INVESTMENT

After years of operating in an environment where debt was practically free flowing and few investors paid close attention to underlying fundamentals, 2008 has been a challenging transitional period for many buyers and sellers in the U.S. commercial real estate industry. "The dynamics of the market have dramatically changed since the onset of the credit crisis," notes an investor. Debt availability is down. Economic uncertainty is up. And, tenant demand has slipped for most types of space. "We are definitely in a downturn, and it has buyers and sellers at odds over pricing," remarks a participant.

Due to the bid-ask pricing gap, sales activity has dropped considerably on a year-over-year basis in the four major property sectors – office, industrial, apartments, and retail. In April 2008, year-over-year sales of significant properties were down 80.0% in the office sector, 67.0% in the industrial sector, 81.0% in the apartment sector, and 79.0% in the retail sector, according to Real Capital Analytics, Inc. "Buyers and sellers are having a hard time reconciling today's economic uncertainty and capital constraints with yesterday's prosperous expansion and high use of leverage," comments a participant.

Another reason for the decline in sales activity is that tighter lending restrictions have reduced the number of potential buyers. "Leveraged buyers, who dominated the investment arena for many months, have vanished," remarks a participant, who noted that the number of bidders on a recent offering was well below the level witnessed in 2006 and the start of 2007.

With fewer bidders vying for available assets, investors are finding it tricky to pinpoint exactly where price levels and overall cap rates now stand. "We need more data points in order to figure out the new pricing levels," shares a participant.

To date, the consensus among investors is that price declines and overall cap rate expansions have not been uniform across all property types and locations. For the most part, strong investment interest is keeping price levels elevated for high-quality, stable assets in top-performing markets despite a drop in transaction activity. "A flight to quality is very apparent," affirms a participant. On the other hand, secondary and tertiary markets have seen the greatest increases in overall cap rates due to a sharp decline in investor interest. "Assets in secondary markets are finally being priced correctly," insists another.

Even though continued investor interest is lessening price declines in larger, more dominant office markets, it is only a matter of time before downward shifts in investors' key cash flow assumptions negatively impact the pricing in such areas. "Fundamentals have held up relatively well, but we are starting to see rental growth decline and vacancy rates inch up, which ultimately reduces value," states a participant. This quarter, the initial-year market rent change rate declined in 14 of the 18 individual office markets in our survey. This downward trend materialized in the fourth quarter of 2007, at which time just seven office markets reported decreases, and picked up steam in the first quarter of 2008.

MAJOR INVESTMENT TRANSACTIONS

INVESTMENT	CITY	SALE PRICE
Independence Center	Independence Twp	$11,991,000
16445 23 Mile Rd	Macomb Twp	$ 8,200,000
5755 New King Ct	Troy	$ 6,300,000
1220 S. University Ave	Ann Arbor	$ 6,000,000
Countryside Apartments	Monroe	$ 5,850,000

NCREIF TOTAL RETURNS (All Types) – 2Q 2008

METRO	1-YEAR AVERAGE	3-YEAR AVERAGE	5-YEAR AVERAGE	10-YEAR AVERAGE
Atlanta	5.88%	11.95%	11.29%	9.35%
Boston	15.13%	19.39%	16.47%	14.79%
Chicago	10.27%	13.18%	12.59%	10.69%
Dallas	8.20%	12.25%	11.26%	9.19%
Houston	22.05%	18.15%	15.40%	12.44%
Los Angeles	12.83%	18.84%	17.43%	14.89%
Minneapolis	5.98%	11.77%	11.22%	10.04%
New York	11.63%	19.61%	18.96%	15.45%
San Francisco	10.96%	18.89%	16.05%	13.39%
Seattle	12.20%	17.38%	15.45%	12.93%
Washington D.C.	8.73%	15.25%	17.34%	15.05%

Source: NCREIF, compiled by RERC.

NCREIF PROPERTY INDEX RETURNS – 2Q 2008

	2Q 2008	2007	2006	2005	2004	2003
Office	11.46%	20.51%	19.16%	19.46%	12.02%	5.67%
Industrial	8.45%	14.95%	16.96%	20.31%	12.07%	8.23%
Retail	8.70%	13.51%	13.35%	19.98%	22.95%	17.15%
Apartment	6.46%	11.36%	14.63%	21.15%	13.04%	8.90%
Hotel	10.54%	18.10%	23.57%	18.99%	10.16%	6.05%
East	9.41%	16.03%	17.74%	21.58%	15.75%	10.92%
West	9.73%	18.29%	18.45%	21.04%	15.34%	9.01%
Midwest	7.91%	13.52%	11.46%	14.10%	12.50%	6.86%
South	8.70%	12.78%	14.72%	19.83%	12.50%	7.79%
National	9.21%	15.85%	16.60%	20.06%	14.49%	9.00%

Source: NCREIF, compiled by RERC.

...INVESTMENT CONTINUED

As the industry continues to work through the economic slowdown, the credit disruption, and the ensuing price correction, investors will continue to raise funds and look for opportunities. After all, many of them find solace in knowing that what goes up must come down and that another upturn lies ahead.

[Source: Korpacz Real Estate Investor Survey]

PROPERTY TYPES

Office transaction volume continued its lackluster performance during the second quarter 2008, although there are reports of negotiations underway for key office properties. RERC expects office vacancy rates to increase for the rest of 2008 as the economy struggles and unemployment rises.

With consumers cutting back due to the slowing economy, retail sales, as well as retail property fundamentals, are down. The sector is seeing increased availability and negative net absorption, and with the economy unlikely to rebound soon, investors should expect the retail sector to have a few unstable months ahead.

The industrial property market slowed further during second quarter 2008. Fundamentals moved in generally negative directions, with availability rates increasing and absorption decreasing notably, and rental rates likely to face downward pressure in the coming months. Although the industrial property sector is not performing as poorly as other sectors, there have been very few large deals recently. The increasing cost of fuel, negative consumer confidence, and low consumer spending on big-ticket items are negatively impacting manufacturing, further adding to industrial space absorption challenges in 2008.

Like last quarter, the apartment sector received the highest investment conditions rating among all property types during second quarter 2008. RERC's institutional investment survey respondents gave the sector an investment conditions rating of 6.5 on a scale of 1 to 10, with 10 being high, which was slightly higher than first quarter's rating of 6.2.

[Source: Real Estate Research Corporation]

LOCAL MARKET

The Detroit area banks stopped lending on commercial real estate for the most part on May 1, 2008. As such, the local market has ground to a halt. A sliver of activity remains in the "all cash" buyer segment as most industry participants have cash. They are unable to get a new loan on acceptable terms.

Notable sales in the second half of 2008 include: 1220 S. University, Ann Arbor, retail, $6,000,000, $226.42 per square foot; Independence Center, Independence Twp., $11,991,000, $134.60 per square foot, 7.4% cap rate; Countryside Apartments, Monroe, $5,850,000, 216 units, 7% cap rate; 16445 23 Mile Road, Macomb, Industrial, $8,200,000, 214,240 square feet, $38.27 per square foot, 5755 New King Court, Troy, Office, 59,034 square feet, $6,300,000, $106.72 per square foot.