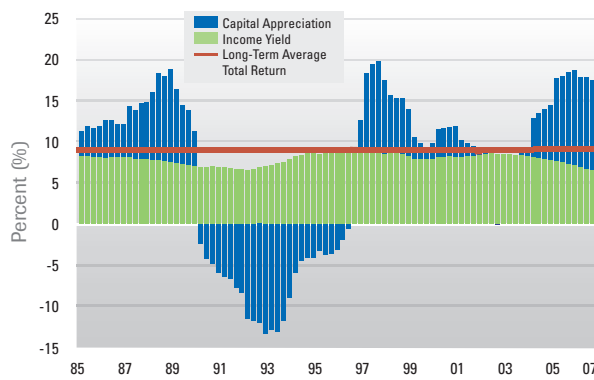


what happens next?

The 2007 meltdown in global credit markets is a major turning point for the ample liquidity and attractively priced debt that partly drove recent real estate activity.

> For Canadian commercial real estate investors, 2007 began very much as the previous four years. Thanks to ample liquidity, strong capital flows from a myriad of sources continued to drive up asset values and income yields for most properties compressed further. As a result, appraisal values continued to move higher and capital appreciation accounted for the majority of real estate's large twelve-month return of 18.6% as of Q3 2007. Seasoned real estate professionals recognize that this return profile is not consistent with historical norms. The income component of real estate has traditionally accounted for more than 80% of real estate's 20-year average annual return of 9.5%.

CANADIAN REAL ESTATE RETURNS BY INCOME YIELD AND CAPITAL APPRECIATION



Source: IPD, Russell Canada

However, the meltdown in global credit markets in 2007 and the re-pricing of risk that has ensued for almost every type of asset, together with growing concerns about a possible U.S. recession, suggest that we have entered the latter stages of the investment and property cycle. As we move away from the peak, a key question real estate investment professionals are pondering is, "What happens next?" In particular, will Canadian real estate investments be forced to give back some of the outsized returns achieved over the last few years?

ASSESSING RISK

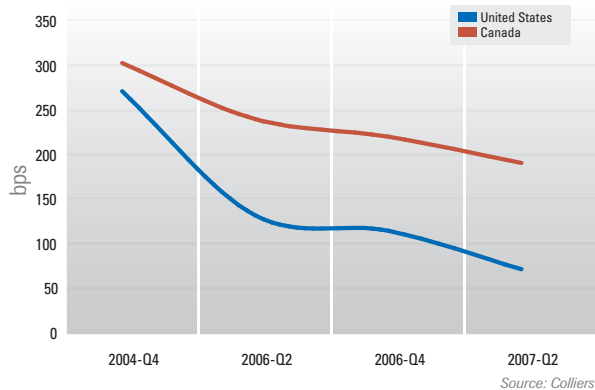
To answer these questions, we must be mindful of the forces that have taken us here. Real estate's recent hefty returns, not only in Canada but elsewhere around the world, are primarily the result of a substantial compression in cap rates owing to a number of fundamental factors. One of the most important is that

real estate has become an accepted asset class among institutional and other investors. Generally greater portfolio diversification contributed to this increased acceptance. At the same time, the secular reduction of global interest rates since 2002 forced investors to search for higher yields in alternative assets. As a result, a significant amount of capital poured into the real estate sector over the last few years. Together with increased discipline and transparency in the commercial real estate market itself, the implied risk premium on direct real estate (the spread between real estate cap rates and risk free fixed income investments such as the yield on the 10-year Government of Canada bond) has been bid down to approximately 200 basis points from 400 basis points in 2000.

Advancements in the public real estate equity and debt markets over the past few years also made it possible for commercial property risk to be spread through capital markets to a wider array of investors. Debt capital, particularly in the more innovative U.S. capital market, became far more abundant with lower rates than historical standards. In addition, lending criteria south of the border were relaxed significantly. These cyclical changes permitted highly leveraged transactions in the U.S. at low interest rates. The enhanced returns generated facilitated a further bidding down of cap rates via additional reductions in risk premia, drawing more buyers into the market. History may well show that the high watermark for leveraged buyout activity was the US\$39 billion Blackstone/EOP transaction in the spring of 2007 and the even more aggressive subsequent re-selling of portions of the EOP portfolio.

The implied risk premium for real estate has similarly fallen in Canada, although the compression has not been as large or as broad based as in the U.S. This is likely partially due to more cautious underwriting practices on this side of the border. More importantly, capital market innovation in Canada has also tended to lag behind the U.S., so there may have been less ability for investors, particularly private equity, to tranche away asset risk via conduits. In this regard, the institutionally-dominated Canadian market avoided the "momentum buying" seen south of the border. Nevertheless, real estate values in Canada have also reached record highs and require sober scrutiny.

REAL ESTATE RISK PREMIUM Spread between Cap Rate* and 10-Year Bond Yield



*Note: Cap rates for Class A Downtown and Suburban Office for top 3 cities in US and Canada

REAL ESTATE VALUES DRAGGED DOWN BY CREDIT CRUNCH

Following the August 2007 liquidity crunch, credit spreads for commercial real estate loans widened by as much as 30 to 60 basis points. Conduit loan spreads also spiked dramatically and by the end of 2007, there were virtually no bids available in any of these products. Some whole loan lenders still have capital ready to deploy, especially because global central banks (particularly the Fed) have shown a willingness to support financial markets by lowering interest rates. The main difference today is that liquidity now has a different risk premium attached to it. The higher cost of capital implied by this suggests that riskier deals will be either more difficult to get completed or more expensive, or both. Accordingly, the downward bidding of cap rates due to leverage caused by excessive liquidity is unlikely to continue. In short, cap rate compression, the defining feature of the real estate investment market over the last few years, is no longer in effect.

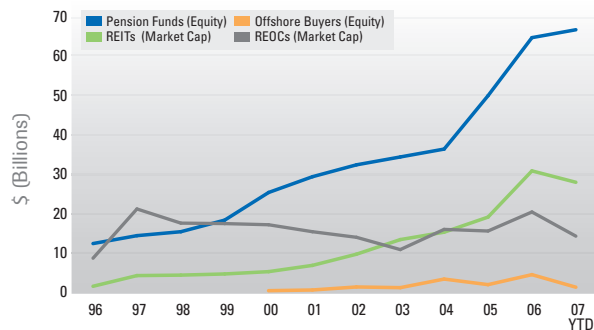
In the U.S., risk re-pricing is indicating a potential upward adjustment in cap rates of anywhere between 50 and 200 basis points. Evidence of this adjustment is already apparent. Moody's found that the value of U.S. commercial properties declined by 1.2% in September 2007 from the previous month. Particularly hard hit were apartments in the western states and office properties in most states other than California.

In Canada, we believe that cap rates will move up as well. Lower-tier properties in riskier markets and submarkets will likely rise by 50 to 150 basis points (an asset value decline of between 3% and 10% over a full year for an unlevered investment) as pricing adjusts to

better reflect the underlying risk of the asset. As of late November 2007, we have observed that cap rates in many instances may have already adjusted by at least 25 basis points. The relative scarcity of product in Western Canada suggests that overall adjustments may occur more slowly in this region.

Cap rates for institutional quality properties in Canada will also move up, but we expect this adjustment will be more modest. This comparatively softer increase will be mainly due to the continued buying and dominating influence of lower leveraged institutional investors in Canada compared to the U.S. In an era of historically low fixed income returns, institutional investors in Canada, particularly pension funds, have increased their allocation to real estate and have become considerable equity investors. Based on a funding formula that takes into consideration inflation-adjusted fixed income returns, core unlevered net real estate returns of about 7% to 7.5% are generally acceptable to pension funds. Going-in cap rates for institutional quality product are therefore likely to rise by no more than 25 to 50 basis points over the next 12 months.

GROWTH IN INVESTED EQUITY



Not all of the increased real estate allocation will be invested in Canada going forward. Many of the country's largest pension funds are nearing their targeted domestic real estate allocation, due both to acquisitions already made and rising prices. However, the allocation to real estate among smaller domestic pension funds, particularly those with defined benefit obligations, amounted to just 4% as of the end of 2006, which is only about half the amount allocated by larger pension funds. As long as interest rates do not materially rise, we think many of these smaller pension funds will continue building their domestic real estate allocations, given the unique ability of this asset class

In a post-cap rate compression era, prospects for further capital appreciation will depend less on capital market forces and more on specific property level performance. Income growth will be key.

to be a stable future cash flow generator. The limited amount of institutional quality product available in Canada should provide some support of current valuations for the best in class properties.

Canada's larger pension funds will remain attracted to real estate but will shift to more strategic investing from their previous asset accumulation phase. This strategic focus has moved noticeably to the pursuit of real estate opportunities outside of Canada and has also involved exploring alternative real estate investments, including storage, hospitality and seniors' housing within Canada. In 2007, entity-level transactions in the two latter categories included the privatizations of Retirement Residents REIT by PSPIB and CHIP REIT by bclMC. These public-to-private deals offer pension funds economies of scale, critical mass and the opportunity to deploy large amounts of capital in a single transaction.

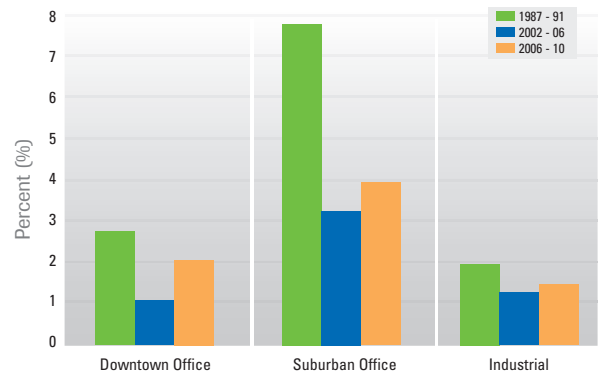
IT IS ABOUT THE FUNDAMENTALS AGAIN

In a post-cap rate compression era, further capital appreciation may still exist. However, this will depend less on broad capital market forces and more on specific property-level performance in the context of regional supply and demand conditions. Income growth – the main historical driver of real estate capital appreciation – will be key.

Property demand in Western Canada has been especially strong and vacancy rates in this region are near all time lows in most markets. High commodity prices have also provided the foundation for solid commercial real estate demand in central Canada. To illustrate, consider that the commodity boom has largely been responsible for substantial equity returns on the resource-heavy TSX in recent years. This has, in turn, generated strong tenant demand in Toronto's large financial and commercial services sector (via increased investment banking, M&A activity and wealth management). In fact, overall service sector job growth in Ontario has more than offset the significant job losses experienced in that province's large manufacturing sector due to the rapid appreciation of the Canadian dollar. While over 150,000 manufacturing jobs have been lost in Ontario since 2004, well over 400,000 jobs have been gained in the service sector during this period, with a significant portion attributed to office-oriented occupations.

Amidst this healthy demand, new supply has remained quite disciplined in most markets. Contrasting previous cycles, the development process today has been constrained by a multitude of factors, particularly high construction costs for materials and labour, especially in Western Canada. In addition, increasing urban densities, greater attention to environmental factors and local resistance to development have all contributed to lengthening the planning process compared to the late 1980s. As a result, the overbuilding that has typically ushered in the end of the growth phase for most property cycles has been broadly mitigated today.

NATIONAL CONSTRUCTION COMPLETIONS*



Source: Cushman & Wakefield LePage

* Annual construction as % of Class A inventory

PROPERTY CYCLE PAST ITS PEAK

A slowing U.S. economy, together with the tighter financial market conditions caused by the credit crunch, is now negatively impacting U.S. business confidence. Indeed, there is evidence that commercial vacancy rates in some U.S. markets are beginning to rise and this could ultimately disrupt net operating income (NOI) growth for some U.S. properties. History has shown that, when U.S. NOI growth is negatively affected, so too is Canada's given our extensive economic relationship and proximity.

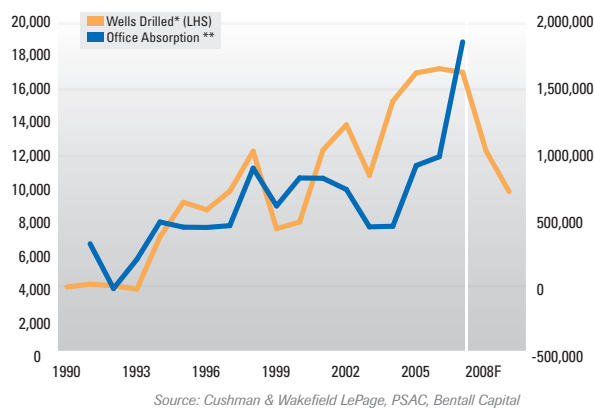
For Canada, the main area of resulting weakness will continue to be the export sector, which is also battling the impact of the loonie's appreciation. We expect that the weakness currently isolated to the wood products and domestic auto manufacturing industries will broaden and significantly impact NOI growth for those markets that depend upon either the distribution or manufacturing of goods destined for U.S. consumer markets.

It is time to get back to the basics of "bricks and mortar" investing. Specialized property management skills are the surest way to drive NOI growth and implicitly, value.

Canadian domestic demand conditions are also likely to moderate in 2008. Strong corporate profit growth (the driving force behind the healthy property demand this cycle) is likely to ease owing to losses stemming from the credit crunch, a more moderate pace of expansion in commodity prices, lukewarm U.S. demand and higher debt costs. While this will not severely crimp business investment growth as firms can continue to draw upon their large stockpiles of internally generated cash, it suggests that the pace of office absorption in Canada may be near or even past its peak.

The best example of a Canadian office market that may be passing its peak is Calgary. Sublease space in Calgary's downtown office market is starting to reappear and head-lease space is now sitting vacant for longer periods of time, largely due to uncertainty caused by softer natural gas pricing, lower drilling activity over 2007 and consolidations in the energy trust sector. Landlords are consenting to some subleases rather than taking space back, a further sign that this market may be softening. In addition, the implementation of higher royalties and the risk of federally imposed carbon taxes now pose some downside risks to the strong investment and runaway growth picture that became synonymous with Calgary in the past two years.

CALGARY OFFICE DEMAND & ALBERTA DRILLING ACTIVITY



* Advanced one year

** Total class A downtown and suburban office, 3 yr moving average

While most forecasters continue to believe that energy prices will remain well supported by demand in emerging Asia, it is becoming increasingly clear that a normalization of energy activity is in the cards for Alberta, at least until oil sands production comes on

line in 2009 or 2010. Given the new supply that is in the pipeline, this normalization in demand suggests that downtown office vacancy rates in Calgary will move higher over the next few years and that rental rates will decline over the next two years.

NOI IS THE FOCUS

All told, we expect that 2008 will be remembered as a turning point for commercial real estate investment. A major implication of the re-pricing of assets and debt theme is that cash will once again be king. Indeed, cash buyers will likely have greater influence on the market compared to the last few years when levered buyers had the upper hand. To this end, realistic underwriting assumptions must prevail. If one were to underwrite based on the favourable conditions of the recent past continuing indefinitely, there would be more downside than upside embedded in pricing.

Investors should also appreciate that, more than other asset classes, real estate is a "hands-on" business. Capable leasing and property management skills are essential in determining performance. Specialized skill, extensive industry knowledge and tenant relationships are what drive property NOI and, implicitly, value. Tenants today are more demanding than ever and require more from the facilities that house their operations, including environmentally friendly options and designs.

In 2008, the ability to retain tenants and differentiate property level services will therefore be crucial to increasing property NOI – the main driver of real estate's historical return. Appropriately priced core investments should continue to deliver acceptable returns for investors. But above-average property returns are not likely to be generated by buying accretively, but rather by working the asset post-acquisition. The challenge, as always, will be to find properties where density can be added, the use and value to the tenant can be materially altered, or specialized skills can be applied to realistically grow NOI by more than inflation.

As we all recognize, the wind has been at the back of commercial real estate investors over the last few years. Fundamentals have been strong and liquidity abundant. Now that the winds of change are shifting, it is time to be defensive, patient and disciplined.