MSCI QUARTERLY UPDATE

US COMMERCIAL PROPERTY PERFORMANCE & INCOME RISK

Q1 2015

US TOTAL RETURNS **Q1 2015**

	3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
INFLATION	0.6	-0.1	1.6	2.0
BONDS	2.5	8.6	6.2	6.0
EQUITIES	1.4	12.8	14.6	8.2
LISTED PROPERTY	3.9	23.0	15.4	8.1
UNLISTED PROPERTY	3.1	12.2	13.0	7.8

RELATIVE TO UNLISTED ALL PROPERTY (in basis points)

		3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
BY SECTOR	*Retail*	*12*	*-27*	*-13*	*7*
	Office	*26*	*73*	*-60*	*-18*
	Industrial	*53*	*199*	*78*	*18*
	Residential	*-91*	*-254*	*99*	*12*
BY MAJOR URBAN AREA	*Washington DC*	*-139*	*-560*	*-221*	*-22*
	NY / NNJ / LI	*-9*	*10*	*23*	*61*
	Los Angeles	*46*	*160*	*3*	*29*
	Chicago	*104*	*35*	*-148*	*-158*
	Boston	*-68*	*-72*	*21*	*-6*
	San Francisco	*176*	*672*	*430*	*169*
	Dallas / Ft. Worth	*-34*	*-76*	*37*	*-27*
	Atlanta	*135*	*333*	*-161*	*-143*
	South Florida	*56*	*107*	*-13*	*-21*
	Houston	*-248*	*-286*	*56*	*237*

US INCOME RETURNS **Q1 2015**

	3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
UNLISTED PROPERTY	1.2	5.3	5.8	6.0

RELATIVE TO UNLISTED ALL PROPERTY (in basis points)

		3 MONTHS	1 YEAR	5 YEAR (annualized)	10 YEAR (annualized)
BY SECTOR	*Retail*	*4*	*15*	*23*	*19*
	Office	*-4*	*-7*	*-5*	*-1*
	Industrial	*16*	*51*	*57*	*50*
	Residential	*-7*	*-48*	*-63*	*-76*
BY MAJOR URBAN AREA	*Washington DC*	*-7*	*-36*	*-41*	*-39*
	NY / NNJ / LI	*-17*	*-27*	*-52*	*-43*
	Los Angeles	*-5*	*-36*	*-19*	*-22*
	Chicago	*7*	*30*	*32*	*29*
	Boston	*-22*	*-43*	*-40*	*-46*
	San Francisco	*-12*	*-48*	*-37*	*-25*
	Dallas / Ft. Worth	*28*	*57*	*50*	*50*
	Atlanta	*19*	*52*	*68*	*44*
	South Florida	*7*	*3*	*-2*	*-17*
	Houston	*10*	*34*	*12*	*26*

Sources: MSCI for equities, listed property, unlisted property (IPD US Quarterly Property Index); JP Morgan (bonds); and US Bureau of Labor Statistics (inflation)

• **US REAL ESTATE INCOME RISK**—As of Q1 2015, more than half the US tenant leases tracked by MSCI were set to expire within the next five years. Those leases expiring in 2015 are well positioned for gains as contracted rents roll to market rates averaging nearly 14% above expiring contracts. Leases up for renewal in New York and the SF Bay Area continue to be poised for the strongest future gains if they renew at current market rates. Among the property sectors, CBD offices should roll to market rates as much 13% above existing contracts, while suburban office holdings will see only marginal gains, if at all. Industrial properties account for about one-fifth of institutional holdings, but these leases have shorter average terms than retail properties or CBD offices and fewer opportunities for rolling to higher market rates. Credit risks can be masked when individual tenants are pooled into higher categories, but nuances exist nonetheless, such as the slightly elevated risks associated with industrial tenants. Markets with a relatively large composition of distribution activity such as Southern California, New Jersey, and Atlanta all show slightly elevated risks, due in part to their sectoral compositions.

SPOTLIGHT THIS QUARTER **WASHINGTON DC**

Unlisted real estate in Washington, DC, provided investors with an annualized total return of 6.6% for the year ending Q1 2015. Not only did DC property underperform other major US cities during this period, it lagged other major asset classes as well, including US bonds. Moreover, because DC is perceived as a relatively stable property market, its income return has historically run as much 40 basis points below the national average. DC's cyclical pattern offers few surprises, at least at the surface. In the depths of the 2009 recession, front-loaded federal stimulus spending made this market an odds-on cyclical bet. Yes, it was first out of the property gate, first to peak, but also first to fade. Since the recession, other US metropolitan markets have stabilized and the national economy has gradually recovered. In DC, federal gridlock may not have thawed, but at least it is not getting worse. Why then has the DC market not yet bounced back? In this quarterly report we review the DC market's leasing structure in order to assess its prospects.

US REAL ESTATE INCOME RISK* **Q1 2015**

		CONCENTRATION CONTRACTED RENT *% of national market*	TERM REMAINING LEASE TERM *years (weighted)*	MARKET % GAIN / LOSS TO LEASES *contract rent vs market rate*	CREDIT RISK SCORE LOW MEDIUM HIGH
	US ALL PROPERTY	100.0%	5.2	8.3%	
BY EXPIRY	2015	9.0%	—	13.9%	
	2016	11.5%	—	4.9%	
	2017	11.8%	—	6.3%	
	2018	11.2%	—	2.9%	
	2019	10.9%	—	0.4%	
	2020 & beyond	45.6%	—	11.9%	
BY METROPOLITAN AREA	LA / OC / Riverside	14.0%	4.9	-1.8%	
	SF Bay Area	11.4%	4.4	26.3%	
	Washington DC	10.9%	5.6	2.0%	
	NY / NNJ / LI	9.4%	6.2	24.4%	
	Chicago	7.2%	6.2	11.1%	
	Boston	6.9%	5.4	9.2%	
	Houston	4.3%	5.8	10.6%	
	South Florida	4.1%	4.1	7.1%	
	Seattle	4.1%	5.5	12.1%	
	Atlanta	3.6%	5.9	-0.9%	
	Dallas / Ft. Worth	3.2%	5.3	-7.6%	
	San Diego	2.7%	3.3	-2.1%	
	Denver	1.6%	6.2	16.1%	
BY SECTOR	CBD Office	38.2%	5.6	12.9%	
	Suburban Office	22.8%	4.7	0.7%	
	Industrial	20.5%	4.0	5.2%	
	Retail	18.1%	6.0	11.1%	

Sources: MSCI's IPD Rental Information Service, or 'IRIS' (tenancy-related risk metrics); and Dun & Bradstreet (credit risk)

**based on MSCI's databases of institutional property holdings*

WASHINGTON DC REAL ESTATE INCOME RISK* **Q1 2015**

CONCENTRATION **RISK**

		US CONTRACTED RENT *% of national market*	WASHINGTON DC CONTRACTED RENT *% of metropolitan market*
	ALL PROPERTY TOTAL	100.0%	100.0%
BY EXPIRY	2015	9.0%	8.9%
	2016	11.5%	13.2%
	2017	11.8%	10.0%
	2018	11.2%	9.1%
	2019	10.9%	9.1%
	2020 & beyond	45.6%	49.6%
BY SECTOR	CBD Office	38.2%	51.6%
	Suburban Office	22.8%	25.6%
	Industrial	20.5%	6.5%
	Retail	18.1%	16.3%

• **WASHINGTON DC CONCENTRATION RISK**—In a list of "typical" US property markets, DC would be an unlikely contender. Take the industrial sector, for example. It is one-fifth of the national commercial property market, but in DC it represents just 6.5% of contracted rent. In fact, a great deal of local distribution activity is relegated to adjacent counties in suburban Baltimore, a location that provides relatively affordable access to both the DC and Baltimore markets. Not surprisingly, Washington is a market where office properties dominate investment activity. More than half of DC's institutional holdings lie in centrally located District offices, an area of intense Class A office demand where rigid height restrictions have long attracted investors. Another quarter of the area's institutional holdings can be found in office properties located in the surrounding Maryland and Northern Virginia suburbs where development is less restricted, especially on the Virginia side.

TERM **RISK**

		US REMAINING LEASE TERM *years (weighted)*		WASHINGTON DC REMAINING LEASE TERM *years (weighted)*	
	ALL PROPERTY TOTAL	5.2	5.2	5.6	5.6
BY EXPIRY	2015	—		—	
	2016	—		—	
	2017	—		—	
	2018	—		—	
	2019	—		—	
	2020 & beyond	—		—	
BY SECTOR	CBD Office	5.6	5.6	6.3	6.3
	Suburban Office	4.7	4.7	4.7	4.7
	Industrial	4.0	4.0	2.7	2.7
	Retail	6.0	6.0	5.7	5.7

Sources: MSCI's IPD Rental Information Service, or 'IRIS' (tenancy-related risk metrics); and Dun & Bradstreet (credit risk)

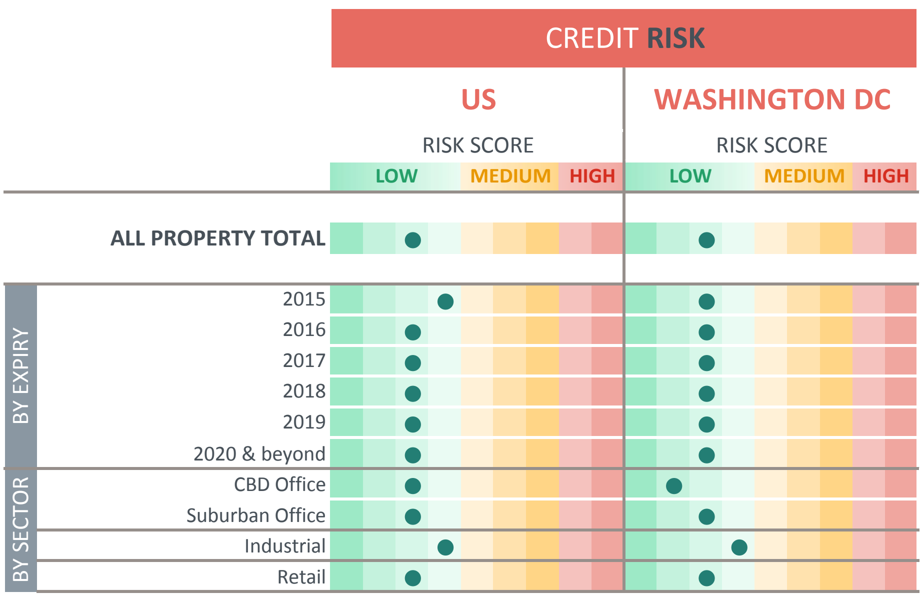
**based on MSCI's databases of institutional property holdings*

• **WASHINGTON DC TERM RISK**—The average remaining lease term in the US institutional property market is 5.2 years compared to 5.6 years in Washington. Again, DC's dissimilarity with the US is on display. Nationwide, industrial leases average 4.0 years to expiration, but in DC, a much shorter 2.7 years. CBD offices are the opposite: 5.6 years nationwide versus 6.3 years in DC. This effectively nudges the average remaining lease term in DC above the national average, though structural change may be on the way. Political gridlock and failure to agree on long-term federal spending priorities have left the General Services Administration, the federal government agency in charge of real estate management, more prone to short-term lease extensions in an uncertain funding environment.

WASHINGTON DC REAL ESTATE INCOME RISK* **Q1 2015**

MARKET RISK

		US: % GAIN / LOSS TO LEASES *contract rent vs market rate*	WASHINGTON DC: % GAIN / LOSS TO LEASES *contract rent vs market rate*
	ALL PROPERTY TOTAL	8.3%	2.0%
BY EXPIRY	2015	13.9%	4.2%
	2016	4.9%	-7.1%
	2017	6.3%	3.3%
	2018	2.9%	-4.3%
	2019	0.4%	-6.4%
	2020 & beyond	11.9%	6.5%
BY SECTOR	CBD Office	12.9%	3.4%
	Suburban Office	0.7%	4.8%
	Industrial	5.2%	-17.1%
	Retail	11.1%	0.9%



Sources: MSCI's IPD Rental Information Service, or 'IRIS' (tenancy-related risk metrics); and Dun & Bradstreet (credit risk)

**based on MSCI's databases of institutional property holdings*

- **WASHINGTON DC MARKET RISK**—Relatively weak market performance may suggest concern for Washington's institutional owners who have major tenants up for renewal. Indeed, in the industrial sector there is much room to fret. Expiring industrial leases nationwide are expected to roll up 5.2% to market rates, but Washington's overleased industrial tenants can expect to see their renewal rates fall by up to 17% on average. Other Washington property sectors should see modest gains. Both CBD offices and retail properties will roll to higher market rates, though the gains will be far below the national average. Only suburban offices will beat the national market, with leases rolling up nearly 5.0% compared to a national average of less than 1%.

- **WASHINGTON DC CREDIT RISK**—Credit scores are assigned at the firm level, but inherent company or industry level risks can roll up to the asset or fund level depending on specific lease-up or investment strategies. Weighted credit risks can appear more diluted at a national or metropolitan level, thus any geographic analysis requires a close look at the nuances. In Washington, the weighted risk scores for CBD office tenants run below the national average and below other local property sectors. This is notable, as this is about as "blue chip" as commercial leases in the US get when weighted and aggregated by property sector and metropolitan area. In other property sectors, including suburban offices, the weighted risk scores fall more in line with national benchmarks, with shorter industrial leases tending to carry the most risk at a sector level.