

Time for More Reflection, Too Soon for an Inflection

by James R. DeLisle, PhD

Commentary

Now that the economy is beginning to show some signs of a recovery, some are proclaiming that the turning point is imminent for the commercial market. These claims begin by citing improvements in the national and global economies (with the exception of Greece) and then extend that optimism to the commercial real estate market. On that front, claims are bolstered by stories about increasing transaction activity, aggressive bidding on properties, and increasing capital flows to real estate. There also has been a resurgence in commercial mortgage-backed securities (CMBS) land, stabilization in fundamentals, a decline in write-downs, and an increase in attendance at trade shows.

The economy has shown signs of improvement with gross domestic product (GDP) turning up at 2009 year-end, and many expecting the expansion, albeit at tempered rates, to continue. However, the risk of losing footing is real, especially as the federal government winds down its stimulus packages and state and local governments scramble to balance budgets by cutting costs and increasing taxes.

The real estate market has seen a recent increase in transactions. The majority of those deals have fallen into one of two categories: prime properties, for which the seller is motivated to unload assets to free up capital, and distressed assets facing an uncertain future. For the prime assets, bidding has been aggressive although this reflects a flight to quality and an aversion to risk rather than an inflection point in the market.

At the same time, the queue of distressed assets continues to build. Some reports indicate only 10% of troubled assets held by special servicers were worked out in 2009. More pressure is expected to

force properties into the market ahead of the surge in refinancing activity that will begin in earnest next year. The imminent shortfall in replacement capital may trigger another wave of strategic foreclosures as values continue to drop and owners realize that it may be economically impossible to hold on in anticipation of a recovery.

In terms of capital flows to real estate, there has been a continued increase, although the bulk of the funds are waiting for signs the market is approaching an inflection point. A number of signs suggest a turning point is not on the horizon and some veteran advisers have returned money to investors or closed funds to new investors.

This strategy is based on a little soul searching and the harsh realization that, over the near term, advisors will not be able to source product that would provide the returns demanded by investors. Veterans who survived the crisis in the early 1990s realize that the dilution of returns created by having capital sitting in low-yielding, short-term investments will not allow them to hit time-weighted hurdle rates necessary to trigger incentive fees.

With respect to the CMBS industry, some activity has occurred, but by no means is the securitized industry back in terms of new issuances. The CMBS industry will remain on life support until it receives some transplant capital. Some savvy investors will be bottom fishing, but they will be extremely selective and focus on high returns and short-term exposures. In the meantime, delinquency rates and foreclosures are expected to climb, with special servicers and bank real estate owned (REO) departments falling behind on disposing troubled assets.

In terms of real estate market fundamentals, the rate of erosion may indeed be slowing in some

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markets, although few report any significant uptick in leasing activity with vacancy rates still trending upward and rents softening. As to the decline in write-downs, more are on the horizon as institutional capitalization rates on market-based accounts continue well below long-term averages. For example, the NCREIF Property Index was marked down over 22% for 2009.¹

Despite these write-downs, the implicit capitalization rate in the mark-to-market NCREIF Property Index was around 6%, well below the 8% long-term averages. A 200 basis point correction would translate to another 16% decline, which could be exacerbated by declining net operating income resulting from weak fundamentals. Finally, trade show attendance is a signal of an inflection point. Indeed, in cases where attendance has increased, the upward trends are likely to be stimulated by the need to network, to learn new schemes that can be adapted to the market, or to commiserate with colleagues. Discounted rates on convention fees and hotels have also helped prop up attendance. In this observer's eyes, the commercial real estate industry is set for a period of continued reflection rather than the euphoria of a post-inflection recovery.

The Economic Environment

Economic Growth

Over the past two years, the federal government has been on the defensive, working to help prevent an institutional and economic collapse. Recently, these efforts have gone on the offensive, taking steps to help nurture the economy back onto a positive track. By all appearances, the government's efforts have paid off, at least in the short-term. This turnaround allowed the government to officially declare the recession at an end. While the proclamation was welcome news and reinforced by a number of positive indicators, the general consensus is that the economy is by no means out of the woods. Indeed, growth in GDP will likely lag that of previous post-recessionary phases, at least over the foreseeable future.

In addition to being concerned over the prospects for a prolonged recovery, several downside risks are noteworthy. First, the federal government withdrawal of its record-breaking financial support may jeopardize the fledgling recovery. This is particularly true for the

vulnerable housing and small business sectors that depend on cheap and accessible credit, which remains elusive.

A second downside risk is that the outrage over the financial crisis and the failure of Wall Street to rein in compensation benefits and risk taking may lead to a wave of regulatory reform that could cause disruption in the industry. Third, despite recent passage, fallout from the divisive healthcare debates could create partisan rifts that would make it difficult to get new initiatives approved in order to help troubled industry sectors. This is especially true given the anger that has built up over record deficit spending.

A fourth downside risk is a reduction in offshore capital flows to the United States, which has caused a record deficit, coupled with the risk of the dollar losing its designation as the global currency. Fifth, a return of the recent global slowdown could take exports out of the equation and could lead to greater trade imbalances. Finally, the emergence of a capital crisis induced by the commercial real estate sector could ripple across the country and severely inhibit financial institutions, shut down the capital markets, raise long-term rates, and inhibit credit flows.

Financial Industry Reform

Given the heated debates over the regulation of the financial industry, there are some noteworthy trends that may affect the structure of the industry and its role in the broader economy. An example of the types of interventions that may be imposed on the financial industry is Senator Christopher Dodd's financial regulatory reform legislation. While the final form of the bill or other legislation is an unknown, several provisions suggest where members of Congress are trying to rein in the industry that many view as out of control.

The proposed bill contains four major initiatives: greater shareholder input on executive compensation, a new consumer financial products regulator, a systemic risk council charged with avoiding future bubbles, and legal authority enabling government take-over and winding down of troubled nonbank financial institutions. Insights into other potential changes in the regulatory environment were provided in Chairman Bernanke's prepared comments regarding the Federal Reserve's (Fed) role in bank supervision. While defending the Fed's role in regulatory oversight

1. For details, see http://jrdelisle.com/market_update/NCREIF/NCREIF_returns.php.

with large banks, Chairman Bernanke argued that federal oversight should be expanded to banks of all sizes, which would provide a more unified approach to the industry.

In another move to expand and clarify its role, the Fed pointed out in congressional testimony that as part of its oversight of bank holding companies (BHCs), its impact has spread to the insurance industry. A number of BHCs provide insurance products that pose their own sets of risks. The Fed argued that its authority was necessary to help the industry avoid systemic risk from outside the scope of traditional operations of insured depository institutions. Since the economy depends on a healthy, broadly defined, and functioning financial industry, these efforts by the Fed should be closely monitored to flag unintended consequences of structural changes.

The call for reform of the financial industry has spilled over to the private sector. This concern was articulated in a report issued by the not-for-profit Institutional Limited Partners Association.² The report targeted several major areas for reform that are likely to resonate with investors and may become a model for joint ventures. First, alignment of interests will be strengthened to ensure investors and advisors share the good times and the bad times. This alignment is to be achieved through a combination of incentive fees as well as meaningful coinvestment, some of which may be in promoted positions.

Second, greater attention will be placed on governance in order to protect investors from weak business practices ranging from negligence to mission drift. This oversight is to be implemented, in part, through the creation of advisory committees that are dominated by investors who will have real power over operations and strategic decisions.

Finally, compensation programs and incentive plans should exhibit greater transparency and clarity to provide accurate and timely insights into the levels of costs, risks, and benefits. These reforms will put sponsors of new real estate opportunity funds on notice, making them more accountable than they were in the 1990s. This should discipline the industry, although some sponsors have already been able to raise capital without being held accountable to such standards. Hopefully, they will have enough discipline and real estate savvy to deliver promised returns without taking on excessive risk.

Employment

Over the past several years, employment losses continued at a record-breaking pace. The limited permanent hiring that did occur was dominated by internal transfers and promotions. On the other hand, referrals from existing employees accounted for a significant portion of external hires, suggesting the importance of connections in the soft labor market.

The employment situation is perceived as the bellwether for the overall economy. There has been a decline in the pace of layoffs, providing an indication the fledgling recovery is staying on track. The importance of employment to the economy is punctuated by the stock market's positive reaction to job reports, and the Fed noting that economic activity was strengthening and the labor market was stabilizing.

On the strength of five straight months of employment gains in temporary help services, there are some signs that the employment situation may be poised for improvement. Despite these gains, there is little evidence these jobs will be converted to permanent positions. Furthermore, competition for temporary jobs is extremely tight. Even if the jobs were converted, many temporary employees would move on when more suitable jobs open up. This creates the potential for a temporary surge in employment when businesses regain confidence in the economy.

On the unemployment front, the modest improvement has been partially attributable to a decline in the workforce as frustrated employees give up hope of finding employment. Initial unemployment insurance claims have bounced around recently, although they remain at uncomfortable levels, especially for displaced workers facing dim prospects for finding comparable jobs.

The plight of the long-term unemployed workers may get worse if Congress fails to act on extending the eligibility period for emergency compensation that has provided unemployed workers with benefits. Since Congress has extended the program several times since 2008, it is likely that it will be extended again especially since the failure to act would put additional downward pressure on consumer sales. The need for short-term extensions or a longer-term solution is likely to repeat itself until companies begin to add permanent jobs to their payrolls. Until then,

2. The complete ILPA report released in November 2009 can be accessed at <http://www.ilpa.org>.

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attention will continue to be focused on employment and unemployment figures.

Inflation and Interest Rates

On a positive note, inflation remains in check due to the combination of excess capacity across-the-board, and tempered demand for goods and services. Indeed, consumer prices rose at the lowest annualized rate of increase in some six years. Rising medical costs are one of the few components of the consumer price index that have increased, although not enough to make a significant difference to the broader index. On the other hand, the index has benefited from declines in the cost of shelter, which is one positive element of the continued softness in the housing market. Automobile prices have also experienced weakness due to a combination of the hangover from the Cash for Clunkers program and the unwillingness of consumers to take on additional debt. Looking forward, continued high unemployment levels preclude any sort of wage pressure.

Real average earnings have recently tapered off. Since there are few signs that these trends will change over the near term, consumers are likely to remain in a defensive mode creating additional downward pressure on consumer prices, which could create another series of problems for the economy. Excess capacity has also taken pressure off of producer prices, as companies have been unable to pass on price increases. This situation is likely to continue until the economic recovery gains more traction and producer and consumer confidence return.

In its February 18 meeting, the Fed surprised the market by announcing modifications to its discount window lending programs. In what it characterized as a return to normalization, these changes included a 25 basis point increase in the discount rate. The announcement was made after close of the trading day, creating short-term ripples in the stock market and helping strengthen the dollar against the weakened euro.

To avoid future shocks, observers have spent much more time looking for insights that may signal additional tightening. Over the near term, the spate of good news on inflation has given the Fed additional breathing room before it makes the inevitable increase in interest rates. In something that could become a self-fulfilling prophecy, the market seems to be anticipating a moderate increase in short-term interest rates. Assuming the recovery stays on track, the economy should be able to adjust gradual increases in interest rates.

While the Fed remains committed to holding short-term interest rates at low levels, its actions on the mortgage front are not as reassuring. To the chagrin of many industry insiders, in mid-March the Fed indicated that it would end its purchases of some \$1.25 trillion of mortgage-backed securities. The program was phased out by the end of March 2010, removing the price support for mortgage-backed securities (MBS), which has helped hold down both residential and commercial mortgage rates. The impact of this withdrawal on mortgage rates is uncertain, although any contraction in available mortgage capital is likely to put upward pressure on rates. While it is possible that private investors may step into the void, much will depend on how the sector is faring in terms of the risk return balance. To hedge its bets in case of a downturn, the Fed stated it would continue to monitor the economic outlook and deploy policy tools to promote economic recovery and price stability.

In addition to getting out of the market for new acquisitions, the Fed is debating what to do with the significant pool of MBS it has acquired to date. The options range from holding them until they mature to liquidating them. Given the significant risks facing the mortgage-backed industry, the Fed will move very cautiously. Despite these efforts, the industry is likely to come under tremendous pressure and struggle with erosion in underlying real estate market fundamentals. As such, values of many vintage securitized pools are expected to slide, while spreads for replacement capital widen as investors remain very selective and focus attention on the risk side of the equation.

Business Indicators

Over the past several quarters, business indicators have been relatively mixed with good news on some fronts being dampened by bad news on

others. This has created some confusion and left many businesses—especially small businesses—on the defensive. This situation is gradually shifting to a more positive blend although things are still somewhat tentative. One of the positive trends is the number of manufacturing businesses reporting an increase in goods orders. While these figures have been skewed upward by military and aircraft, which are somewhat volatile, they do hint to a gradual but unsteady increase in durable goods orders.

The automobile sector has been a drag on manufacturing as the industry weathers the bad press associated with Toyota's problems and overall sales decline as consumers remain unwilling to commit to nonessential, big-ticket items. On the other hand, additional support for the manufacturing sector may come from pressures for inventory build-up in the wholesale and retail sectors. This activity would reverse the downward trend in inventory to sales ratios, which have reached record lows. While the outlook for manufacturing could improve if sales pick up as the economy expands, the near-term recovery will be somewhat muted especially in terms of other post-recessionary recovery periods.

Despite improving prospects, it should be noted that the manufacturing industry is undergoing a number of structural changes that may have long-term implications for the U.S. economy. Certain sectors are undergoing a transformation—shedding excess capacity and placing more emphasis on efficiency and productivity, revisiting labor requirements, rethinking supply chains, and continuing the movement offshore. The end result may be a leaner manufacturing industry in the United States, with greater emphasis on competitive advantage. These changes will have ripple effects across the industry and will spill over to related industries.

Despite signs of improvement in many business indicators, small businesses continue to struggle due to lack of confidence and access to credit. While the Fed has put pressure on banks to get money into the hands of small businesses, those efforts have had limited success. At the same time, small business owners continue to reduce inventories and are reluctant to take on additional financial obligations. Small businesses continue to shed employees, although at a slower pace than in 2009. This situation is unlikely to change until small businesses begin to see an uptick in sales and increasing access to affordable credit.

Consumer Confidence

Consumer confidence levels are highly correlated with consumer sales and are carefully scrutinized as a leading indicator for the overall economy. Downturns in confidence levels coincide with recessions since retail sales account for some 70% of the U.S. economy. In the recent recession, consumer confidence levels plummeted to levels not experienced since the recession in the early 1980s. Confidence levels have trended upward since, although the improvement has not been smooth. This trend has carried into 2010, with consumers picking up on the early-stage economic recovery. Despite the modest upward trend, confidence levels remain significantly below long-term averages.

Consumer confidence levels slipped a bit in the 2010 first quarter, with softness on the job front continuing to be one of the major drags on consumer sentiment. Consumer confidence levels will continue to fluctuate with some downside risk. This uncertainty will continue until it becomes evident that the economy can sustain the recent improvement.

The recent passage of health care reform may be a move in the right direction, signifying to some that the government can get some of the hard things done and that health care costs might eventually be reined in. However, the acrimony associated with the debates and the uncertainty over the impacts on long-term health care costs on top of the record federal deficit makes it something of a wild card that will be closely watched by consumers.

Retail Sales

Retail sales improved in early 2010 despite severe winter weather that dampened activity in a number of regions. The renewed determination of consumers to satisfy pent-up demand continued recent trends, with comparable-store sale increases of some 4% on a year-over basis. In general, sale increases were greatest for value-oriented goods, while sales for high-end goods and major purchases lagged.

The retail gains were fairly widespread, suggesting consumers have been adjusting to the economy and their tightened wallets. The Cash for Clunker Appliances tax breaks may have had a positive impact on sales figures as a number of states launched programs to tap into the \$300 million federal stimulus program. Since the program is temporary, the effect will be short-term but may help carry some segments of durable retail goods through a difficult period.

The modest but unsteady gain in retail sales has been welcome news for retailers who have been managing inventory levels very closely over the past year. This is evidenced by the record-low inventory-sale ratios, which may have placed some downward pressure on sale volumes in some sectors, although there were no broad-based shortages.

Sales of automobiles and other major ticket items have remained generally sluggish and continue to drag down sales figures. The fallout from the Toyota scandal will be interesting to watch in terms of how it plays out and how competitors react. Rising gasoline costs may also put a damper on consumer spending, although the recent increases have not dampened spirits. Looking forward, retail sales will remain tempered with prospects hinging on improvements in the broader economy, especially on the labor front, and a return of consumer confidence levels to more traditional, long-term averages.

Housing Market

Since the conflicting year-end results were released, the housing market has received a spate of bad news. New home sales plummeted in January, catching off guard some homebuilders who had begun to build up pipelines and ratchet up inventory levels. As might be expected, homebuilder sentiment lost ground across the board with declines in all three components of the single-family detached housing indexes: present situation, expected situation over six months, and traffic of prospective buyers.

Fortunately, the industry had not gotten too far ahead of the market and quickly pulled the plug on starts, with multifamily starts declining and single-family starts flatlining. Single-family permit issuances have held although limited activity is anticipated until the outlook for the industry has improved.

The volatility in the housing market can be attributed to a several factors. First, the federal tax credit program targeted at first-time homebuyers and qualifying repeat buyers stimulated sales and created a temporary surge in demand. Since this program is being phased out, the market is losing much-needed support. Unfortunately, while helping prop up the bottom of the trough and prevent further erosion, the stimulus was not enough to help the industry reach a sustainable recovery. Indeed, as in the case of the automobile industry, withdrawal of the intervention is likely to create lagged effects that play out in mid-2010.

Second, delinquency and foreclosure rates are continuing to rise. This pattern is likely to continue with more strategic foreclosures as it becomes clearer that neither government-led loan modification programs nor short-term recovery in property values will be able to save troubled borrowers who are upside down. While the increase in short sales and condominium auctions has helped, this activity has not been able to clear the market, leaving more downside risk and pressure on prices.

Going forward, the housing industry faces a number of additional risks that will drag out the recovery and create more downside risk. For example, withdrawal of the Fed's support of the MBS industry will put upward pressure on rates. Further, uncertainty regarding the restructuring of the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, both of which remain in conservatorship, clouds prospects for the multifamily sector.

Indeed, when coupled with Ginnie Mae, the GSEs account for some 40% of multifamily mortgage debt. With commercial banks making up the bulk of the rest of multifamily debt, many of whom are dealing with commercial real estate issues in their own portfolios, the industry is facing a critical shortage of capital. This situation will only get worse when bullet loans begin maturing along with those on the commercial side of the industry.

In much-awaited news, Treasury Secretary Timothy Geithner told Congress that the Obama administration will propose legislation to fix the nation's housing finance system over the next several months. He noted that the GSEs must operate under a different business model than in the past and acknowledged reform would be a complicated but necessary process. While the details are sketchy, a few guiding principles have become apparent.

First, borrowers should be able to access mortgages throughout the economic cycle. Second, lower- and moderate-income households should not be excluded from homeownership by lack of access to mortgages. Finally, after reform, the GSEs will be held accountable for the risks they take on. How the reforms get hammered through the forthcoming public debates and political wrangling is an unknown, although the emphasis on accountability and risk-reward may suggest tightening of housing

credit. Thus, the outcomes will be an important harbinger for the housing market and will be carefully monitored by affected parties.

Regardless of what Congress does to get the residential mortgage market back on track, the industry will face headwinds. These winds will be fueled by an anticipated rise in mortgage rates, which promises to be at a modest pace, and continued softness in the job front for at least the near term. The seasonal uptick in demand during the spring may create a false sense of recovery. The real test of the market will come in the second half of the year. The worst of it does seem behind the beleaguered housing sector. However, the best of times is a way off.

Real Estate Outlook Market Overview

During the first quarter of 2010, the commercial real estate market has continued its downward trek although the rate of deterioration has abated. While demand remains weak, the modest improvement in the economy and a slowdown in the pace of job losses have provided some respite for the industry. However, many companies are still operating at low-capacity utilization, revealing significant slack in the system that will have to be absorbed for any real improvement can occur.

While the absence of new construction activity has helped avoid greater slippage, overall the industry has significant excess capacity that must be burned off before the inflection point is reached. This situation is compounded by the significant but uncounted shadow space, or space held by tenants locked into long-term leases after a period of employment retrenchment. Since these figures are not captured in vacancy rates, there is even more excess capacity that will have to be absorbed before tenants seek new space.

As such, the outlook for new construction activity over the next several years remains guarded with the exception of build-to-suits, government-supported projects, and preleased projects that address some pent-up demand. However, rather than stimulating new construction, some of this demand will be channeled into existing buildings in good locations that can be economically retrofit and allow owners and tenants to take advantage of low prices.

During this phase of the cycle, there will be much finger-pointing at traditional players who got caught up in the collapse. This will open the door for

“The industry has significant excess capacity that must be burned off before the inflection point is reached.”

some of the new players who can slip into the void as veterans get bogged down with low-trailing returns and other problems. This position is based in part on recognition that the capital markets have yet to come to an appreciation of the fundamentals of supply and demand. As such, the potential for mistakes in the commercial real estate industry in an attempt to capture value constitutes an additional downside risk, as buyers, sellers, and owners struggle to find accurate mark-to-market values.

Office Market

Going into 2010, tenants are expected to cut back on spatial commitments and renegotiate leases, setting the stage for additional deterioration in market fundamentals. However, the modest economic recovery and improved corporate balance sheets and stock prices might take some of the edge out of the equation.

Leasing activity is likely to pick up although much of it will remain focused on renegotiations. Sublease space has declined modestly, although it is still significantly above long-term averages. This improvement was due to lease expirations and take-ups, as well as tenants' shelving of plans to shed further space as the economy picked up a bit.

Since most large-space users have already played their hand, or had it forced, few markets are facing a glut of large blocks of space. The exceptions to this rule are the markets and submarkets where large speculative office product that was years in the making came online after the market had collapsed.

During the first quarter of 2010, office vacancy rates will face additional upward pressure, pushing the overall rate over 20%, with many suburban markets at even higher levels. As such, rents are likely to remain soft.

In this environment, replacement costs will remain significantly higher than market values, helping defer new construction activity well into the

next year or so. A wild card is the fate of distressed asset sales, which may create even more competition for scarce tenants and pull rents down below levels suggested by vacancy rates alone. However, larger, higher-credit tenants are likely to take a hard look at ownership to make sure they have the will and ability to maintain assets to the standards they demand.

In 2009, institutional-grade private office market values dropped 24% as reflected in the NCREIF Property Index. Despite these write-downs, the income return was around 6.4%, well below averages and capitalization rates necessary to clear the market. In terms of office subtypes, central business district and suburban offices mirrored each other in terms of performance, average stock prices were down, and office capitalization rates are expected to rise toward longer-term, sustainable levels. Greater awareness of higher risk is likely to accelerate the trend although higher quality assets may avoid such pressures as investors eschew risk and focus in on safer assets.

Among savvy investors, greater attention will be paid to tenant quality and retention with recognition that some buildings have attracted tenants due to lower rents. These forces will combine to create additional erosion in values, leading to a veritable Pandora's Box for cash-strapped owners as well as those facing the imminent threat of refinancing. Since this situation is likely to play out over the next several years, the term *imminent* takes on a longer duration than normal. For owners caught in this trap, reflective thinking might lead to a wave of strategic foreclosures or outright defaults.

Retail Market

The recent uptick in retail sales has provided some hope for the retail sector. Although the improvement has not been long enough to signal a pattern, the results have been widely noted. Going forward, gains in retail sales are expected to be modest until the labor market tightens up and consumers start feeling some improvement in disposable income. Thus, consumers will continue to seek value, a trend that may characterize the retail industry for several years.

The softness in retail market fundamentals has been fairly widespread, creating greater uncertainty for the industry as a whole. As a result, capitalization rates have increased and exceeded 8% for most

subtypes, ranging from regional malls at the lower end to unanchored neighborhood strip centers at the higher end.

Well-positioned and well-tenanted community centers and grocery-anchored neighborhood properties have fared better than other formats, although the results have been far from stellar. In this environment, mark-to-market retail holdings have lost significant value although the pace of losses has moderated. In terms of distress, the retail sector has been hit fairly hard although the surge in distressed assets was ahead of some other property sectors. Despite growing levels of distress, the rate of resolutions has been modest at best and trailing other property types.

In terms of institutional performance, the private and public retail sectors have taken markedly different paths on the cycle. In terms of retail subtypes, year-end 2009 values were off across the board, although to different degrees. For example, values of super-regional and regional malls were down around 15%, with total returns off slightly under 10%. On the other hand, community, neighborhood, and power centers were down almost 20%, with total returns down 12%–15% on average.

On the public side, the average stock price of regional mall real estate investment trusts (REITs)—excluding General Growth Properties which is struggling to emerge from a capital market-induced bankruptcy—increased dramatically on a year-over basis. However, current prices remain below peak prices.

On the other hand, the average stock prices of larger retail REITs increased at a lower but still significant pace. Retail REITs focusing on medium-sized retail properties improved more moderately while small-size retail REITs led the pack. Whether these trends continue will depend on consumers and retail sale volumes, although prices reflect the consensus expectations of investors and may be an accurate predictor.

Industrial/Warehouse Market

In general, the industrial sector has been less volatile than other property types. This advantage can be attributed in part to the nature of the industry and shorter production cycles needed to bring new product online. As a result, the industrial market avoided some of the major shifts in market fundamentals that have plagued other property types.

In general, investment performance in the industrial sector has been more stable than other property types. The pace of losses declined toward 2009 year-end, but the annualized total returns were still down around 18%. The good news is that income returns were pushing 7%, suggesting the sector was closer to mark-to-market figures than other property types.

The relative performance of private institutional holdings across subtypes provides some additional evidence of the commoditized pricing that occurred in the industry. For example, R&D/flex properties are generally more volatile than warehouse and light manufacturing.

Interestingly, annualized returns among the subtypes were fairly close, with across the board declines. Overall, implicit capitalization rates pushed 7%, with the exception of office-showroom and other, which were in the sub-6% range and are thus in for even more losses as capitalization rates correct to longer-term averages. While not as dramatic as other property types and still below the peak in early 2007, industrial REIT stock prices are on a gradual upward trend.

The increase in manufacturing activity and reversal in the declines in inventory levels provided some respite for the sector, allowing it to show some improvement in fundamentals of supply and demand. Continued weakness in the dollar and the global recovery that has left the United States behind has provided some upside potential on the export front.

However, transformations that have been occurring in manufacturing processes and supply chains have changed some of the dynamics that have traditionally driven the industrial real estate market. As such, the path of recovery in the industrial and warehouse market fundamentals may differ from that in other post-recessionary periods. Of particular concern are facilities that were sited and built under the old regime that may not address user requirements going forward.

On the other hand, projects that can benefit from logistical advantages in the domestic market and resurgence in global demand are likely to turn the corner before other projects. Unfortunately, this inflection point will not be accompanied with a spike, but with a gradual curve more in line with the tempered pace of the economic recovery.

Apartment Market

The apartment market has suffered for the past several years, mirroring the fate of the single-family

“Apartment REITs have rebounded, with year-over stock prices up 80% for larger REITs.”

sector. Vacancy rates have risen, which have forced owners into increased concessions, which in turn have led to record-level declines in effective rent. When combined with the increase in capitalization rates, values have continued to decline.

Fortunately, the increase in apartment capitalization rates has not been as pronounced as in other property types. This relative advantage can be attributed to an appetite for product from individual and institutional investors, as well as to the ability to adjust rents relatively quickly to capture upside benefits from an economic recovery.

This perceived upside potential has manifested itself in the greater share of resolution of apartment distressed assets than in other property types. This is especially true in markets favored by investors with high barriers to entry. Unfortunately, this interest does not carry over to tertiary markets that will continue to struggle to attract capital.

In terms of investment performance, values in the apartment market declined ahead of other property types, with private investments ahead of the public sector. Implicit capitalization rates for apartments were under 5.5%, suggesting the private market is in for additional value losses as capitalization rates rise in the face of weak fundamentals. In terms of subtypes, high-rise apartments fell almost 25% in value, ahead of garden apartments, with a 20% decline in appraised values. This gap between garden and high-rise value losses is expected to widen even further, with implicit capitalization rates for high rises under 5%, which is significantly below warranted levels.

On the public side of the market, apartment REITs have rebounded, with year-over stock prices up 80% for larger REITs and 50%–60% for medium and smaller-sized REITs. Interestingly, public apartment REITs hit their peak prices almost two years after their private counterparts. Furthermore, apartment REITs have started to come back based on stock prices, while the private side is likely in

for more value losses as capitalization rates are adjusted upward.

The dearth of new apartment construction should help the sector recover ahead of other property types. However, access to debt will remain a concern in the face of maturing bullet loans and relatively high levels of leverage in the industry. This situation is also clouded by uncertainty surrounding reforms at Fannie Mae and Freddie Mac.

On a positive note, life insurance companies have eased underwriting standards allowing loan-to-value ratios to rise. However, this access to capital will be measured with emphasis placed on solid projects with strong market fundamentals. Weak projects will languish with little potential for a capital market play that was possible in the not-too-distant past.

Real Estate and Capital Markets

Capital Market Overview

During 2010, the real estate capital markets will undergo dramatic fluctuation as some players jump in ahead of the market and others wait for clear evidence that an inflection point has been reached. This uncertainty will force some established players to exit and shuffle or reduce real estate exposures. At the same time, it will force others to stay on the sidelines and yet others to jump in or double down on the sector.

For example, on the exit side of the equation are the Harvard University and Stanford University endowments that are trying to unload a significant portion of their real estate portfolios. On the shuffle side are investors like California Public Employees' Retirement System that will try to reduce holdings in riskier, noncore assets and replace them with core assets.

In addition, there are some funds seeking to provide moderate-risk investments that promise above-market returns due to a curing in fundamentals. There also will be a number of investors who jump into the distressed waters believing the rising tide will carry all. Other players will decide it is time to increase real estate holdings in a measured, disciplined manner. These funds are characterized by the Yale University endowments that are willing to redeploy assets from hedge funds and other investments and increase investments in real assets.

As might be expected from the potpourri of players and game plans, over the near-term at least,

the real estate capital market will be hitting an interesting, revolutionary period, especially with regulators changing the rules and modifying game plans on the fly.

Construction Activity

At this point in the cycle, distressed sales activity is still off relative to the pent-up activity that has been building up over the last 18 months. On the other hand, good assets are receiving multiple offers with prices exceeding some of the values to which properties have been marked in mark-to-market accounts. This is likely due to the fact that investors in the market are eschewing risk and seeking safe havens for investments.

Unfortunately, in the tumultuous real estate market, few investments can be characterized as safe havens. Indeed, the ongoing threat of a surge of distressed sales could cause further erosion in market fundamentals as buyers compete for tenants' leased assets. The quality of rent rolls, as well as the credit worthiness of tenants and their business models, will become a differentiating factor in managing and pricing risk.

This will also extend to capitalization rates, which are expected to rise and are likely to adjust over longer-term averages until the market begins to clear out product. These factors will place downward pressure on values and the bid-ask spread as motivated owners are forced to move product.

Expectations have come in line with reality, which should set the stage for an increase in transaction volume during the second half of the year. During the initial phases of the sales cycle, the ratio of closings to listings will be dampened as investors seek opportunities to lock in the high returns they are expecting without taking on commensurate risk.

Unfortunately, many of the newer players and the money managers who do not have the horsepower to source and manage product will miss the mark. Since it will take some time for the market to realize pricing mistakes, the industry is in for its own double dip before things begin to settle down and the market returns to a semblance of order. However, that stage in the cycle will not be reached for some time, setting up for a frothy period on the transaction front for brokered transactions.

Since it will take some time to find the bottom of the cycle, the market may be clouded by a surge of for-sale properties. In this environment,

the commitment to closure rates on commercial transactions is likely to slip as some potential buyers approach contracts as an option to purchase rather than an obligation to close.

If this scenario plays out, it will cause a significant pause in the market as sellers refocus efforts at qualifying buyers to make sure they have the will and wherewithal to actually close on transactions. Since the market is expected to be moving at a relatively rapid pace, the severity of loss or disappointment associated with failed closings may become a significant challenge for the market.

Despite the challenges the industry will face in setting realistic clearing prices for individual assets, significant pressure will force the market to act. This will be particularly true in the case of owners facing maturing bullet loans, special servicers trying to avoid criticism for failing to work out problems, and lenders facing a surge in REO and mark-to-market write-downs in mortgage holdings.

Some of these owners will opt for off-market transactions, creating an opportunity for players with access and reputations for the ability to close. At the same time, asset takeovers and asset management transfers will increase as institutional owners look for help in working through failed strategies.

Commercial Mortgage Market

Going forward, equity players are expected to do their part, but will be hampered by the failure of the debt side of the equation to step back to the table. Indeed, the securitized sector will continue to struggle to digest its current holdings as evidenced by record increases in delinquency and foreclosure rates that have hit many pools.

The situation is likely to erode even further as underlying real estate market fundamentals slip and capitalization rates rise. This situation will create a tremendous cloud over the industry, which has been unable to deal with the rapidly accelerating pool of distressed assets. At the same time, recovery rates have been hitting the industry with a double whammy of rising frequencies and severity of losses.

In 2010, the resolution rate for distressed assets should pick up as pressure mounts to clear the backlog. However, the severity of loss is likely to remain an issue for some time. In an effort to mitigate losses, the bulk of distressed CMBS loans were resolved by modifying loan terms and returning them to the master servicers.

Liquidations and foreclosures accounted for a minor component of workouts. This situation may change as rating agencies and investors pay more attention to the quality of assets in residual CMBS pools and sponsors opt to take a current hit to avoid longer-term issues. This strategy is likely to be practiced on the nonsecuritized front as lenders evaluate options and weigh the costs of disposing of a surge of REO properties.

In terms of new debt capital, the commercial real estate market is expected to tighten, with lenders being extremely selective and focusing on good product and borrowers with proven track records. Borrowers who are able to source loans will have to deal with lower loan-to-value ratios, higher debt coverage ratios, and more conservative assumptions on underlying income streams and collateral values. Lenders will be seeking recourse, making sure their interests are aligned with borrowers.

On a positive note, life insurance companies have stepped back into the market, taking advantage of the retreat of the CMBS sector that had forced them to the sidelines on the aggressive deals that were being underwritten as the market approached the peak. Activity in the CMBS sector might also pick up, although issuers will likely have to be satisfied with being able to lay off the top-rated tranches and forcing them to retain the bottom end.

While this will provide some capital, the ability to absorb losses will place a governor on such activity. The end result will be a bifurcated market with the top end plugging along and the bottom end dragging.

Unfortunately, the bottom end is much larger than the top, setting the stage for a difficult period on the debt front. This is especially true in light of the surge of maturing bullet loans that will start hitting the market in 2011. Anticipation of the glut of refinancing will force some borrowers and lenders to seek earlier resolutions, helping shift some of the activity into the second half of the year.

Private and Public Equity Markets

Over the past six months, acquisition activity has been tempered across the board. In addition, there have been some significant shifts in the active players, both on the private and public side. While varying by property type and market, well-capitalized individual and high net worth investors with discretion and the ability to move quickly have been the more active buyers. This is particularly true for distressed

assets, which have been harder to price and are in need of more real estate acumen to turn around.

On the other hand, major institutional players have seen some shifts in market share, with some opting to pull back on the commercial real estate asset class and others making calculated moves to acquire assets, especially stronger assets in good locations. International buyers have continued to target U.S. investments. Despite the weak dollar and declining prices, the overall market share has been fairly stable. There have been some shifts in the composition of international buyers, but the pace of activity has been too limited to discern any major patterns.

Among public entities, equity REITs have been posturing for a wave of acquisitions, although some of that activity will focus on entity investments with further consolidations on the horizon. To position themselves for a potential round of accretive acquisitions, some REITs have issued more paper while others have disposed of assets, especially commodity product that can easily be replaced and have no strategic value.

In some markets, private REITs are also becoming more active, especially those with access to capital and the ability to move quickly. Opportunity funds are expected to become more active although somewhat spotty as they move away from stable properties in search of the higher returns they touted when raising capital.

Conclusion

The commercial real estate market is entering a difficult phase, one that promises to be prolonged and challenging at best. While there are some signs that capital will flow back to the asset class, it will not be sufficient to clear the market. The economic recovery should provide some cushion against more erosion in market fundamentals, but more slippage is expected. This will continue until job growth returns and even then, the sheer volume of excess

capacity will create a lagged recovery for the commercial real estate sector.

On the capital front, money will flow into the asset class as equity players seek opportunities, but further erosion in values associated with rising capitalization rates and lower risk tolerances will create a negative net capital flow. Debt capital will remain tight, forcing the market to come up with more equity to close transactions. The much-awaited inflection point remains some time off, giving the market time to reflect and develop an appropriate action plan. Some will jump in with the hope that the rising tide will carry them forward. Unfortunately, such an approach is likely to leave them underwater before the cycle plays out.

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