BROKER OPINION REPORT

Net Lease Cap Rates – All Markets Are Not Equal.

WHAT HAPPENED TO CAP RATES IN 2010?

The year started strong with investors returning to the market as interest rates fell and debt became available to a larger pool of investors. Unfortunately, the financial crisis in Greece and the potential for instability within the European Union quickly cooled the New Year's optimism. The net lease market changed again in early July in part due to another drop in lending rates and a lack of quality supply of NNN properties. A more positive lending environment and improving market fundamentals along with the volatility of the stock market drove investors to look for more predictable and stable returns. In a few markets, cap rates began to compress dramatically. Sellers in these markets suddenly saw offers 50-100bps below the caps recorded at the beginning of the year.

WHAT MARKETS WERE PARTICULARLY STRONG?

Professionals in the net lease community agree that, from an investor's perspective, first there is New York and Washington DC with Chicago and San Francisco trailing behind and then everywhere else. Those eager to invest quickly discovered that NNN properties in these markets were in short supply and properties of real quality were rarer still. The DC metropolitan region in particular is an extremely stable economy and investors from around the world have turned to the area for net lease investments. These investors viewed the DC metro area as one of the most stable markets in the world. International investors closed on bank and pharmacy deals in the DC metro area in 2010. The lease structure provided long initial terms with regular rent increases that, along with the investment grade credit rating of the tenants, offered a secure, stable and solid return on investment for the investors. The forecast remains strong and ULI in Emerging Trends In Real Estate 2011 predicts the DC area to be the top market for investing in 2011.

CAN YOU QUANTIFY CAP RATE DIFFERENCES BY MARKET FOR THE SAME CREDIT TENANT?

Demand for credit rated property within the MSA of the elite primary markets is strong but the lack of product means that a NNN investor is going to pay a premium for that property. The spread for credit rated tenants can vary by up to 100 bps if you are in NYC or DC versus other primary market cities with another modest drop in cap as you enter the secondary and tertiary markets around the country. There is not as significant a variance in the recorded caps for credit rated tenants in secondary, tertiary and the primary markets outside of the elite group mentioned above. A review of closed transactions in 2010 shows that a Walgreens minutes from DC in suburban Virginia might sell for a 6.5 cap or better whereas a similar property might sell at a 7.5 cap in Philadelphia.

HOW DO INVESTORS WEIGH CREDIT TENANT VERSUS STRONG LOCATION AND MARKET?

The greatest disparity in cap rates between markets can be seen in the transactions recorded for non-credit rated tenants. At the height of the market, investors often looked at NNN properties with the same overly optimistic view as their well-documented counterparts in residential real estate. Today, NNN investors rightly focus on core real estate fundamentals, the survivability and strength

of the tenant and the landlord's ability to replace the tenant and rent should the tenant fail. NNN investors are buying national non-credit rated tenants and local mom and pop shops in the elite markets if the performance and prospects of the tenant is known and the underlying real estate is strong. In DC, the seller of a NNN retail condominium with a local tenant operating a quick serve restaurant in the heart of a thriving urban market sold at a 7% cap rate. By comparison, non-credit retail properties outside of the primary markets trade from 50 to 200 bps higher than their primary market counterparts.

HAVE YOU SEEN A DIFFERENCE IN DEBT TERMS BASED ON GEOGRAPHY OR IS IT JUST ON THE INVESTOR SIDE?

Debt terms do vary by market and tenant with a local lender the only prospect for debt in some markets. National lenders continue to pull back in many cities but insurers and the big banks are financing a great variety of transactions in the primary markets.

AS THE SUPPLY OF NNN PROPERTY REMAINS LIMITED, DO YOU SEE INVESTORS MOVING TOWARDS LOWER CREDIT OR OTHER MARKETS?

In today's market, suitable NNN investment property is hard to find. Quality NNN investment property is harder still. Perhaps the hardest of all, are the $1 million to $5 million size transactions where average investors focus their attention. For many of these investors, as with many of the REITs, the return will not be equal to the risks associated with non-credit tenants in secondary and tertiary markets and they will remain on the sideline.

ARE THERE OTHER NNN ASSET TYPES THAT ARE EMERGING?

Unable to find quality assets in a tight market and unable to secure favorable debt for less well known tenants in secondary and tertiary markets, investors are finding that lenders are putting more emphasis on the intrinsic value of the real estate. Investors seeking passive real estate investments are turning to urban, income-producing condominiums as a suitable component of their investment portfolios. Urban retail condominiums fit this niche and NNN investors have demonstrated a willingness to step up and pay in excess of $1,000 a square foot to acquire these assets. The willingness of traditional NNN investors to pursue these assets offers an opportunity for developers to monetize portions of the assets and unhook from the completed portion of the project. Developers using this streamlined method of disposition have used their proceeds to either pay down existing debt or fund new projects.

WHERE DO YOU SEE THE MARKET MOVING ON CAP RATES FOR NNN PROPERTIES IN 2011?

The passive income of a NNN investment remains appealing and offers a return that is equal to or better than is otherwise available to the average investor. New development is slowly underway but many of those properties are six months to a year out before they will reach the net lease market. The compression in cap rates may unwind as the influx of NNN product increases deal flow and divides competition over a larger asset pool. Until then, the flight to quality in those few primary markets will continue to drive cap rates down. The investment grade credit of the top performers in banking, pharmacy, retail and dining essentially offer the NNN investor bond-like investment assets backed by the credit of the tenant and the underling real estate. Strong credit and real estate fundamentals born of the market research and analysis that go into site selection will continue to make the top performers in these sectors attractive to NNN investors.

FOR MORE INFORMATION

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