DIVIDEND CAPITAL RESEARCH

Cycle Monitor — *Real Estate Market Cycles*

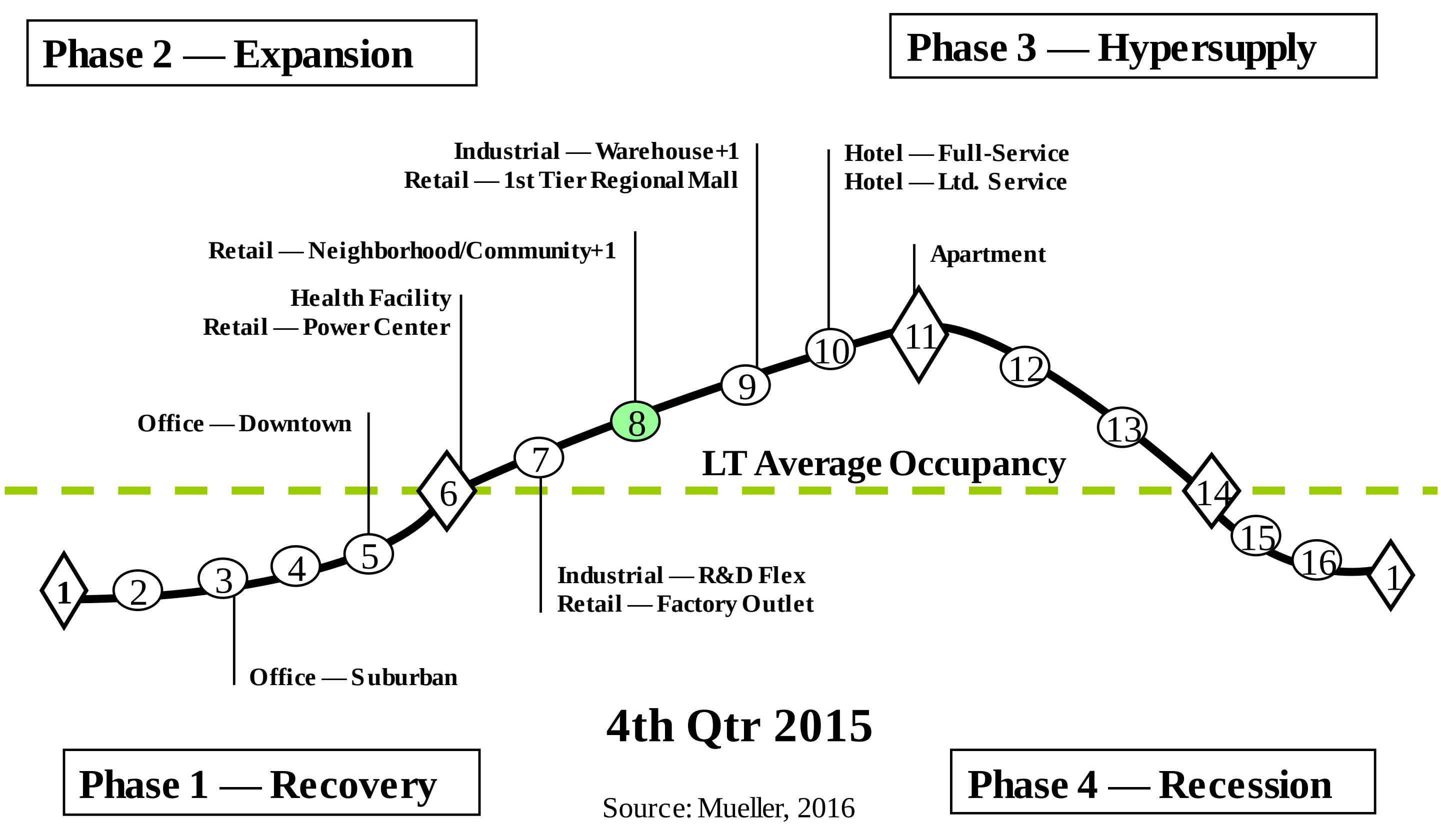
Fourth Quarter 2015 Analysis

February 2016

Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.
Gross Domestic Product (GDP) continued to grow at a moderate 2% level as it has since the great recession seven years ago. Continued stock market volatility and a slowing global economy have not deterred employment growth, which is the main driver for income producing commercial real estate demand. Low interest rates and low gas prices are supporting home buying and consumer spending. The economic expansion is creating abundant job opportunities even though the manufacturing and energy sectors are contracting. Commercial real estate is expected to perform well again in 2016.

Office occupancies **improved** 0.2% in 4Q15, and rents grew 1.2% for the quarter and 4.4% annually.
Industrial occupancies **improved** 0.2% in 4Q15, and rents grew 0.6% for the quarter and 5.5% annually.
Apartment occupancies **declined** 0.3% in 4Q15, and rents declined 0.1% for the quarter, but were up and 4.0% annually.
Retail occupancy **improved** 0.1% in 4Q15, and rents grew 0.1% for the quarter and 2.4% annually.
Hotel occupancies **improved** 0.2% in 4Q15, and room rates declined 1.4% for the quarter, but increased 2.6% annually.

National Property Type Cycle Locations



Source: Mueller, 2016

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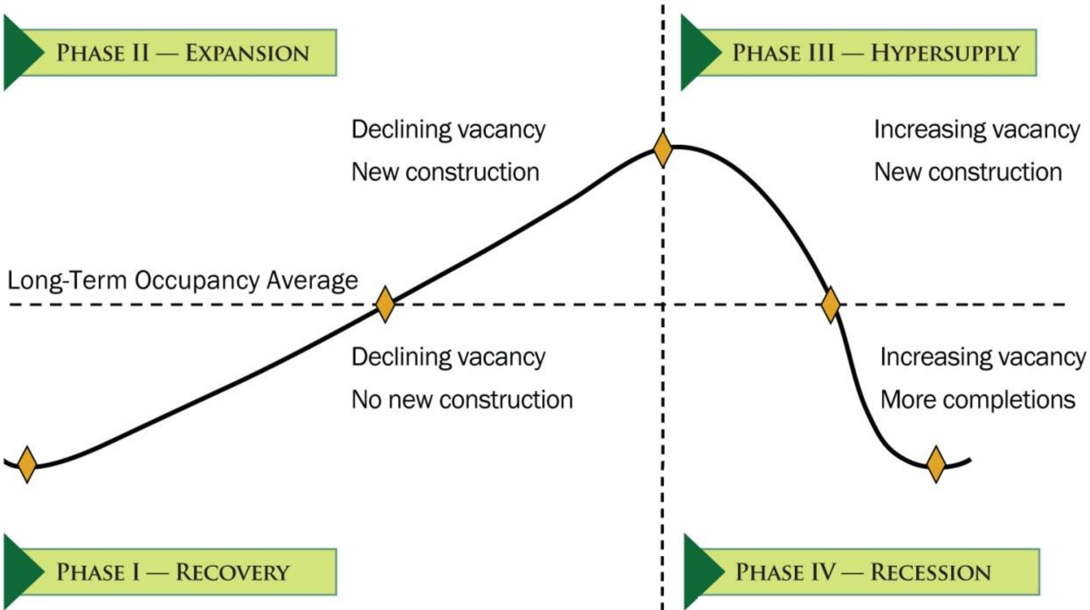
All relevant disclosures and certifications appear on page 9 of this report.

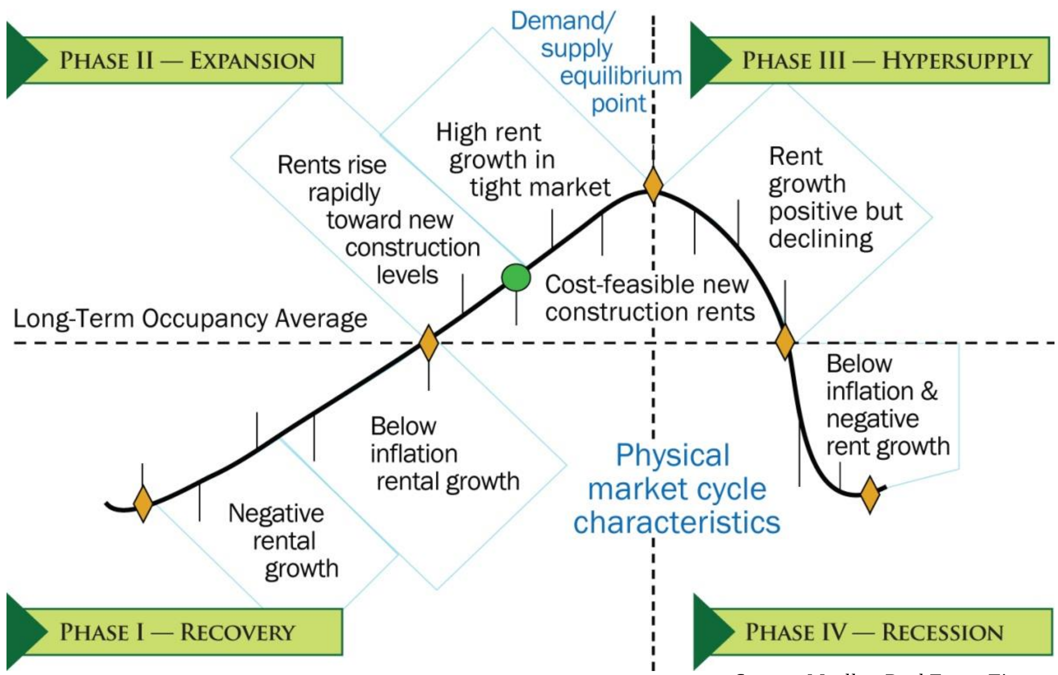
The cycle monitor analyzes occupancy movements in five property types in more than 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that analyze occupancy levels and rental growth rates to provide the foundation for long-term investment success. Real estate markets are cyclical due to the lagged relationship between demand and supply for physical space. The long-term occupancy average is different for each market and each property type. ***Long-term occupancy average*** is a key factor in determining rental growth rates — a key factor that affects real estate returns.

Market Cycle Quadrants



Source: Mueller, Real Estate Finance, 2016.

Rental growth rates can be characterized in different parts of the market cycle, as shown below.



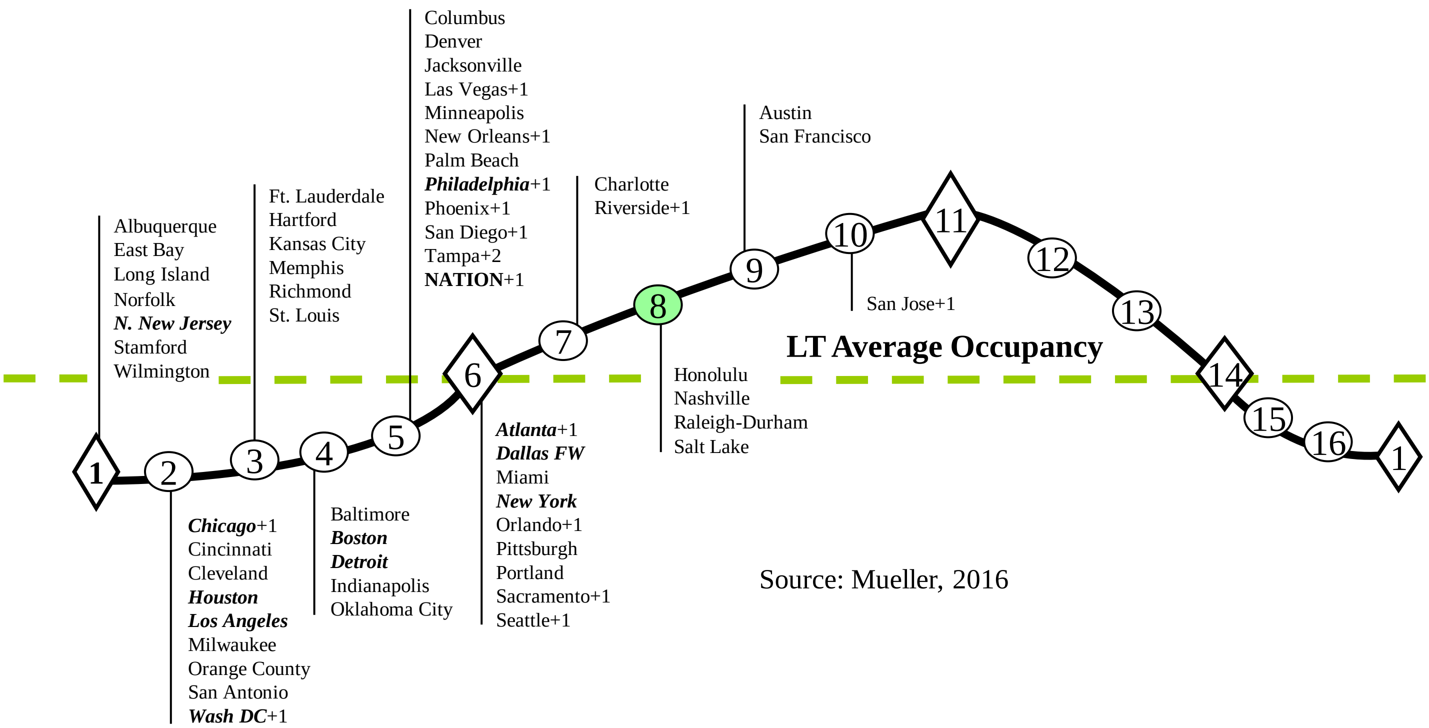
Source: Mueller, Real Estate Finance, 2016.

OFFICE

The national office market occupancy level improved 0.2% in 4Q15 and was up 0.5% year-over-year. This is the twenty-first quarter of consecutive improvement. Solid employment growth helped tenants absorb more than 17 million square feet in 4Q15 lead by the Chicago, San Francisco and Seattle markets. New construction remained lower than absorption for the year and was still 30% less than the pre-recession peak in 2006. Pre-leased space was above 60% in new construction indicating that tenants are optimistic about their future business prospects. Space completions continued to trail absorption, reducing options for tenants and pushing rents higher. Average national rents were up 1.2% in 4Q15 and rents were up 4.4% year-over-year.

Office Market Cycle Analysis

4th Quarter, 2015



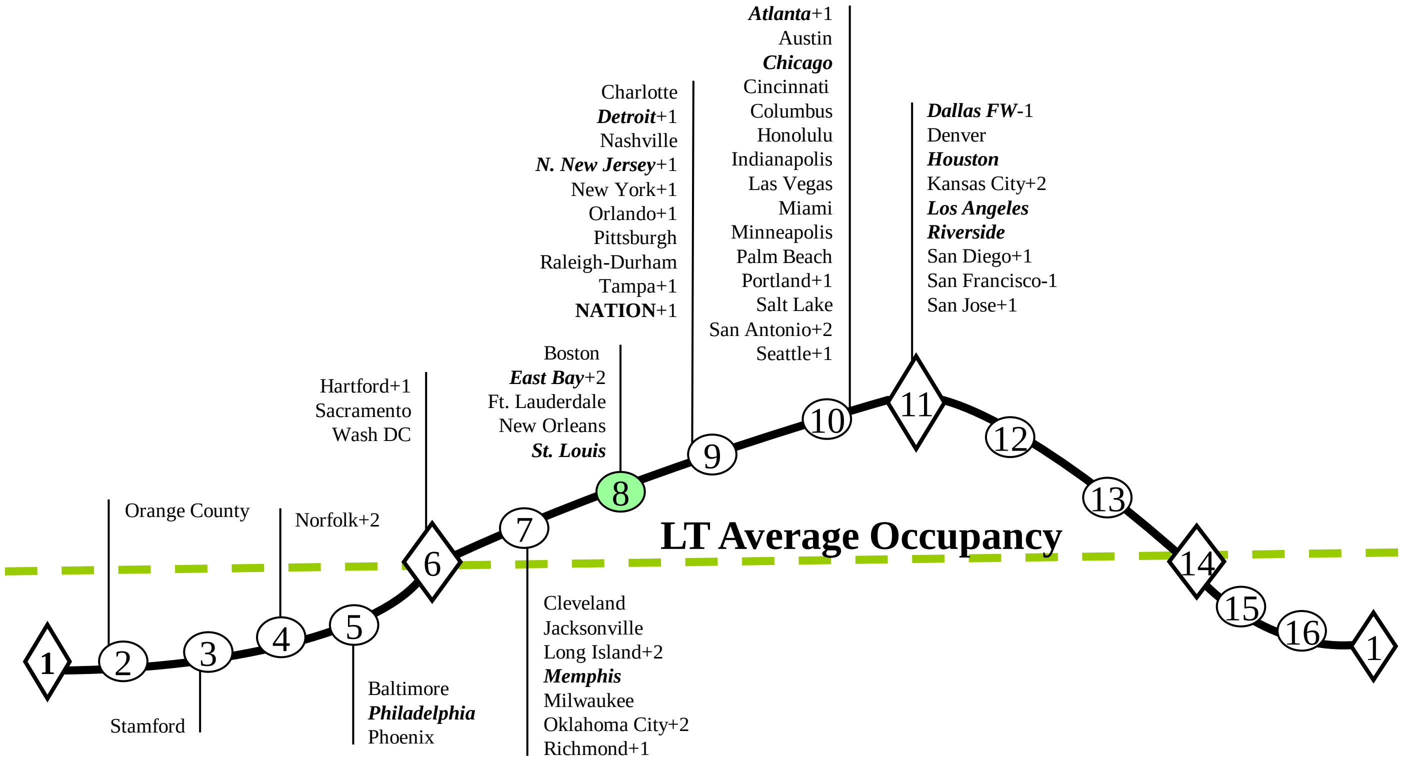
Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor. Thus, the 11-largest office markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

INDUSTRIAL

Industrial occupancies improved 0.2% in 4Q15 and were up 0.6% year-over-year. The occupancy increase was enough to push the national average occupancy rate up to point 9 on the cycle chart with 70% of the markets covered now having rents that allow for cost feasible new construction. Consumer spending continues to create increased demand for storage and many retailers are looking to provide faster delivery with more warehouse locations. Industrial rent growth was the highest of all the property types for 2015. The industrial national average rent index increased 0.6% in 4Q15 and was up 5.5% year-over-year.

Industrial Market Cycle Analysis
4th Quarter, 2015



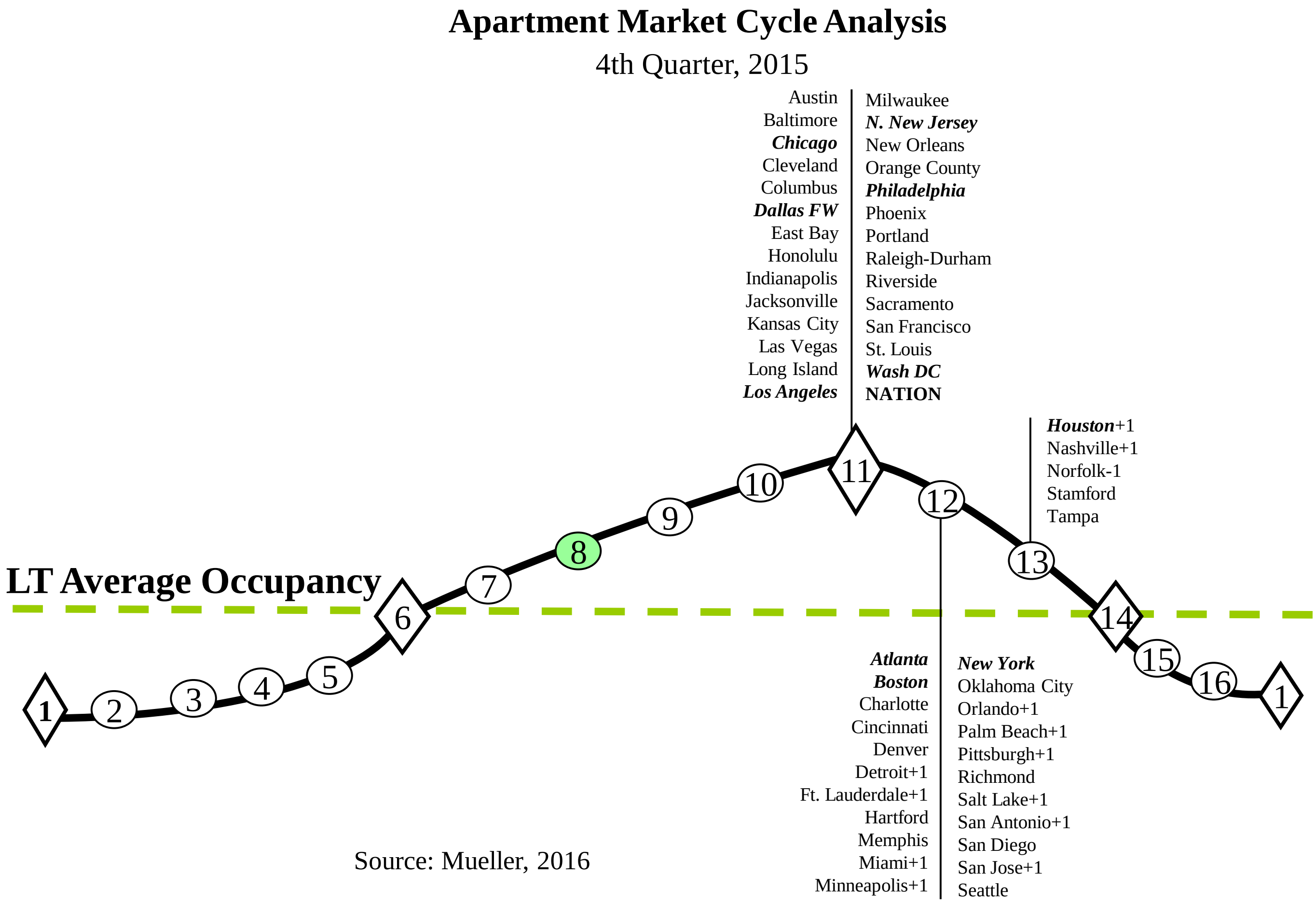
Source: Mueller, 2016

Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space we monitor. Thus, the 12-largest industrial markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

APARTMENT

The national apartment occupancy average declined 0.3% in 4Q15 and was flat year-over-year. This means that the apartment occupancy cycle is passing its peak, but not quite enough yet to move to point 12 on the cycle. The reason for this is not a lack of demand as millennials continue to enter the workforce and rent apartments. It is still because new construction is higher than demand and continues to accelerate. Apartment deliveries are expected to be the strongest yet in 2016. Average national apartment rent growth began to decline with a 0.1% drop in 4Q15, but was up 4.0% year-over-year.



Note: The 10-largest apartment markets make up 50% of the total square footage of multifamily space we monitor. Thus, the 10-largest apartment markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

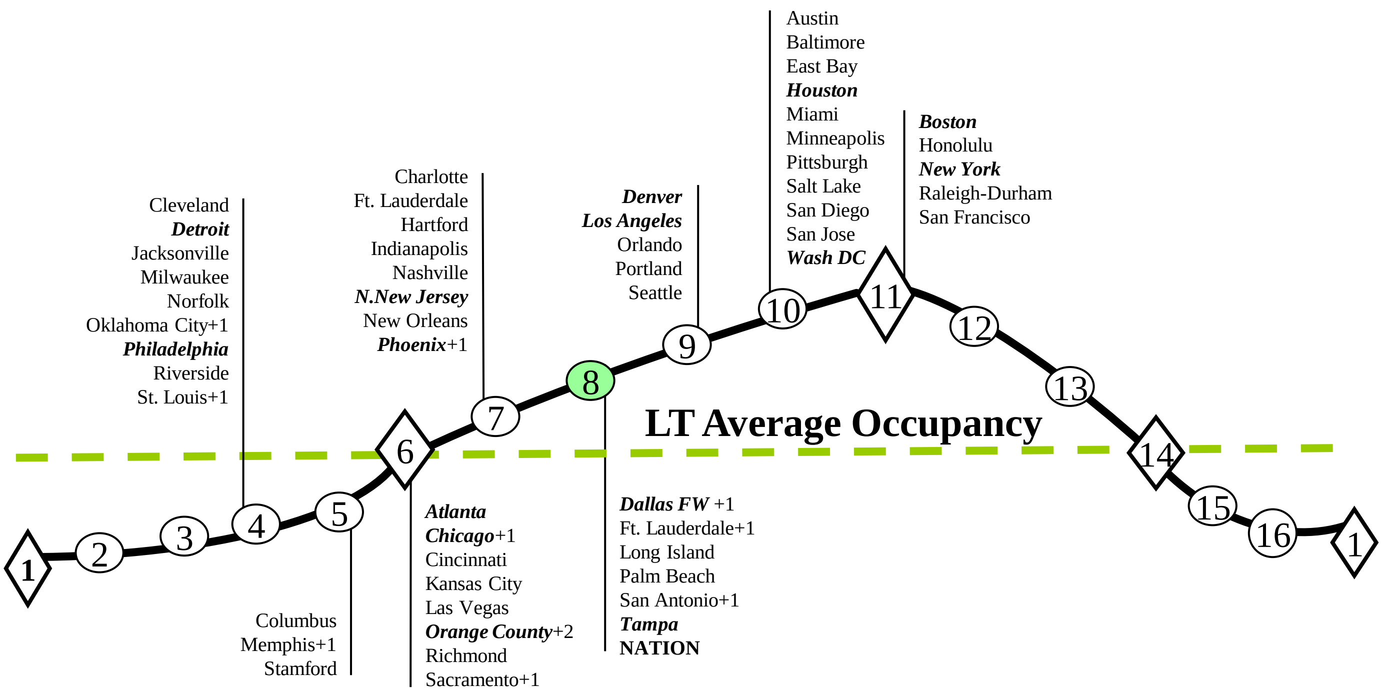
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

RETAIL

Retail occupancies were up 0.1% in 4Q15 and were up 0.5% year-over-year. Holiday sales were reported to have had a minor drop initially, but then were revised to have a 3.4% gain. This gave retailers the confidence to expand stores, leading to 66 million square feet of net absorption in 2015. The major catalyst now is lower gas prices which give consumers more disposable income. National average retail rents increased 0.1% in 4Q15 and were up 2.4% year-over-year.

Retail Market Cycle Analysis

4th Quarter, 2015



Source: Mueller, 2016

Note: The 15-largest retail markets make up 50% of the total square footage of retail space we monitor. Thus, the 15-largest retail markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

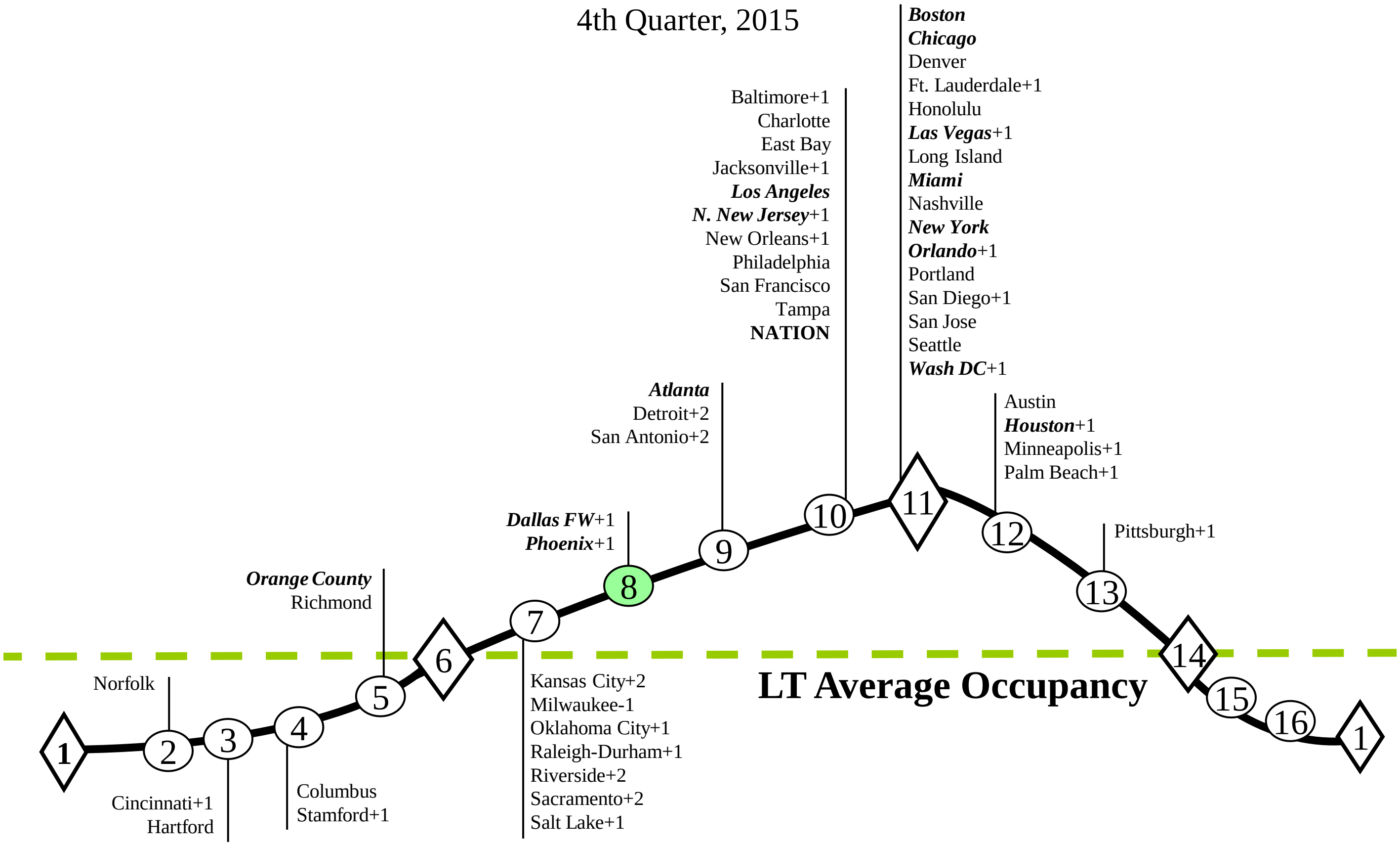
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

HOTEL

Hotel occupancies increased an average of 0.2% in 4Q15 and were up 1.0% year-over-year. Reduced energy prices helped to fuel holiday travel and room demand. New projects continued to come online increasing competition and while the increased occupancy should have translated into increased room rates, it did not happen. The National average hotel room rate declined 1.4% in 4Q15, but was up 2.6% year-over-year.

Hotel Market Cycle Analysis

4th Quarter, 2015



Source: Mueller, 2016

Note: The 14-largest hotel markets make up 50% of the total square footage of hotel space that we monitor. Thus, the 14-largest hotel markets are in boldface italics to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

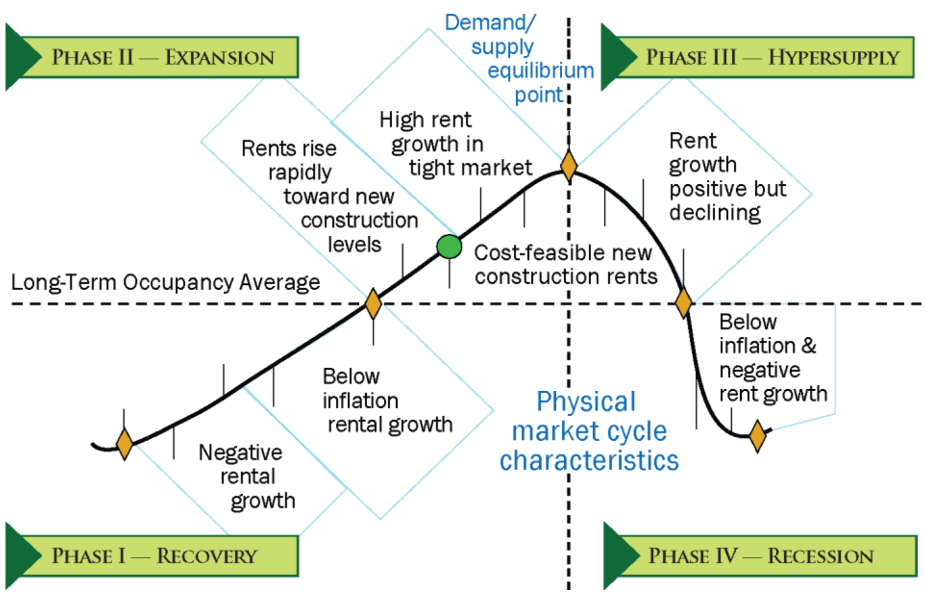
MARKET CYCLE ANALYSIS — Explanation

Supply and demand interaction is important to understand. Starting in Recovery Phase I at the bottom of a cycle (see chart below), the marketplace is in a state of oversupply from previous new construction or negative demand growth. At this bottom point, occupancy is at its trough. Typically, the market bottom occurs when the excess construction from the previous cycle stops. As the cycle bottom is passed, demand growth begins to slowly absorb the existing oversupply and supply growth is nonexistent or very low. As excess space is absorbed, vacancy rates fall allowing rental rates in the market to stabilize and even begin to increase. As this recovery phase continues, positive expectations about the market allow landlords to increase rents at a slow pace (typically at or below inflation). Eventually, each local market reaches its ***long-term occupancy average*** whereby rental ***growth is equal to inflation***.

In Expansion Phase II, demand growth continues at increasing levels, creating a need for additional space. As vacancy rates fall below the ***long-term occupancy average***, signaling that supply is tightening in the marketplace, rents begin to rise rapidly until they reach a cost-feasible level that allows new construction to commence. In this period of tight supply, rapid rental growth can be experienced, which some observers call "rent spikes." (Some developers may also begin speculative construction in anticipation of cost-feasible rents if they are able to obtain financing.) Once cost-feasible rents are achieved in the marketplace, demand growth is still ahead of supply growth — a lag in providing new space due to the time to construct. Long expansionary periods are possible and many historical real estate cycles show that the overall up-cycle is a slow, long-term uphill climb. As long as demand growth rates are higher than supply growth rates, vacancy rates will continue to fall. The cycle peak point is where demand and supply are growing at the same rate ***or equilibrium.*** Before equilibrium, demand grows faster than supply; after equilibrium, supply grows faster than demand.

Hypersupply Phase III of the real estate cycle commences after the peak/equilibrium point #11 — where demand growth equals supply growth. Most real estate participants do not recognize this peak/equilibrium's passing, as occupancy rates are at their highest and well above long-term averages, a strong and tight market. During Phase III, supply growth is higher than demand growth (hypersupply), causing vacancy rates to rise back toward the long-term occupancy average. While there is no painful oversupply during this period, new supply completions compete for tenants in the marketplace. As more space is delivered to the market, rental growth slows. Eventually, market participants realize that the market has turned down and commitments to new construction should slow or stop. If new supply grows faster than demand once the long-term occupancy average is passed, the market falls into Phase IV.

Recession Phase IV begins as the market moves past the long-term occupancy average with high supply growth and low or negative demand growth. The extent of the market down-cycle will be determined by the difference (excess) between the market supply growth and demand growth. Massive oversupply, coupled with negative demand growth (that started when the market passed through long-term occupancy average in 1984), sent most U.S. office markets into the largest down-cycle ever experienced. During Phase IV, landlords realize that they will quickly lose market share if their rental rates are not competitive; they then lower rents to capture tenants, even if only to cover their buildings' fixed expenses. Market liquidity is also low or nonexistent in this phase, as the bid–ask spread in property prices is too wide. The cycle eventually reaches bottom as new construction and completions cease, or as demand growth turns up and begins to grow at rates higher than that of new supply added to the marketplace.



Source: Mueller, Real Estate Finance, 2016.

This research currently monitors five property types in more than 50 major markets. We gather data from numerous sources to evaluate and forecast market movements. The market cycle model we developed looks at the interaction of supply and demand to estimate future vacancy and rental rates. Our individual market models are combined to create a national average model for all U.S. markets. This model examines the current cycle locations for each property type and can be used for asset allocation and acquisition decisions.

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