

THE QUARTERLY

# TRUST REPORT

## || MULTI-EMPLOYER PROPERTY TRUST

### INSIDE:

- Understanding Real Estate Yields – *Jim Valente, Kennedy Associates Real Estate Counsel's Research Director*
- MEPT's Active Asset Management Approach

FOURTH QUARTER | JANUARY 2009 | VOLUME 23, NUMBER 4



**THE MULTI-EMPLOYER PROPERTY TRUST** closed the fourth quarter of 2008 with a unit value of **\$6,983.33, down 10.12 percent** (net of fees) from the previous quarter. For the trailing four quarters, MEPT's net return is **negative 10.41 percent**.

**The global recession and continued credit crisis had a severe and swift impact on commercial real estate values in the fourth quarter.** The grim financial news and capital markets volatility that persisted throughout the third and fourth quarters were indications that the economic downturn is widespread and far reaching. During the quarter, the massive credit contraction caused economic activity to further decline as consumers, businesses and financial institutions withdrew from normal business activities and adopted highly defensive, risk averse positions. Furthermore, the lack of available capital, inevitable deleveraging, and more conservative expectations caused significant repricing across all asset classes.

**As the quarter progressed and total job losses in 2008 quickly topped 2.6 million, weakening supply/demand characteristics emerged in all property types in most markets throughout the country, with varying severity.** The significant job losses most directly impacted demand for office space; the national office vacancy rate increased to 11.8 percent at year-end 2008 from 11.1 percent at year-end 2007, according to CoStar Group. Vacancy rates in the industrial sector increased (8.8 percent at year-end 2008 versus 8.1 percent at year-end 2007) due to lower demand for US consumer products globally, and a reduction in US exports. Vacancy rates rose slightly for apartments because of an increase in supply caused by condominiums and vacant single-family homes put on the market for-rent. While, at the same time, household formation growth slowed as potential renters move in with parents or roommates. The retail sector has been hit particularly hard by a significant decline in consumer spending. Finally, hotel properties have begun to experience weakness as business and vacation travel declines.

**The scarcity of debt financing and absence of active equity investors in the current market has brought commercial real estate transactions to a virtual standstill.** The volume of sales activity in 2008 was approximately 75 percent lower than in 2007, according to Real Capital Analytics, and the lack of transaction activity has made it challenging to determine property pricing. **Furthermore, market fundamentals continue to soften and there is considerable uncertainty about the full impact of the downturn on commercial real estate. As a result, value adjustments are now reflecting the expectation that net operating income will decline as a result of lower demand, rising vacancies and falling rental rates.** ||

USE EVERY TOOL YOU HAVE

## NEWS BRIEFS

### **IN OCTOBER, MEPT SOLD SAYBROOK, A 47,000 SQUARE FOOT INDUSTRIAL BUILDING, FOR GROSS PROCEEDS OF \$3.9 MILLION.**

Saybrook, located in the Los Angeles market, was originally purchased by MEPT in 2003 as part of the 17 asset Western Industrial Portfolio. When the sole tenant's lease expired in early 2008, MEPT recognized that, based on its characteristics, the property would be attractive to a local owner/user and began marketing the property for sale. In the fourth quarter, MEPT found a local user to purchase the property, which resulted in an IRR of approximately 23 percent for MEPT.

### **AT THE END OF THE FOURTH QUARTER, A TOPPING-OUT CEREMONY WAS HELD IN DENVER AT 1900 SIXTEENTH STREET.**

This 18-story, 403,789 square foot office building is adjacent to another MEPT asset, a 285,197 square foot office building that the Fund developed in 2003 and leased to Gates Corporation prior to completion. 1900 16th Street's construction has generated over \$330 million in economic activity in the Denver area and has created approximately 1.8 million job hours for members of the Buildings Trades. Furthermore, the project is creating green jobs since 1900 16th Street is pre-certified LEED-Gold. The project is a transit-oriented development, located close to Union Station and light rail in the Lower Downtown area, which should increase its appeal to tenants.



### **DURING THE QUARTER, MEPT ADVANCED ITS RESPONSIBLE PROPERTY INVESTING INITIATIVES AT TWO ASSETS IN THE LOS ANGELES METRO AREA.**

On December 1, a 458,262 square foot building at Centrepointe Chino II, an industrial park built by MEPT in 1999, was selected by Southern California Edison (SCE) as the second building to receive solar photovoltaic roof panels as part of a massive solar energy project. SCE, a local utility company, was appointed by the California Public Utilities Commission to engage in an \$875 million project to install solar panels on 150 commercial buildings in Southern California. At the selection, Governor Arnold Schwarzenegger noted that, "...Projects like this one show the world you can protect the environment and also pump up the economy..." At Corporate Pointe at West Hills, MEPT made progress on the master plan for the site, approving a \$2.7 million investment towards the completion of the entitlement process. MEPT is currently redeveloping an existing cafeteria facility into a business campus amenities building that will include a LEED-certified cafeteria and conference facility. Other plans include completing upgrades to make the business park more environmentally-friendly. MEPT's activities will generate green job hours for the local Building Trades and create significant economic stimulus in the San Fernando Valley.

### **IN DECEMBER, A GROUNDBREAKING CEREMONY WAS HELD AT 360 STATE STREET IN NEW HAVEN, CT.**

360 State Street is a planned multi-family project that will include approximately 500 rental units, 15,700 square feet of commercial space and 500 parking spaces. 360 State Street will not only be Connecticut's largest residential building, but it is being built to LEED-Silver standards, so it will also be the state's first residential LEED building. Among the speakers at the groundbreaking ceremony was New Haven Mayor John DeStefano who said, "...What resonates most about this accomplishment



is that, despite difficult economic times, New Haven continues to thrive. This project means good jobs, increased traffic to patronize local businesses, and a continued spirit of vitality in our downtown." The 360 State Street project will create over 2 million green job hours for members of the Building Trades, as well as generate over \$400 million of economic impact in the New Haven metropolitan area. **||**

## FOURTH QUARTER RESULTS

Net Return,  
Fourth Quarter:  
**-10.12%**

Net Return,  
1/1/08-12/31/08:  
**-10.41%**

Net Asset Value:  
**\$5.97 billion**



# PERFORMANCE

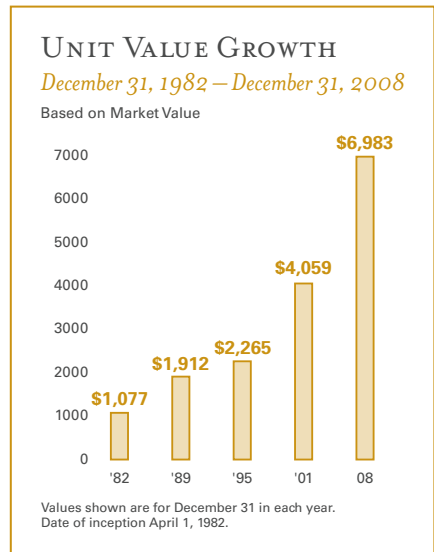
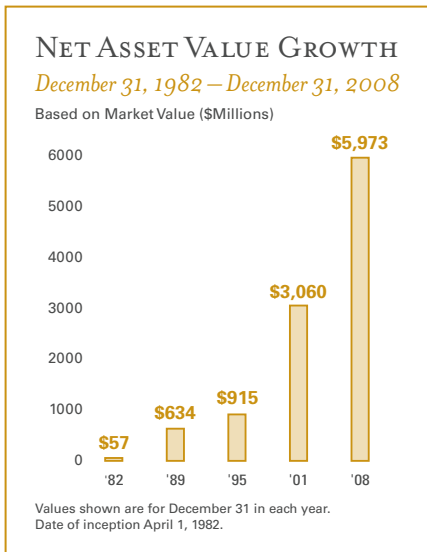
**TOTAL RETURN:** In the fourth quarter, MEPT’s total gross return was -9.92 percent, composed of 1.21 percent income and 11.13 percent depreciation. For 2008, MEPT’s total gross return was -9.63 percent, composed of 4.80 percent income and 13.94 percent depreciation.

**INCOME RETURN:** Historically, and especially during 2008, MEPT’s income from property operations cushioned the Fund against depreciation, underscoring the importance of MEPT’s active asset management and focus on competitive property performance. MEPT’s stable net operating income is secured by more than 1,400 medium to long-term leases, a well-diversified tenant base, prudent rollover exposure, and modest tenant delinquencies.

**CAPITAL APPRECIATION RETURN:** The depreciation in MEPT’s portfolio reflects weakening real estate market fundamentals, which is a function of a decline in demand and a stalled lending environment. Both external appraisals and internal valuations, managed by NewTower’s Valuation Services team, generally reflected adjusted assumptions that included rental rates flattening or declining, lower growth assumptions, leasing pace slowing both in terms of time to lease vacant space and the amount of space that will be absorbed, and rising leasing costs (i.e., leasing commissions and tenant improvement allowances). **The unprecedented fourth quarter value decline in the portfolio was driven by the combination of new, more cautious operational assumptions, and residual capitalization rates and discount rates increasing by 50 basis points, on average, across the portfolio.**

Yield		
	FOURTH QUARTER 2008	TRAILING FOUR QUARTERS (COMPOUNDED)
<b>NET</b>	<b>-10.12%</b>	<b>-10.41%</b>
INCOME	1.01%	3.94%
APPRECIATION	-11.13%	-13.94%
<b>GROSS</b>	<b>-9.92%</b>	<b>-9.63%</b>
INCOME	1.21%	4.80%
APPRECIATION	-11.13%	-13.94%

Commercial real estate, similar to other asset classes, is in a period of risk repricing. There is substantial deleveraging underway and prices are reflecting a “new reality.” Reaching market clearing prices may take some time and cause volatility in the short-term. **Therefore, further depreciation is likely to occur in the asset class.** Portfolios with low leverage, such as MEPT with only 15.9 percent debt, should experience less impact from negative leverage caused by property value declines than portfolios carrying substantially more debt. In addition, the stable income return should help to offset the effect of depreciation on total return — MEPT’s annualized income return since inception is 7.6 percent. With years of easy credit, low volatility, strong economic growth and financial engineering in the “rear-view mirror”, investors are returning to a focus on risk-adjusted returns that are based on more conservative assumptions and offer higher going-in-yields based on income return. 🏗️



# PORTFOLIO SPOTLIGHT

MEPT, DESIGNED TO BRING ITS INVESTORS LOW-RISK returns throughout all real estate cycles, relies on a long-term portfolio management strategy focused on stable income, low leverage, diversification, maintaining a development capability, and liquidity. **MEPT's consistent and disciplined approach is particularly important in this challenging market environment where value will be realized through protecting net operating income and improving property performance.**

MEPT's value-oriented investment strategy is to acquire institutional-quality properties or develop new buildings and create value through active asset management. In 2008, MEPT's Acquisition Team successfully completed 10 transactions in 8 markets, representing total commitments of \$562.9 million. Additionally, MEPT sold four industrial assets for gross proceeds of \$25.2 million.

By investing in new construction property types, MEPT can exercise significant control in the development process, and capitalize on its considerable experience. Occasionally, MEPT acquires land for future development, and these "captive" development projects give MEPT the flexibility and control to build projects as market conditions warrant. **Furthermore, a secondary benefit is that the construction activity stimulates economic activity by creating jobs, producing tax revenue and generating contributions for pension plans.**

Well-located, Class-A, modern buildings substantially mitigate the risk normally associated with owning real property because they elicit demand from the broadest base of credit tenants. Additionally, energy-efficient buildings are increasingly important to tenants as they select space to lease, and MEPT's commitment to sustainable development and energy conservation means its properties will be attractive to a growing list of tenants.


As a result of construction completions and existing property acquisitions, MEPT's portfolio grew by 1.3 million square feet in 2008. MEPT's Asset Management Team, focused on tenant retention in 2008, signed 330 new, expansion and renewal lease transactions and completed approximately 6.7 million square feet of gross leasing activity. While most markets across the country experienced negative absorption, MEPT had positive absorption in its overall portfolio of 1.2 million square feet. At year-end, MEPT's operating portfolio was 90.6 percent leased — significantly higher than the national average.

Vital to the Asset Management team's success in maintaining the portfolio's high occupancy rate is their direct interaction with existing and prospective tenants. Even before a company becomes a tenant, asset managers develop a thorough understanding of a prospective tenant's business. Once tenants move in, asset managers visit properties quarterly and meet face-to-face with key tenants on each visit. This gives the asset manager an opportunity to assess and understand the status of the tenancy, get early indications of occupancy issues, and ensure tenants are receiving first-class onsite service.

**Additionally, MEPT has comprehensive tenant risk mitigation procedures which include performing detailed financial due diligence to assess creditworthiness for all prospective tenants prior to and during lease negotiations.** The process is structured to result in a complete understanding of the prospective tenant, including its industry, specific business model, and its financial strength. The analysis is targeted to identify potential risks and to provide guidance to structure the terms of the lease to mitigate those risks.

The stringent underwriting followed by the Asset Management Team has resulted in a diversified and creditworthy tenant base. **As a result, MEPT has avoided an overweight to certain industries such as housing, mortgage and financial services — all industries that have higher business risk in this economy.**

Finally, tenant account receivable delinquencies and write-offs represented approximately 0.64 percent of total MEPT revenue at year-end 2008. This is lower than the portfolio's average rate of delinquencies and write-offs at year-end in 2005, 2006 and 2007 of approximately 0.71 percent of total revenue. Best practices in the industry target a delinquency rate of two percent or less of total revenue, and MEPT's historical record is a manifestation of the Fund's capabilities, tight controls and quality processes aimed at effectively managing high-risk tenants, account receivable delinquencies, and lease payment risk.

**The current economic environment requires a sustained focus on maintaining portfolio occupancy, tenant credit quality, cost containment and improving energy utilization/efficiency at each asset.** All of these initiatives should safeguard and enhance MEPT's stable income for the long-term. 

## FUND OVERVIEW

Inception Date	<b>April 1, 1982</b>
Assets Held	<b>189</b>
Number of Buildings	<b>513</b>
Total Operating Square Footage	<b>40.9 million</b>
Operating Portfolio Occupancy	<b>90.6%</b>
Average Age of Properties	<b>10.7 years</b>
Markets	<b>26</b>
Net Asset Value	<b>\$5.97 billion</b>
Unit Value	<b>\$6,983.33</b>
Participating Plans	<b>341</b>

## IN APPRECIATION AND RECOGNITION OF OUR 25 YEAR PARTNERSHIP MEPT SALUTES:

- Building Trades United Pension Trust Fund Milwaukee and Vicinity
- Plumbers and Steamfitters Local 486 Pension Fund
- Maryland Electrical Industry Pension Fund
- Mid-Atlantic Regional Council of Carpenters Pension Fund

## PROJECTS SOLD

Saybrook  
Los Angeles, CA

# UNDERSTANDING REAL ESTATE YIELDS



**CONTRIBUTOR:** Jim Valente, Senior Vice President and Research Director, Kennedy Associates, joined the MEPT management team in June 2008 with over 15 years of real estate research experience. Mr. Valente's research has been published in both academic and trade journals, and he appears frequently as a speaker at industry conferences.

THE GLOBAL CREDIT CRISIS DESCENDED upon commercial real estate in a very profound way during the fourth quarter of 2008. Indeed, the industry is dealing with the same issues that are plaguing individual consumers, businesses, and investors in all asset classes around the world — too much debt and the reintroduction of risk into the determination of asset prices.

For investors in private equity real estate, the determination of a “fair” price or value of an asset is challenging in normal times, because unlike stocks and bonds that have homogeneous divisible shares, private equity real estate assets are unique and not easily divisible. In the current environment, price discovery is even harder because there are a very limited number of transactions to use as a benchmark.

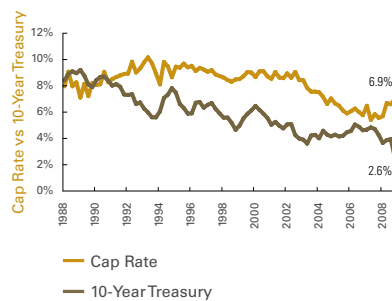
While there is still much uncertainty ahead, especially over the next 9 to 12 months as the global economy contracts, **MEPT management believes that a rigorous analysis of capitalization rates<sup>1</sup> (“cap rates”) in the context of the overall capital markets and investors’ expectations suggests a continued correction in commercial real estate in 2009 that could cause additional value declines of 10% to 20%.** For properties with considerable debt, values may fall further as a result of the effect of negative leverage. In this In-Depth Report, we provide two approaches to determining a “fair” cap rate and then conclude what this could mean to values in the near-term.

## Yield Spread Approach

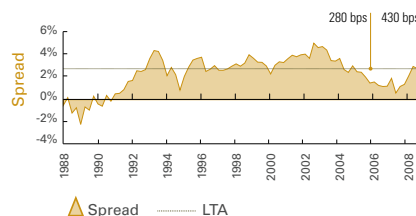
The cap rate represents the expected income return of a property, and is often compared to the yield on a U.S. Treasury bond with an equivalent maturity, or “hold”. The difference between the average cap rate and, for example, a 10-year Treasury, represents

the additional return an investor requires to compensate for the risk of investing in commercial real estate. In other words, the spread between the two yields represents the risk premium. At year-end 2008, transaction data reported by NCREIF suggested that cap rates had risen 158 basis points to approximately 6.9%, from the previous cyclical low in the second quarter of 2007. As the chart below indicates, with the 10-year Treasury hovering around 2.6% at the time of this report, current pricing equates to a 430 basis point risk premium — well above real estate’s historical risk premium range of 250 - 300 basis points.

**CAP RATE VS TREASURY YIELDS**  
*As of December 31, 2008*



**CAP RATE TO TREASURY SPREADS**  
*As of December 31, 2008*



This does not necessarily mean that real estate is currently under-priced, but rather that the 10-year Treasury has been temporarily “mispriced” as investors search for absolute security

in a more risk-averse environment. As markets stabilize over the intermediate term, we expect the 10-year Treasury yield to revert to a “normalized” level between 4.5% and 5.0%. We estimate this yield by dividing the yield on the 10-year Treasury into two components: the long-term real growth potential of the U.S. economy of 2.5% to 3.0% and an inflation expectation of 2%. **Adding the historical risk premium to a normalized Treasury yield suggest that cap rates should stabilize in a range of 7% - 8%.** This is only slightly higher than where some sales transactions are being negotiated at today.

With that said, there is significant diversity across markets and properties. As a result, better properties in more space-constrained markets should trade at the low end of this range, or even lower, while inferior properties in markets lacking sufficient barriers to entry may trade above the range.

## Components of Return Approach

Core real estate is unique because it provides the growth characteristics of a stock and the stable income stream of a bond. About 80% of commercial real estate’s historical return has come from its stable, bond-like income return, which is attributable to long-term tenant leases. The other 20% has come from appreciation, which is attributable to the fact that a property is, in many ways, equivalent to a business, where owners can add value by actively managing the property to maximize performance. But, like a publicly traded company, economic and market conditions can cause property, or business, values to change, despite the fundamental health of the underlying assets.

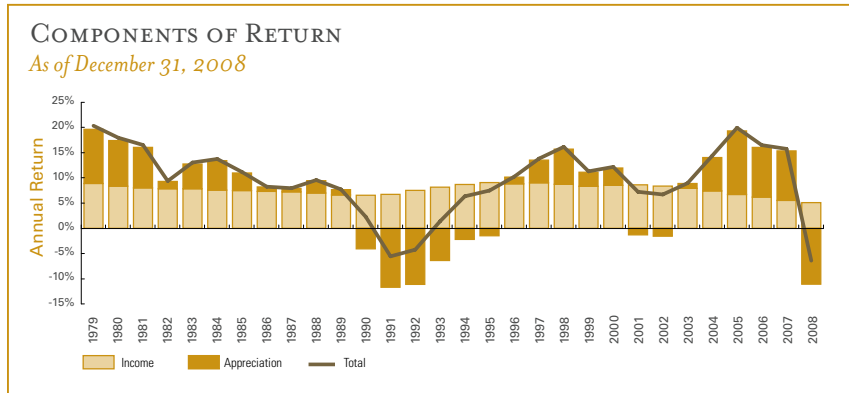
Over the past 30 years, private equity real estate has provided a real return to investors of approximately 6% — and

*(continued on back)*

<sup>1</sup>A capitalization rate is an approximation of expected current income return determined by dividing net operating income by the purchase price or value.

**Management Fee**—The Trustee of MEPT charges an annual investment management fee based on the net assets of the Fund. The current annual MEPT fee is approximately 0.88%. The fee is determined as follows: 1.25% on the first \$1 billion of MEPT total net assets, 1.0% on the second \$1 billion of MEPT total net assets, and 0.75% on MEPT total net assets above \$2 billion. Cash balances in excess of 7.5% of Property Trust net assets are excluded from the above fee calculation and will be subject to an annual fee of 0.15%. Therefore, the fee decreases as MEPT grows. There are no charges for entry or exit, and the Trustee charges no additional investment management fees to its investors.

**IN-DEPTH REPORT** (continued from inside)



approximately 6.9%) will have to rise, through a decline in the cap rate's denominator — which is the real estate value. In the near to medium term, a reasonable expectation would be for cap rates to climb to the higher end of the 6.5% - 8% range,

if a 2% target inflation rate is assumed, then a “fair” return for investing in core private equity commercial real estate would be approximately 8%. **If investors expect to receive 20% of their return from appreciation this suggests an average cap rate of 6.5%. Similarly, it would suggest an average cap rate closer to 8%, if investors expect to derive little of their return from appreciation.**

**What Does This Mean for Values?**

Reviewing the analysis above, the Yield Spread Approach suggests

cap rates will stabilize in the range of 7% - 8%. The Components of Return Approach shows that investors will seek yields in the 6.5% - 8% range, depending on their expectation for appreciation.

The numerator used in calculating a cap rate is net operating income, and, currently, the contracting economy and softening real estate fundamentals limit opportunities to substantially grow net operating income. **Therefore, in order for investors to achieve their “fair” return of approximately 8%, as discussed above, cap rates (currently at**

in which case they may need to rise another 100 basis points to provide what investors deem an appropriate return. **This means that property values could fall another 10% to 20% in order for yields to meet investor expectations.**

Investors with longer-term investment horizon can benefit in this current environment because they will be able to invest at higher yields today and then sell into a recovered economy when risk premiums have narrowed and there is a greater expectation for growth and appreciation. **||**

The *Trust Report* is published by Multi-Employer Property Trust (MEPT), a commingled open-end real estate equity fund that invests in a diversified portfolio of institutional-quality real estate assets and 100% union-built new construction properties in major metropolitan markets around the country. MEPT's primary investment strategy is to create top-quality, income producing assets through development, rehabilitation or acquisition and repositioning of under-valued assets. MEPT's investor base is diverse and is composed of Taft-Hartley, public employee and corporate pension plans.

For more information, please contact Landon Butler & Company, LP at 202-737-7300, or through the Web site, [www.mept.com](http://www.mept.com).

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