FALCON

REAL ESTATE INVESTMENT MANAGEMENT, LTD.

Advisory Services for Investors in US Real Estate

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The Surprising United States

Much to the surprise of many observers both in the US and overseas, the US economy continues to show slow but consistent growth. Whereas just this past summer many economists were forecasting that the US was headed back into another recession, gross domestic product instead increased at an annual rate of 2% in the third quarter, up significantly from the rate of 1.3% in the second quarter. The improving rate of growth occurred despite the crisis that is affecting the euro zone and the recession that is affecting Japan.

This rate of growth in the US is coming almost exclusively from the private sector and is offsetting the negative impact on the economy resulting from cutbacks at the state and local government levels. The Federal government, of course, continues to operate with an enormous deficit and this, combined with the expansive policies being followed by the Federal Reserve Board, provides considerable stimulus to the US economy.

Reflecting the stronger economy, the unemployment rate fell in 43 states in November, the most number of states to report such declines in eight years. The economy has now generated 100,000 or more jobs five months in a row — the first time that has happened since 2006, before the recent recession. And the number of Americans filing new claims for jobless benefits dropped to a 3-1/2-year low in mid-December, reaching the lowest level since May 2008. The continued improvement in the employment statistics is a strong indication that total growth in the 4th quarter will show an increase over the 2% rate of growth in the 3rd quarter.

The US commercial real estate market is also showing surprising strength. The real estate market benefits not only from the recovering economy, but also from the underlying health of the commercial market itself. This market was not overbuilt, as the residential market was, and there has been no deluge of foreclosed properties inundating the market, as many observers had predicted. As a result, with an improving economy, vacancy rates are declining in most sectors of the real estate market and rental rates are starting to move up.

Office Market

The improvement in the office market is clearly picking up speed. Cushman & Wakefield reports that overall vacancy in 30 core CBD markets dropped 1.1 percentage points from a year ago to 13.8% at the end of September. Net absorption in those markets has been positive for four consecutive quarters, and was the highest third-quarter absorption level since 2006 and also the third-highest volume recorded in any quarter since the year 2000. Washington DC, Midtown Manhattan, San Francisco, Chicago and Orange County were the markets showing the best absorption levels. At the same time, year-to-date total leasing activity has jumped almost 23% over the same period last year, reaching close to 59 million square feet. The strong office leasing activity is beginning to have an effect on rental rates, with Class A rents being 1% higher than a year ago, although Class B and C rents continue to lag the recovery and are still slightly below the level of one year ago. However, some cities, such as San Francisco and New York, are already experiencing sharp increases in rental rates, with rents in some prime New York City buildings now exceeding $100 per square foot. The strength in the office leasing market is a clear indication that corporate management is optimistic as to the business outlook, and is another indication that 4th quarter GDP is likely to surprise on the upside.

As we have indicated in previous newsletters, pricing in the office market in cities such as New York, Boston and San Francisco seems to have risen in anticipation of rental increases that may not be realized for another year or two. But we continue to see good opportunities in other locations, including Houston, Chicago and Seattle, or in extended metropolitan areas such as Northern New Jersey and Orange County, California.

Industrial Market

The US industrial and logistics market is also showing a good deal of strength. Jones Lang LaSalle reports that this market "is sailing ahead on a slow, steady course," and has now experienced six consecutive quarters of demand growth. Leading the pace is the "big box" bulk warehousing and logistics sector, where strength has brought the overall US industrial vacancy rate down to 9.6% at the end of the third quarter. This is 60 basis points below the level of one year ago, and it is expected that space availability should continue to tighten in 2012. Rents have been slow to stabilize in the industrial market, but the third quarter did see a slight upturn of about ½ of 1% nationwide. As with the office market, little new speculative construction is projected for the coming year and this should provide pressure for some further increase in rents in this sector.

The strength in the industrial market has been concentrated in those markets that are major distribution centers and that have a strong transportation infrastructure. This includes Atlanta, Chicago, Dallas, Houston, the Inland Empire of Southern California, Philadelphia and Central New Jersey. All of these locations depend to a very great extent on internal US distribution, and therefore benefit from the recovering US economy. On the other hand, those industrial markets that are focused primarily on the export markets, are experiencing a slower rate of recovery.

Apartments

The rental apartment market has maintained its position as the strongest part of the US commercial real estate market. The vacancy rate in the market continues to drop, falling another 30 basis points in the third quarter to reach 5.6%. There are a number of basic trends that are supporting the apartment market at this time. First of all, the collapse of the condo and housing markets has led to a significant decline in home ownership, moving a large percentage of the US population into the rental market. This trend is accelerated by the high level of unemployment that prevents many people from even attempting to own their own home. And with marriage in the United States now generally occurring much later in life, rental apartments become an acceptable form of housing for a longer period of time for more people.

From an investment viewpoint, the favorable conditions in the rental apartment market should continue well into 2012. The only foreseeable change will be the addition of new supply in some markets. The construction of new apartment projects, particularly of suburban garden apartments, can be completed relatively quickly, and the low level of vacancy rates has led some developers to begin such projects in major markets around the country. However, Falcon believes that there is very little chance that competitive pressures will arise due to overbuilding, and we feel that a well-located, well-managed project will retain its position in the market and continue to produce good returns.

On a long-term basis, the NCREIF performance statistics show that apartments have been the best performing asset class in the US commercial real estate market, consistently producing higher IRR's than other sections of the market. Therefore, Falcon recommends that any well-diversified portfolio of US commercial real estate should include rental apartments as one of its asset classes. We have had considerable experience in providing asset management for apartment complexes, and believe that we have management procedures in place that permit us to effectively manage such properties.

Retail

The Congressional Budget Office has reported that in 2011 there was a continued and growing disparity between the top levels of society in the United States and just about everyone else. This disparity has received a great deal of attention in the press due to political movements such as the "Tea Party" and "Occupy Wall Street". The principal effect of this disparity as it affects commercial real estate is, of course, on the retailing industry. High-end retailers clearly benefit from this situation, while all other segments of the retail industry are faced with a more difficult marketing environment. Falcon has always had a negative view of investing in properties leased to so-called "big box" retailers such as Walmart, Kmart or Target, because of their long-term flat leases. Competition in most other segments of the retail market has been increasing, particularly during the recent recession, and therefore we believe that it is important to be very selective in investing in any retail property. The very high-end retailers, however, in locations such as Fifth Avenue and Madison Avenue in New York, Michigan Avenue in Chicago and Rodeo Drive in Beverly Hills, have the advantage of the best possible locations and the strongest credit tenants. From time to time Falcon also recommends other select retailers in major urban areas if they meet stringent investment criteria.

Conclusion

With the slow but steady improvement of the US economy, we are seeing a surprisingly strong recovery in most segments of the US commercial real estate market. The rental apartment market is leading the way, but the office market in major metropolitan areas around the country is also doing very well, with leasing activity in the first nine months of 2011 jumping 23% from the previous year. In addition, the vacancy rate in the industrial and logistics sector has dropped to 9.6% following six consecutive quarters of increased leasing demand. We believe that both of these factors indicate a fairly optimistic outlook by American businessmen for 2012.

For further information, log on to www.falconreal.com or contact Falcon Real Estate:

570 Lexington Avenue, New York, New York 10022
www.falconreal.com