

U.S. and Canada Property Market Review

31 Major Distribution & Warehouse Markets

Midyear Results — 2010

On the Mend

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By midyear, the nation's distribution property leasing markets were finally showing signs of recovery. As long as the U.S. economic recovery continues to unfold, so should the recovery of the distribution property leasing markets.

- The overall vacancy rate for the nation's top 31 markets edged down to 10.2% in Q2-10 from 10.4% in Q1-10, after having been virtually flat during the two previous quarters.
- Tenants have not only stopped giving space back to their landlords, but have begun to lease more space and expand their operations. Total occupied space (realized demand) climbed 15 million square feet (MSF) during Q2-10, a modest 0.2% increase — but still well above the tiny gains posted in the previous two quarters.
- As the U.S. economic recovery gains traction, so will the growth in the demand for distribution space. By comparison, during the cyclical expansion years of 2004-07, the net growth in occupied space for the top 31 markets averaged 153 MSF a year.
- Property owners are continuing to “buy” occupancy by offering lower rents. Asking rents in the major markets slipped 1.6% on average in Q2-10, their ninth consecutive quarterly decline, and are now 18.4% below their cyclical peak in Q1-08.
- At this early stage of the real estate recovery, it is customary for market rents to be declining even as occupancy is rising. Typically, market rents continue to fall for about 9-to-12 months after total occupied space has begun to rise.
- New construction has slowed to a crawl. New completions are on track to set a new record low in 2010. What few new starts there are consist almost exclusively of build-to-suit projects for specific customers.
- With the U.S. economy on the mend and with very little new supply in the pipeline, the stage is set for a continuing recovery in the nation's distribution property leasing markets.

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The Second Shoe — Dangling

The economic recession of 2008-09 ended in mid-2009, and the U.S. economy is now one full year into its recovery. Commercial property owners and developers, including those who specialize in the warehouse/distribution sector, were among the hardest hit during the recession, and many analysts today are suggesting that commercial real estate may well be the “other shoe to fall,” with residential real estate having been the first.

Against this ominous backdrop, it may come as a surprise to learn that many warehouse and distribution property owners are anticipating a fairly robust recovery — one that will set the stage for substantial rent growth within the next two to three years. Some observers will dismiss this rosy scenario as little more than wishful thinking. Yet for many analysts, the key question is not whether market rents (and property prices) will spike — but when and by how much they’ll do so.

Market Update

At midyear 2010, the light at the end of the tunnel had brightened to the point where it revealed that the distribution property markets have exited the tunnel.

The overall vacancy rate for the nation’s top 31 markets edged down to 10.2% in Q2-10 from 10.4% in the previous quarter, the first such decline in over two years. (See Exhibit 1.) Although it wasn’t a huge improvement, it did signal the end of the severe, lengthy cyclical downturn in the distribution property leasing markets.

Tenants finally have not only stopped giving space back to their landlords, but have begun to lease more space and expand their operations. Total occupied space (realized demand) climbed 15 MSF during Q2-10 — a modest 0.2% increase, but still well above the tiny gains posted in the previous two quarters. Demand remains below its pre-recession high, but it has begun to grow again. And for the first time in two and a half years, it outpaced deliveries and thus resulted in positive net absorption. (See Exhibit 2.) Moreover, the steep upward trend in net absorption over the past six quarters points toward continued tightening.

The cyclical recovery of the distribution property leasing markets is still in its infancy and, as such, is not yet broadly based. The larger distribution markets outperformed the smaller ones. In Q2-10, for example, the growth in total occupied space in five of the six largest markets (namely, LA/ Orange Counties, Toronto, Chicago, New Jersey,

Exhibit 1: Highlights of the U.S. Warehouse/Distribution Market

31 Major Warehouse Markets

	2007	2008	2009	YTD-10	Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10
New Deliveries (msf)	158	155	65	8	29	14	15	8	3	5
As % of Inventory	2.4%	2.3%	0.9%	0.1%	0.4%	0.2%	0.2%	0.1%	0.0%	0.1%
Occupied Space (msf)	6,223	6,255	6,198	6,214	6,232	6,200	6,196	6,198	6,198	6,214
% Change	2.3%	0.5%	-0.9%	0.3%	-0.4%	-0.5%	-0.1%	0.0%	0.0%	0.2%
Net Change (msf)	141	32	(57)	16	(23)	(32)	(5)	2	0	15
Vacancy Rate (%)	7.0%	8.7%	10.3%	10.2%	9.37%	10.01%	10.27%	10.34%	10.37%	10.21%
Addendum:										
New Starts (msf)	161	92	13	9	2	4	4	2	3	6
BTSS (msf)	33	27	10	8	2	3	4	1	3	6
Inventory Projects (msf)	129	65	2	0	1	2	0	0	0	0
Total Stock (msf)	6,692	6,848	6,912	6,920	6,876	6,890	6,905	6,912	6,916	6,920

msf: millions of square feet.
Source: ProLogis.

and the Inland Empire) added up to 17 MSF, which exceeded the total for the 31 top markets. In contrast, many of the smaller markets continued to languish without any signs of cyclical improvement — including the Central Valley, Seattle, Orlando, and Reno.

At this early stage of the real estate recovery, it is customary for market rents to continue to decline even as occupancy is rising. Typically, market rents continue to fall for about 9-to-12 months after total occupied space has begun to rise, and then level off for a while. The current recovery appears to be unfolding in conformity to this pattern, with property owners continuing to “buy” occupancy by offering lower rents. Asking rents in the major markets slipped further during Q2-10, and so did net effective rents. (See Exhibit 3.)

Developers are still hunkered down and concentrating on leasing up the new warehouses and distribution facilities delivered during the past 24 months or so. New starts have slowed to a trickle; and what few new starts there are consist almost exclusively of build-to-suit (BTS) projects, pre-leased to specific customers. New starts are on track to set new a record low in 2010.

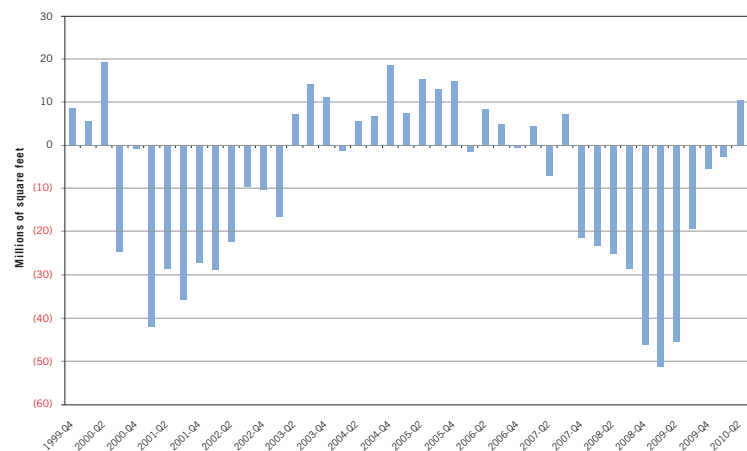
Better Times Ahead

No two real estate recoveries are exactly alike. The distinguishing feature of the current one is the dearth of new supply. New construction has slowed to a crawl. New starts and deliveries will likely amount to 15-to-20 million square feet (MSF) for all of 2010 — a paltry 0.3% increase in the inventory in-place and well below the previous record low of 44 MSF delivered during 1993. (See Exhibit 4.)

Looking ahead, analysts are doubtful that new commercial property development, including distribution facilities, will revive any time soon. U.S. banks ap-

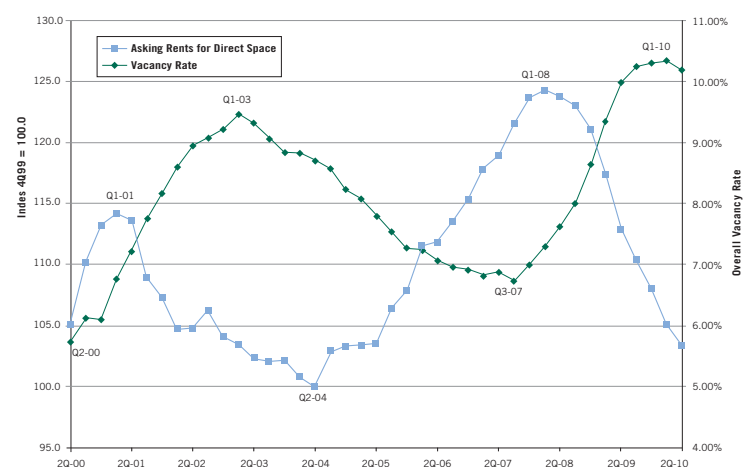
pear to be facing heavy write-downs and write-offs on the commercial property portfolios, especially on their loans for commercial construction projects. In this setting, few banks are likely to be brash enough to begin making new loans for commercial development projects of any sort. Considering that banks traditionally have accounted for the lion’s share of such financing, it could well be three-to-four years

Exhibit 2: Net Absorption of Warehouse and Distribution Centers, 1999-2010 31 Major U.S. Markets



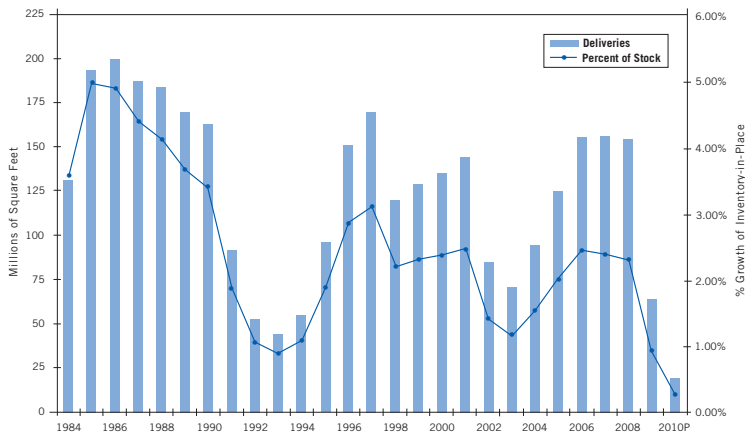
Net Absorption: defined as change in occupied space, less deliveries.
Sources: Cushman & Wakefield, CBRE, Colliers Turley Martin Tucker, NAI, Grubb & Ellis, and ProLogis.

Exhibit 3: U.S. Vacancy Rates and Asking Rents for Warehouses and Distribution Centers 31 Major Markets



Source: ProLogis.

Exhibit 4: Deliveries of Warehouses and Distribution Centers, 1984-2010P 31 Major U.S. Markets



P: projected
Sources: Cushman & Wakefield, Colliers, Peermark, CB Richard Ellis, NAI, PPR, and ProLogis.

before commercial property development recovers to pre-recession levels.

With a tightly constricted new supply, it shouldn't take long for newly signed leases to whittle down the overhang of vacant space. During the cyclical expansion years of 2004-07, the net growth in occupied floorspace (realized demand) for the top 31 markets averaged 153 MSF a year. Demand is likely to grow less than that much this year, considering how sluggish the economic recovery has been. However, as the U.S. economic recovery gains traction, so will the growth in the demand for distribution space. During the past 25 years, the growth in demand for distribution facilities has been highly correlated with the growth in real GDP. (See Exhibit 5.) Hence the maxim: as the U.S. economy goes, so goes the demand for distribution space.

For investors and property owners, the combination of growing demand for distribution facilities plus tightly constrained new supply is the dream scenario. Property leasing market conditions should continue to tighten in coming months, especially as the U.S. economic recovery shifts into higher gear.

Although the U.S. economy's slow progress during the past year has been disappointing, consumers and businesses have been busy restructuring their balance sheets, thus setting the stage for faster growth ahead. Moreover, once the oversupply of residential housing gets corrected, the residential construction industry will begin contributing additional upward momentum to the economic recovery.

Rent Hikes on the Horizon?

Looking ahead, as the property leasing markets continue to tighten, market rents eventually will begin to rise. And they'll continue to climb and converge toward so-called feasibility rents, which may be defined as the threshold rent levels at which builders will just be able

to break even on new development projects. Only as market rents surpass the feasibility rent levels will developers then have an incentive to build new distribution facilities.

At present, however, market rents lie substantially below the feasibility rent levels. (The gaps vary widely across the individual markets.) From their cyclical peak at yearend 2007, market rents have fallen about 25% on average. At the same time, with cap rates having risen roughly 150-to-250 basis points, and after allowing for a 10-to-15% decline in construction costs including land, feasibility rents today are probably about 15-to-20% above where they were at yearend 2007. Hence, on balance and on average, feasibility rents today are probably somewhere around 20-to-25% (or more) above current market rents.

It will be a while, however, before market rents actually begin to rise. The U.S. distribution property markets will not need any more newly built facilities until the existing overhang of vacant space has been whittled down to a more manageable level. The overall U.S. vacancy rate currently stands at 10.2%, just 20 basis points below its cyclical peak. At some point during the currently unfolding

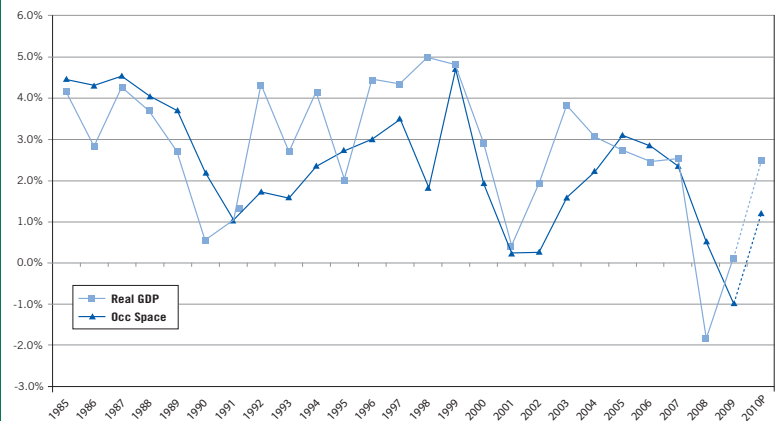
real estate recovery/expansion, as the vacancy rate continues to decline, market rents will first converge to, and then climb above, feasibility rents, signaling developers that it is time for them to begin breaking ground for new facilities.

Some markets will experience rent hikes sooner than others. The vacancy rate is already fairly low in a number of land-constrained markets — e.g., Toronto, Canada (4.75%), Southern California (5.75%), the Inland Empire (7.36%), Portland OR (8.10%), and South Florida (8.89%). As the U.S. economic recovery gains traction, the vacancy rates in these already tight markets will recede to even lower levels, triggering market rent hikes somewhat sooner than in the other markets.

No one knows for sure how far the overall vacancy rate must fall before it triggers systemic rent increases, but we do have two benchmarks to use in estimating frictional vacancy. First, during the last cyclical recovery/expansion, the overall vacancy rate for the top 31 markets bottomed out at 6.7% in Q3-07, and market rents were then climbing at a fairly brisk pace. Second, the average vacancy rate for the past ten years was 7.9%. Judging by past experience, it appears that an overall vacancy rate of 8.0-to-8.5% corresponds roughly to the trigger point where rents begin to move upwards.

With the overall vacancy rate at 10.2% at midyear, the overhang of vacant existing space thus ranged somewhere between 180 MSF for a “frictional” vacancy rate of 7.9% to as much as 260 MSF for a “frictional” vacancy rate of 6.7%. Plus, when the 20 MSF of new facilities in the construction pipeline at midyear are included, the estimated overhang then amounts to between 200-to-280 MSF. How soon this overhang of excess vacant space will be whittled down to zero depends, of course, on the strength and durability of the U.S. economic recovery.

Exhibit 5: Growth in Occupied Warehouse Space vs. Growth in Real GDP
1985-2010P, Percent Change, YoY



P: projected
Sources: PPR, ProLogis and Bureau of Economic Analysis.

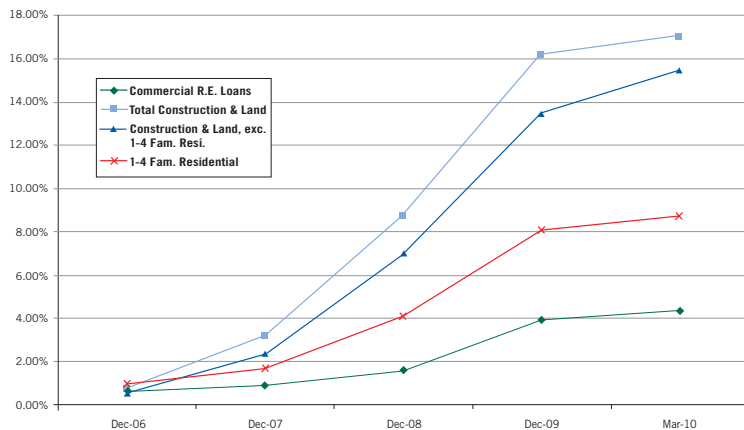
No Financing, No New Construction

Ordinarily, as market conditions tighten to the point where rents begin to rise, there would be a few markets or niches where market rents would be high enough to justify breaking ground on “spec” development projects. And developers would have lined up their financing and started a number of these new projects.

These are not ordinary times, however, and it is doubtful that the banks will be willing to provide construction financing for new commercial real estate projects any time soon. Indeed, by 2011-12, U.S. commercial banks are likely to have written down or written off completely many tens or even hundreds of billions of dollars of commercial construction and development loans. In the face of mounting losses on their commercial construction and development loan portfolios, few banks are likely to be brave enough to begin making new loans for commercial development projects, however meritorious these new projects might appear to be. (See Exhibit 6.) Another deterrent is that any new commercial property construction loans would surely raise red flags for bank examiners and regulators.

Exhibit 6: Noncurrent Commercial Real Estate Loans

All U.S. Commercial Banks



Note: noncurrent loans include both nonaccruing loans plus loans past due 90+ days.
Source: FDIC.

If banks won't lend for new development and construction, then commercial property development starts will be severely pinched. U.S. commercial banks traditionally have been the mainstay of financing for such development projects. No one compiles complete statistics; but here in the U.S., banks are thought to have financed about two-thirds to three-quarters of new commercial property developments. The rest has gotten financed by an amalgam of lenders, including U.S. savings institutions (which are in essentially the same leaky boat as commercial banks) and bank credit lines to publicly traded property development companies.

Non-bank lenders will be likely to step into the breach to provide commercial construction financing. Likely candidates include hedge funds, private equity funds, opportunity funds, and pension funds, to name just a few. But commercial construction represents uncharted waters for these new lenders, and we suspect that they will enter the market cautiously and keep one foot on the

brake, so to speak, as they build their loan portfolios. In any event, the cost of money from these non-bank sources tends to be extremely high.

Going forward, if developers cannot finance their new development projects, they won't be able to build them. Within the next two to three years, there will likely be little new commercial property construction, including distribution facilities, even if leasing market conditions improve enough to justify new construction.

Developers with access to the capital markets, however, will be able to finance new commercial construction projects. So as the demand for new distribution facilities continues to grow, these developers will be among the few able to accommodate the growing need for

additional floorspace. The majority of these new projects, we suspect, will probably get done as BTSs for specific customers. Developers without access to the capital markets will be at a distinct competitive disadvantage.

Concluding Remarks

Analysts remain cautiously optimistic about the outlook for the distribution property markets. With the U.S. economy on the mend and with very little new supply in the pipeline, the stage is set for a continuing recovery in the nation's distribution property leasing markets. Although the consensus forecast does still call for a pickup in economic growth by year-end 2010 or early 2011, some analysts are worried that the current lull could persist. But by the same token, there are also a few real estate analysts who are contemplating the possibility of rent spikes within the distribution property leasing markets in 2012 or 2013.

From the Editor...

The U.S. economy is now one full year into its recovery. But the recovery itself has slowed, causing many observers to worry that this lull will persist. Where, they lament, will the growth come from?

One overlooked source is consumer spending. True, consumer spending has been weak-to-lackluster during the past few quarters. But that's because households were busy rebuilding their savings. Indeed, the U.S. personal savings rate has increased from 2% in 2007 to 6% in mid- 2010. Once households have raised the savings rate to the desired level, they can adjust the pace of their consumer spending upwards to align with the growth in their disposable income. We're looking for a pickup in consumer spending in the coming months.



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About ProLogis

ProLogis is a leading global provider of distribution facilities, with more than 475 million square feet of industrial space (44 million square meters) in markets across North America, Europe, and Asia. The company leases its industrial facilities to more than 4,500 customers, including manufacturers, retailers, transportation companies, third-party logistics providers and other enterprises with large-scale distribution needs.

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