ElmTree Funds
NET LEASE INVESTMENTS
TRACKER
2014 Volume 1

2014 MARKET OUTLOOK

IN THIS ISSUE

After years of slow recovery from the recession, the market finally began to gain momentum in the second half of 2013. GDP growth reached 4.1% in the third quarter and 2.4% in the fourth quarter. Unemployment rate is now at 6.6%, lowest since October 2008. Furthermore, the Federal Reserve recently implemented the third round of quantitative easing policies. Combined with low interest rates, the government stimulus agenda seems to have finally pushed the economy over the hump. The overall commercial real estate market has benefited from the recovery, as transaction volume, prices, vacancy rates, and capitalization rates show strong signs of improvement. However, the recovery has not uniformly propelled all asset classes within the real estate sector. In review of the office and industrial market, the differentiation is still notable, which is a reflection of where we are in the current recovery. Certain pockets in the US have seen tremendous growth and values have recovered to pre-recession levels, while other markets continue to struggle to break-even.

10-YEAR TREASURY

Source: Yahoo! Finance

From its lowest point in May 2013, 10-Year Treasury yield has steadily risen over 100bps. It now hovers between 2.60% and 2.90%.

The office market continued to improve in 2013. With over 7 million people re-entering the job market since the 2008 recession, absorption has increased especially in primary markets resulting in sub-5% cap rates with bullish investors believing in rental growth in 24-36 months.

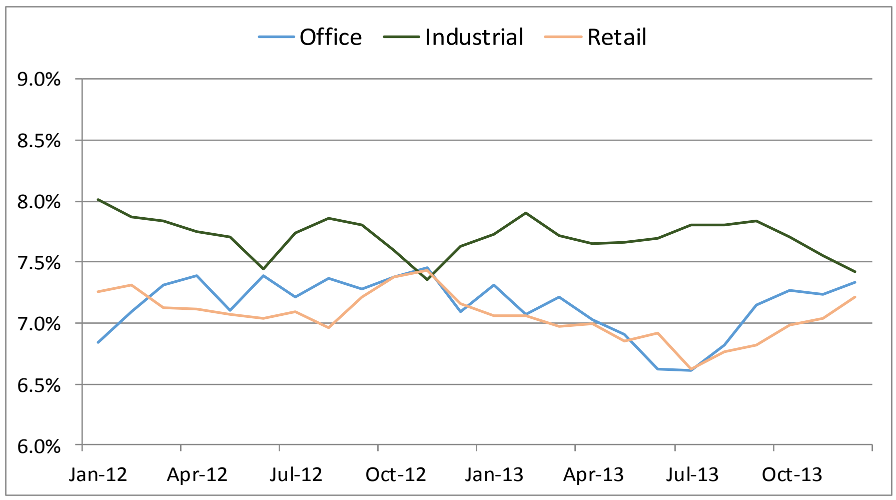
Core markets like Manhattan, San Francisco, and downtown Los Angeles continue to lead the office recovery, driven by both improving fundamentals and the low interest rate environment. The dark horse in this Great Recession has been Houston, now considered a gateway city by both international and institutional investors. Meanwhile, Seattle, Atlanta, and Denver are amongst the top 10 office markets. Other secondary markets like Austin and Minneapolis have had modest absorption, and investors have flocked to those markets in search for higher yield. Both markets are expected to triple their sales volume in 2014. While some cities are showing positive signs of growth, other markets such as St. Louis and Baltimore are lagging in terms of transaction volume and price appreciation, which suggests corporate

America's seismic shift back to urban and downtown metropolitan areas for their office space. This urban shift is driven by the permanent reduction in home ownership coupled with workers' awareness of cultural and technological trends.

But like every cycle, suburban office will come back when CBD rent becomes too expensive and creates spillover into these secondary markets. Until then, investors will most likely employ a "wait-and-see" strategy and react after they see reliable signs of sustainable growth.

While there are obvious winners and losers in the office sector, the industrial asset class enjoyed one of their best years in recent history in 2013. Most industrial markets survived the recession, stabilized, and are back in the expansion phase of the cycle. With year-end figures yet to be compiled, industrial sales volume from January through September reached $32 billion, a 33% increase over 2012. Unlike the office market, the increase in sales came from all market tiers. Dallas, Houston, Los Angeles, and Northern New Jersey are among some of the most active markets in 2013, recording volumes higher than their respective 10-year historical averages. At the same time, there is also a significant influx of capital into smaller markets. Jacksonville, St. Louis, and Cleveland all showed triple-digit growth in sales, the complete antithesis to their performance in the office sector.

NET LEASE CAP RATES



Source: Real Capital Analytics

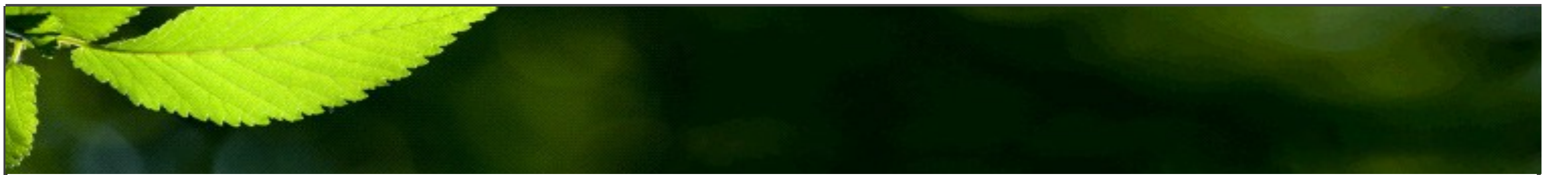
Concerns over rising interest rates may cause capitalization rates to rise and discourage investors, but the market should continue to expand in 2014 as the economy continues to recover.

Despite the increased demand in industrial space, the average transaction prices remained relatively unchanged. It suggests that the market's supply has been keeping up with the demand, and the markets have stayed fundamentally sound with modest development. Meanwhile, capitalization rates have decreased to near-record lows, especially in the West and the Northeast.

While all signs point to a positive 2014, the increase in demand will bring upward pressure on prices as vacancy rates continue to decline. According to Newmark Grubb Knight Frank, net absorption is expected to be around 175 million square feet while 100 million square feet is scheduled to break ground in 2014. As a result of tenants competing for space, landlords should have more leverage in raising rents in the upcoming year.

The evidence above suggests that though the economy is regaining its footing, companies are more focused on investing in logistics and technology to drive efficiency rather than expanding their labor resources, particularly in secondary markets. There is a growing discrepancy in demand between office and industrial assets in secondary cities like St. Louis, and it remains to be seen whether this discrepancy will contract. This will be a pivotal bellwether to American's current satisfaction with the President and the nation's course. Nevertheless, for the economy to grow in the long run, it is necessary for the market to utilize both labor and capital resources. As fundamentals improve, the commercial real estate market should continue to expand in 2014, in light of rising interest rates.

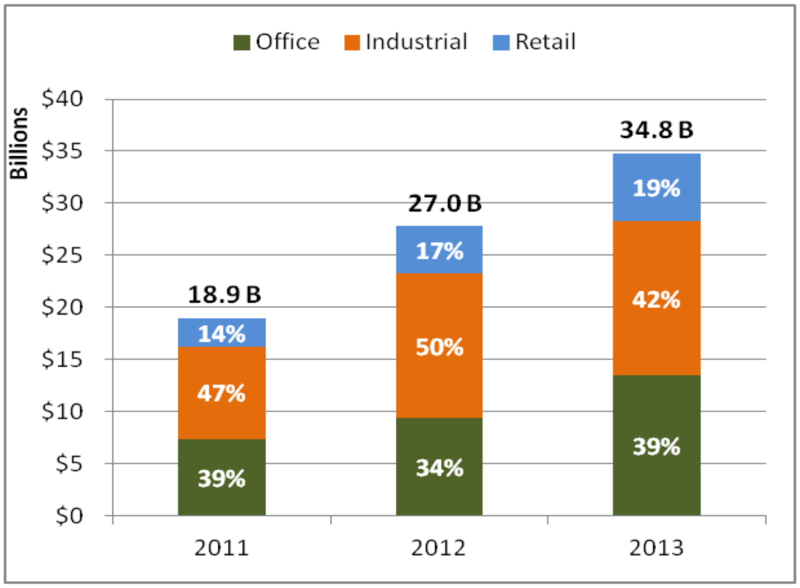
Sources: Real Capital Analytics, Integra Realty Resources, National Association of Realtors



market WATCH

as of 2/1/2014

NET LEASE SALES VOLUME

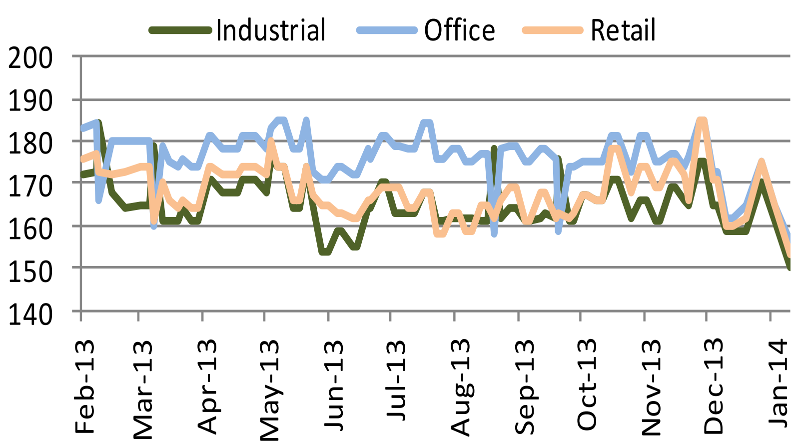


Source: Real Capital Analytics

LOAN SPREADS

ASKING SPREAD OVER TREASURY

10-year loans with 50-59% LTV



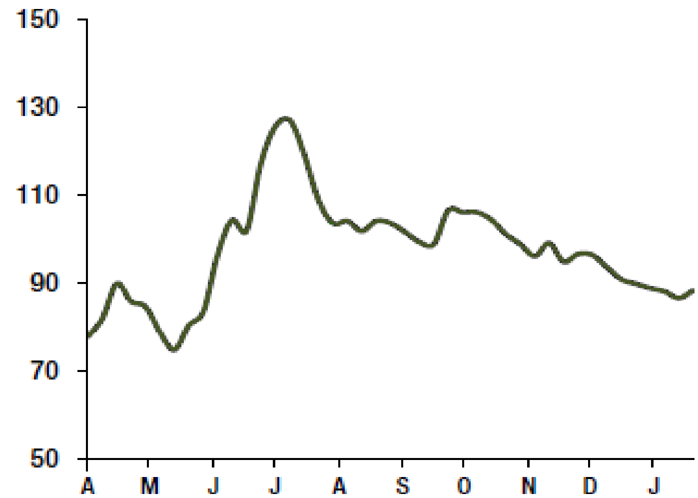
	1/24	Month Earlier
Office	155 bp	175 bp
Industrial	150 bp	170 bp
Retail	151 bp	175 bp

Source: Trepp

CMBS SPREADS

NEW-ISSUE SPREAD OVER SWAPS

10-Year AAA

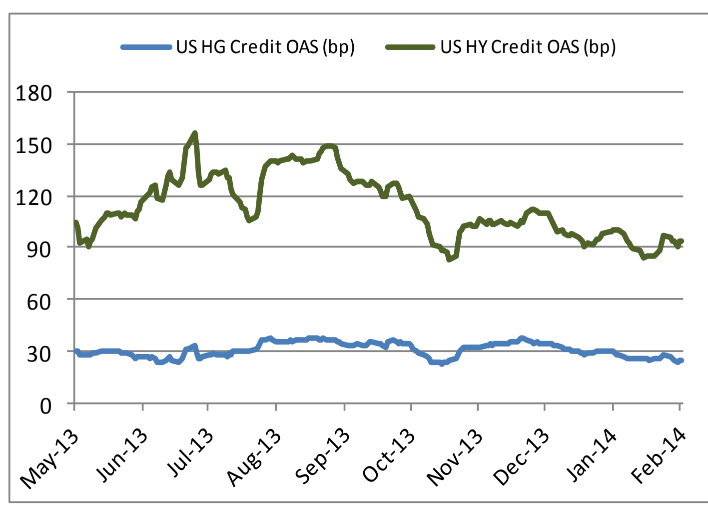


New Issue Fixed Rate (Conduit)	Avg. Life (years)	Spread (bp) 1/29	Week Earlier	52-wk. Avg.
AAA	5.0	S+64	S+62	60
	10.0	S+88	S+87	94
AA	10.0	S+153	S+149	161
A	10.0	S+205	S+211	214
BBB	10.0	S+343	S+346	379

Source: Trepp

COAS SPREADS

US HG Credit OAS vs. US HY Credit OAS



Source: Merrill Lynch

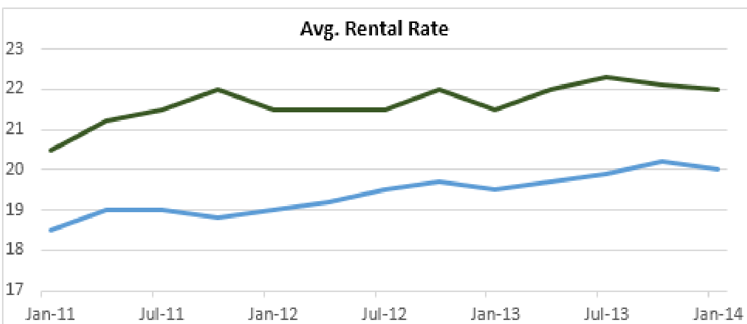
Market Spotlight

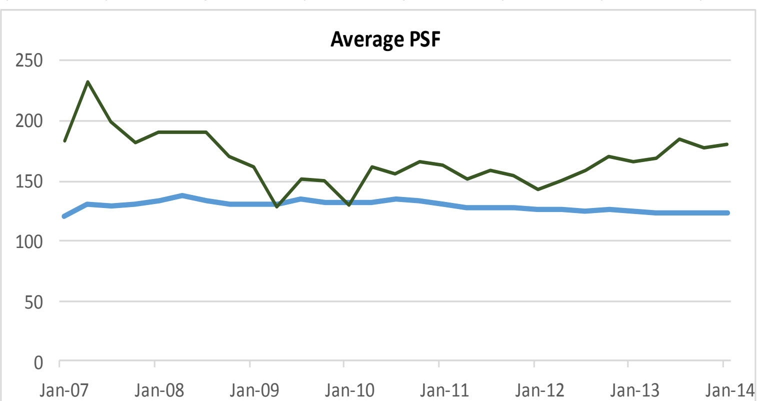
SAN ANTONIO, TEXAS

The real estate market in San Antonio is set up for a strong year in 2014. Unemployment rate was at 5.8% in October, lower than the statewide figure of 6.0% and the national rate of 7.0%. It ranked sixth-lowest among all metro areas in the US. The strong employment figures suggest a high demand and rising rental rates for office inventory. There was a slight increase in year-end vacancy rate, but we believe it was due to the completion of several projects that have yet to be absorbed by the market. Due to the city's business-friendly environment and low cost of living, the market should pick up where it left off at the end of 2013.
There is a similarly high demand for industrial facilities as San Antonio is recognized as one of the best cities for global trade in the US. In fact, availability in existing projects are limited and declining, prompting prospective tenants to consider build-to-suit facilities instead.

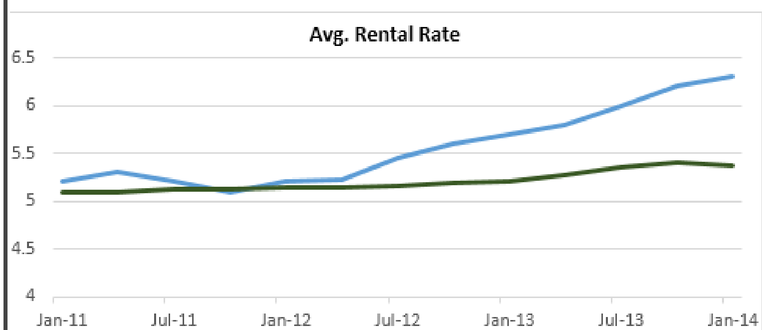
Sources: Jones Lang LaSalle

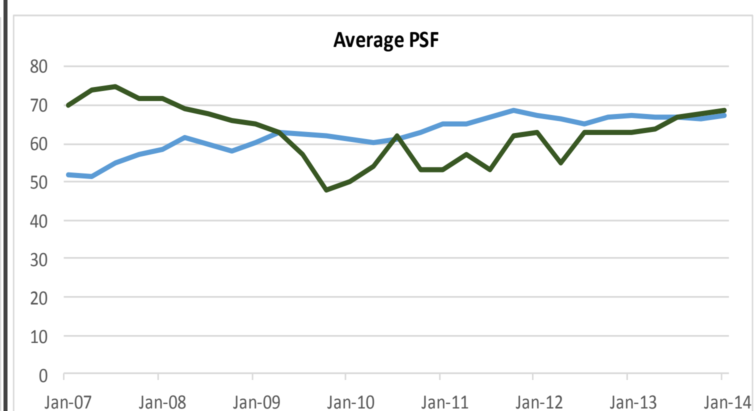
San Antonio Office vs. US Office





San Antonio Industrial vs. US Industrial





Source: Real Capital Analytics

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Private Equity Real Estate

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