TIAA-CREF Asset Management

Real Estate Quarterly Highlights

Third Quarter 2014

What's Inside

Real Estate Investment Quarterly Highlights features overviews of the following:

Financial Services

U.S. Commercial Real Estate Outlook

Capital Markets

Risk Spreads and Interest Rates

Capital markets drive CRE pricing through Treasury rates and risk spreads. Ten-year Treasury yields started and ended 3Q at 2.5%, but dropped to 2.1% early in 4Q due to concerns about slowing global growth. With QE3 now ended, investors are closely watching the Fed. The Fed has stated any move will be data dependent; most economists do not expect a hike in the fed funds rate until mid-2015 at the earliest. Current cap rate spreads are in-line with long-term historical averages; this should offer comfort to real estate investors.

Labor Market

Employment and Unemployment Rate

Employment growth drives demand for space. Employment has grown by 2.6 million jobs over the last 12 months as compared with 2.2 million jobs at the start of the year. Gains have been broad-based and accelerating across all sectors. Solid additions continued into 4Q, with October marking the ninth straight month of gains in excess of 200,000 jobs. The Blue Chip consensus expects monthly employment to grow by an average of over 220,000 jobs in 2015. This healthy level of employment growth bodes well for real estate demand.

Leading Indicators of U.S. Commercial Real Estate Performance — 3Q2014

Indicators	Position	Stall	Overheat
Interest rates	Historically low making real estate investment attractive		
Investor risk appetite	Spreads are tightening but not to last cycle peak		
Debt for investors	Commercial mortgages available with easing standards		
Debt for construction	Easing but not yet abundant		
Employment growth	Improving to absorb labor force growth		
Unemployment rate	Much improved but with low labor force participation		
Vacancy rates	Mostly declining to long-term averages and below		
Commercial property rents	Mixed across property types depending on new supply		

Source: TIAA Research

Debt Availability

Construction and Investor Financing

Debt Flows affect the amount of new construction and the volume of transactions for existing properties. Solid total returns, strong capital flows and expanding debt availability have created an environment that is ripe for new construction. Demand for construction financing has increased and standards have eased somewhat, but recourse loans and moderate loan-to-cost ratios prevail. Availability of commercial mortgage financing is a positive for real estate investors, but hungry capital can become destructive if credit standards erode and new construction lending disconnects from demand. There are early indications of moderate credit quality erosion in CMBS lending.

CRE Fundamentals

Vacancy Rates and Rent Growth

CRE Market Fundamentals determine net operating income growth prospects. Despite an increase in construction, fundamentals continued to improve modestly across all sectors in 3Q. Prospects are most favorable for the office, industrial and retail sectors due to moderate demand growth and minimal construction. Multifamily markets bear monitoring as construction has ramped up and is expected to approach historic norms in the near term. Thus far, new apartment supply has been readily absorbed with vacancy rates stable or falling and rents continuing to grow due to favorable demographic-driven demand.

Conclusions

U.S. commercial real estate investment performance outlook: NPI annualized total returns have been stuck in the 11% range (± 50 bps) for the past eight quarters.

Investors have welcomed returns of this magnitude, especially considering that commercial real estate was in the midst of one of its worst downturns just five years ago.

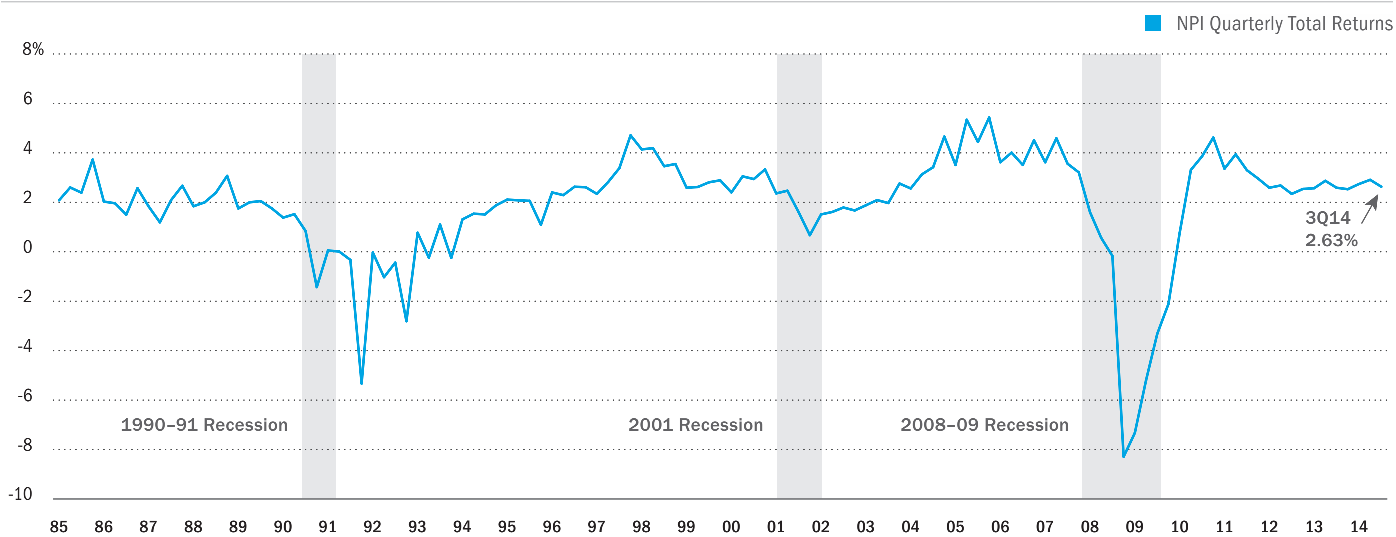
There are solid reasons why return performance can be expected to remain favorable. First, market fundamentals are healthy. The prolonged economic recovery has steadily driven down vacancies across the country, but mostly without the spikes in demand that cause rents to surge and construction cranes to sprout up. Second, construction lending is likely to remain constrained. Big banks are nurturing existing capital and are anxious to avoid accumulating large portfolios of "risky" loans, thus limiting the risk of overbuilding. Third, leasing activity remains brisk but companies are making careful decisions about long-term space needs, including leasing less space when appropriate given current workplace trends. In past cycles, markets were glutted when companies dumped "grey space" that was leased to accommodate growth and undercapitalized dot.coms went bust. In short, the market excesses that have characterized prior cyclical peaks are not evident.

The only apparent excess is capital. Offerings of top properties in major markets are attracting bids from multiple investors, pushing prices to 2007 levels and driving down cap rates to 5% or lower. Yet, returns still remain attractive relative to other asset types. Further, NPI transaction cap rate spreads still maintain a more than 300 basis point spread to ten-year Treasury yields. Long-term historical cap rate spreads have averaged approximately 300 basis points.

The low interest rate environment of the past six years has contributed to the surplus of capital. The flood of capital has boosted prices for commercial real estate along with other asset classes like stocks, timber and farmland. While the resulting search for yield has generated intermittent concern about pricing bubbles, the low interest rate environment provided the necessary support to nurture the economy to recovery. But with quantitative easing ending in October, the Federal Reserve's commitment to extraordinarily low interest rates is likely coming to a close. Consequently, investor focus has turned to the potential impact of rising interest rates on commercial real estate and other asset types.

While investors may fear rising interest rates, a material increase in interest rates might not occur for some time for several reasons. The FOMC's October statement noted that "…even after employment and inflation are near mandate-consistent levels, economic conditions may…warrant keeping the target federal funds rate below levels viewed as normal in the long run." Low Treasury yields have also been caused by safe haven flows. Treasuries will likely continue to serve that function in the future, especially given indications of recession in Europe and Japan and weakening growth in China. Given these factors, it is plausible that the moderate economic growth/low interest rate environment will continue in 2015 and further support healthy commercial real estate performance. If the interest rate and capital markets environments remain supportive in 2015 as expected, it will be imperative to closely monitor changes in fundamentals and capital flows which could compromise future performance.

Economic and Real Estate Cycles



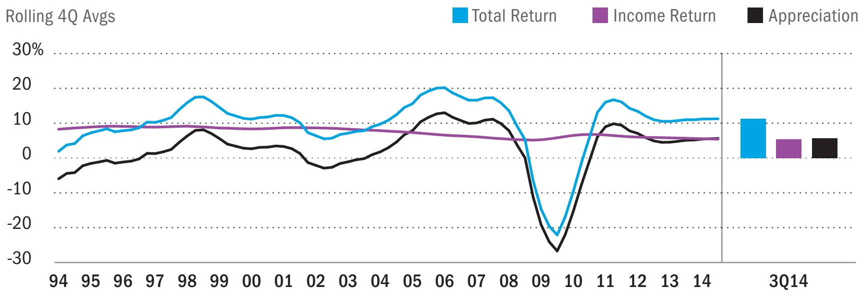
U.S. Real Estate Performance Overview

Total Return Remains Compelling

The NCREIF Property Index (NPI) ended the four quarters through 3Q14 with an 11.3% total return, virtually identical to the prior two quarters. Income and capital returns were 5.4% and 5.6%, respectively, and again similar to the previous quarters. Four-quarter total returns have remained at ~11% over the past six quarters, bolstered by a slowly improving national economy. Recent GDP and employment data show a pickup in activity which bodes well for commercial real estate performance in 4Q and into 2015.

NCREIF Returns for All Property Types

Rolling 4Q Avgs

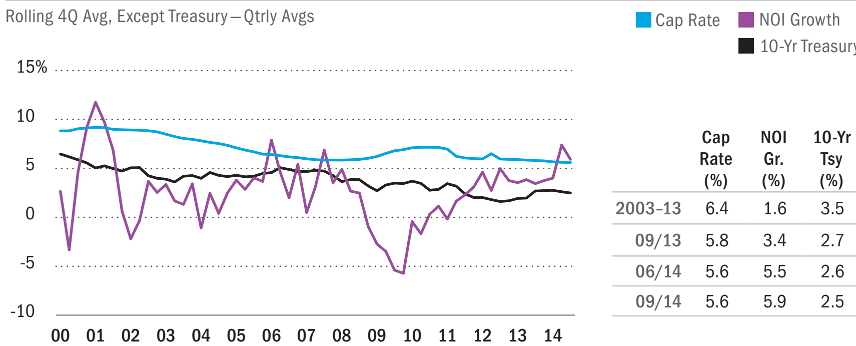


Valuation Cap Rates Inching Lower

Cap rates implied by NPI property valuations averaged 5.59% for the four quarters ending September 2014 vs. 5.63% previously. Even though investors worry about rising rates, interest rates remain low and may continue to do so in the near term. A "lower-rates-for-longer" environment benefits real estate by helping prolong the upside of the current cycle. Despite concern about the prospect of rising interest rates, the more than 300 bps cap rate spread over 10-year Treasury yields remains attractive compared to long-term historical averages.

Pricing for All Property Types

Rolling 4Q Avg, Except Treasury – Qtrly Avgs



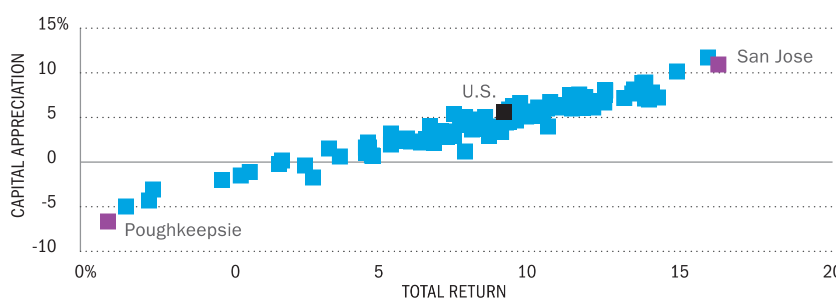
	Cap Rate (%)	NOI Gr. (%)	10-Yr Tsy (%)
2003–13	6.4	1.6	3.5
09/13	5.8	3.4	2.7
06/14	5.6	5.5	2.6
09/14	5.6	5.9	2.5

Solid Returns in Virtually All Markets

NPI returns were healthy across the nation, with positive one-year total returns recorded in all NCREIF markets and double-digit total returns recorded in 66 of 103 markets. Regionally, the South led for the sixth consecutive quarter with average one-year total returns of 12.8% followed closely by the West at 12.7%. San Jose and San Francisco were the top-performing markets; Houston, Denver and Miami were other major market leaders. Returns in Washington, D.C. and Bethesda continued to lag as a result of ongoing weakness from cutbacks in federal government spending.

NCREIF MSA Dispersion

Rolling 4 Quarters Ending 3Q 2014

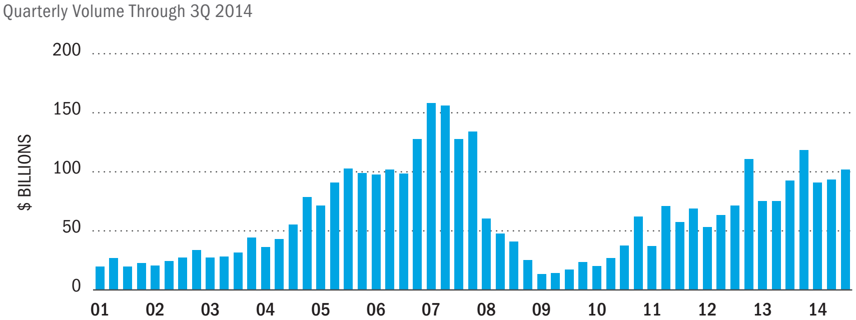


Transaction Activity Remains Healthy

Commercial property sales (excl. hotels and land) totaled $89 billion in 3Q compared with $80 billion in 2Q. Through the first three quarters of 2014, sales were up 18%. Manhattan, L.A., San Francisco, Boston and Chicago were office sales leaders. L.A., Chicago, and Dallas were industrial sales leaders. Manhattan, L.A., and the NYC Boroughs were leading apartment investor markets; major metros in the South, Southeast and West also saw healthy apartment sales activity (e.g., Dallas, Houston, Atlanta, San Diego and Seattle.)

RCA Transactions

Quarterly Volume Through 3Q 2014



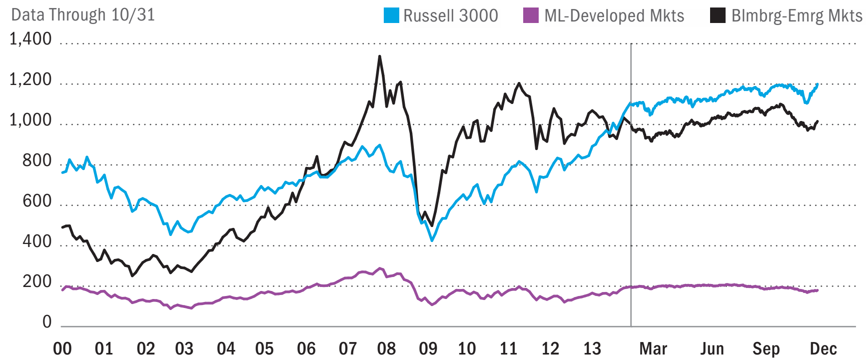
Sources: CBRE-Econometric Advisors, NCREIF, RCA, Bloomberg and TIAA Research

Financial Markets Overview

Equities Still Playing Into the Wind

Financial markets have weathered a number of headwinds in 2014 including violence in the Middle East, conflict in the Ukraine, Argentina's credit default, and concerns over the timing and pace of US rate hikes. The Russell 3000 Index lost 1% in 3Q after gaining 4% in 2Q; however, 3Q's loss was recouped in October. Developed markets, excluding the US, were flat in 2Q, but were walloped in 3Q, declining 9% as investors worried about the spread of Ebola and the potential impact of new sanctions against Russia. Similarly, equities in emerging markets lost 4% in 3Q following a 6% gain in 2Q. Emerging markets recouped 1% of 3Q's loss in October, while developed markets excluding the US were flat. Continuing tension in the Ukraine suggests that market volatility will persist in 2015.

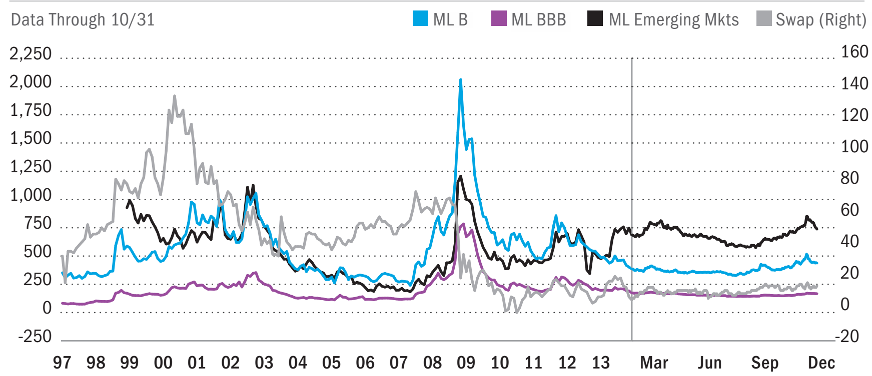
U.S. vs. Foreign Stocks



Credit Spreads Widen

Credit spreads reversed in 3Q as a flight to safety resulted from concerns about slowing global growth and rising geopolitical tensions. High-yield B-quality corporate spreads jumped from 346 bps at the start of 3Q to 444 bps at the end of the quarter and have remained at this elevated level as of early 4Q. After tightening in 2Q, investment grade BBB's widened from 144 bps to 161 bps during the quarter and inched higher to 167 bps as of early 4Q. Emerging markets followed a similar trend with spreads widening from 597 bps at the start of 3Q to 746 bps as of quarter end. Despite wider spreads, investor appetite for emerging market paper has weakened due to rising geopolitical tensions.

Credit Spreads

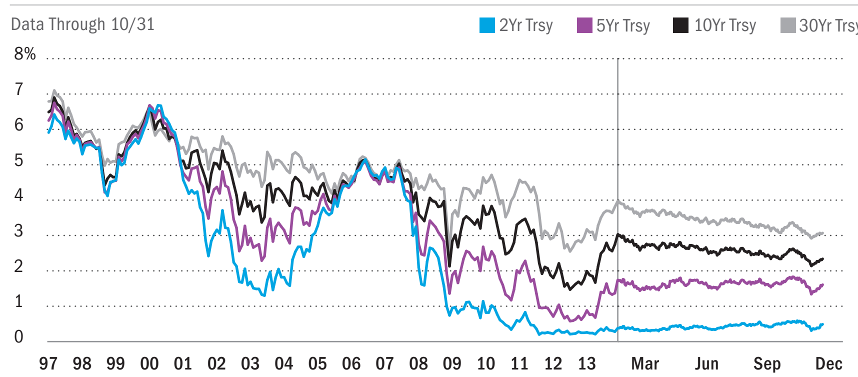


* Merrill Lynch Global Indices Option-Adjusted Spreads, except 10-yr Swap which is a simple spread over the 10-yr Treasury rate.

U.S. Tapering Ends

The FOMC formally ended quantitative easing in October as planned due to the improvement in the labor market and underlying strength in the broader economy. Still, FOMC reinvestment of principal payments from existing debt should help maintain accommodative financial conditions over the near term. Rate increases, if they do occur, are likely to be modest and gradual as the Committee has expressed concerns about acting prematurely. To date, investors' fears of rising Treasury rates have not yet materialized. After starting the year at 3.00%, the yield on the 10-yr Treasury fell to 2.75% at the end of 1Q, to 2.56% at the end of 2Q, to 2.40% at the end of 3Q, and to 2.35% as of early 4Q. These declines point to demand for Treasuries that is replacing the Fed purchases and more. Investors are therefore well-advised to watch capital flows carefully.

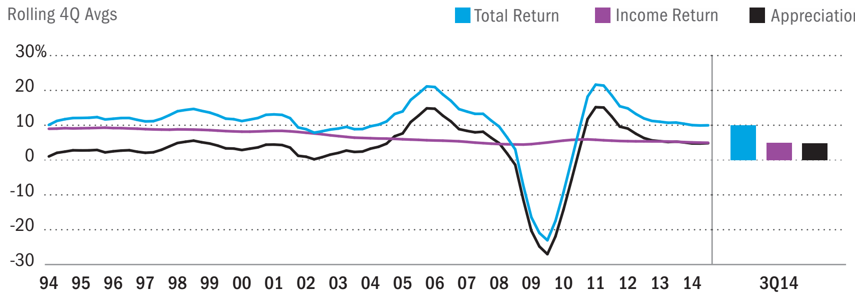
U.S. Treasury Rates



Sources: CBRE-Econometric Advisors, NCREIF, RCA, Bloomberg and TIAA Research

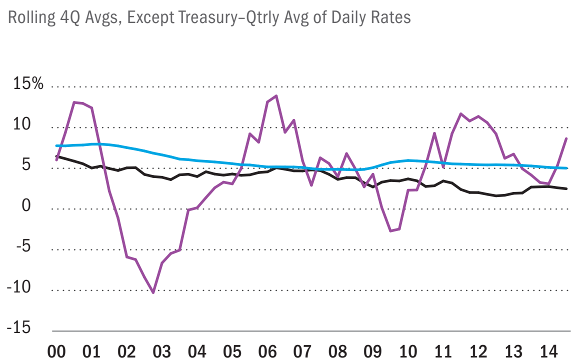
Apartment Properties Trail the Pack
Apartment properties remained in fourth place among the four major property types for the third consecutive quarter. Total return, nonetheless, remained attractive at 10.0% for the four-quarter period ending September 2014 vs. 9.9% previously. Income and appreciation returns were stable at 5.0% and 4.8%, respectively. The solid ongoing returns are noteworthy given the moderation in rent growth resulting from new supply in many markets.

NCREIF Apartment Returns



Apartment Cap Rates Bottoming Out
Cap rates implied in NPI apartment valuations averaged 5.0% for the four quarters ending September 2014, almost the same as the prior 4-quarter period. Stabilization of cap rates is not surprising given the strong value growth of recent years combined with new supply. However, transaction cap rates compressed further in the quarter according to RCA, dipping below 6% overall. Notably, cap rates for top properties in major metros dipped below 4% which has increased interest and sales activity in secondary and tertiary markets.

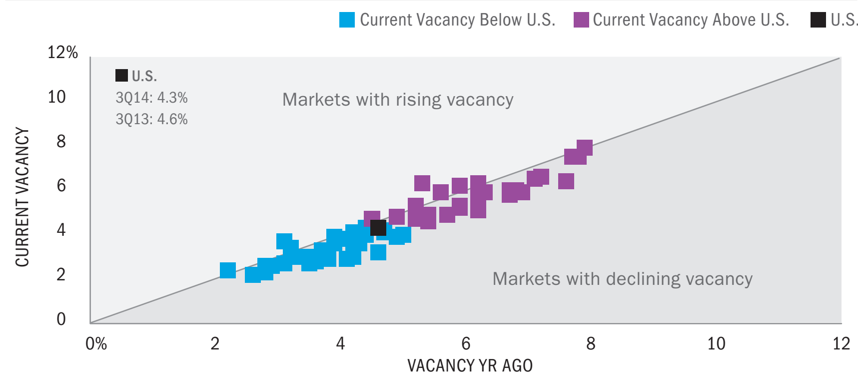
Apartment Property Pricing and Treasury



	Cap Rate (%)	NOI Gr. (%)	10-Yr Tsy (%)
2003–13	5.5	4.9	3.5
09/13	5.3	4.2	2.7
06/14	5.1	5.4	2.6
09/14	5.0	8.7	2.5

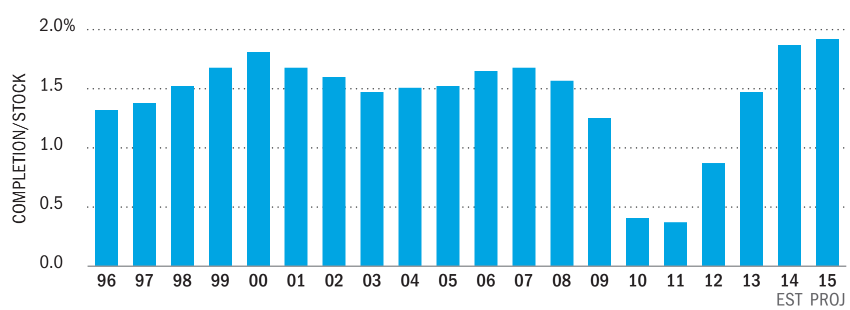
Apartment Markets Maintain Strength
Apartment market conditions remained tight with the national vacancy rate averaging 4.3% in 3Q14 vs. 4.6% in 3Q13. (Year-over-year comparisons are necessary to account for seasonal leasing patterns.) The third quarter is a prime leasing period, so the quarter's strong results are indicative of still healthy demand. Vacancy rates declined in 51 of the 63 markets tracked by CBRE-EA. While new supply is being delivered, markets are tight, with vacancy at or below 5% in 42 markets and 4% or less in 31 metros. Minimal vacancies and demand generated by healthy job growth should provide a sufficient cushion for new supply in many markets.

Apartment Vacancy Rate Dispersion



Supply Hits the Market
New product is being delivered in both high- and low-barriers-to-entry markets, with construction nationally expected to total upwards of 200,000 units in 2014 and 2015. With the recovery of the single-family market appearing to slow, move-out-to-buy rates should remain subdued. Stronger job growth and growth of the Gen Y demographic cohort will help absorb new units too. Still, moderation in rent growth should be expected as new supply is being absorbed.

Apartment Construction

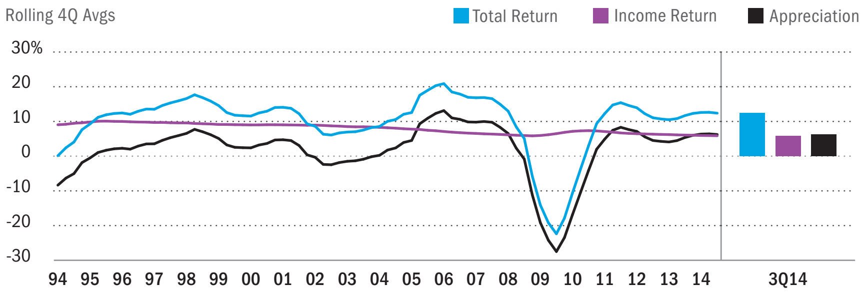


Sources: CBRE-Econometric Advisors, NCREIF, RCA, Bloomberg and TIAA Research

Industrial Market Overview

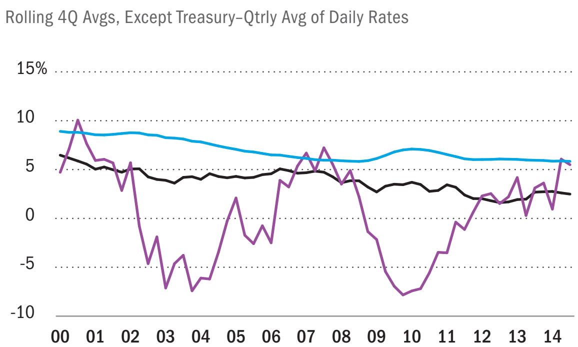
Industrial Sector Holds Second Place
Industrial property held onto second place among the four major property sectors for the fifth straight quarter. Total returns averaged 12.4% for the four-quarter period ending September 2014, which was similar to returns in the prior five quarters. Income and appreciation returns were both steady at 5.9% and 6.2%, respectively. Market drivers include industrial production which grew at 3.2% in 3Q14, roughly its average quarterly increase since the end of 2010.

NCREIF Industrial Returns



Cap Rates Steady while NOI Grows Strongly
Valuation cap rates remained steady at 5.8% for the four quarters ending September 2014 and have been at or close to 6.0% for the past thirteen quarters. Transaction cap rates reported by RCA averaged 7%, but cap rates for top properties in major industrial markets are 150 bps tighter. NOI grew 5.5% on a four-quarter rolling basis, following a 6% gain previously. Solid operational gains are reflective of improving fundamentals and the rollover of leases signed at the 2009 market trough.

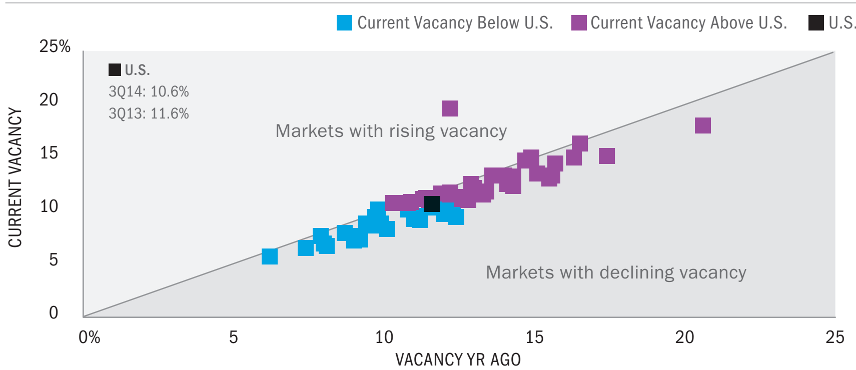
Industrial Property Pricing and Treasury



	Cap Rate (%)	NOI Gr. (%)	10-Yr Tsy (%)
2003–13	6.6	-0.7	3.5
09/13	6.0	3.1	2.7
06/14	5.9	6.1	2.6
09/14	5.8	5.5	2.5

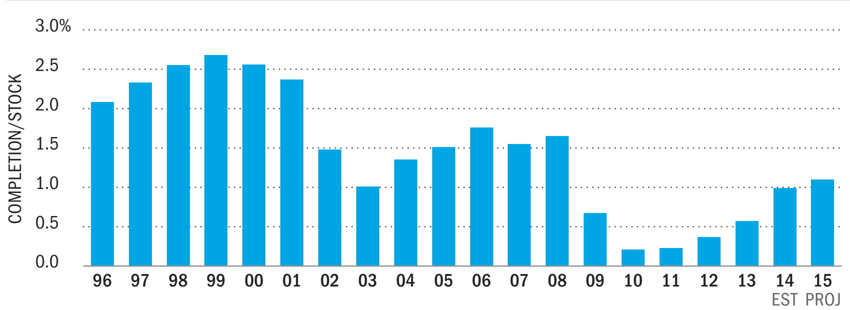
Industrial Availability Rate Drops Yet Again
The U.S. industrial availability rate fell to 10.6% vs. 10.8% in 2Q14, the thirteenth consecutive quarterly decline. Year-over-year, the decline was 100 bps. Market gains were broad-based, with the availability rate declining in 54 of the 59 markets tracked by CBRE-EA. Major markets with the lowest availability rates were concentrated in the West and included Los Angeles, Orange County, Seattle, Denver and Riverside. Nationally, absorption was almost double that of construction in the first three quarters of 2014.

Industrial Vacancy Rate Dispersion



Construction On the Rise
Declining vacancies, modest rent growth and strong acquisition activity has spurred a pick-up in construction, with the biggest pipelines in Riverside, Chicago, Dallas/Ft. Worth, and Atlanta. A portion consists of build-to-suits due to a shortage of large blocks of space that meet tenant-specific needs. Speculative construction is also increasing, but aggregate completions are expected to remain well below peak levels of the late-1990's and 2006–2008.

Industrial Construction



Sources: CBRE-Econometric Advisors, NCREIF, RCA, Bloomberg and TIAA Research

Office Market Overview

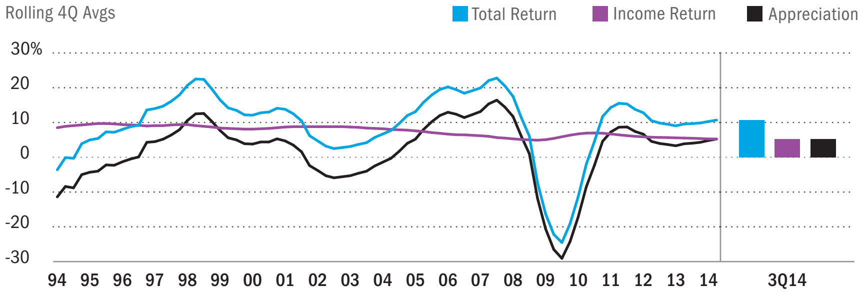
Office Sector Maintains Third Position
The office sector retained third position for the third consecutive quarter after being mired in last place for the prior eight quarters. Total returns were 10.7% for the four-quarter period ending September 2014 vs. 10.3% previously. As with other property types, income and capital returns were both steady compared with previous quarters at 5.2% and 5.2%, respectively. The office sector has been the slowest to recover, but appears to be gaining steam as total returns have now increased for six consecutive quarters whereas returns for other property types have been flat to modestly down.

Cap Rates Drop and NOI Surges
Office cap rates implied by NPI valuations were steady at 5.4%, but have declined by 20 bps over the last year and 50 bps over the past two years. Investor interest and activity is increasing with office sales volume up 25% in the first three quarters of 2014. According to RCA, transaction cap rates declined by 25 bps in the quarter to an average of 6.7%. Cap rates for top properties in major metro markets averaged 4%, the lowest since RCA began tracking sales in 2001. However, market momentum is accelerating with NOI growth increasing to a 4-quarter rolling average of 6.1% vs. 5.9% previously.

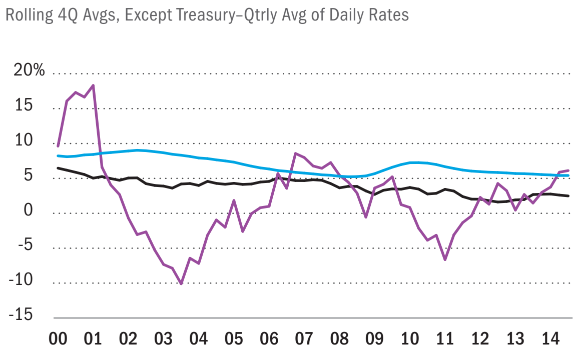
Office Fundamentals Improve Again
The national office vacancy rate dipped to 14.1% in 3Q14 vs. 14.5% in 2Q14. Year-over-year, the decline was 100 bps. Headwinds prevail — including open floor layouts which reduce average space per employee — but growth in professional and business services, tech, and entertainment has been a source of demand in many markets. There was another strong showing at the market level with vacancy rates declining in 53 of the 63 markets tracked by CBRE-EA.

Office Pipeline Still Modest but Growing
With its long lead time, office construction is highly cyclical. Market conditions and rents still do not warrant new construction in most markets. Exceptions include San Francisco, Houston, and Dallas where employment growth and rent growth have been strong. Functional obsolescence of older buildings will drive demand in the future as technologically efficient, state-of-the-art space can provide operational efficiencies and lower costs. However, construction will remain well below peak levels of the late-1990's and 2006–2008.

NCREIF Office Returns

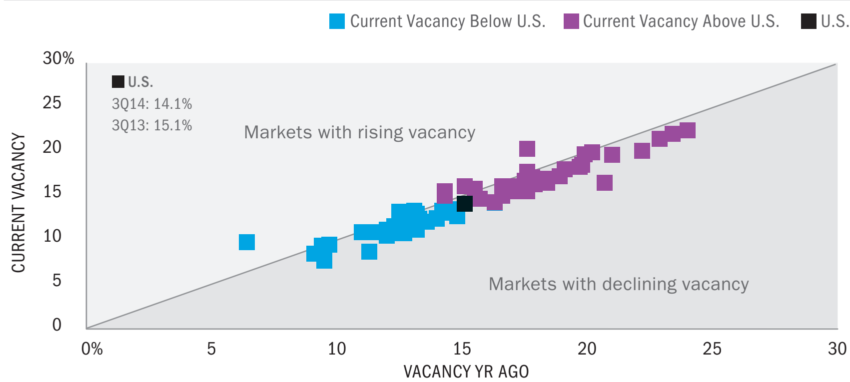


Office Property Pricing and Treasury

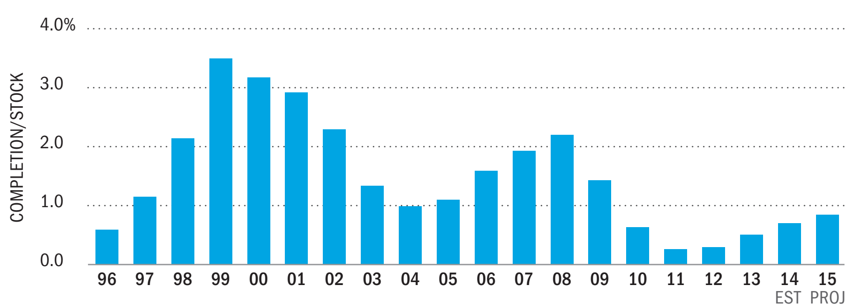


	Cap Rate (%)	NOI Gr. (%)	10-Yr Tsy (%)
2003–13	6.5	0.6	3.5
09/13	5.6	1.5	2.7
06/14	5.4	5.9	2.6
09/14	5.4	6.1	2.5

Office Vacancy Rate Dispersion



Office Construction



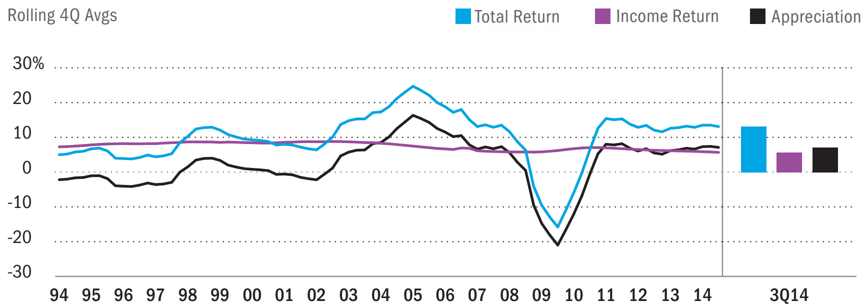
Sources: CBRE-Econometric Advisors, NCREIF, RCA, Bloomberg and TIAA Research

Retail Market Overview

Retail Retains Lead Position

The retail sector generated the highest total return of the four major property types for the ninth consecutive quarter. Total return averaged 13.1% for the four-quarter period ending September 2014, compared with 13.5% previously. As with other property types, both income and capital returns were largely unchanged from the prior quarter at 5.7% and 7.1%, respectively.

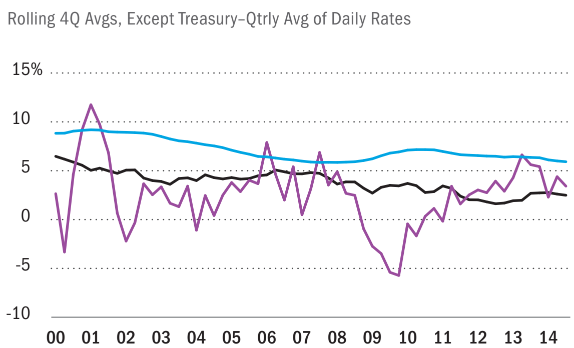
NCREIF Retail Returns



Retail Cap Rates Bottoming Out

As with most other property sectors, retail cap rates, as implied by NPI property valuations, were largely unchanged at 5.9% for the four-quarter period ending September 2014 vs. 6.0% previously. According to RCA, transaction cap rates dipped once again, falling to 6.8% vs. 7.0% previously, but there continues to be significant differences between property sub-types and markets. High quality property is in especially strong demand. This has driven down cap rates for top malls and lifestyle centers to the mid- to low-4% range.

Retail Property Pricing and Treasury

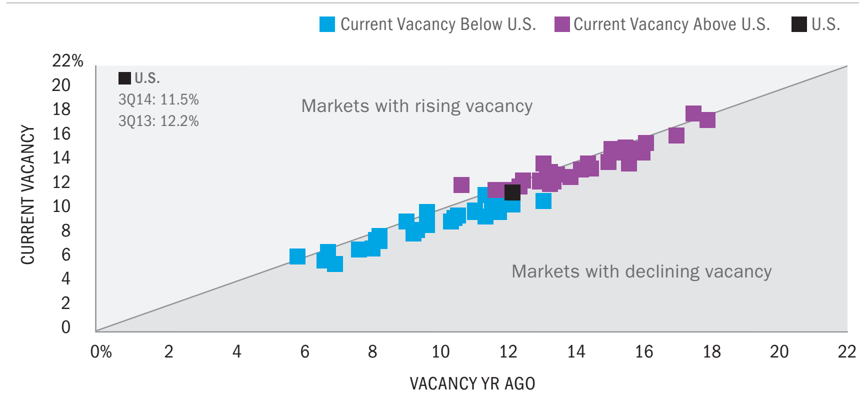


	Cap Rate (%)	NOI Gr. (%)	10-Yr Tsy (%)
2003–13	6.7	2.2	3.5
09/13	6.4	5.6	2.7
06/14	6.0	4.4	2.6
09/14	5.9	3.4	2.5

Retail Fundamentals Soft but Improving

Availability rates in neighborhood and community centers declined to 11.5% in 3Q14 vs. 11.7% in 2Q14. Retail sales excl. motor vehicles and parts were up just 0.7% vs. 2Q14, but 3.4% vs. 3Q13. However, spending on apparel and general merchandise was generally weak to modest. While mall and lifestyle fundamentals are strong, strip conditions are improving. Availability rates remain high, but they declined in 54 of the 63 markets tracked by CBRE-EA. The 1.8% increase in consumer spending in 3Q14 coupled with stronger employment growth in recent months bode well for retail market prospects.

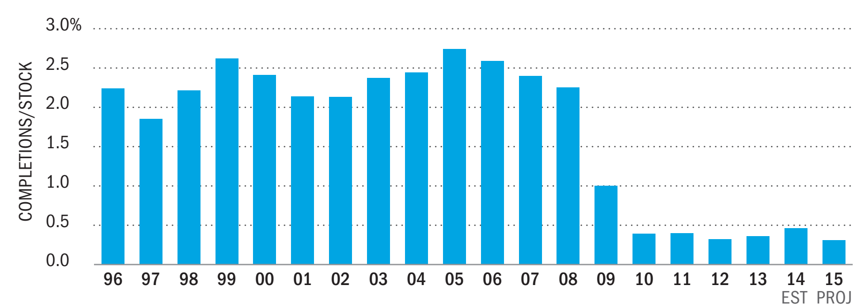
Retail Vacancy Rate Dispersion



Retail Construction at Historic Lows

Neighborhood and community center construction is expected to total just 13 msf in 2014. Completions should remain subdued through 2015, but move slowly higher in subsequent years. Still, a significant pick-up is not expected until 2017–2018. Outlet centers are experiencing the most growth, driven by strong interest in bargain shopping. While not directly competitive with other segments, outlets do compete for consumers' dollars. Nonetheless, a lack of construction coupled with labor market gains should benefit retail market fundamentals over the short and longer term.

Retail Construction



Sources: CBRE-Econometric Advisors, NCREIF, RCA, Bloomberg and TIAA Research

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Data is as of 9/30/2014 unless noted otherwise.

Real estate investing risks include fluctuations in property values, higher expenses or lower income than expected, higher interest rates which affect leveraged investments, and potential environmental problems and liability.

Investment, insurance and annuity products are not FDIC insured, are not bank guaranteed, are not deposits, are not insured by any federal government agency, are not a condition to any banking service or activity, and may lose value.

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Financial Services

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