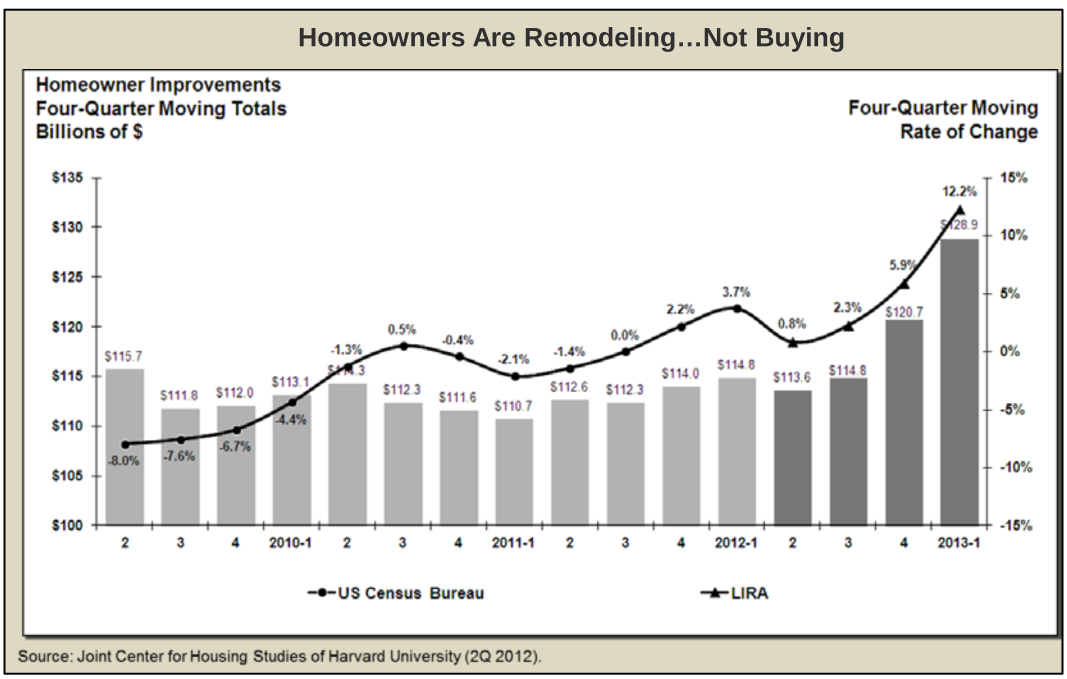
Annual losses of apartment units due to age, redevelopment or destruction should remain around 100,000 units. The number of multifamily permits should range from 235,000 to 260,000, which is still far below the 300,000 to 400,000 units needed annually to meet demand. As a consequence average annual effective rent growth nationally will range from 3.4% to 3.7%, with some markets enjoying over 4.0% rent increases. **Between 2013 and 2015 I expect demand for multifamily to range from 2.5 million to 3 million units**. With limited new construction, a shortage of apartment units will occur within 24 -36 months.



Very few geographic locations do not look favorable for multifamily development and/or ownership. If you are a long-term investor, I like San Francisco, Austin, San Jose, Riverside/San Bernardino (Inland Empire), Denver, Charlotte, Minneapolis, Southern California, select areas in south Florida, Seattle and Detroit. I like all high-barrier-to-entry markets.

Investors must be cautious and not give in to the temptation to compete in overheated, highly competitive markets. With overall cap rates in the 5.6% range and announced sales with sub 4 cap rates, the margin for error must be carefully monitored. I expect cap rates to decline even farther in 2013 (around 30 bsp – 65 bsp). Transaction volume ($75 billion in 2012) should remain in the $70 billion to $80 billion range in 2013).

New construction activity should range from $24 billion to $26 billion in 2013, and $30 billion to $35 billion in 2014 and 2015.



Closing Comments

So there you have it….as author Bill Vaughn said, **"An optimist stays up until midnight to welcome in the New Year. A pessimist stays up to make sure the old year leaves."** As our memories of 2012 fade and our expectations for 2013 move to our priorities and attention, we must remember that real estate has been, is and will continue to be the foundation upon which people dream and realize their potential. Ending one year and beginning the next is not a process, but an experience from which possibilities emerge. **Now is not the time for resolutions…it is the time to chart your course and ascend to the top**…a journey over which you and you alone have control. Now is the time to take charge of the outcome and your destiny before future events determine your fate. **Now is the time to Ascend**.

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

Regards,

Christopher Lee

KEY STRATEGIES FOR 2013

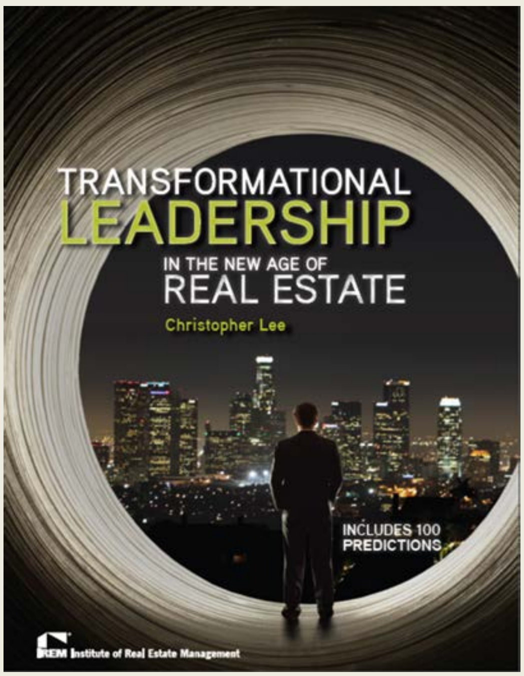
Based on the data and analysis presented above, what should real estate companies do to grow and prosper in 2013 and the years ahead? CEL & Associates, Inc. has prepared a list of eight strategies that every real estate firm should consider, embrace and deploy. To obtain your copy of these recommended strategies go to: http://www.celassociates.com/onlinenewsletter/EightKeyStrategiesfor2013-SA-K120712.pdf

COMPENSATION SURVEY RESULTS ARE NOW AVAILABLE

The **2012-2013 National Real Estate Compensation & Benefits Survey Results** are now available for purchase. Covering nearly 200 positions and incorporating data from approximately 400 firms, this 450 page report is a very valuable tool for everyone who is involved with setting compensation and benefits for the coming year. This year's report was done in partnership with NAIOP, the Commercial Real Estate Development Association and NAA, the National Apartment Association.

To purchase a copy of the current and **most comprehensive compensation survey in the real estate industry**, go to ***http://www.naiop.org/en/E-Library/Business-Trends/2012-CEL-Associates-Inc.aspx***

JUST RELEASED!



★★★★★

Surviving, prospering and achieving a competitive edge in today's marketplace can be challenging. *Transformational Leadership* is a book that traces the history of real estate, provides insights into what's ahead, highlights the timing of the next real estate cycle and provides strategies on how to succeed and thrive. The book also includes 100 predictions you will find fascinating and thought-provoking.

Simply click on this following link *IREM* and you will be directed on how to purchase your copy.

Full text link is below:

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SPECIAL ANNOUNCEMENT

Due to an increasing number of requests from Owners and Boards of Directors to assist:

- Finding secure/stable long-term financial partners.
- Owners wishing to sell all or a portion of their company.
- Finding a long-term source of capital to facilitate growth.

CEL & Associates, Inc. has formed:

CEL Capital Advisors

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Prior Newsletters: If you would like to download prior newsletters, please go to the following links.

"The Times…They Are A' Changing" Eight Key Strategies for 2013

http://www.celassociates.com/onlinenewsletter/EightKeyStrategiesfor2013-SA-K120712.pdf

The Great Generational Divide

http://www.celassociates.com/onlinenewsletter/TheGreatGenerationalDivide-SA-K091812.pdf

Becoming A Customer-Centric Company

http://www.celassociates.com/onlinenewsletter/BecomingACustomer-CentricCompany-SA-K040212.pdf

It Is Time To Get Rid Of Oldco!

http://www.celassociates.com/onlinenewsletter/TimeToGetRidOfOldco-SA-K030712.pdf

2012…A Year of Dubitare

http://www.celassociates.com/onlinenewsletter/2012...AYearOfDubitare-SA-K011712.pdf

Growth Is An Art As Well As A Science

http://www.celassociates.com/onlinenewsletter/GrowthIsAnArtAsWellAsAScience-SA-K112911-CEL.pdf

A Contrarian Perspective

http://www.celassociates.com/onlinenewsletter/AContrarianPerspective-SA-K110211.pdf

The Role Of Real Estate In Society

http://www.celassociates.com/onlinenewsletter/TheRoleOfRealEstateInSociety-SA-K091411.pdf

Tomorrow Has Already Arrived

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Age Of Consequence & Opportunity

http://www.celassociates.com/onlinenewsletter/AgeOfConsequence-SA-K050611.pdf

Take Control Of Your Destiny

http://www.celassociates.com/onlinenewsletter/TakeControlOfYourDestiny-SA-K032911.pdf

Real Estate Outlook 2010-2020 Part II

http://www.celassociates.com/onlinenewsletter/RealEstateOutlook.2010-2020-PartII.SA-K060110.pdf

Real Estate Outlook 2010-2020 Part I

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Real Estate Cycles – They Exist…And Are Predictable

http://www.celassociates.com/onlinenewsletter/Cycles-2010-SA-K040110.pdf