



North America Real Estate Market Report Summer 2010

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Introduction – a marked improvement in sentiment

- The previous Aviva Investors' North America Real Estate Report (January 2010) looked to other countries – in particular the UK – for indications of the likely path for US real estate.
- While experience elsewhere suggested the market may have been nearing an inflexion point, sentiment in the industry remained very negative with many commentators believing that the US would experience a continued decline.
- The report concluded that while the fundamentals of US real estate seemed extremely weak, the possibility of an imminent and significant turnaround in market metrics could not be dismissed and the short and medium term future for the trajectory of the market was uncertain.
- A few months on and the uncertainty continues, however there has been a marked improvement in sentiment.
- It may be sparse and patchy, but the industry is now generating positive news and the gloom that has pervaded the market for a couple of years may be starting to lift.
- Certainly, it can be stated with significantly increased confidence that the worst of the downturn appears to have passed and discussion of the nature of the recovery is of increasing relevance.

Economic prospects seem to be improving

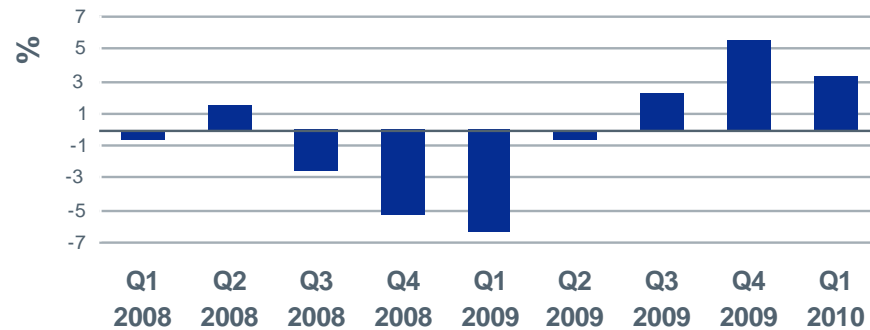
- A number of developments over recent months point to a more positive outlook for US real estate. These include:

1. Better news on economic backdrop

- **GDP forecasts have been revised upwards.** The Aviva Investors house view (April 2010) is that the US economy will grow by 3.3% in 2010 and 2.9% in 2011. This compares to expectations of 2.4% in 2010 and 2.3% in 2011 back in November 2009. Improving economic sentiment has been supported by relatively rapid growth in the first quarter when, according to the Bureau of Economic Affairs (BEA), the economy expanded at an annualised rate of 3.2%
- Although unemployment remains very high by historical standards, **total employment is now increasing.** According to the Bureau of Labor Statistics (BLS), nonfarm payroll employment rose by 290,000 in April, including 80,000 new jobs in professional and business services. Positive revisions to previous estimates suggest the labour market has now been growing for three months. With 431,000 jobs added in May, headline employment growth figures continued to impress, although these numbers were very significantly inflated by the temporary employment of people to work on the 2010 census.
- **Retail sales have surprised on the upside** with annualised growth of around 4.5% achieved since the low point in the cycle was reached in 2009. Household resilience has driven much of the improvement in the economic outlook.
- Recent PMI data suggests **business confidence in the corporate sector is relatively high.**

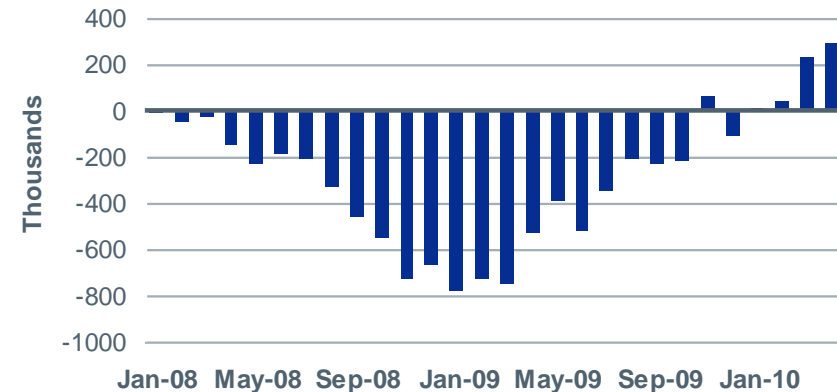
Economic outlook is brightening

Annualised Quarterly US GDP - strong growth recorded



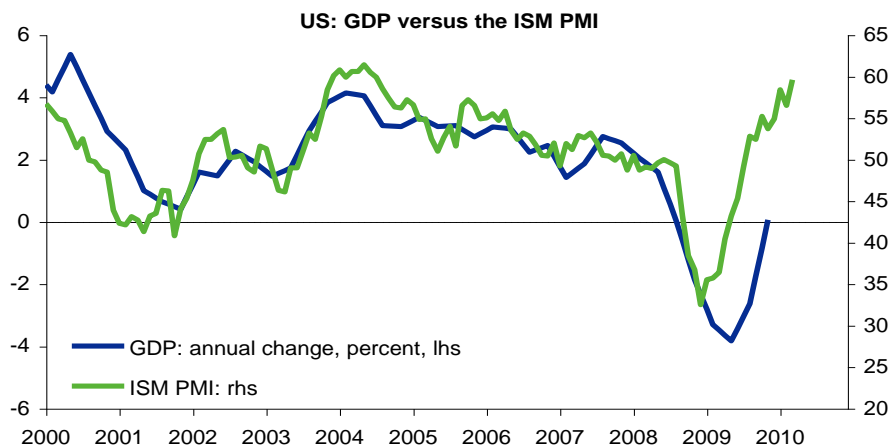
Source: Factset, May 2010

Monthly employment growth - back into positive territory



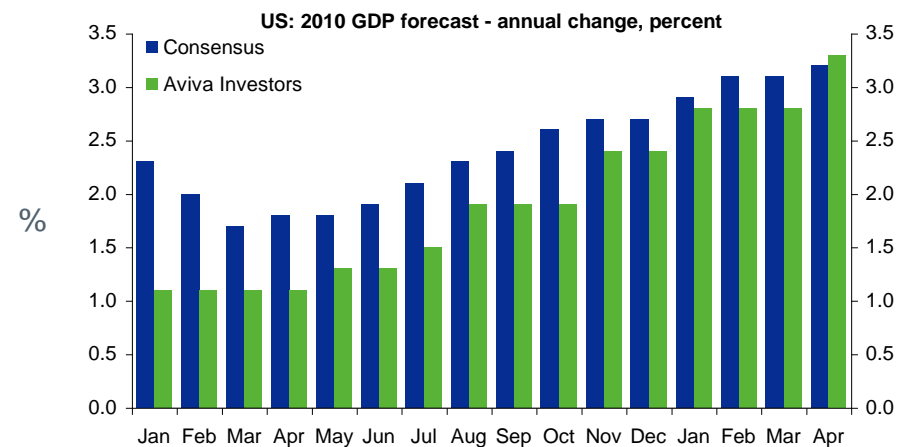
Source: Factset, May 2010

Survey data suggests continuing recovery



Source: Thomson Financial and Aviva Investors
April, 2010

GDP forecasts revised upwards



Source: Consensus Forecasts and Aviva Investors
April, 2010

Capital flowing into the sector as debt availability improves

2. Favourable capital trends

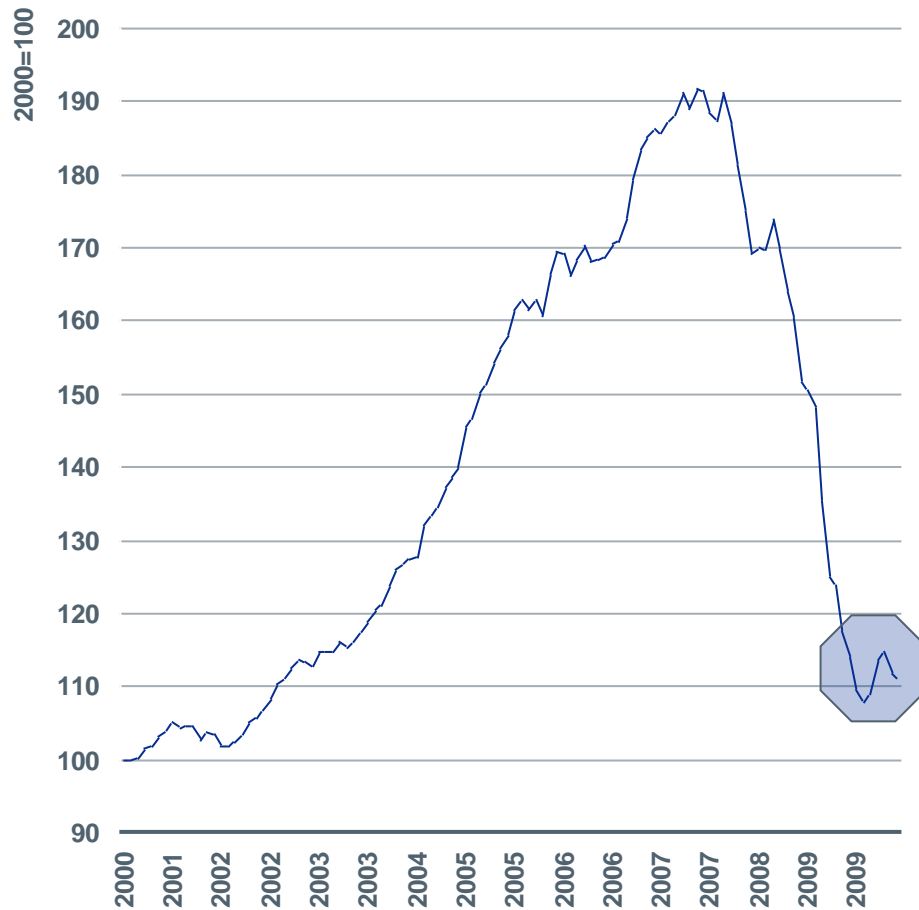
- **Capital is flowing into the sector.** It appears that large pools of capital are becoming increasingly available for global investing.
- There appears to be **more debt available for new deals and on more favourable terms** than at any time since the start of the credit crunch.
- **Bank lending remains scarce but spreads are tightening.** Bank loans are still conservatively underwritten with a maximum 65% loan-to-value ratio being typical.
- **Life companies have become keen lenders** after spending being highly restrained in 2009. Eager to take advantage of historically high returns, competition between life companies has seen spreads on high quality mortgages narrow.
- **The securitisation market has reawakened** with a dozen or so commercial mortgage-backed securities (CMBS) operations launched successfully this year. With CMBS spreads narrowing, their appeal to borrowers will grow and securitised lending seems likely.
- These trends mean that **large loans are now available**, albeit very selectively.

3. Improving investment market metrics

- **Positive total returns have been recorded for the first time since the second quarter of 2008.** According to the National Council of Real Estate Investment Fiduciaries (NCREIF) All Property Index, US total returns were 0.8% in the first quarter of 2010. The US IPD Quarterly Property Index also recorded a positive total return of 1.2%, the first positive quarterly return for 18 months.
- While capital values remain in decline, a fall in the NCREIF index of 0.9% suggests **the rate of decline in capital values is easing**. IPD data suggested the first quarter decline in capital values was even lower at just 0.5%.
- **Transaction pricing indices have recorded a significant turnaround in pricing** with evidence of strong demand for core assets in the best markets. For example, the Moody's Property Index suggests pricing turned in November. Following a decline in values of 43.7% between October 2007 and October 2009, transaction prices increased by a total of 6.3% over the following three months. Prices did then fall by 2.6% in February and 0.5% in March, however.
- There have been numerous reports of **deals done for income-secure property on the basis of very keen pricing** and anecdotal evidence suggests **capitalisation rates on core product have fallen** considerably.

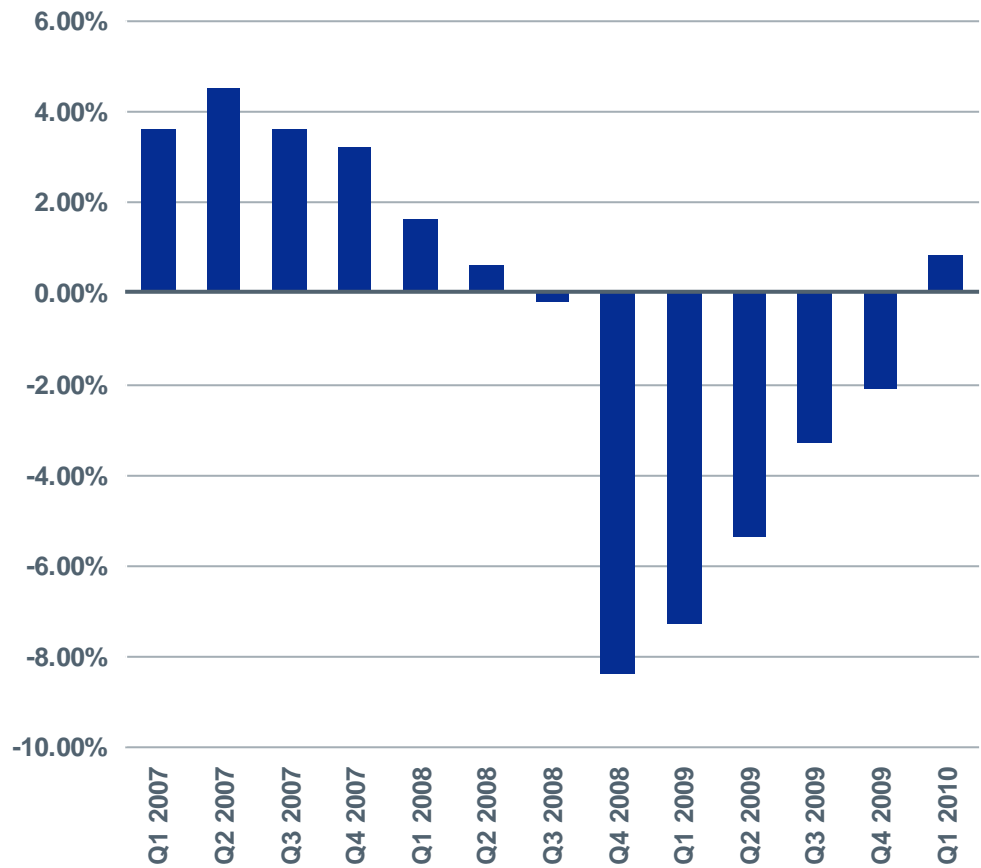
Market metrics give reason for optimism

Transaction pricing - recent data suggest decline may be over



Source: Moodys/REAL CPPI, April 2010

NCREIF - Total returns now positive again



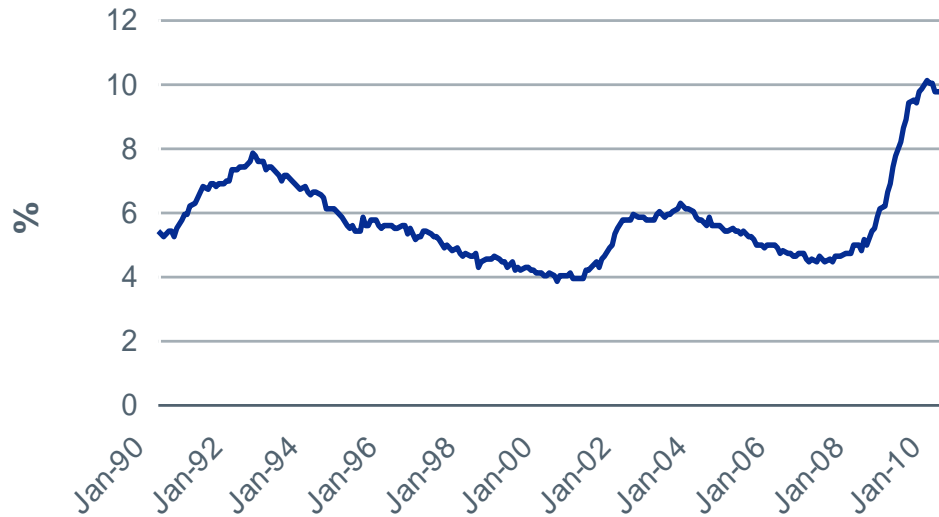
Source: NCREIF, Q1 2010

Market prospects remain constrained by numerous factors

- There remain a number of reasons not to get carried away by the recent relative improvement in market prospects. These include:
 1. **The labour market is still severely impaired** with unemployment at close to 10% (BLS, May 2010) and elevated fears that the economic recovery will prove jobless. Furthermore, downside risks to the economic outlook abound: sovereign debt needs addressing, household balance sheet repair is ongoing and economic output remains below pre-crisis levels.
 2. **Fundamentals remain very weak.** According to Reis, at the end of the first quarter the national vacancy rate in the office sector reached 17.2%, the highest it has been since the early 1990s. At 10.8%, shopping centre vacancy rates at the end of Q1 were higher than at any point since 1991. Rents therefore maintain a downward trajectory and even if they trough soon, income decline will continue for some time as expiring leases are renewed at lower market rents.
 3. **Capital values continue to decline and are approximately a third below peak levels,** according to NCREIF. It is very hard to discover evidence of any form of recovery in anything but the most income-secure assets. The bounce in pricing is unique to very prime product. Levels of transaction activity remain very low by historic standards.
 4. New debt for risky assets remains nearly impossible to find and overall **credit conditions remain very tight.** In aggregate, banks are continuing to reduce their exposure to real estate debt.
 5. **Evidence of debt-related distress continues to mount** with, for example, market commentators TreppWire have reported that the CMBS delinquency rate increased by 40 basis points in May to 8.42%.
 6. Despite the small but noticeable increase in debt availability, **debt maturities are likely to swamp the supply of debt** in both the near and medium term meaning recapitalisation of the sector remains necessary. There is a lack of clarity as to how this can be achieved.

Still plenty of reasons for caution

US unemployment - very high by historic standards



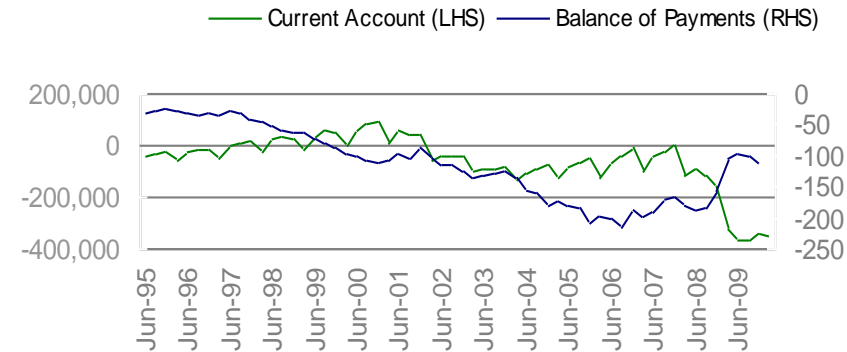
Source: Factset, May 2010

Annual change in banks' assets and liabilities - credit crunch is ongoing



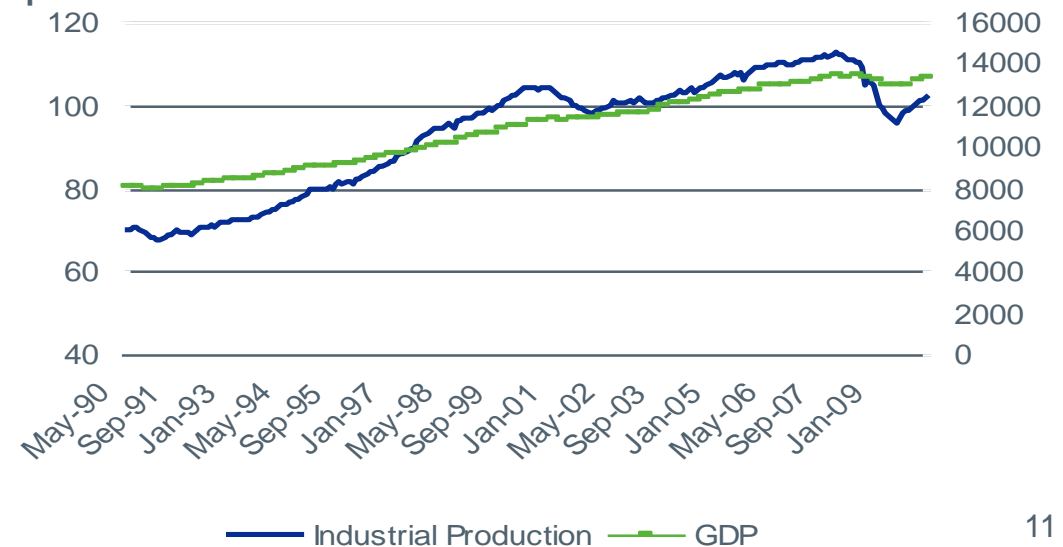
Source: Factset, May 2010

Balance of payments and current account deficit – rebalancing of economy continues



Source: Factset, May 2010

US GDP and industrial production - current output still below pre-crisis levels

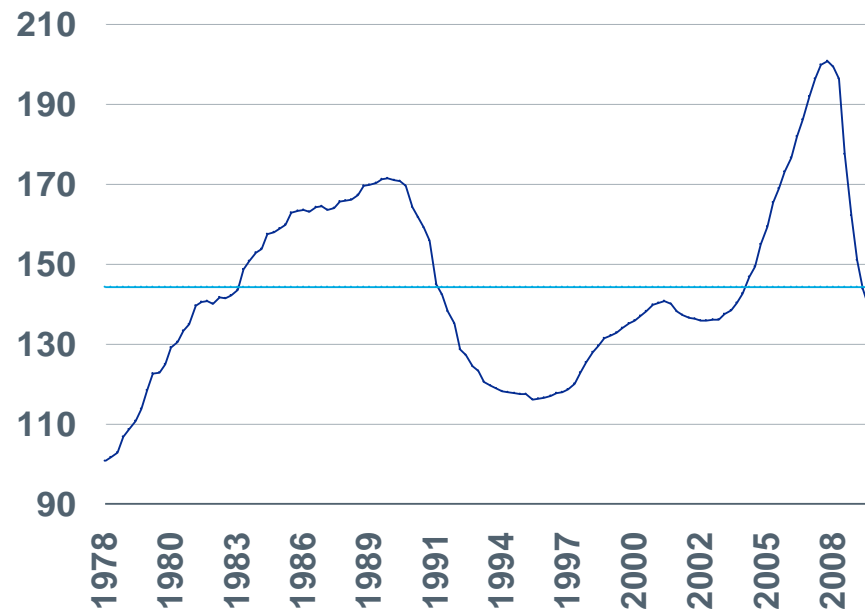


Source: Factset, May 2010

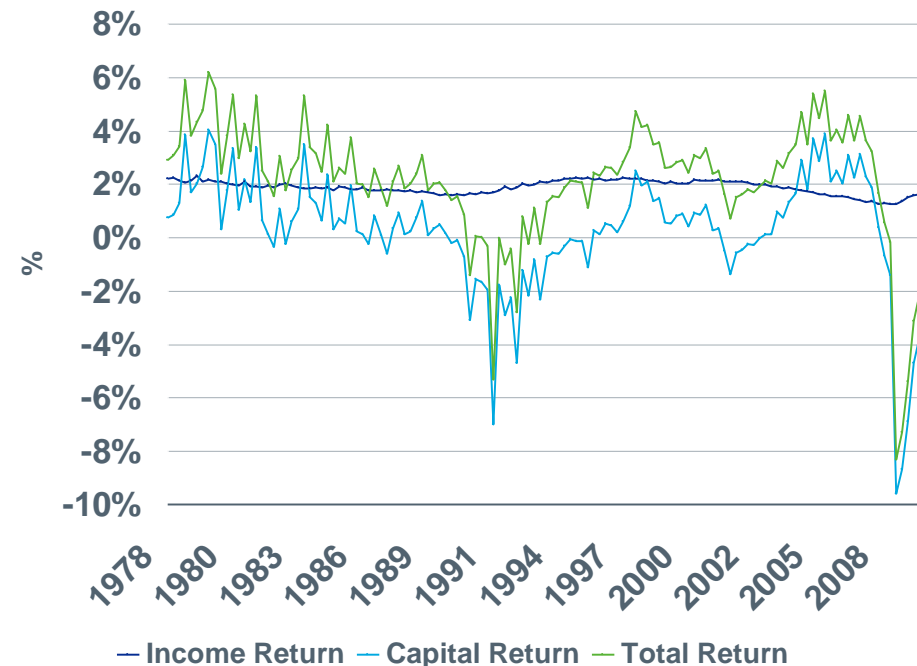
Looking back for lessons in the shape of a recovery

- Despite the recent improvement in market conditions, US commercial real estate remains in a very weak state. A recovery has to start from somewhere, however, and discussion of the nature of a prospective recovery no longer seems premature.
- The remainder of this report examines the prospective pace of recovery, looking to learn from the past. Specifically, it examines the downturn of the late-1980s/early-1990s – the only downturn of a comparable scale for which we have reliable data – to discover what lessons can be learnt about the likely shape of the emerging recovery.

Capital Return Index



NCREIF Returns



Outline of rest of the report

- We start by examining the duration of the downturn and the pace of recovery in the late-1980s/early-1990s and show that during that cycle adjustment was very slow. We then examine how appropriate it is to compare the two downturns to judge whether a similar experience awaits us this time, asking in particular:
 1. How the genesis of the two downturns compares.
 2. Trends in fundamentals in each downturn and their influence upon the investment market.
 3. The role debt played in each crisis as previous analysis has suggested this is a key driver of market outcomes.
- We conclude with a summary of how the two recoveries are likely to compare.



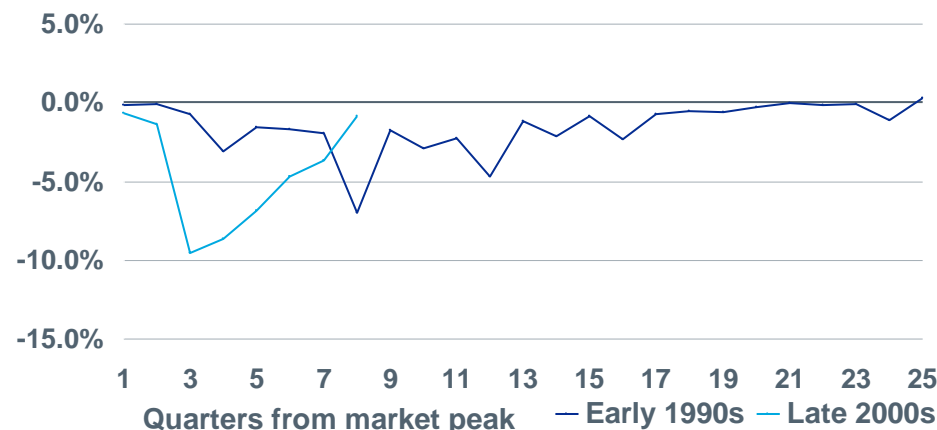
The length of the downturn and pace of recovery

Comparing the two cycles

The recovery of capital returns

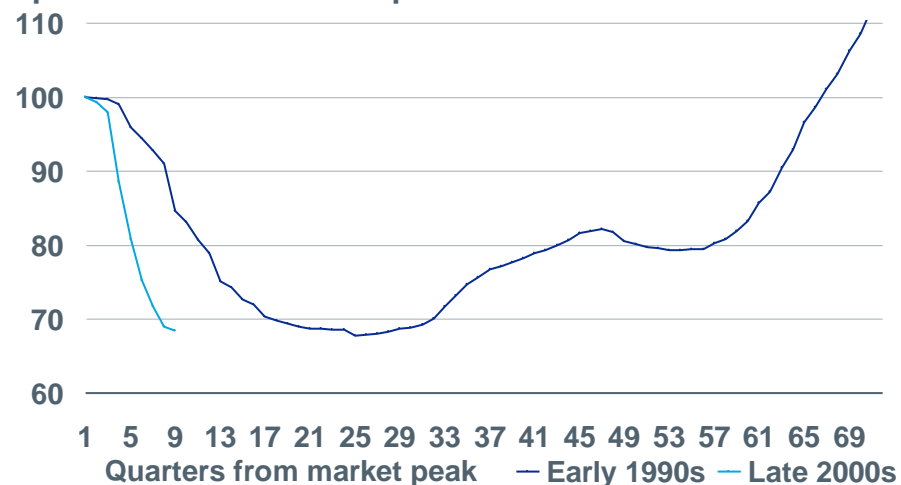
- The following graphs plot the quarterly movements of capital values during each of the two downturns examined, starting with the first quarter of negative capital value growth of each downturn.
- Capital values declined for 24 quarters in the early 1990s. So far in this downturn capital values have been declining for just seven quarters.
- This may suggest that a return to positive capital growth is some time off. However, the pace of adjustment has been much more rapid in this downturn – in the early 1990s, NCREIF capital values declined by just 9% in the first seven quarters of the downturn compared to 31% this time.
- Indeed, in the 1990s it took 18 quarters for capital values to decline as far as they have so far in the current downturn. A recent increase in the frequency of appraisals and a rise in the proportion of appraisals undertaken externally rather than internally may play a role in explaining faster adjustment in this cycle, but it seems clear that the primary cause of the difference is a faster moving market.
- This may suggest that the current downturn is likely to be shorter but sharper than the early 1990s.
- Nevertheless, as the second graph shows, the 1990s experience suggests a return in capital values to pre-crisis levels appears to be a very considerable number of years away.

Capital returns - return of positive growth



Source: NCREIF, Q1 2010

Capital returns - return to peak values

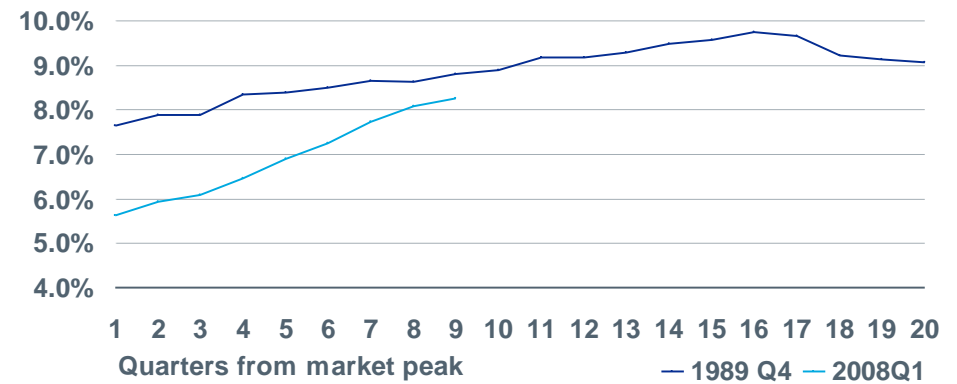


Source: NCREIF, Q1 2010

The recovery in capitalisation rates

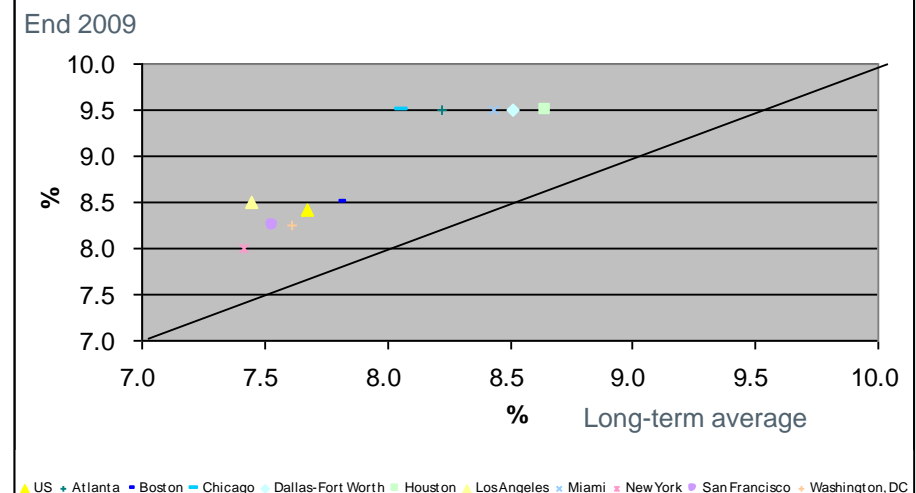
- Further evidence of the contrast between the slow steady adjustment of the 1990s and the sharp and hopefully short adjustment of the current downturn can be seen by looking at yield movements.
- In the early 1990s, yields peaked 16 quarters after they bottomed out, having increased by 305 basis points.
- In the current downturn, yields have moved out by around 250bps in just eight quarters.
- Yields still remain low relative to previous peaks, but in most office markets they are well above long-term averages and spreads between government bonds and prime real estate yields are unusually large.
- According to PMA, the average spread between prime office yields and ten year government bonds since the early 1990s has been around 2.3% whereas at the end of 2009 it was about 4.2%. Such large spreads may be justified by the extraordinary (and possibly temporary) reasons for low treasury yields, but they are acting as a brake on the outward movement of real estate yields and there is tentative evidence that these are now peaking.
- Again, however, if the late-1980s/early-1990s experience was to be replicated, yields look set to remain high relative to recent levels for a significant period. Following the early 1990s downturn, it took many years for yields to fall to the level of long-term average.

Four Quarter Rolling Average Cap Rate



Source: NCREIF, Q1 2010

Current Net Prime Yields Against Long-term Average Net Prime Yields



Source: Aviva Investors/PMA, Q1 2010



Causes of the downturns

Causes of the downturn – debt inflows inflated values

- This section examines the causes of both of the downturns to assess whether they are broadly comparable.
- Both downturns can be seen as corrections of markets that became very significantly overvalued. In both cases, a key driver of overvaluation was the rapid inflow of debt into the sector.
- As the graph below shows, both downturns were preceded by significant periods of above average increases in commercial real estate lending.

Annual change in commercial real estate debt held by commercial banks



Source: Factset, April 2010

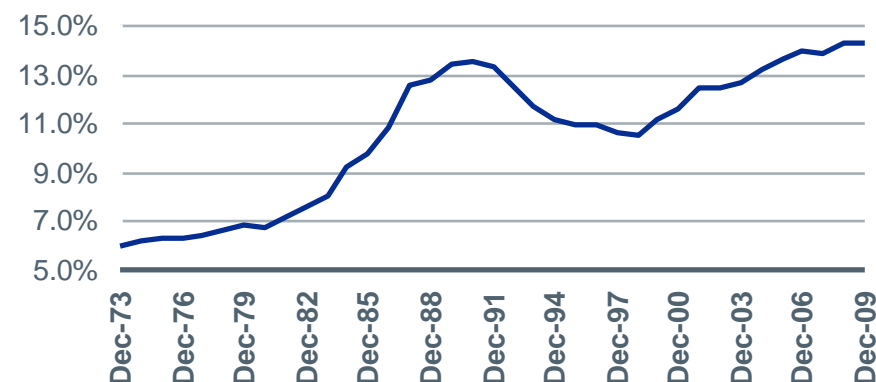
Large increases in mortgage lending proceeded both downturns

Commercial mortgages as a proportion of GDP



Source: Factest, April 2010

Commercial mortgages as a proportion of all bank lending



Source: Factest, April 2010

- Both downturns came at the end of long periods of rapidly increasing commercial mortgage lending.
- Between 1981 and 1991, the value of commercial mortgages held by commercial banks as a proportion of GDP more than doubled. In September 1981 it was 2.9% and in June 1991 it peaked at 6.4%. In the years leading up to the current downturn there was another significant increase in commercial mortgage holdings as proportion of GDP, up from 5.5% in March 2000 to a peak of 9.4% in March 2009.
- Furthermore, both downturns examined were preceded by peaks in commercial mortgage lending as a proportion of all bank lending suggesting the increase in commercial mortgage lending was largely a consequence of factors particular to the commercial real estate rather than changes in the wider credit environment.
- Both downturns saw a decrease in commercial mortgages as a proportion of GDP; in the 1980s the decline lasted several years suggesting declines seen since early last year may represent the beginning of a long period of constrained levels of lending to commercial real estate.

Factors behind the commercial real estate lending boom of the late-1980s



- **Between 1980 and 1990, the total value of commercial real estate loans issued by US banks tripled, (according to the Federal Reserve) and commercial real estate loans increased from 5.8% to 11.0% of banks' total assets. So, why did bank lending to commercial real estate increase so rapidly in the 1980s?**
 1. **Strong demand for office space** – An economic recovery combined with an increasing proportion of the labour force working in offices meant that there was significant demand for the construction of workspace in most major US markets. This enabled investors (and appraisers) to believe that an improvement in fundamentals was driving the investment market. However, overbuilding meant that office vacancy rates increased from very low levels at the start of the decade to very high levels by the middle of the 1980s.
 2. **Tax law changes** – The Economic Recovery Tax Act of 1981 (ERTA) introduced measures that increased the tax deductions available in the early years of a property's holding period, dramatically improving the rate of return. An investor could borrow heavily (which provided further tax efficiencies) to purchase commercial real estate that could then be depreciated at an accelerated rate and sold on for a capital gain to another investor looking to repeat the process. Not surprisingly, the introduction of these measures was shortly followed by an investment boom. When these measures were reversed, in 1986, there was a subsequent softening of capital values.
 3. **Intensifying competition amongst lending institutions leading to lax lending practices** – In the 1980s approximately 2,800 new banking charters were granted and regulatory change meant thrift institutions were able to move into riskier lending and investing, including more commercial real estate lending. These trends occurred as the growth of the commercial paper market was taking a sizeable proportion of banks' commercial and industrial lending business. With banks under pressure, market share of the booming commercial real estate sector became highly prized and in order to compete lending institutions started to engage in risky business practices. Lenders increased loan-to-value ratios, became less rigorous in enforcing principal payment schedules and allowed lending standards to weaken.
 4. **Unreliable appraisals** – Lack of experience, discipline and appropriate incentivisation meant appraisers over-valued properties in the flawed belief that the boom in commercial real estate values was sustainable. As a consequence, appraisals failed to provide a reliable check on the market.

Factors behind the boom of the noughties

- Against the backdrop of a wider credit bubble, there were large inflows of debt into real estate during the first decade of the millennium. Indeed between 1999 and 2007, according to DTZ, the total amount of public and private debt in US commercial real estate grew by 136%. Among the reasons for a debt fuelled bubble were:
 1. **Low interest rates** by historical standards and relative to economic conditions. This gave rise to a 'search for yield' as investors moved into higher yielding assets, including real estate, in an attempt to maintain the level of nominal returns that could be achieved in a normal interest rate environment. It also meant the cost of borrowing against commercial real estate was very low.
 2. **Underestimations of investment risk** following several years of strong economic performance was widespread. This included the overestimation of the capabilities of policy makers to smooth economic cycles given the apparent success of policy after the bursting of the dot com bubble. Furthermore, many investors had excessive faith in the on-going strength of the US consumer that was driving the cycle. These factors increased the demand for loans and also meant that lenders were more willing to lend to commercial real estate and offer favourable terms.
 3. **A significant deterioration in lending standards** following the rapid increase in the issuance of commercial mortgage backed securities (CMBS). Between 1999 and 2007, the amount of commercial real estate debt accounted for by CMBS increased by around 330%, according to DTZ. By 2008, about 16% of capital holdings in US commercial real estate was financed by CMBS. The use of the 'originate and distribute' lending model allowed general lending standards to become less restrictive than at any time in the past, leading to loan-to-value ratios of up to 80% becoming typical. Issuers were facilitated in their efforts to pass on loans made on risky terms by rating agencies who erroneously rated collateralised debt obligations comprised of CMBS as high-investment grade. Traditional lenders had to either apply similar, competitive standards or focus their lending on riskier parts of the commercial real estate market, such as construction and development loans, where there was little CMBS activity.

Shared drivers of both crises

- Both booms were therefore the consequence of large infusions of capital multiplied by debt that were triggered by unsustainable factors. In neither period was the increase in capital values proportional to any long-term improvement in real estate fundamentals.
- The dynamics of the two downturns are therefore comparable and it seems sensible to look to the 1980s for lessons as to how the market may recover.
- As seen in the introductory section, the recovery from the late-1980s/early-1990s downturn was slow and drawn out. The recovery was very gradual for two key reasons:
 - Firstly, fundamentals remained weak for a prolonged period.
 - Secondly, debt-related problems lingered for the best part of a decade
- The following sections explore how these factors impacted on the real estate market during the 1990s and whether they are likely to be replicated in the years ahead.



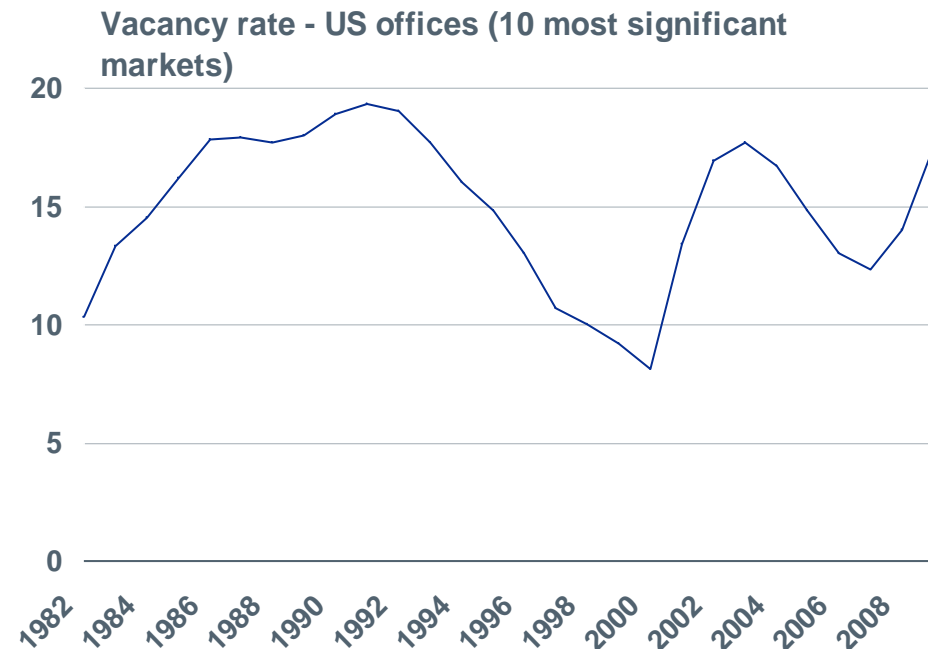
The relationship with fundamentals

Severe and pro-longed weakness in occupier market delayed and constrained recovery in the early 1990s

- Occupier market weakness is a key characteristic of both the 1980/90s downturn and the current downturn.
- In the late-1980s, commercial real estate vacancy rates reached historic highs and remained elevated for several years. High levels of availability weighed on rents and significant rental growth did not return until the mid-to-late 1990s.
- Low or negative rental growth expectations, combined with high vacancy rates, delayed and constrained the pace of the recovery in the late-1980s/early 1990s. Only once a sustainable strengthening in the occupier market was within sight did the investment market recover.



Source: NCREIF, Q1 2010



Source: PMA, Q1 2010

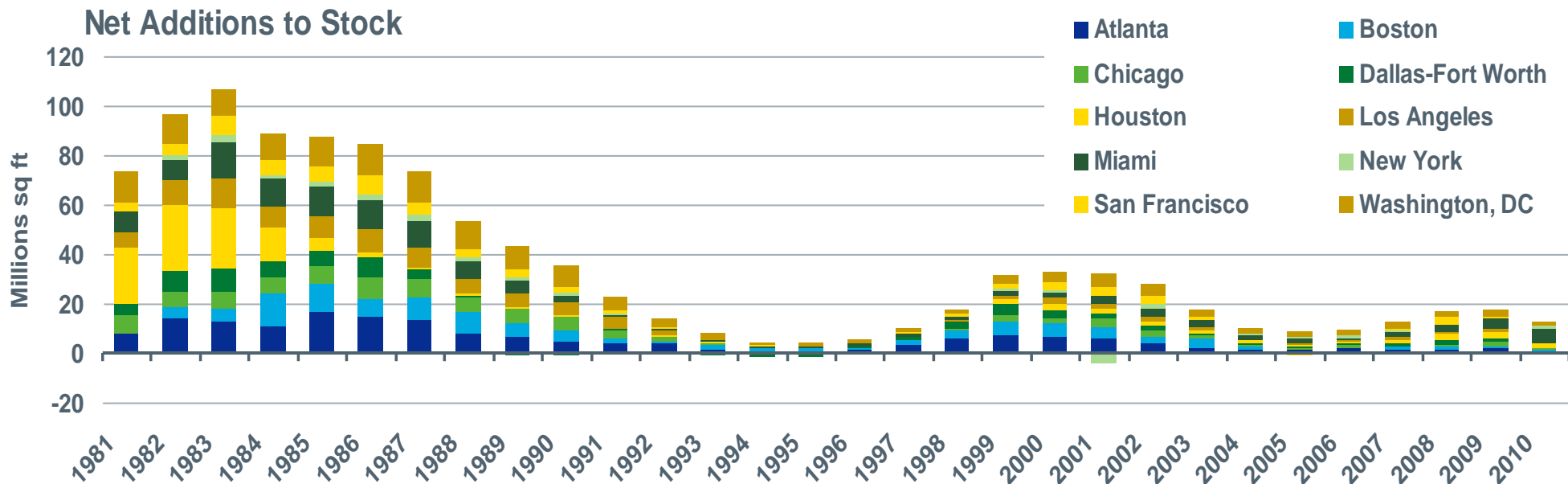
Current occupier market weakness comparable to early 1990s



- According to the latest data, the occupier market has now deteriorated to such an extent that it is in a comparable state to the early 1990s.
- Reis data shows that in the first quarter, national office vacancy rates reached 17.2%, the highest level recorded since 1994. Vacancy is now 2.0% higher than a year ago and significantly above the cyclical low of 12.5% reached in Q3 2007. High vacancy rates have weakened landlords' bargaining positions, with headline rents down 4.2% over the year to the end of the first quarter and effective rents declining 7.4%, according to Reis.
- Weakness is not confined to the office sector. Reis data shows that at 7.2%, the vacancy rate in the apartment sector was high at the end of Q1 and up 1.1% on a year earlier. Furthermore, rents declined more rapidly in the first quarter than in any point since Reis started tracking performance data in 1999.
- In the retail sector, effective rents for local shopping centres are now below 2005 levels and vacancy rates of 10.8% at the end of Q1 are higher than at any point since 1991, according to Reis. Across all sectors, occupier market conditions are expected to continue to worsen.

Supply or demand

- With occupier market weakness currently at comparable levels to the early 1990s, the fear of a prolonged period of poor performance similar to that experienced in the last crash is a constraint on confidence in the investment market now.
- However, it is important to understand the different causes in high vacancy rates. The primary reason that vacancy rates are currently so high is a lack of demand caused by the ongoing economic crisis and high unemployment. Unemployment has increased from less than 5% in early 2008 to just under 10% today (source: Bureau of Labour Studies).
- In contrast, in the late-1980s when vacancy rates were increasing rapidly, the US unemployment rate was actually falling (although it rose sharply between 1990 and 1992). So the increase in vacancy was driven not by a fall in demand but a significant increase in supply in markets such as Houston, Dallas and Washington which all experienced a prolonged development boom.
- This dramatic increase in construction activity was not repeated in the recent real estate cycle. To generalise, whereas the flows of capital into commercial real estate fuelled a development boom in the 1980s, it served to bid up the prices of existing property in the years leading up to 2007.



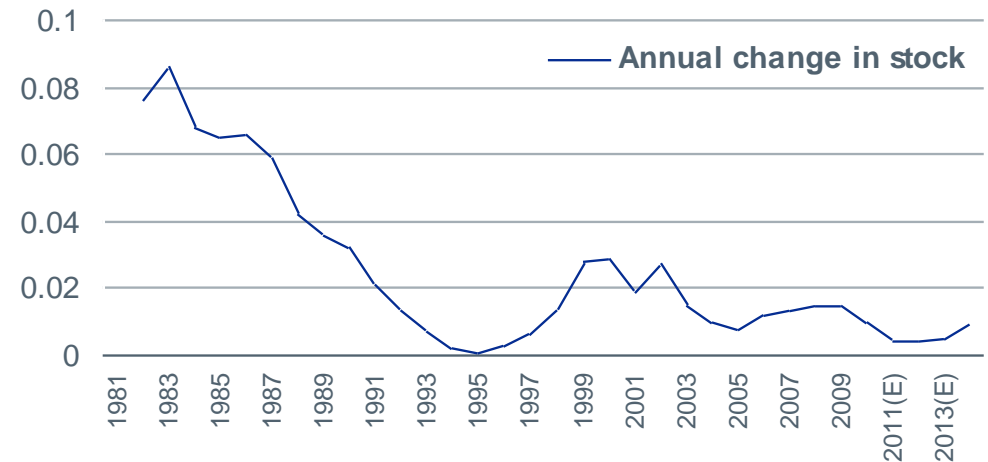
Source: PMA

Severe and pro-longed weakness in occupier market delayed and constrained recovery in the early 1990s



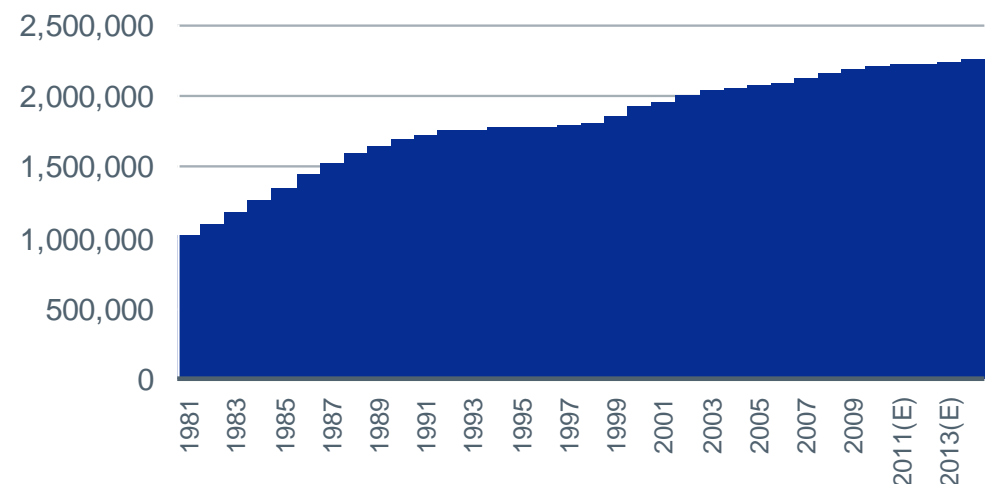
- The stock of US office space in the ten primary markets increased by nearly two-thirds in the ten years up to 1990. This caused a significant supply overhang which restricted rental growth for many years.
- In contrast, in the ten years leading up to 2007, office stock grew by less than a fifth. Furthermore, current development levels are extremely low suggesting very little increase in the stock of office space in the near future.
- At a national level, there is a very benign supply outlook for the office sector. Supply side risks may be greater in the retail sector but are far lower than those experienced in the early 1990s.
- Occupier markets will therefore be well placed for a recovery if and when a strong and sustained economic recovery generates strong employment growth.

Annual change in US office stock



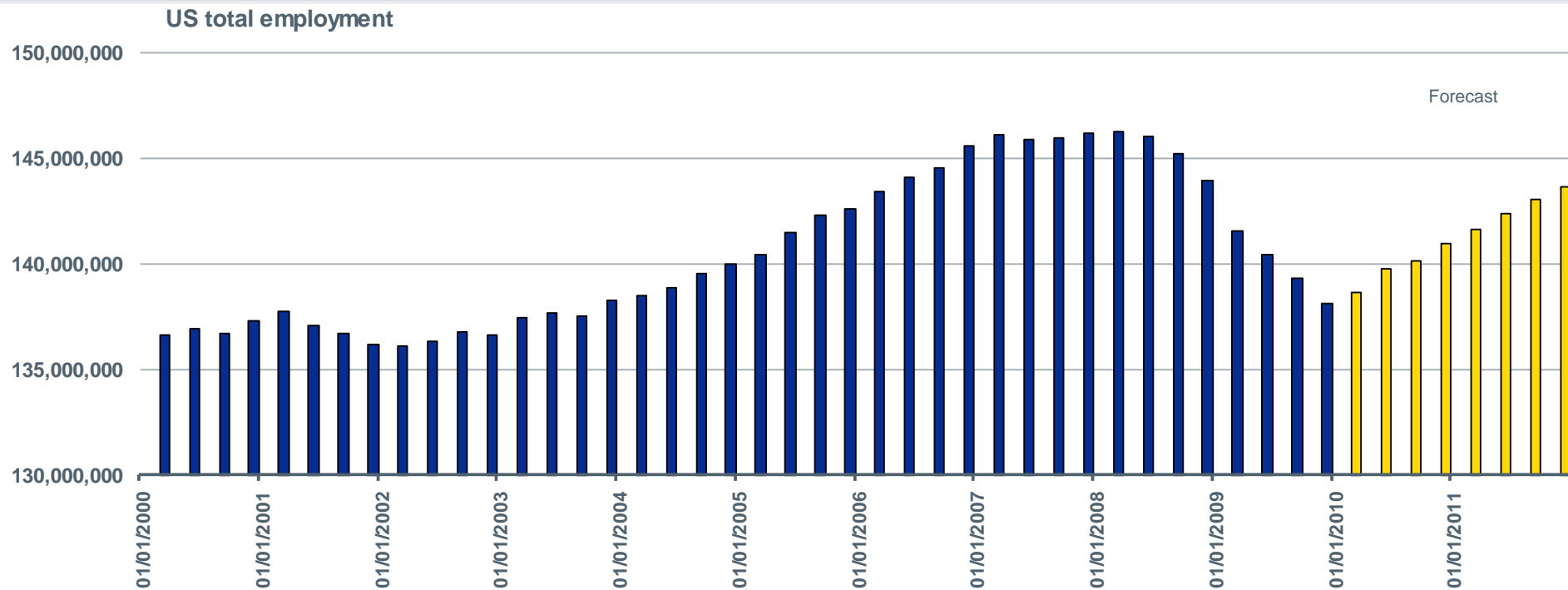
Source: PMA, April 2010

Total US office stock



Source: PMA, April 2010

A healthy labour market is a distant prospect



Source: OECD, June 2010

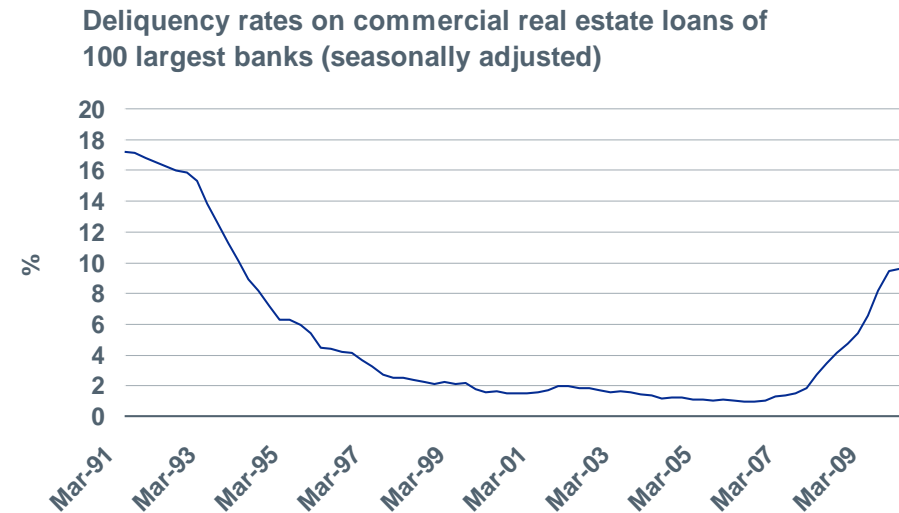
- Many US occupier markets are free from excessive supply but prospects are reliant on a strong economic recovery and job growth.
- Unfortunately, the near-term outlook for the labour market is poor with most commentators expecting the pace of labour market recovery to be constrained. Pointing to several years of historically high joblessness. The US economy lost over eight million jobs in less than two years. Even with sustained employment growth, the OECD forecasts there to be 2.6 million fewer jobs at the end of 2011 than in early 2008.
- If investors take a bullish view on economic prospects and develop the view that strong economic growth will drive rapid employment growth, the absence of a supply overhang means that occupier markets need not necessarily constrain a recovery in capital markets. However, if a central scenario of the employment outlook is adopted, continuing weakness in occupier markets is likely to act as a drag on the pace and extent of any recovery in real estate values.



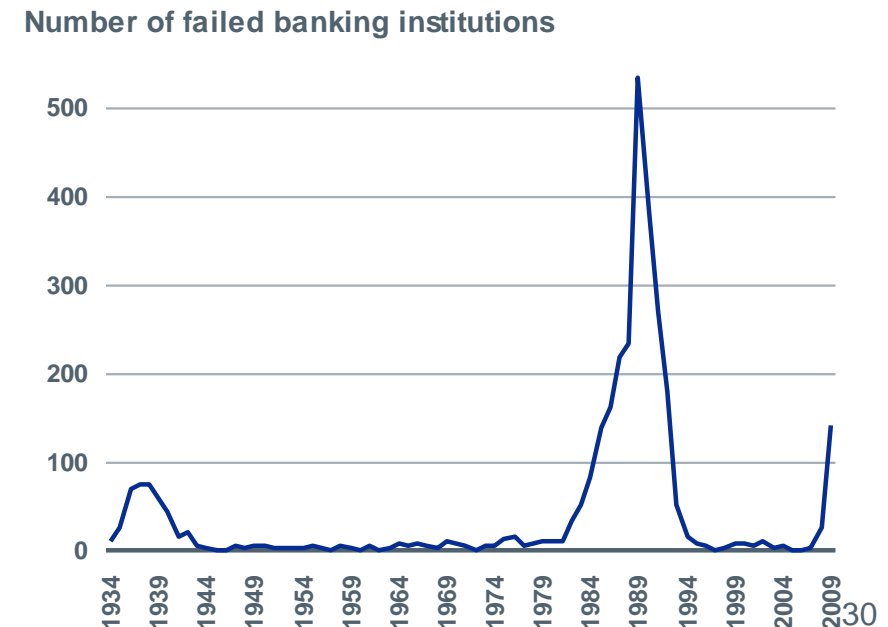
Debt in the downturns

Commercial real estate lending – boom and bust

- In the run-up to both downturns, banks reduced lending standards for real estate loans and significantly increased their exposure to the industry.
- In the 1980s, total bank lending doubled but total real estate lending more than tripled and commercial real estate loans almost quadrupled, from \$64bn to \$238bn (source: Federal Reserve). Furthermore, lenders crowded in to riskier forms of commercial real estate lending with construction loans increasing from 2% to 4% of total bank assets over the decades.
- However, as the property cycle progressed, the boom in commercial real estate lending turned to bust as loans went bad. Firstly, non-performing loans swelled in number. By 1991 (the first year for which data is available), 8.2% of commercial real estate loans were non-performing or foreclosed, according to Federal Deposit Insurance Corporation (FDIC). In 1992, the net charge-offs for commercial real estate peaked at 2.1%.
- Secondly, as their loan books deteriorated, many banks failed. During the late-1980s/early-1990s there were unprecedented levels of bank failures by post-war standards. According to the FDIC, between 1985 and 1992, more than 2,100 banks failed including over 500 in 1989 alone.



Source: Factset, May 2010



Non-performing loans a major cause of banking sector distress in late-1980s/early-1990s



- In the 1980s and early 1990s, as banks suffered an unprecedented losses on real estate loans, a record number failed. Exposure to real estate is widely thought to have been the main driver of the banking crisis. Indeed, the concentrations of commercial real estate loans were higher for banks that subsequently failed than for those that survived for every year from 1980 to 1993.
- According to the FDIC, in comparison with banks that survived, banks that subsequently failed in the 1980s had higher ratios of:
 1. Commercial real estate loans to total assets
 2. Commercial real estate loans to total real estate loans
 3. Non current commercial real estate loans to total commercial real estate loans
 4. Real estate charge-offs to total charge-offs
- Of 224 loans of failed banks reviewed by the FDIC in 1992, almost one half had lost more than 50% of their value since origination. The average collateral value for the 224 loans was 54%.

Non-performing loans a major cause of banking sector distress in late-1980s/early-1990s

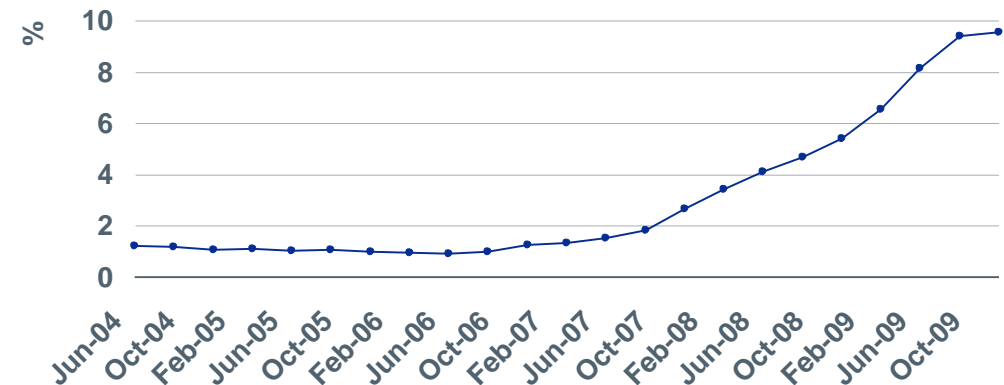


- As hundreds of banks collapsed and surviving institutions struggled to manage their overexposure to real estate, lending was greatly constrained for several years.
 - Commercial real estate lending growth slowed significantly to just 2-3% per annum by 1992-93 and grew at below average rates from early-1991 to mid-1997, according to the FDIC. At the peak of the boom, it had been growing at an annual rate of over 20%.
 - Commercial real estate lending as a proportion of GDP fell from 6.4% in mid-1991 to 4.9% by mid-1996, according to the Federal Reserve.
 - Commercial mortgages as a proportion of all bank lending fell from a peak of 13.5% at the end of 2009 to 10.5% at the end of 1998, according to Federal Reserve statistics.
- With real estate pricing sensitive to credit conditions, this prolonged slowdown in flows of debt into real estate significantly weakened capital values and is a primary cause of the slow pace of recovery in the 1990s.
- History therefore suggests that trends in debt markets and the level of distress amongst lenders will play a key role in the strength and timing of commercial real estate markets in this cycle.

Bank failures – 2008 onwards

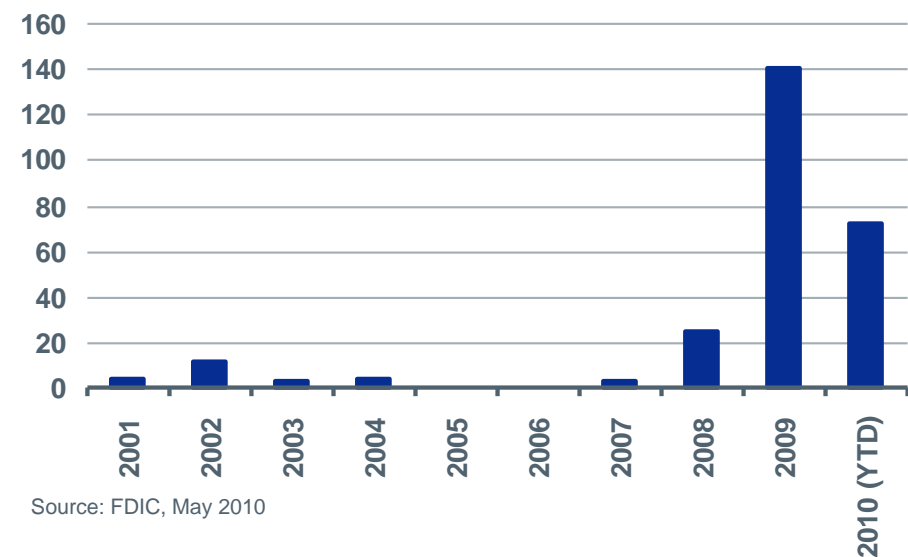
- According to the Federal Reserve, commercial real estate markets currently absorb \$3.4 trillion in debt; 6.5% of total outstanding credit debt. Commercial real estate debt grew by 52% between 2004 and the peak in Q4 2008. But, as in the 1980s, the boom has turned to bust.
- Now the level of debt in commercial real estate is falling. Total commercial real estate debt was down 1.3% from its peak by the end of 2009, according to the Federal Reserve. So whereas in the late-1980s/early-1990s, credit growth slowed, at present it is actually contracting.
- Evidence of growing distress amongst real estate lenders is plentiful. For the 100 largest banks, the delinquency rate on commercial real estate mortgages reached 9.6% at the end of 2009, up from less than 1% in mid-2006. Furthermore, CMBS delinquency rates have reached historical highs.
- Meanwhile the number of banking institutions that have failed has jumped upwards. While there were no banking failures in 2005 and 2006, 140 banks failed in 2009 and 72 had gone out of business by May this year suggesting the rate of failure is increasing. Real estate distress is again understood to be a primary cause of bank failures.

Delinquency rates on commercial real estate loans of 100 largest banks (seasonally adjusted)



Source: Factset, May 2010

Number of failed banking institutions

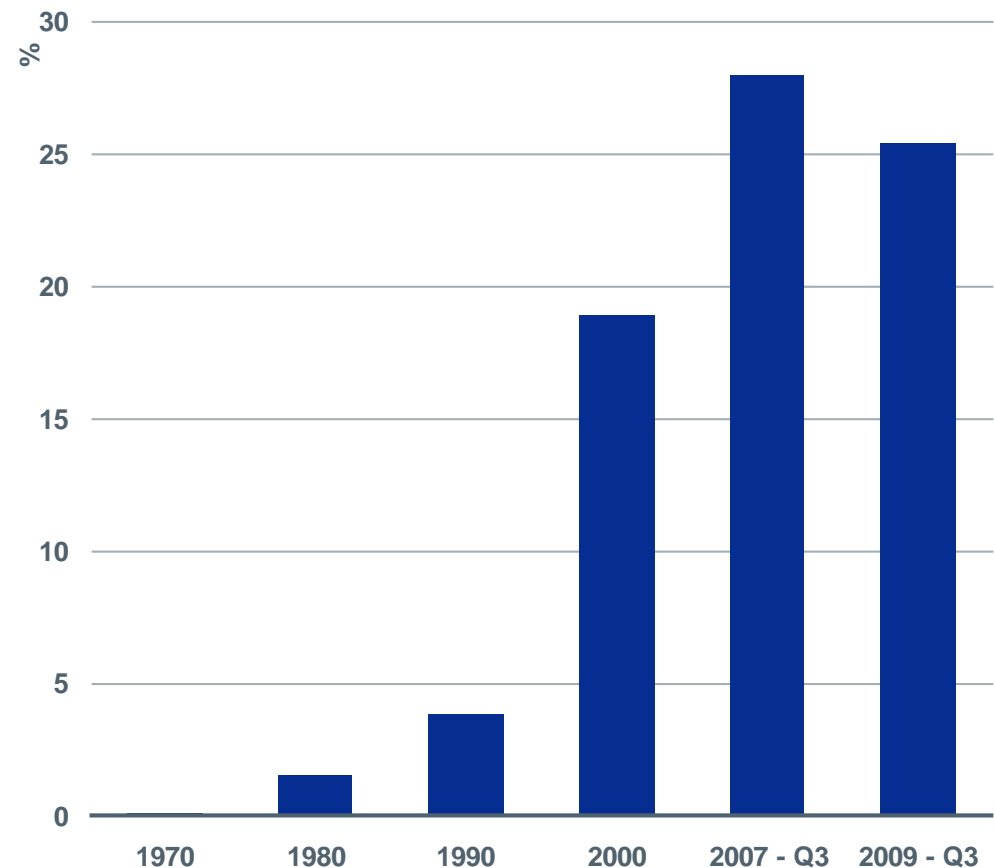


Source: FDIC, May 2010

Bank failures – 2008 onwards

- A key development in commercial real estate lending since the 1980s/1990s is the increase in securitisation. Whereas less than 5% of commercial real estate debt was securitised in the late-1980s/early-1990s, at the peak of the recent cycle CMBS represented 28% of the lending market.
- During recent years, the largest banks issued higher quality commercial real estate loans for the purpose of securitising, packaging and distributing them, leaving mid-size and small banks to do the remaining lending for construction and local commercial real estate.
- Debt-related distress concerns are therefore concentrated in two areas:
 1. Amongst holders of CMBS given the high levels of issuance at the peak of the market and the deterioration in lending standards particular to the ‘originate and distribute’ model.
 2. Amongst small and medium sized banks given (a) their greater exposure to commercial real estate and (b) their greater exposure to riskier forms of real estate.

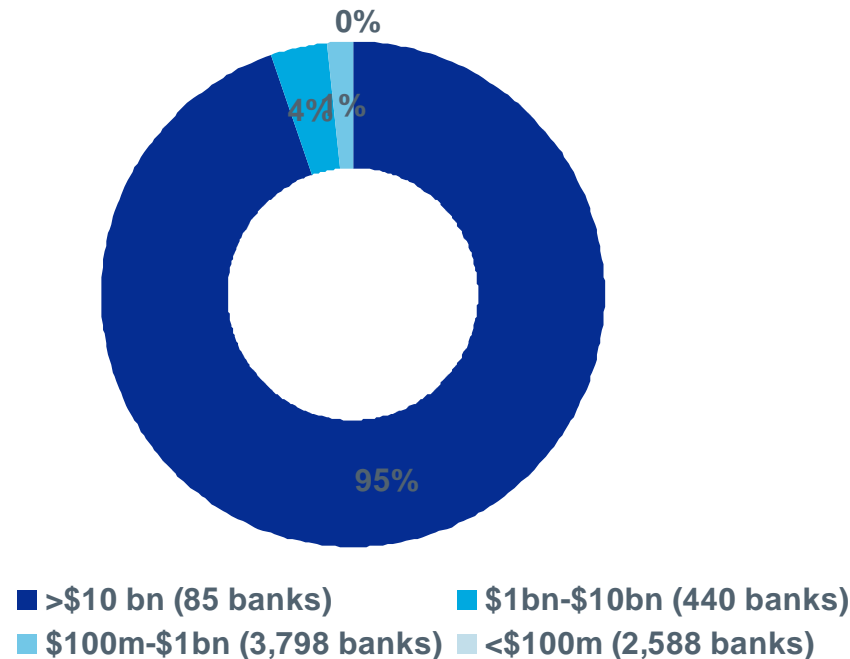
Total commercial real estate debt securitised



Source: Commercial Mortgage Securities Association, January 2010

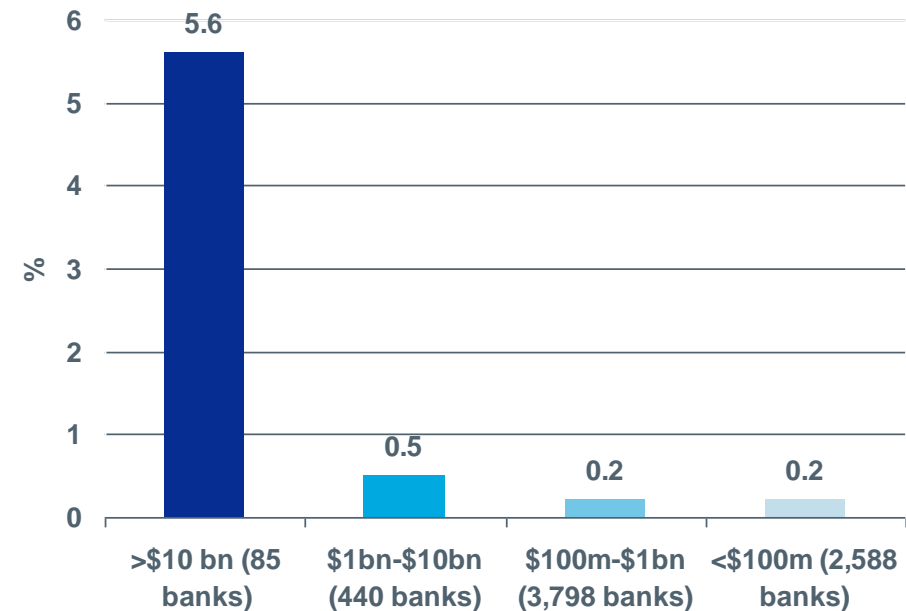
Large banks exposed to CMBS

Exposure to CMBS (banks classified by asset size)



Source: Federal Deposit Insurance Corporation (as of 30/09/09)

CMBS exposure as a percentage of total commercial real estate exposure (banks classified by asset size)



Source: Federal Deposit Insurance Corporation (as of 30/09/09)

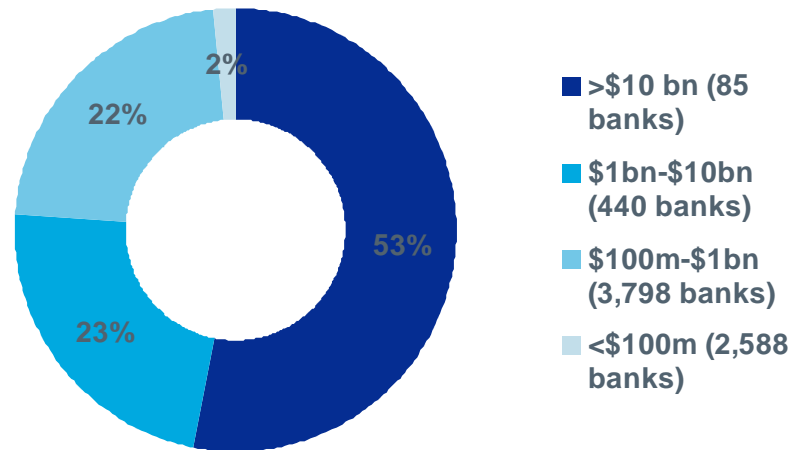
- Large banks are the most exposed to CMBS. Medium and small sized banks have very little exposure.
- Given the greater degree of deterioration in lending standards during the boom for loans that could be securitised, this sector of lending seems particularly exposed to distress.
- However, the quality of the underlying property lent to for securitisation is typically relatively high, suggesting that income risks will be lower.

CDS multiplies potential distress caused by CMBS

- In February 2010, the Federal Reserve reported that the CMBS market was valued at \$709bn. Furthermore, the potential impact of commercial real estate problems on CMBS is multiplied by “synthetic CMBS”, or credit default swaps (CDS). However, the obscurity and opacity of such instruments makes it very difficult to estimate the potential impact.
- Comparisons with the CDS market for residential mortgage backed securities (RMBS) are not favourable. According to the Depository Trust and Clearing Corporation (DTCC), the net notional expenditure – i.e. the maximum amount of credit exposure or payout in case of default – for CMBS was \$5.0bn in January compared to \$67.7m for RMBS. Furthermore, CMBS exposure was concentrated in 2,065 contracts whereas RMBS exposure is spread through nearly 28,000 contracts.
- So not only is the maximum credit exposure for CMBS-backed CDS bigger than that of RMBS-backed CDS, it is also concentrated in fewer contracts. Given that RMBS-backed CDS played an integral role in the collapse of financial markets in 2008, it appears there is potential for synthetic CMBS products to have far reaching implications.
- It therefore appears likely that distress from the CMBS sector is going to negatively impact on the health of large banks over the years ahead. A rapid revival of large scale commercial real estate lending from large banks therefore seems unlikely.

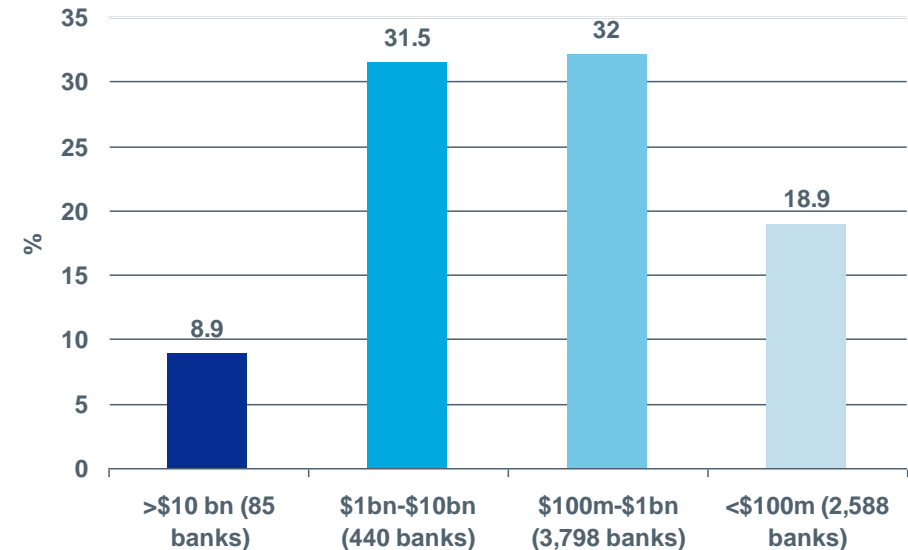
Small banks more exposed to commercial real estate, especially riskier loans

Bank exposure to commercial real estate (banks classified by asset size)



Source: Federal Deposit Insurance Corporation (as at 30 September 2009)

Commercial real estate exposure as a percentage of total assets (banks classified by asset size)



Source: Federal Deposit Insurance Corporation (as at 30 September 2009)

- In relative terms, small banks have much greater exposure to commercial real estate than America's largest banks. However, most small banks were unable to compete with loans issued for securitisation on prime assets. Consequently relatively small, local and regional banks have developed significant exposures to riskier CRE loans, including construction and development. Even in these sectors, competitive forces drove lending standards down significantly.
- Construction loans are by far the riskiest with newly or partially constructed commercial properties experiencing the biggest vacancy problems. Construction projects are consequently stalling.
- The Federal Reserve reported in February 2010 that the total delinquency rate of construction loans had already reached 16%, but this figure is being suppressed by extremely low interest rates allowing upfront interest reserves to last. When interest rates eventually move up, delinquency rates are widely expected to increase significantly.
- There are growing fears that real estate distress could lead to the failure of hundreds more small banks and inability of the local and regional banking sector to lend to the small and medium business sector is recognised as a threat to the wider economic recovery.

Debt related distress to be a major drag on the recovery

- Meanwhile, a refinancing crisis continues to loom over the market. It has been estimated that around \$1.3trn of commercial real estate loans is due to mature by 2013 and \$2.4trn by 2018. The refinancing risk is judged particularly significant from 2010 to 2013.
- The scale of the decline in commercial real estate values is such that even healthy properties are likely to find refinancing difficult. According to the Federal Reserve, the Real Estate Roundtable estimates that the total equity gap for commercial real estate could be over \$1trn.
- It appears, therefore, that the prospects for a strong and sustained improvement in bank lending are very dim. Indeed, commercial real estate distress seems to continue to act as a potential threat to the banking sector and therefore the economic recovery; the Congressional Oversight Panel's Report (10 February 2010) into Commercial Real Estate Losses and the Risk to Financial Stability concluded that:

“Until the Treasury and bank supervisors take coordinated action to address forthrightly and transparently the state of the commercial real estate markets – and the potential impact that a breakdown in those markets could have on local communities, small business, and individuals – the financial crisis will not end ”
- It appears that debt related distress and the attempts of the banking sector to reduce their overexposure to commercial real estate will act as a significant drag on the recovery of property markets on a scale at least comparable to the late-1980s and early-1990s.



Conclusion

- There has been a marked improvement in sentiment in the US commercial real estate market in recent months as confidence in the economic recovery builds, debt availability improves slightly and market metrics show relative improvement. While fundamentals remain very weak, discussion of the potential nature of the commercial real estate recovery is of increasing relevance.
- The experience of the commercial real estate market downturn of the late-1980s/early-1990s showed that a recovery can be a very slow and gradual process. An examination of the causes of each boom and bust suggests a comparison between the two could provide useful insights.
- A primary reason for the slow nature of the recovery in the late-1980s/early-1990s was the prolonged weakness of fundamentals. This was primarily due to a dramatic period of over-building during the 1980s which left many markets oversupplied.
- Real estate fundamentals are currently very weak and comparable to the downturn of the late-1980s/early-1990s. However, the recent boom in the industry did not result in a highly significant increase in supply at the national level. Most markets are not condemned to years of weak fundamentals by oversupply. In the current cycle, large inflows of debt into the industry did not fuel speculative construction as much as bid-up capital values of existing properties.
- The primary problem for occupier markets is a lack of demand. For fundamentals to improve significantly, a strong and sustained economic recovery is required to generate significant employment growth.
- A real estate recovery could be driven by trends in other asset classes and favourable relative pricing rather than an improvement in the occupier market outlook. Nevertheless, unless job creation improves faster and more significantly than widely expected, the poor state of occupier markets could have a considerable and lasting constraining influence.

Concluding summary

- Another cause of the slow pace of recovery in the late-1980s/early-1990s was the slow growth in the debt availability to the commercial real estate sector. As delinquencies and subsequent bank failures increased, financial institutions sought to correct their overexposure to the sector. Lack of debt weighed significantly on capital values for several years.
- In the current downturn, the need for banks to reduce their overexposure to the industry appears larger, a view supported by the fact that banks' commercial real estate lending by banks is currently negative. The wider weakness of the finance sector further worsens the prospects for a strong and significant recovery in commercial real estate lending.
- Large banks are expected to experience further significant losses through their exposure to CMBS while small banks are failing at an increasing rate, partly, it appears, due to their large exposure to commercial real estate and in particular construction and speculative developments. Looming refinancing gaps are massive and it remains highly uncertain how they can be bridged without major losses to lenders and borrowers.
- Commercial real estate loans therefore seem set to cause further distress to the financial sector and the prospects for a strong and sustained recovery in lending to the sector appears distant. It seems that debt related distress may well be a more significant constraint on the recovery than it was in the late-1980s/early-1990s.
- The recent improvement in sentiment is welcome and a recovery may well be underway, but nevertheless several years of significant difficulties lie ahead for the US commercial real estate industry and we expect investors to retain a highly cautious approach to the market.

Important notes



Except where stated as otherwise, the source of all information is Aviva Investors as at 31 March 2010

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