

Market Update

October 28, 2009

We signed another lease on the Northwoods property this week. You will recall that PRF II will own a majority interest in Northwoods (approximately 72%). Liberty Mutual Insurance will take 1,861 SF on the first floor of the Columbus office property. This brings the total space leased this year to 16,399 SF or nearly 14% of the total leasable area. We will continue to focus on tenant retention as well as leasing to new tenants.

Market Update

We reviewed the quarterly report from Prudential Real Estate Investors today and it says generally what we have been saying—few transactions, continuing tight credit with some indications of improvement, large gap between “bid and ask” and capital waiting in the wings for lenders to force property to market. We are all waiting for the “tipping point.”

PREI’s research department’s report says, “The commercial real estate market presents a bit of a paradox. Property values continue to fall, the outlook for fundamentals is weak, and the debt markets remain relatively dysfunctional. Nonetheless, a tone of optimism has crept into the market despite these bleak conditions. Some of this may reflect the broad sense of relief that the worst of the financial crisis has passed, the improved economic conditions, and the rally in the equity markets. Or it may reflect the sense that a floor is forming for property values and that distress-induced transactions – which have yet to materialize – will soon become more widely available. Distress that has been evident to date has mostly involved non-income producing assets, such as land and failed condo projects, which represent a disproportionate share of the real estate holdings of some troubled regional banks.

On the subject of REITs, PREI says, similarly to what we wrote a couple of weeks ago, the public companies have reaped higher multiples following their actions to raise additional debt and equity. The mere perception by analysts and investors that by virtue of their stronger balance sheets, they will have opportunities to take advantage of down markets has driven share prices up. This perception looks beyond the fact that these companies hold large volumes of real estate already and that they will have to endure the next 12-30 months of weak fundamental demand for space. PREI says, “Where REITs go from here is a tricky question. Capital flows into dedicated REIT mutual funds and ETFs have been positive for most of the year, including 10 out of 13 weeks in 3Q09, and anecdotal evidence suggests that more non-dedicated investors are looking at

the sector again. REIT share prices likely have discounted further deterioration in property market fundamentals and REIT earnings over the next 12 months. Whether they have over- or under-estimated the magnitude of the decline in earnings will depend on the timing and strength of the job market recovery. But since the recovery is not likely to be evenly distributed across all markets and regions, performance of individual companies will continue to vary widely. With investors focusing increasingly on fundamentals, companies that fail to meet expectations may be susceptible to selloffs. Although volatility has eased significantly from earlier this year, it remains high enough that the market could see a meaningful pullback – or pop – on any given day. Over the next 12 months, we expect equity REITs should deliver total returns of 6% to 8%, on average. If the broader equity market pulls back, however, REITs will not be spared.”

On the topic of debt, there seems to be some improvement. Anecdotally, our CFO says that she is now getting phone calls from banks. Last fall, one might not even get a return phone call. One bank, as we mentioned in a prior communication, is talking about loan structures that are life company-like in many ways, with good loan to values (75%) and reasonable spreads over LIBOR.

PREI cites the rise of public and private specialty lenders such as Starwood Capital’s \$1 Billion offering. There are others, but they constitute a relatively small amount of capital. We will, however, keep our eye on them as prospective sources.

The life companies have also begun to stir from the dead. As the yields on corporate and government bonds decrease, these alternatives to producing mortgage loans look less attractive. So, life companies are looking more aggressively at mortgages. While the spreads (pricing) have decreased by 40%, they are still high relative to history and the loan-to-value ratios are still very demanding (60% range).

We fully expect that in some cases lenders in place on a given asset may be lenders going forward under new ownership with fresh capital. We will continue to look at these situations. Please call us with any questions you may have. We will continue to communicate with you and look forward to locating great investment opportunities. Thank you.