

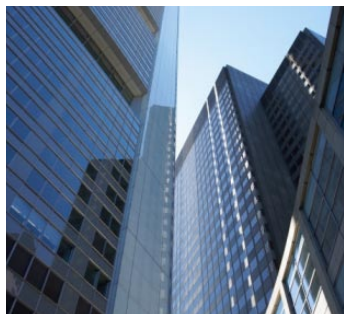


Madison Harbor Capital, LLC

Our View

Our View / December 7, 2006

Summary



“So far, so good!” This is a simple, yet accurate summary of what is currently unfolding in the U.S. economy and the commercial property market. Neither recession nor stagflation is considered a probable alternative economic scenario. Instead, there is gathering evidence that we are in the early stages of a Fed-induced mid-recovery slowdown. Inflationary pressures are subsiding and, most importantly, commercial real estate fundamentals remain solid and improving across all property sectors.

The U.S. Economy

Through midyear, the economy ran stronger than we had expected, but a slowdown has begun. Third quarter real GDP growth came in at 1.6%, down from 2.6% in the prior quarter and 5.6% in the first quarter. Housing, which kept the economic recovery going longer and stronger, is now clearly in decline. All of the major domestic automakers have announced production declines stretching well into 2007. Oil has dropped by \$20 a barrel, from \$80 to \$60, largely on reduced demand signaling a possible cyclical peak in the economy. The yield curve remains flat to slightly inverted, which points to a slowdown, and through October, the U.S. Leading Economic Indicator (LEI) also continues to point toward a slowdown.

The consumer, who has driven this five year old recovery, continues to do so, assisted by reduced energy costs and continued high levels of home equity withdrawals from single home refinancings, but at a decelerating rate of growth. Warning flags on future retail spending declines are flashing, including Wal-Mart's recent numbers and projections. Wal-Mart is an important proxy for low- to middle-income retail spending trends.

MODERATING INFLATION, BUT...

Understanding that cyclical inflation lags and always peaks after GDP peaks, the recent news on inflation is

mixed, with a growing bias toward moderating inflation. Importantly, there is no evidence that inflation is baking itself into higher wages and benefits. This series within the economy commands the Fed's greatest scrutiny as it fights to prevent cyclical inflation flare-ups from becoming structurally embedded via payrolls.

The Fed, following 17 consecutive 25 basis point rate increases, stood down and took no action in August. This Fed pattern continues with key leading technical indicators prompting Fed pronouncements regarding “moderating inflation” tempered with language that reminds the market the Fed can and will hike rates further if moderating inflation fails to continue. Also, we need to be reminded that despite encouraging trends, the core inflation rate has not yet returned to within the Fed's desired 1 to 2% safe harbor. For the foreseeable future we expect the Fed to feel good about the economy while maintaining a hawkish posture on inflation.

HOUSING UNWINDING

The single family housing sector has peaked and is in rapid decline without yet bottoming. Following five years where home prices had a compounded annual growth rate of approximately 15%, we can look back and say it was the highest national rate of house price appreciation ever. A phenomenon of that magnitude will not be corrected in a few quarters. Most observers

feel the correction has further to play out in terms of duration and magnitude. Nominal house prices are falling nationally for the first time in the post-World War II period. While history shows the U.S. can unwind a housing bubble and avoid recession, the U.S. cannot avoid some meaningful consumer belt-tightening which is still largely in the pipeline. This means the housing correction will be a significant contributor to below-trend GDP growth through at least 2007.



STOCKS FINALLY RESPOND

One very encouraging development has been the recent stock market performance. Since last communicating with you the market has apparently overcome its stagflation obsession. This is demonstrated by the healthy year-to-date performances in the Dow, S&P, NYSE, AMEX and Russell 2000 indices with even the NASDAQ now in positive territory at +8.4%.

The economy is downshifting, cyclical inflation fires are being dampened and, to date, the housing correction has proved manageable. However, the overall situation remains fragile with unforeseen accidents continuing to pose a threat to this scenario. Moving forward it will be important to closely monitor job trends, the U.S. dollar and the continuing ramifications of the housing correction. If history is any guide and we continue on this mid-recovery slowdown path, the Fed should be in a position to consider reducing rates in 2007, allowing the economy to return to trend line GDP growth during 2008.

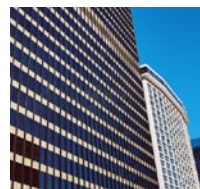
The U.S. Commercial Property Market

The picture for commercial real estate is very strong where it counts the most – the fundamentals. Despite the slowing general economy, demand for rental space across all property types remains strong. At the same time, the pipeline for new supply of space remains constrained in most local markets by the high costs for land, entitlements and building materials.

The result is rising occupancies, increasing rents, sharp declines in the need for concessions and improving net operating income to fund maintenance/replacements and investor cash distributions.

RENTS ARE UP

As 2006 winds to a close there will be many “firsts” and “records” in the full year numbers. But the story we feel that will prove to be the most compelling is what is being achieved in rent increases. According to third quarter 2006 data compiled by Global Real Analytics, nationwide commercial rents have increased 6% on a trailing 12 month basis through September 2006. Tracked by quarter over the prior year each property type, except retail, achieved an accelerating rate of rental growth. Even retail properties maintained a steady and respectable 5.2% average rent increase. Obviously, there was a broad range across regions led by the Pacific Coast states’ 8.2% growth with even the lowest regions recording a positive 2.0% growth (in the East Central region). By property type, rent growth experienced a tighter range spanned from Retail’s 5.2%, to 6.7% for Class A Central Business District office properties and Class A Apartments.



REAL ESTATE WELL POSITIONED

Remembering that private real estate equity’s historical returns are comprised mainly of current income, the fundamentals indeed look solid even going into a mid-recovery economic slowdown, given the equilibrium existing between demand and supply for space. With strong liquidity and ample capital for debt and especially already mobilized private equity, commercial real estate is well positioned for the next several years. Total returns are likely to moderate as the rate of appreciation slows. Even if real estate reverts back to its historical unleveraged NCREIF 9.5% to 10% total returns, it still represents a solid diversification with attractive absolute and relative returns.

PUBLIC REAL ESTATE INVESTMENT TRUSTS (“REITS”)

We are private real estate equity investors working in a market segment that represents over 75% (or \$750 billion) of the U.S. institutional real estate equity market. We are not experts in publicly traded REITs, but we do follow that market. This third iteration of public REITs that began in 1993 has enjoyed a strong performance run for its investors. REITs NOW represent roughly 25% of U.S. real estate equity capital and the public REIT structure is now being replicated in other countries with the UK the latest to introduce public REITs on January 1, 2007.



The REIT performance in the U.S. has been well chronicled and needs no repeating here except to say that 2003-2005 produced continuous 30%+ annual returns with 2006

returning 23%+ year-to-date, well ahead of the major stock indices which, if maintained through year end, will be the seventh consecutive year REITs have outperformed the indices.

Yet behind the headline performance numbers there are other important REIT trends that draw into play private real estate equity. At an accelerating pace over the past 12 to 18 months, REITs are experiencing consolidation as well as public to private conversions. According to Prudential Real Estate Investors, approximately \$44 billion in REIT M&A transactions have closed through the first three quarters of 2006, including \$24 billion of transactions first announced in 2005. There are \$43 billion of additional deals announced but not yet closed.

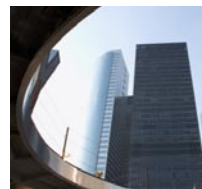
While some of the activity involves public-to-public mergers, the vast majority are privatizations of either the entities or the underlying asset portfolios. As share prices have appreciated, investors who were ostensibly drawn to REITs for their dividends have seen their yields cut in half. Many REITs that continue to be publicly owned are making ample use of private real estate equity capital to form joint ventures for the purpose of purchasing portfolios of core properties.

A look at capital market activity for the public REITs year-to-date 2006 vs. full year 2005 are as follows:

- 2 IPOs totalling \$267 million vs. 17 for \$6.5 billion in 2005
- 61 Secondary Equity Offerings for \$9.5 billion vs. 75 for \$8.9 billion in 2005
- 31 Preferred Stock Offerings for \$3.4 billion vs. 35 for \$3.0 billion in 2005
- 66 Unsecured Debt Offerings for \$19.4 billion* vs. 104 for \$16 billion in 2005

* includes 34 deals for \$8.4 billion completed in third quarter 2006

There are some fascinating current trends behind the headline performance numbers that are very different than what occurred with REITs between 1993-2004. Right now REITs, despite the returns, cannot be perceived as a growth market. Instead, REIT IPO issuance is non-existent and the volume of unsecured leveraging is increasing, while the entire sector is being rationalized through consolidation and public-to-private conversion.

**Wrap-Up**

The investment environment remains fragile and risky. The Fed's pre-emptive move to tighten in mid-2004 seems to be working in engineering a mid-recovery slowdown to defuse an inflationary flare-up and to prick the bubble in home prices. Implementation is proceeding in an orderly fashion but can still be sabotaged by the fallout from the housing correction or an unforeseen accident. The threats of either a recession or a stagflation scenario have receded and a resumption to trend-line GDP growth is probable within 12 to 24 months. Commercial real estate fundamentals are sound, still improving and positioned to perform well, albeit at somewhat lower appreciation rates as we move through the slowdown phase of this economic cycle. So far, so good...but it's early — so stay tuned!

For More Information

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About Madison Harbor

Madison Harbor Capital is an independent investment firm serving institutional and high net worth investors with timely and distinctive real estate investment strategies through primary investments into newly formed real estate partnerships and secondary acquisitions of existing interests in real estate. The firm is led by real estate industry veterans Edward M. Casal and Richard W. Maine as Co-Managing Partners, as well as Russell H. Bates, Partner in charge of real estate underwriting. The firm focuses on providing investors with a proper balance of risk and return through a high level of diversification. Madison Harbor's principals collectively have over 125 years in commercial real estate and capital markets experience. For more information, please visit **www.madison-harbor.com**.