Eaton Vance
Investment Managers

Market Commentaries Third Quarter 2009

Real Estate Market

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While the commercial real estate market deteriorated further in the third quarter of 2009, things worsened at a decelerating pace, as signs emerged of a still embryonic broad economic recovery. These signs included some improvements in the capital markets. Key trends included:

- Slight loosening of credit availability, although lenders remain guarded;
- Very limited investment sales transaction activity, with the exception of multifamily properties, where transactional activity picked up;
- Cap rates[1] relatively flat on a sequential basis, but sharply higher relative to one year ago; and
- In almost every market and property type, declining rental income and cash flow.

Eaton Vance manages a portfolio of commercial real estate, including properties in the multifamily, industrial distribution and office sectors.

Multifamily properties: During the third quarter of 2009, the multifamily sector on average across the country showed better operating metrics than did any other sector, despite more than seven million jobs lost over the past seven quarters and despite the historically high correlation between employment and demand for multifamily space. Nationally, rents averaged approximately 0%-2% below 2008 levels. Expenses rose approximately 0%-2% amid still historically low turnover. Occupancy remained in the range of approximately 92% nationally. The financing available for multifamily properties from government-sponsored entities, Fannie Mae and Freddie Mac, supported increased transactional activity during the period. These lenders have tightened their underwriting, with somewhat lower loan-to-value standards and slightly higher debt service coverage requirements than was the case a year earlier, but they remain open for business to investors in the sector. Single-asset 10-year mortgages remained available during the quarter in the range of 5.25%-5.75%, historically very attractive pricing particularly relative to current cap rate levels. Cap rates on institutional-grade multifamily assets in major markets crept up very modestly on a sequential basis during the quarter, to the low-7% to mid-7% range, although this increase was approximately 100 bps on a year-over-year basis.

Office properties: The office sector varies greatly by market, sub market and individual asset. Rent levels were down in most markets during the third quarter, with declines on expiring leases exceeding 10% in many markets across the country. However, depending on the specifics of a particular property or lease, the change in net effective rents varies widely. Occupancy on a national basis declined again, by about 0.50%, to approximately 83% during the quarter. Certain suburban markets, including Chicago, Dallas and Atlanta, showed vacancy rates over 20%, while Central Business Districts fared only marginally better. A significant percentage of Eaton Vance's portfolio of office investments is located in the greater Washington, D.C. area, which held up better than most U.S. markets during the quarter but included pockets of weakness nonetheless. Debt capital remained very scarce. Transaction volume remains very low—a fraction of the level of the previous year. Lenders have continued to be highly reluctant to lend, as they focus principally on addressing problems in their existing loan portfolios, including many loans which cannot be repaid in full in the short or intermediate term. The most frequent solution, albeit not a long-term one, is to extend the loans and hope for improvement in the operating metrics and/or capital market environment. Market coupons on new mortgages are generally at around 8%. Cap rates are very challenging to estimate, given the scarcity of transactions, but appear to have risen to around 9%, up 50-100 bps in the quarter.

Industrial distribution properties: The operating fundamentals in the industrial distribution market deteriorated further in the quarter, as the national vacancy rate hit 10.4%, up only 30 bps sequentially but to a level not seen in 15 years. The values of these properties deteriorated as well, as cap rates continued to widen and both rent levels and NOI levels declined. In the third quarter, net effective rents generally declined, at an estimated rate averaging 10% nationally. Industrial absorption remains negative, as demand depends on a resurgence of life in the retail sector which drives so much of industrial distribution activity. Tenants remain generally risk-averse, and landlords are finding it difficult to get commitment on new leases and even on renewals. Debt capital remains scarce, although life insurance companies have expressed incipient interest in lending into the sector. Relatively few transactions are occurring, but institutional-grade industrial property appears to be trading at cap rates in a range of 9%-10%. The one bright spot is on the supply front, where construction of new industrial property has fallen to levels under 10 million square feet nationally, down some 80% from typical levels. But the overhang from vacant space, particularly high-quality recently-built warehouses, is overwhelming the benefit of dramatically reduced supply. Improvement seems unlikely in the near term.

All information is as of September 30, 2009, unless otherwise noted.

[1]Capitalization rate (or "cap rate") is a measure of the ratio between the net operating income produced by an asset (usually real estate) and its capital cost (the original price paid to buy the asset) or, alternatively, its current market value. The rate is calculated by dividing the asset's annual net operating income by its cost or value. For example, if a building is purchased for $1,000,000, and it produces $100,000 in positive net operating income (the amount left over after fixed costs and variable costs are subtracted from gross lease income) during one year, then the asset's capitalization rate is 10%.

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