

# RAIT Financial Trust

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## US Commercial Real Estate and CMBS

### The Capital Report: Prices, Cap Rates and Capital Flows - Winter 2011 Update

A closer look at the commercial real estate transaction market

What a difference a year makes. Optimism abounds throughout the commercial real estate sector as prices, on average, are increasing, cap rates are tightening, and demand has returned with vengeance. The following report takes a closer look at the current state of the commercial real estate transaction market as the sector emerges from the Great Recession with new found strength. Highlights include:

- **Prices:** Commercial real estate prices have increased 6.4% since bottoming in August 2010.
- **Demand:** Transaction volume more than doubled in 2010 (up 120% YoY), although it remains well below results recorded from 2005 to 2007.
- **Cap Rates:** Cap rates have stabilized and are tightening in all five major commercial real estate sectors.

With substantial wind at its back, we expect **transaction volume in 2011 will surpass \$200 billion after totaling \$120 billion in 2010**. Our forecast is an increase from our mid-2010 prediction of \$100 to \$200 billion in transaction volume for 2011. We expect **cap rates will continue their tightening trend**, while average **prices should register solid growth in 2011**.

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## Market Turned the Corner in 2010; Positioned for Strong Growth in 2011

Like a Phoenix, the commercial real estate transaction market rose from its ashes as demand surged in the second half of 2010. Helped by stabilizing fundamentals, narrowing bid-ask spreads, wider availability of credit, low interest rates and historically high risk premiums, transaction activity posted significant year-over-year increases in all five major property types. While risks remain, with the return of the CMBS sector as a viable source of financing and improving leasing fundamentals we expect that prices and demand will continue their positive momentum over the near term.

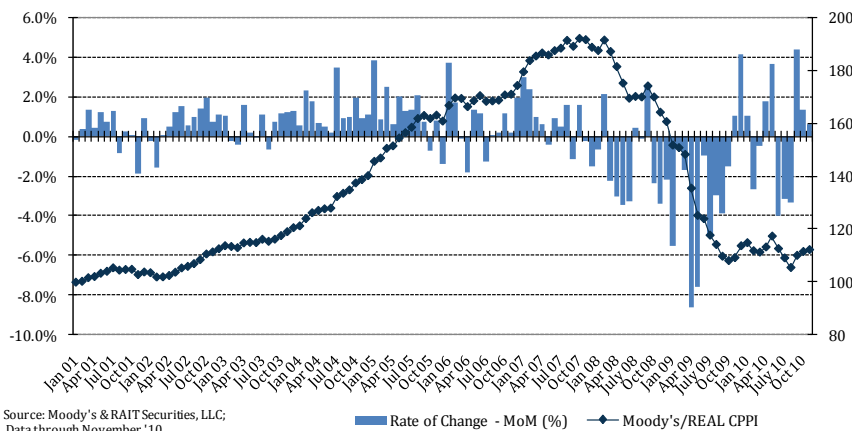
### Highlights

- **Prices Rising:** Prices for commercial real estate appear to have bottomed as the **Moody's/REAL CPPI index has increased 6.4% since bottoming in August 2010**. On a sector basis, all major commercial real estate sectors have seen average prices increase after bottoming in late-2009 or early-2010 with the exception of the industrial sector, which saw prices soften in mid-2010.
- **Surge in Demand:** Transaction volume of **\$50.8b in Q4 2010 (all sectors) was the highest recorded since Q4 2007**, according to Real Capital Analytics (RCA). **Overall transaction volume in 2010 totaled \$120b, a 120% increase over 2009's total volume of \$54.6b**.
- **Cap Rates Tightening:** Cap rates have stabilized and begun to tighten as the **twelve month moving average fell to 7.47% in Q4 2010 – down from a near term high of 7.78% in Q2 2010**, according to Real Capital Analytics The **twelve-month moving average cap rate has tightened in all sectors**.

### Prices via Moody's/REAL Commercial Property Price Indices

Although the path has been rocky, repeat “same store prices” have begun to rebound with the Moody's/REAL CPPI index increasing 6.4% over the past three months. This follows 45.1% decline since the index peaked in October 2007. We expect near term performance of the index will trend incrementally higher as appreciating prices of performing properties in primary markets outperform the drag from distressed sales. Highlighting the precarious stabilization of commercial real estate prices, even with the uptrend prices as measured by the index, remain 41.6% below their peak.

Figure 1: Moody's/REAL Commercial Property Price Indices

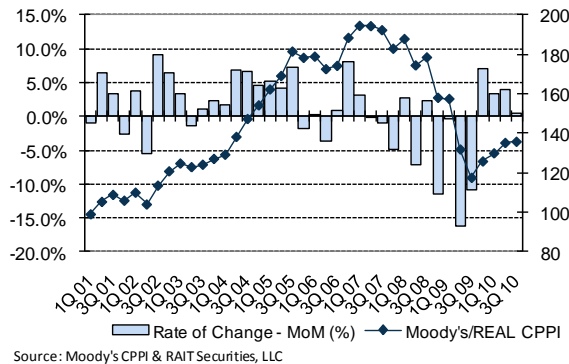


The Moody's/REAL CPPI index has increased 6.4% since August 2010 after falling 54.1% from its peak in October 2007.

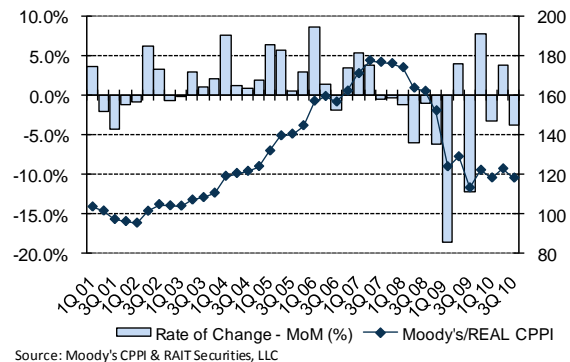
While the overall index has trended higher, sector performance has varied as illustrated by the Moody's/REAL CPPI index for the four major property sectors shown below.

## Prices by Sector

**Figure 2: Moody's/REAL CPPI – Apartment Sector**

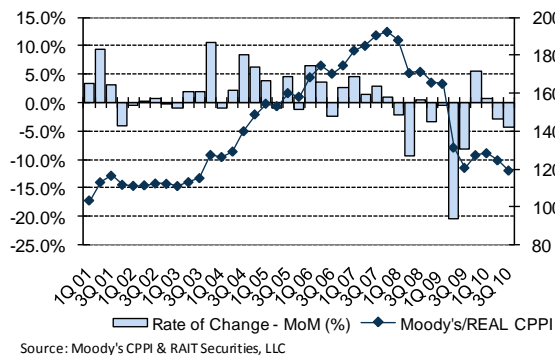


**Figure 3: Moody's/REAL CPPI – Office Sector**

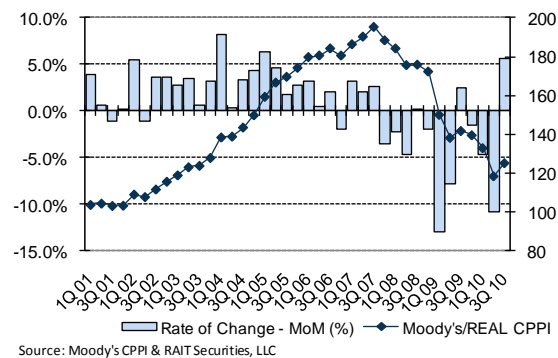


Apartment sector pricing has increased sharply after its precipitous fall in 2008 and much of 2009 with the index increasing 16% from a low of 117.6 in Q3 2009. The office sector's price movement has been choppy; however, the index at the end of Q3 2010 was 118.2, up 4.4% from its low in Q3 2009.

**Figure 4: Moody's/REAL CPPI – Industrial Sector**



**Figure 5: Moody's/REAL CPPI – Retail Sector**



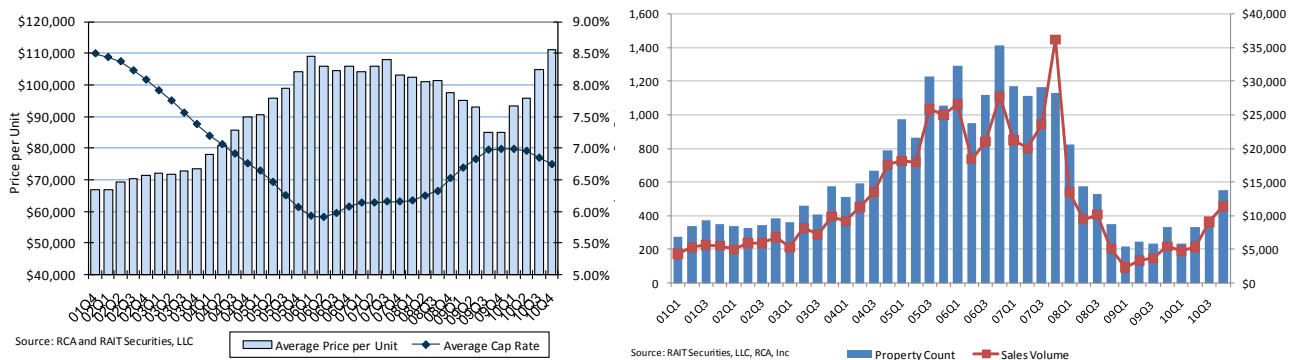
Industrial sector pricing faltered in mid-2010 as the index fell 7.2% in Q2 and Q3 2010 to a new low of 119.2. The retail sector rebounded in Q3 2010 and its index now stands at 125.3, up 5.7% from its trough in Q2 2010.

The bottoming and improvement in prices is a result of the increase in demand and compression of cap rates. Following we take a closer look at cap rates, price per unit, and sales volume by sector as measured by Real Capital Analytics.

## Cap Rates and Transaction Volume by Sector

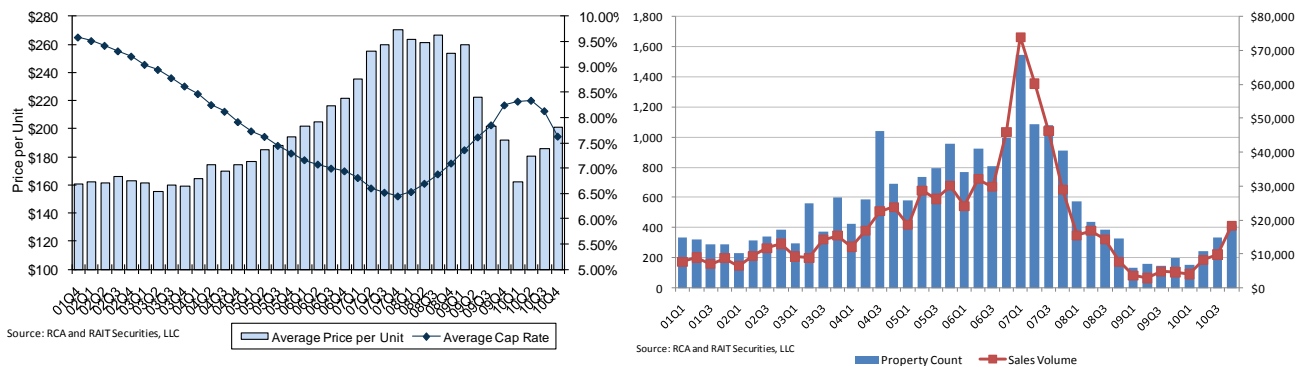
After a dramatic decrease in transaction flow, investor interest has returned as credit has become more readily available and the risk premium to own real estate has widened near historic levels.

**Figure 6: Apartment Sector Cap Rates, Price per Unit, Quarterly Sales Volume & Property Count**



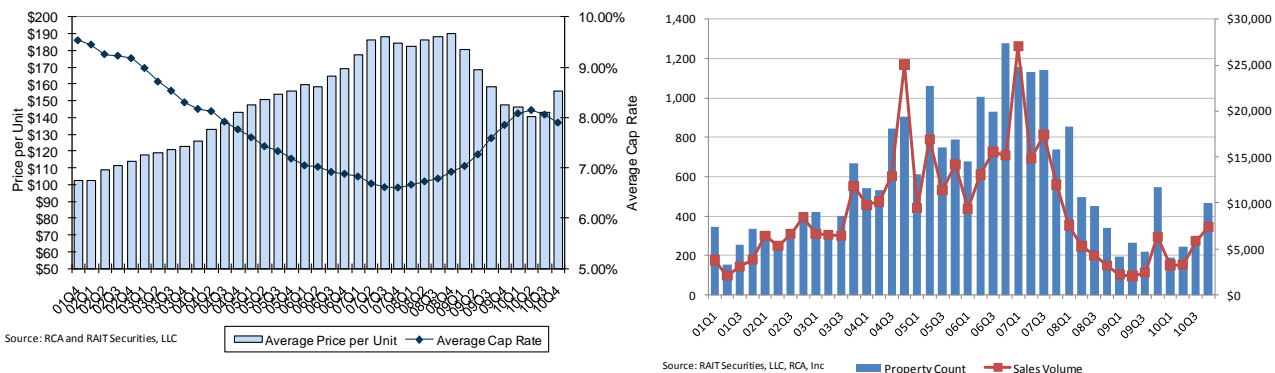
Apartment sector cap rates (twelve-month moving average) tightened a total of 25 bps to 6.74% over the last three quarters of 2010, helping fuel a 30% YoY increase in average price per unit, according to RCA. Sales volume surged in 2010 totaling almost \$31 billion, a 107% increase over the 2009 total.

**Figure 7: Office Sector Cap Rates, Price per Unit, Quarterly Sales Volume & Property Count**



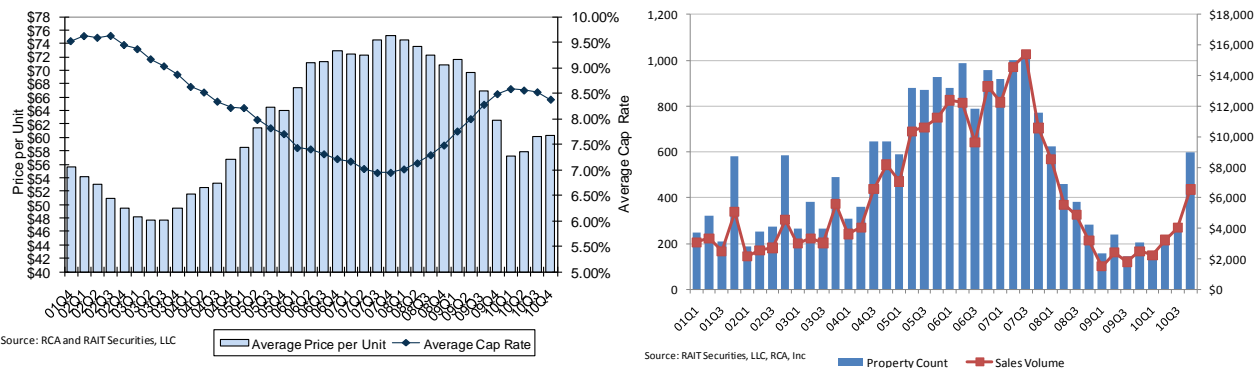
Sales volume in the office sector in 2010 more than doubled (\$40.3 billion vs. \$16.0 billion, up 152%) the volume recorded in 2009 with \$18.2 billion of sales volume in Q4 2010 alone, the most on a quarterly basis since the Q4 2007. After topping out at 8.34% in Q2 2010, cap rates tightened dramatically with the twelve-month moving average compressing 71bps to end the year at a 7.63% average. As a result, the average price per square foot (12-month moving average) has increased 24% according to Real Capital Analytics.

**Figure 8: Retail Sector Cap Rates, Price per Unit, Quarterly Sales Volume & Property Count**



Cap rates in the retail sector reversed trend and tightened 25 bps in the second half of 2010 as monthly retail sales turned decidedly positive. Tightening cap rates helped the average price per square foot break higher in Q4 2010 (up 10%) after trending lower most of the year. The twelve-month moving average cap rate ended 2010 at 7.9%, while 2010 transaction volume was up approximately 52% in comparison to last year, according to RCA. Of significance was the Q4 2010 volume of \$7.4 billion, which was 25% more than the Q3 2010 volume and did not benefit from a large portfolio sale such as the \$2.3 billion sale of Prime Outlets to Simon Property Group in August. In addition, the Q4 2010 volume was the highest amount recorded since Q1 2008.

**Figure 9: Industrial Sector Cap Rates, Price per Unit, Quarterly Sales Volume & Property Count**



Industrial sector cap rates have tightened three quarters in a row moving from 8.58% to 8.38%, still the highest average cap rate of the four major sectors. Sales volume of \$16 billion in 2010 almost doubled the 2009 total of \$8.2 billion with volume in the second half of 2010 totaling \$10.6 billion. In contrast to the Moody's/REAL CPPI index, the twelve-month moving average price per square foot increased 5.5% after bottoming in Q1 2010, according to Real Capital Analytics.

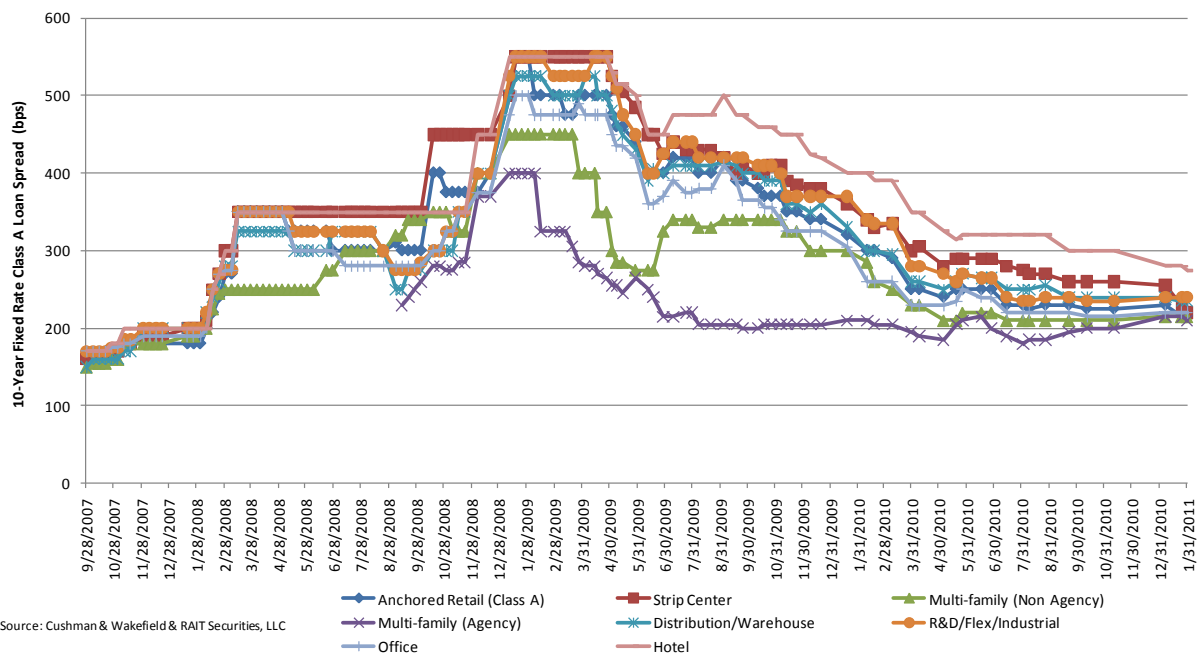
Given the strengthening tailwind at the back of the commercial real estate sector (improving leasing fundamentals, greater availability of credit, etc), we expect that transaction volume will continue to accelerate in 2011. Even with the recent increase in the 10-Year Treasury yield, we believe that the

elevated risk premium for purchasing commercial real estate and improving leasing conditions should continue to pressure cap rates tighter. That said the very real risks remaining in the U.S. economy (high unemployment, struggling housing sector, and a banking sector that has still not fully healed) should temper growth and limit the frothiness experienced in the mid-2000's.

## Fueling Growth in 2011

We expect that total sales volume will breach the \$200 billion mark and could possibly double last year's total in 2011. Fueling that growth is an increasing risk appetite among investors, an economic recovery that is gaining traction, close to historically wide risk premiums, a resurgence in the CMBS sector (with about 25 groups, including RAIT, announcing that they will be active in the conduit lending business), and greater demand to originate loans from insurance companies. As a result of increasing competition among lenders, lending spreads have tightened rather significantly and are now inside pre-Great Recession levels. We expect lending spreads will continue to grind incrementally tighter as leasing fundamentals improve and lenders compete for deals. Even with the upward pressure on 10-Year Treasury yields, tight lending spreads should give cap rates room to continue to compress.

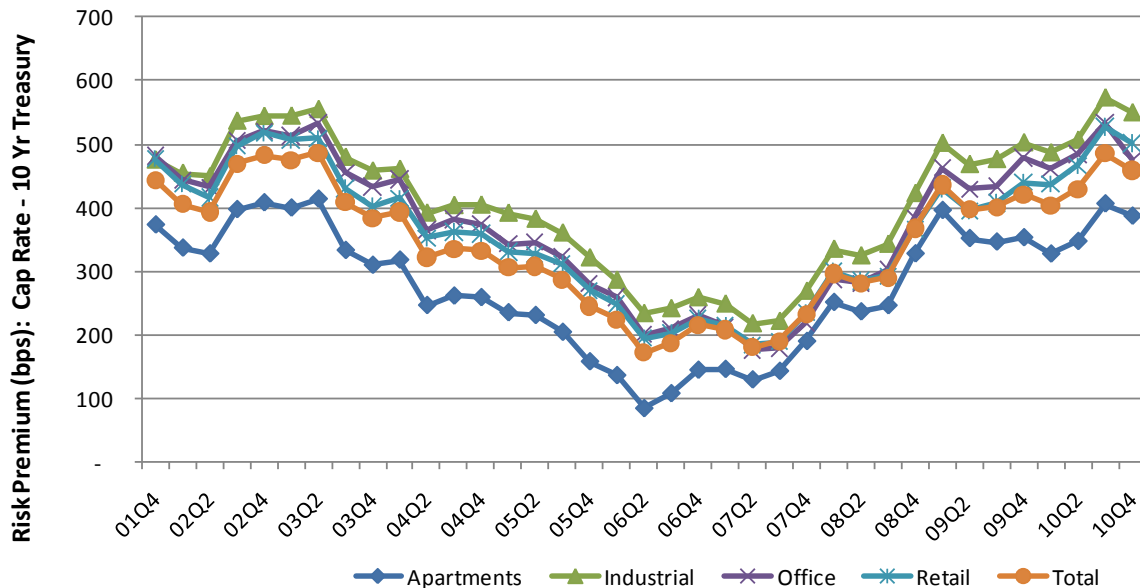
**Figure 10: 10-Year Fixed Rate Class A Loan Spreads by Property Type**



## Risk Premium

Even with the recent upward trend in the 10-Year Treasury rate and cap rate compression, the risk premium, or the spread between the cap rate and the 10-Year Treasury, remains near the highest levels experienced in recent history.

**Figure 11: Risk Premium Chart by Sector**



Source: RAIT Securities, LLC, Federal Reserve & RCA

## CMBS

The CMBS market is quickly gaining steam thanks to a confluence of factors including an increasing risk appetite among investors and lenders, improving economic conditions, and a dearth of supply to satisfy growing demand. After recording only \$2.7 billion of issuance in 2009 and \$11.6 billion of issuance in 2010, market experts are predicting approximately \$40 billion in issuance in 2011. In fact, two deals totaling \$3.7 billion are already in the market, while at least four additional multi-borrower deals totaling roughly \$5.5 billion are projected to price by the end of the first quarter. Given the strong start to the year and the increasing number of participants in the market, the \$40 billion projection of issuance for 2011 may be conservative.

**Figure 12: CMBS and Life Company Originations – Recent History and Projection**

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011 (est)</u>
U.S. CMBS Issuance (\$Mil.)	12,146	2,744	11,633	40,000
Life Company (\$Mil)	26,666	16,390	20,320 *	30,000 - 35,000

Note: Excludes agency deals and resecuritizations. \* ACLI data through Q3 2010, Annualized is \$27,093 Million.

Source: RAIT Securities, ACLI and Commercial Mortgage Alert

The reemergence of the CMBS market as a finance option should help fuel continued sales volume growth in the commercial real estate transaction market.

## A Closer Look at the Transaction Markets by Metro

### ***Apartments***

While not a surprise, primary, global-type markets lived up to their reputation and dominated the ranking of overall apartment market sales volume in 2010. Leading the way was the **Washington, D.C. metro area** with almost \$3.4 billion in sales transactions, or 11.1% of the national total. **Manhattan** with more than \$2 billion in sales (6.7% of national sales) and **Los Angeles**, which recorded \$1.64 billion in sales (5.4%), helped the **Washington, D.C. metro area, Manhattan, and Los Angeles** capture almost 25% of total national sales volume in 2010.

**Figure 12: Apartment Market 2010 Transaction Data - Top 20 Metros by Sales Volume**

	2010 Volume	Average Price per Unit (\$)	Average Cap Rate
Manhattan	2,064.0	305,600	5.9%
Los Angeles	1,640.5	207,266	6.0%
Northern Virginia	1,521.0	204,579	6.3%
Houston	1,186.3	83,199	6.3%
Suburban Maryland	1,152.0	134,763	7.0%
Phoenix	1,139.5	63,353	6.4%
Atlanta	1,051.7	65,523	7.6%
Orange County	1,028.5	212,230	5.8%
Chicago	838.3	165,269	6.0%
Seattle	794.8	157,310	6.2%
Fort Lauderdale	723.6	122,371	6.4%
Dallas	719.8	78,353	6.9%
Washington DC	719.8	233,997	5.4%
Tampa	683.3	79,621	7.7%
Orlando	681.1	81,654	8.6%
San Diego	675.6	204,593	5.7%
Boston	660.5	207,751	5.1%
Northern New Jersey	585.4	132,872	6.5%
Baltimore	580.4	114,649	6.2%
Denver	567.7	81,180	6.1%

Source: Real Capital Analytics, Bloomberg LP, RAIT Securities, LLC

Other markets that experienced strong demand included **Phoenix, Atlanta, Florida markets (Fort Lauderdale, Tampa & Orlando), and Houston**, which highlights the influence of distressed-related sales of large pools of troubled assets.

The markets that topped the list for transaction volume in 2010 will likely remain on top in 2011, while some of the secondary cities may see an uptick in demand as potential buyers get priced out of the primary markets and search less liquid markets for yield.

## Office

**Manhattan** more than doubled its sales volume in 2010 with almost \$6.7 billion in transactions helping spur the 152% increase in national office sales volume last year. Coming in second is **Washington, D.C.** with over \$3.0 billion of sales volume. In fact, total sales volume in **Manhattan** and **Washington, D.C.** was almost 25% of the national total in 2010. Markets with large CBD's tended to lead the way in 2010 as metro's such as **Chicago, San Francisco, and Boston** saw the majority of their sales volume occur in the CBD rather than their suburban markets. Other markets with significantly more sales volume in 2010 in comparison to the previous year include **San Jose** (up 483%), **Houston** (up 276%), and **Fort Lauderdale** (up 528%), according to Real Capital Analytics.

**Figure 13: Office Market 2010 Transaction Data - Top 20 Metros by Sales Volume**

	2010 Volume	Average Price per Unit (\$)	Average Cap Rate
Manhattan	6,658.4	452	5.5%
Washington DC	3,054.8	487	6.3%
Chicago	2,671.3	187	7.9%
San Francisco	2,127.1	285	6.2%
Northern Virginia	2,081.4	245	7.3%
Boston	1,965.0	240	6.8%
Houston	1,618.2	178	8.5%
Los Angeles	1,616.1	230	7.3%
Northern New Jersey	1,511.7	124	7.4%
Seattle	1,335.9	337	7.3%
San Jose	1,329.5	242	6.9%
Orange County	1,163.0	221	8.0%
Dallas	965.6	119	7.2%
San Diego	885.9	275	7.3%
Oakland/East Bay	856.4	142	N/A
Denver	798.0	165	8.6%
Fort Lauderdale	483.1	247	7.5%
Miami	451.1	164	7.2%
Atlanta	369.2	94	7.8%
Minneapolis	355.8	173	N/A

Source: Real Capital Analytics, Bloomberg LP, RAIT Securities, LLC

We believe demand for CBD product will remain strong in 2011, which will help keep markets such as **Washington, D.C., San Francisco, and Boston** near the top of the list (**Manhattan** is always number one in sales volume). Markets that have less significant CBD's and large suburban markets (**Los Angeles, Orange County, Atlanta, Dallas**) will likely underperform in terms of sales volume as the suburban leasing sector has been slower to pick up.

## Retail

**Los Angeles** was the only market to top \$1 billion in retail transaction volume in 2010 with **Chicago** and **Manhattan** totaling more than \$850 million each. The surprise at the top of the list is **San Jose**, which was helped by the \$288 million sale of the Great Mall of the Bay Area, which accounted for almost half of **San Jose's** 2010 total volume. Other markets with significantly more sales volume in 2010 in comparison to the previous year include **Austin** (up 308%), **Orlando** (up 542%), and **Nashville** (up 664%), according to Real Capital Analytics.

**Figure 14: Retail Market 2010 Transaction Data - Top 20 Metros by Sales Volume**

	2010 Volume	Average Price	Average Cap
Los Angeles	1,039.0	212	7.0%
Chicago	862.6	173	7.7%
Manhattan	853.3	1,011	6.1%
San Jose	667.4	219	7.9%
Austin	528.3	157	8.9%
Miami	514.0	143	7.4%
Atlanta	509.1	96	7.9%
Orlando	503.3	75	8.6%
Inland Empire	485.2	178	7.9%
Suburban Maryland	478.1	259	N/A
Houston	476.8	128	8.6%
San Diego	426.5	230	7.4%
Nashville	419.2	236	8.7%
Portland	414.7	145	7.8%
Phoenix	411.8	173	8.1%
Dallas	407.5	161	7.2%
Sacramento	336.5	244	7.8%
Boston	322.3	136	7.9%
Northern Virginia	285.4	162	7.6%
Orange County	277.7	253	7.6%

Source: Real Capital Analytics, Bloomberg LP, RAIT Securities, LLC

Increasing monthly retail sales, which recently surpassed their all time high, and improved consumer confidence has eased investor concerns regarding the struggling housing sector and modest job recovery. We expect that overall sales volume will increase rather substantially overall, which should push prices higher and pressure cap rates tighter in most markets. We still anticipate that demand will remain strongest for well-located, in-fill neighborhood centers and fortress-type malls, while demand for big box and exurban centers will lag.

## Summary

Given our expectations of no double-dip in the economy, increasing availability of debt capital, and the return of the securitization market, we believe that the commercial real estate transaction market will experience significant growth in 2011. Increased demand, improving leasing fundamentals, and an easing of credit will likely put tightening pressure on the risk premium, which will result in solid price growth and further compression in cap rates.

# RAIT Expectations

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