



# Q1 2011 Quarterly Real Estate Commentary

*Authored by Carlos Valdivia, Real Estate Investment Advisor*

It's a pleasure to introduce myself to you as the newest team member here at Opes Advisors. My primary objective is to provide detailed and expert advice around a major component in many of our clients' personal balance sheets: their investment real estate. My career encompasses more than 15 years of experience in real estate asset management, finance, valuations, and direct investing, having acted as both a principal and a fiduciary. I look forward to meeting you and working with the rest of the Opes team to help you define and achieve your retirement goals.

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Every quarter we will provide a real estate commentary that will cover the commercial (includes apartments greater than 4 units) and residential real estate markets at both a national and local level. Hopefully you will find this real estate commentary informative as well as insightful, and will be able to better assess how market dynamics and fundamentals are impacting your real estate investments.

## Summary

On a national level, the housing and commercial real estate (“CRE”) markets are seemingly going in opposite directions with housing prices and sales totals continuing to fall while CRE markets are taking steps toward recovery. However, the fear of a double-dip housing recession is real and continues to lurk in the back of the minds of CRE investors. When the recession began in 2007, the commercial real estate market declines lagged but eventually paralleled the declines of the hardest-hit residential markets. If the housing market goes into a double-dip recession, the question many are wondering is, will commercial real estate follow? Although most experts don't expect a full-blown double-dip recession in the housing market, the economic recovery remains fragile and any slowdown in the economy will negatively impact the CRE market.

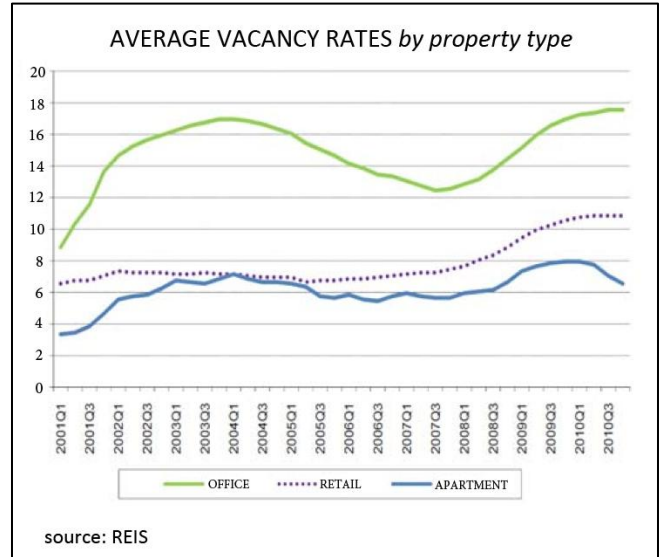
## Commercial Real Estate – National

Commercial real estate fundamentals continued their improvement in 2011 over 2010. Demand in the CRE market is derived from activity in the overall economy. As the economy improves, so does the CRE market. Clearly there has been an improvement in the national economy since the recession ended in 2009, which has translated into improved commercial real estate fundamentals. When looking at the change in economic indicators below, the continued improvement makes sense.

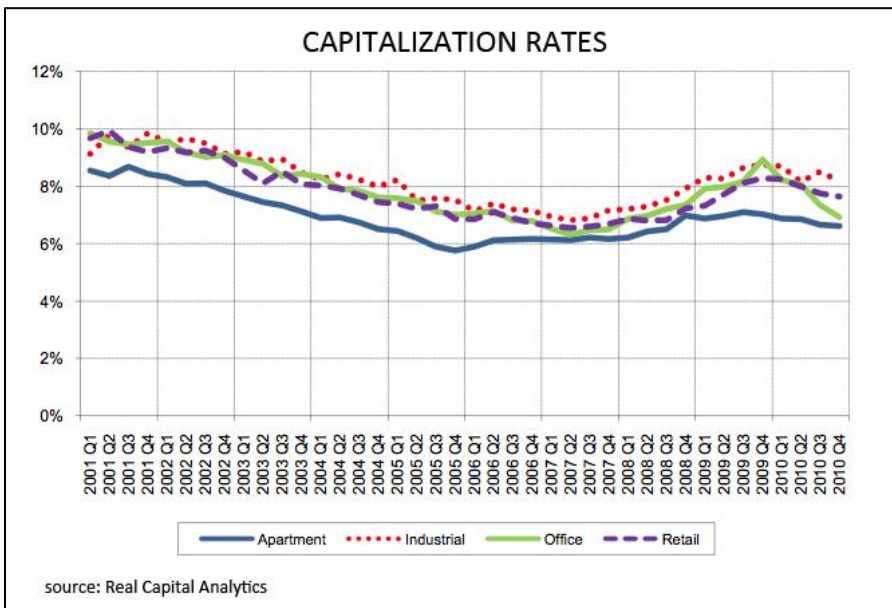
Consider the following:

- This time last year unemployment was at 10.2% versus 8.8% currently.
- Since the February 2010 employment trough, 1.7 million jobs have now been added.
- Manufacturing capacity utilization now stands at 74.3%, up from 69.7% in February of 2010.
- The S&P 500 has doubled from its March 2009 low.

However, the CRE market is only beginning to recover, as indicated by the relatively high vacancy rates in the graph to the right. As the economy continues to improve, vacancy rates should decline which will push market rents higher given the dearth of new construction that has characterized the CRE market during this past cycle. Maybe just as important as an improving economy is to a CRE recovery is investor confidence.



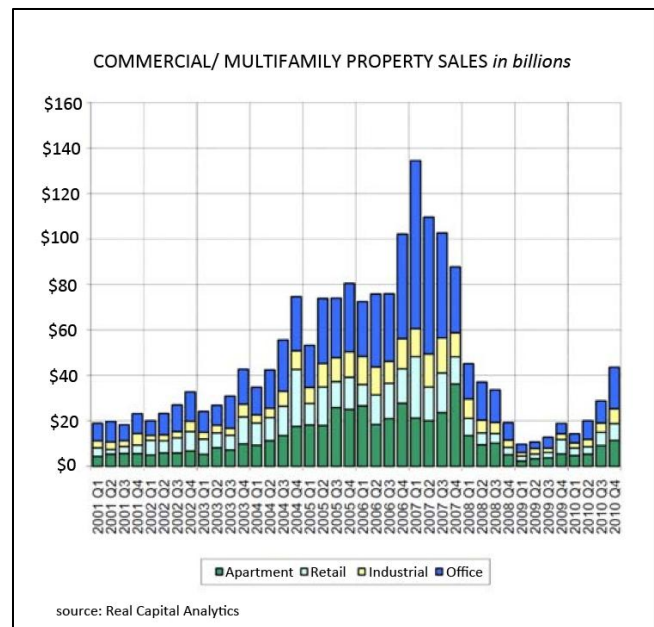
According to PriceWaterhouseCoopers' First Quarter 2011 Real Estate survey, investor confidence is on the rise as evidenced by their cap rate expectations. Capitalization rates are expected to hold steady



or decline in most U.S. markets over the next six months according to PWC survey respondents. After increasing 150 to 200 basis points from the middle of 2007 to the end of 2009, cap rates have compressed to 2006 levels for most property types as a result of historically low interest rates. After all, cheap debt financing is the grease that lubricates levered CRE returns and incentive fees paid to real estate investment managers.

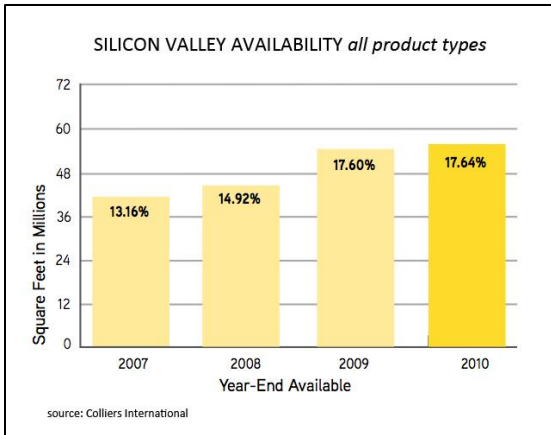
However, some are questioning the upturn in the CRE market as the recovery has been quite bifurcated. Analogous to what has happened in the commercial banking sector with the country's largest banks emerging stronger and with more market share post-2008 financial crisis, while smaller regional and community banks wait in line for FDIC receivership, so goes the CRE market. Investors have split the CRE market into two, with top-notch properties in top-tier cities commanding escalating prices while lower-tier properties in secondary and tertiary markets grapple with lower occupancy and rents, and underwater debt maturities.

Trophy properties in prime markets are fetching record-setting prices because large institutional investors are sitting on tremendous amounts of capital waiting to be deployed. There has been a flight to quality as investors seek stable returns from core properties. Core real estate investments are generally limited to office, retail, industrial, and apartment properties which are well located, have significant occupancy rates, and use a modest amount of leverage, amounting to a targeted loan-to-value ratio of 50% or less. As investors grow more confident that the CRE industry is moving past the bottom part of the cycle, the economy is adding jobs, and property fundamentals are improving, then sales volume should increase substantially. Total sales volume for Q4 2010 was just over \$40 billion, which is \$60 billion less than the same time period in 2006 and \$90 billion below the peak in 2007. Although cap rates have returned to 2006 levels, transaction volume still has a way to go.



### Commercial Real Estate – Local

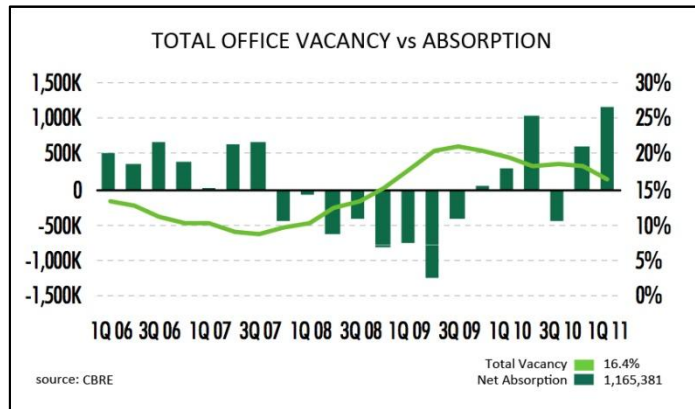
The San Francisco Bay Area is one of the strongest commercial real estate markets in the country, ranked second on Urban Land Institute's Emerging Trends 2011 list for investment performance for the second year in a row. The Bay Area CRE market benefits from many favorable traits: a 24-hour global gateway region, proximity to world-class universities and talent, strong high-tech, bio-tech, clean-tech and finance industries and geographic and political barriers-to-entry. With the economy beginning the slow process towards recovery during the latter half of 2010, the commercial real estate market in the Bay Area kept pace as well. However, as the graph to below attests, the Silicon Valley still has a way to go until vacancy reaches pre-recession levels.



Very similar to what is occurring at the national level, the Bay Area real estate market is being defined by the haves and have-nots. San Francisco saw core capital pour money into Class A assets in 2010, and as opportunities to acquire trophy properties remain scarce, capital sources should cast a wider net in 2011 and move into higher-yielding assets. Properties with manageable vacancy and stable rollover are no longer being overlooked because near-term rent growth in San Francisco and Silicon Valley is projected to be in the double digits. The recovery in the commercial real estate investment market is underway, and with a continued improvement in property fundamentals, investors should

bode well with 2011 vintage year acquisitions.

After two years of significantly negative fundamentals in 2008 and 2009, the Bay Area office market witnessed approximately 1.1 million SF of positive absorption for 1Q 2011 continuing the positive trend from 2010 (see graph right). The industrial market however continued its negative trend, realizing nearly 1.2 MSF of negative net absorption in 2010. The majority of the growth occurred in the office leasing market and was driven by social networking, gaming, cloud computing, life science and clean tech companies, while the residential real estate sector and governmental contractions continue to impact and forestall growth in certain markets. Although the majority of recent leasing activity was dominated by renewal and short-term extensions, a shift towards longer leases is beginning to take place.

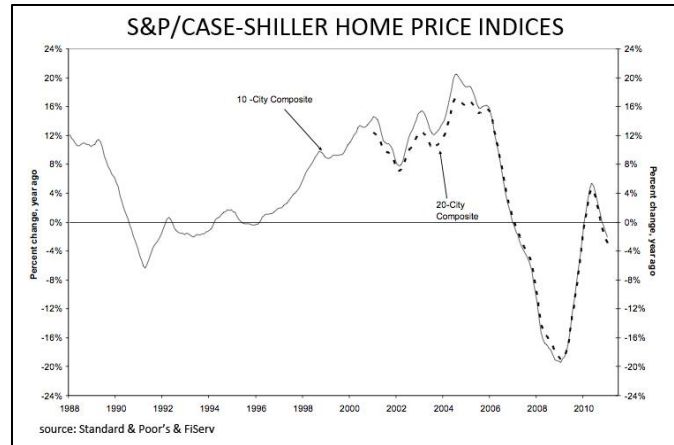


Some of larger recent real estate deals in the Bay Area are:

- Facebook purchased the former Sun Microsystems campus in Menlo Park then entered into a 15 year sale-leaseback transaction with RREEF.
- Zynga agreed to lease about 270,000 square feet in San Francisco.
- HP agreed to lease 400,000 square feet at Moffett Towers in Sunnyvale.
- Shorenstein Properties agreed to purchase Market Square, a 1.1 million square foot office complex in San Francisco.
- San Francisco-based AMB agreed to merge with Denver-based ProLogis, forming the world's largest publicly traded industrial REIT with a market capitalization over \$15 billion.

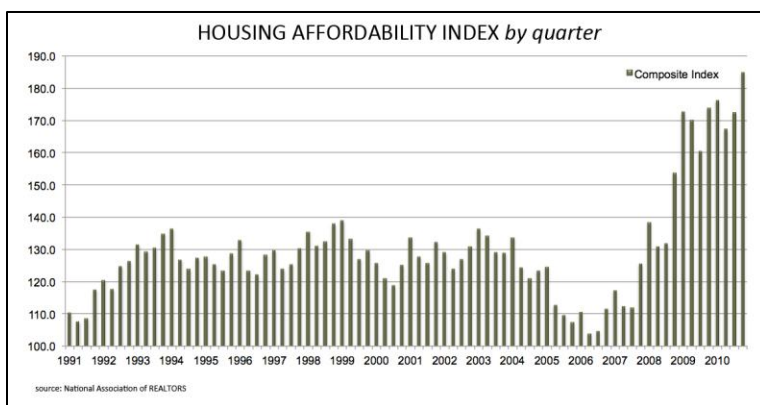
## Residential Real Estate - National

The nation's housing market continued to languish in the first quarter of 2011 as foreclosures continue to weigh on housing prices. The most recent S&P/Case-Shiller home-price index showed a 3.1% price decline for single-family homes in 20 major metropolitan areas. The jury is still out if this trend indicates the beginning of a double-dip in the housing market or is just a temporary phenomenon after a slight improvement over the past three months.



Data provided by the tracking firm RealtyTrac showed foreclosure filings were reported on 681,153 properties during the first three months of this year. Although that figure represents a 15 percent decline from the previous quarter and a 27 percent drop from a year ago, the market remains tepid. Weak demand, declining home prices, and more stringent underwriting requirements are weighing heavily on the market, which is still facing significant headwinds. The threats of a looming shadow inventory of distressed properties and the probability that foreclosure activity will begin to increase as lenders and servicers gradually work their way through the backlog of thousands of foreclosures that have been delayed due to improperly processed paperwork are hanging on the market.

A total of 197,112 U.S. properties received default notices for the first time in the January to March period, a 17 percent decrease from the previous quarter and a 35 percent decrease from the first quarter of 2010. Foreclosure auctions were scheduled for the first time on 268,995 homes. That is down 19 percent from the previous quarter and 27 percent from the first quarter of last year. Although the bleeding appears to have stopped, the nation's residential market is still far away from a full recovery.



The silver lining in all of this is that affordability has never been greater during the past 20 years than it is now according to the National Association of Realtors. Unfortunately unemployment remains stubbornly high which will continue to prolong a housing market recovery until it improves. According to a survey of 111 economists and other housing analysts by MacroMarkets LLC, average home prices are expected to fall 1.4 percent in 2011 and gain 1.3 percent

in 2012, with a firmer recovery not taking place until 2013.

## Residential Real Estate – Local

Bay Area home sales last month logged the best March in four years although prices slipped back a notch. A total of 7,051 new and resale houses and condos sold in the nine-county Bay Area last month. That was up 41.3 percent from 4,991 in February and up 0.2 percent from 7,040 in March 2010. Last month's sales count was the highest for a March since 8,317 homes sold in March 2007.

The housing market has certainly improved from the doldrums of two years ago, but there is quite a ways to go until it reaches a more normalized level. The Bay Area has much less of a foreclosure problem than the rest of the state and country, but negative headlines and relatively high unemployment continue to act as a drag on prices. The big issue continues to be qualifying for mortgage financing, which is still problematic for many potential borrowers.

All homes	Sales Volume			Median Price		
	Mar-10	Mar-11	%Chng	Mar-10	Mar-11	%Chng
Alameda	1,506	1,400	-7.0%	\$360,000	\$341,000	-5.3%
Contra Costa	1,412	1,414	0.1%	\$275,000	\$245,000	-10.90%
Marin	225	249	10.7%	\$640,000	\$668,250	4.4%
Napa	136	128	-5.9%	\$327,500	\$308,000	-6.0%
Santa Clara	1,602	1,665	3.9%	\$500,000	\$460,000	-8.0%
San Francisco	500	495	-1.0%	\$675,000	\$650,000	-3.7%
San Mateo	533	579	8.6%	\$615,000	\$555,000	-9.8%
Solano	660	608	-7.9%	\$215,000	\$190,000	-11.60%
Sonoma	466	513	10.1%	\$318,000	\$285,000	-10.40%
<b>Bay Area</b>	<b>7,040</b>	<b>7,051</b>	<b>0.2%</b>	<b>\$380,000</b>	<b>\$360,000</b>	<b>-5.3%</b>

source: DataQuick Information Systems

It's somewhat of a different story along the Peninsula, where the residential market mirrors the CRE market's Jekyll and Hyde personality. The housing market in Santa Clara County is enjoying a strong revival of sales in homes worth \$1 million and more. The highest end seems especially hot where twice as many homes were sold for \$5 million or more in Santa Clara and San Mateo counties than were sold during the same period of 2010, with most of those sales taking place in the cities of

Los Altos Hills, Palo Alto, Atherton, Portola Valley, and Woodside. Viewed differently, sales in zip codes representing the top one-third of the market, based on historical prices, accounted for 36.1 percent of all sales in March. That was up from 33.0 percent in February and up from 34.5 percent a year ago. Those higher-end areas' contribution to regional sales had dropped to as low as 18.0 percent in January 2009, while the peak was 44.7 percent in July 2007. Their 10-year average monthly contribution is 35.6 percent.

It's been documented by several organizations, Opes Advisors and the Federal Reserve of San Francisco among them, that a strong, positive correlation exists between housing prices, sales volume and stock market valuations. The wealth effect on housing consumption in the Bay Area, especially in Santa Clara County, has its roots in the number of high-tech companies with headquarters here whose stock market valuations are at all-time highs. Couple that with the proliferation of private exchanges where employees can sell their pre-IPO equity stakes at favorable valuations, one can see why the high-end Peninsula housing market feels a lot like 2007. As a fellow real estate colleague recently quipped, "We work in an industry that has ten-year cycles with five-year memories."



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## Conclusion

It really is a tale of two markets. In the commercial sector we see continued investor demand for core, class-A real estate in major metropolitan markets. As the national economy continues to recover, property fundamentals in secondary markets should improve which will make investors more comfortable allocating capital to perceived riskier assets. Nationally, the residential market continues to face headwinds to its recovery. It's doubtful we will see a double-dip in the housing market, but foreclosures and unemployment will continue to hang on the market. Locally, well, if you happen to live in Palo Alto or the surrounding cities, then you have the tech sector to thank for propping up housing values. Otherwise you probably sympathize more with your fellow homeowners across the country than you do with those across the Bay.

On a related note, we have begun providing unbiased, objective advice on investment properties owned by our clients. If you have real estate related questions, contact your Opes advisor to discuss how we might help.

Sincerely,

Carlos Valdivia  
Real Estate Investment Advisor