

# Too Much Pain, Too Little Gain

by James R. DeLisle, PhD

## Commentary

As the 2009 second quarter began, the uncertainty surrounding the economy, financial markets, and real estate continued to dominate the news.

In the previous issue of “Financial Views,” we prefaced our comments with a discussion of the impact of government interventions on market behavior. We noted that the leading indicators of the economy had shifted from traditional factors to a new regime where the behavior of major players would dictate how the situation would unfold. In many respects, this caveat was prescient, especially in the commercial real estate arena where the market has shut down until the players are able to get a better read on the situation. This shutdown has occurred in spite of the herculean efforts of the government, which has pulled out all stops in an effort to avoid a meltdown in the credit and financial markets. Indeed, while the Obama Administration has received solid ratings for its openness and candor, frustration has grown over the continued deterioration in the economy. Thus, confidence remains shaken among CEOs, business leaders, politicians, and consumers.

To provide some insights into how the situation might unfold, it is useful to explore the lessons learned in the bust and boom period of the 1990s. It is hoped that this discussion will provide a useful perspective on the difficult decisions that will have to be made during what promises to be a period of uncertainty and more downside risk.

## A Closer Look at the Commercial Real Estate Market

Many observers have argued that we are in an unprecedented situation, one in which there is no historical parallel to draw on to understand how events surrounding the real estate market might unfold. Granted, the current situation is unique, with the

economy being pulled down by a collapse of the credit and financial markets, and with the effects spreading across the globe. Yet despite the different drivers of this economic downturn, the end result is not as unprecedented as it appears. Thus, the history of the 1990s real estate market may provide us with some insights as to how the current cycle will play out and what it will take to turn the market around.

To understand the collapse and recovery of the commercial real estate market in the 1990s, it is necessary to explore the events that led to that situation. During the early-1980s, the economy was experiencing a difficult recession. To help jump-start a recovery, the federal government launched two major initiatives to position commercial real estate as a catalyst for the broader economy. First, legislation was passed to deregulate financial institutions and allow them to participate in development activities. Second, the tax code was modified to allow losses associated with commercial real estate investments to be used to shelter other income. These two interventions were successful and led to a surge in commercial construction activity, creating jobs and setting the stage for economic recovery.

The surge in development due to government interventions was amplified by an infusion of pension capital and offshore investors drawn to real estate for the high, double-digit returns it generated during the early phases of this stimulus period. In hindsight, the government interventions were too successful, with the renewed interest in real estate as an asset class attracting a wave of new players who were not sensitive to the importance of underlying real estate market fundamentals.

In the absence of countervailing forces, this situation led to a glut of unwarranted space, which set the stage for the collapse that began toward the end of the 1980s. The fallout from the excesses was

dramatic, threatening the viability of the financial markets and intermediaries who had been drawn into the feeding frenzy in the search for assets. Interestingly, the blame for the overbuilding was attributed to a lack of discipline on the part of the development community. While true to some extent, in large part the overbuilding was fueled by excess capital flows and lack of attention to risk—a situation that also describes the chain of events leading up to the current carnage.

After a brief period of denial in the early 1990s—which again, might well characterize the attitudes of many real estate professionals today—it became clear that a day of reckoning was at hand and the consequences would be much more severe than those in a normal cyclical downturn. This awareness led to an almost complete withdrawal of capital and a collapse in commercial property values of some 50%–60% of peak levels. In the absence of capital and with a free fall in values, many developers and investors were taken to the brink of failure. This situation extended to the savings and loan (S&L) industry, which was one of the main culprits behind the surge in construction. As a result of the market collapse, the integrity of the financial industry was called into question. Many commercial banks, life insurance companies, pension funds, and other players were forced to cope with the drag created by record levels of foreclosed properties and problem assets.

To recapitalize the industry, the government set up the Resolution Trust Corporation (RTC) to take over collapsed S&Ls and move real estate owned (REO) and other distressed assets off the balance sheet. (This is analogous to the currently proposed good bank, bad bank proposals for dealing with toxic assets.) To mitigate risk and attract investors, the RTC provided government guarantees, in effect creating excess returns relative to the underlying level of risk to attract capital. Today, many of the preliminary recommendations to address toxic assets bear a striking resemblance to the initiatives of the 1990s, although the specific nature and scope of the new interventions are still being argued.

Reconstruction of the 1990s commercial market, its ultimate turnaround, and its structural changes provide some useful insights into the forces that led to the recent market collapse. For example, the RTC made a tremendous investment in the systems and infrastructure necessary to securitize distressed commercial mortgages and attract capital to the asset

class. As a result, a new industry of service providers (e.g., rating agencies, investment banks) were launched to create commercial mortgage-backed securities (CMBS) pools and to address the need for mortgage servicers to oversee whole loan portfolios and securitized mortgages. Thus, although the RTC was set up to be a self-liquidating entity and ultimately was dissolved, its operation spawned a wave of supportive players, infrastructure, and systems.

When the initial task of moving troubled assets back into the market neared completion, this new industry shifted attention to survival mode, looking for a way to become a permanent part of the commercial real estate landscape. After a wave of lobbying by interest groups that had come to depend on the new players, the modern CMBS industry was born. In inimitable American style, this industry model was exported, resulting in the passage of enabling legislation in many countries seeking equal access to capital to support domestic economies and economic development. Consequently, what started out as a temporary solution to recapitalize the domestic real estate market became permanent and global.

Once the debt markets began to stabilize in the early 1990s, attention shifted to the equity side of the markets. Beginning in 1994, the equity market underwent its own transformation as large, privately held real estate companies were forced to choose between filing bankruptcy or converting to a public entity. Since survival was preferred over the alternative, the modern era of the real estate investment trust (REIT) was born. While losing some control and flexibility, owners became managers of the public entity, allowing them to enjoy some of the benefits of ownership and avoid losing the affected assets.

After some lobbying to relax REIT legislation, the public format became a major force in the recapitalization and recovery of the commercial real estate market as traditional equity players stayed on the sidelines. These efforts were so successful that the moribund REIT industry was catapulted to a major force in the equity side of the commercial real estate market, ultimately growing to a \$200 billion plus industry. To support this growth, REIT rules were relaxed to eliminate barriers to growth. As in the case of CMBS, REIT legislation was exported, with most developed countries passing enabling legislation. The end result was a surge in equity global capital flows to commercial real estate and further stimulus to the globalization of the asset class.

In many respects, new CMBS and REITs attracted capital to the commercial real estate sector by securitizing investments and presumably insulating investors from the underlying risk associated with the nuances of the asset class. This was important since traditional players had been forced out of the market by poor returns and a lack of confidence in their ability to capture returns commensurate with risk for the illiquid asset class. While the line-up of new public capital sources was ultimately a major component in the recapitalization of the commercial real estate market, there was one missing link that is important to recognize in the current cycle: there was no obvious player to take the deep risk associated with a market turnaround. The CMBS and REITs were both positioned to provide moderate risk, and today, many larger institutional players—some of which sold down at the peak of the market—remain on the sidelines, in part due to the denominator effect in which real estate investments are higher than allocations as a result of declining values in other asset classes.

In the mid-1990s recovery, those in the first wave of investors were unabashedly labeled “vultures,” and they prided themselves in being “grave dancers.” The use of such aggressive and somewhat offensive monikers was both appropriate and necessary to help stimulate the market. After these investors swept in and cleaned up through no-brainer investing, which targeted assets at 40% or less of long-term value, then more traditional opportunistic and value-add investors became brave enough to jump into the fray. After these highly mobilized, discretionary investors made their move, this void was quickly filled by a series of opportunistic funds that were spawned by Wall Street firms. Ultimately, more traditional players returned to the asset class which, somewhat ironically, forced opportunistic investors to turn their attention offshore in search of high returns.

Today, a lot of money has been assembled to buy distressed assets. While this should provide some solace and has been interpreted by some as a sign that the market is near bottoming out, the stage has not yet been set for opportunistic investors to step into the battle. This is particularly true since the market has not yet tanked sufficiently to support no-brainer investing in which an understanding of market fundamentals is not necessary to capture returns.

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Until values decline even further, capturing opportunistic returns will depend on the ability to create value through proactive means. Such actions will depend on having an understanding of market fundamentals and having access to discretionary capital that will allow investors to strike quickly and then follow up with property, asset, and portfolio management programs necessary to create, maintain and capture value. During the 1990s, many of such players were created by Wall Street firms, which had the resources and savvy to acquire the talent to step into the market malaise and be successful. Unfortunately, in the current cycle many of these players have been eliminated as a result of the shakeout on Wall Street (e.g., Lehman Brothers, Merrill Lynch) with no obvious replacements. At the same time, the CMBS industry remains on its knees with some uncertainty about if, how, and when it can be reborn, while many REITs are struggling for survival due to problems associated with leverage and the erosion in market fundamentals creating a downward drag on share values.

Many real estate professionals contend the commercial real estate industry will avoid the dramatic decline that occurred during the 1990s period, arguing that predictions of significant deterioration in the commercial sector are overly pessimistic. They find much solace in the nature of the correction, and argue that the absence of overbuilding, which caused prior downturns, will help the industry avoid a major collapse. Despite the intuitive appeal of this position, those who survived past downturns may have a different read on the market.

Several factors argue that much more difficult times are on the horizon. First, the current capitalization of many commercial projects and portfolios is a house built on sand: easy credit, nonrecourse debt, and interest-only or bullet loans. Many of these deals were originated in the heyday of the market between 2005 and 2007, setting the stage for significant rollovers beginning next year. This lumpiness is problematic at best, as strict underwriting standards

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are likely to be enforced, making it difficult to secure mortgages.

Second, many of the record prices captured in the commercial real estate market during the latter phases of its bull run were bolstered by deal-driven activities designed to place capital, rather than to provide stable risk-adjusted returns. In other cases, the premium prices were supported by pro forma statements built on the assumption of a robust economy with increased demand and rising rents.

Third, many players assumed that cap rates had been permanently reduced compared to long-term averages as a result of the greater transparency and market efficiency afforded by the securitization and globalization of the asset class.

Fourth, the commercial real estate industry, which had touted itself as “different from the residential industry,” enjoyed a late-stage rally. This occurred as yield-driven investors pulled investments out of the residential market in favor of the commercial market, which was seen as a safe haven. The rationale behind this move was reinforced by those who argued things were different than in the 1990s, again pointing out that the industry did not suffer from the overbuilding of the last major commercial downturn. The resultant surge in capital flows created a wave of defensive investing that drove prices up to even more unsustainable levels in terms of long-term yield requirements for the asset class. Thus, the peak of the market was prolonged and prices overshot the top of the market.

Finally, the significant downturn in the economy—both domestically and globally—was unexpected and not built into pro forma models for existing assets. Thus, as the economy continues to struggle in spite of government efforts, commercial real estate fundamentals are likely to continue to deteriorate. This phenomenon is particularly troubling in light of the fact that the real estate cycle will lag the economic recovery, suggesting further erosion in fundamentals is likely and any recovery will be well into next year at best.

Although some may argue this preview is overly pessimistic, in fact the proverbial “stars” have a way of falling in and out of line at the same time, making further downturn in the commercial real estate market a distinct possibility. At a minimum, the possibility of this chain of events should be considered by those developing downside scenarios that affect what they will do and when they will make their move.

Opportunistic investors have opted to stay on the sidelines, indicating that many “smart” players are betting on further erosion in value and a prolonged or gradual recovery. In the meantime, the beleaguered state of the economy continues to weigh heavily on the overall psyche of the market, clouding the outlook even more in the aftershock of the credit and economic downturns. The end result is a very difficult period for commercial real estate, which will be particularly distressing for those forced to make decisions before the market settles down.

### **The Economic Environment Economic Growth**

During 2008, gross domestic product (GDP) figures were disappointing, with more than a 6% annualized rate of decline in the fourth quarter. This came on the heels of a string of flat results due to widespread weakness in the economy. In addition, the global recession manifested itself in weak growth in most developed nations.

The widespread nature of slowing economic growth speaks to the challenges in the global economy. Just as there are no obvious sectors that could lead a domestic rally, at the global level there are no obvious nations that are likely to lead a global recovery. Unfortunately, most countries are on the defensive, using bailout funds to avoid further collapses rather than to stimulate growth that could help jump-start a recovery. Indeed, many countries are struggling to deal with the same types of issues that the United States faces, with the need for defensive investment to forestall more failures and a potential implosion taking attention and resources away from initiatives that could help stimulate demand.

The U.S. government continues to wage war on the credit and financial crises. Despite bold efforts at the federal level to implement the initial stimulus package and a spate of new initiatives from the Obama Administration, the Treasury, the Federal Reserve, and Congress, there are few signs that a solution to the economic malaise is on the table.

Indeed, the scandals surrounding the “unconscionable bonuses” paid on Wall Street and exorbitant salaries paid to corporate America in general created significant angst. The absence of decisive action is understandable but nonetheless discomforting. In the face of further increases in unemployment, pleas to bailout even more industries whose collapse could also have catastrophic implications, and prospects for tax increases to bailout state and local governments, few believe predictions that a recovery is on the horizon.

On a positive note, some are contending that the stimulus packages and other attempts to jumpstart the economy may finally be bearing fruit. For example, in early April emerging markets enjoyed a surge after the Group of 20 nations agreed to pump another \$750 billion into the International Monetary Fund (IMF) to raise its capital base to \$1 trillion from \$250 million. Unfortunately, the renewed hopes such efforts stimulate are unlikely to translate to the enduring resurgence in confidence that is necessary to make a sustainable domestic or global turnaround. Thus, despite extraordinary efforts and the open-checkbook approach, the economic news is likely to get worse before it gets better, with businesses and consumers keeping their heads low and focusing on economic survival.

### **Employment**

The employment situation has been one of the sore spots in the economy. Going into the second quarter, the situation remained abysmal. Hiring declined more than 10%, with job openings plummeting even more. Layoffs continued to increase, rising dramatically over the same period in 2008. By April, the unemployment rate had pushed beyond 8.5%, with another percent or more increase likely before the bleeding ends. The severity of these cutbacks forced attention on the question of who is getting hurt the most, with the decline in manufacturing, construction, and service jobs hitting some minorities harder than others. This renewed interest in the debate over domestic versus foreign workers. While the continued loss of jobs is not a new trend, the spread to industries previously immune to a downturn has been disconcerting.

At this point in the cycle, few industries or markets have been able to avoid pressure to reduce employment costs. Most companies that have averted layoffs have implemented other programs to reduce labor-related costs. These programs include hiring freezes;

deferral of new programs and products; decreases in employee benefits and increases in co-pay programs; suspension of matching contributions to retirement accounts; and imposition of mandatory, unpaid furloughs. Outside of Washington, D.C., government agencies have come under the same pressures as the private sector, with budget deficits forcing suspension of nonessential services, cutbacks in basic services, and layoffs to reduce labor costs. Unfortunately, some of these cutbacks are occurring at a time when demand for government services is increasing.

In addition to job cuts, those who have jobs are working fewer hours. Since most affected workers are not salaried, take-home pay has declined for many households. Unfortunately, many families live just over the threshold of solvency, so even a moderate decline in earnings can have devastating effects and add to household stress.

Not surprisingly, the rate of voluntary departures is down dramatically, with many workers resigned to hanging onto their jobs rather than seeking new opportunities. When the employment picture begins to pick up, workers will face some difficult decisions as they struggle to balance the desire to find more rewarding and economically viable jobs with the anxiety that the economy could slip back into the doldrums. Thus, there will be a period when the job market begins to stabilize that is likely to be a precursor to a wave of job changes as employed workers seek new opportunities. If this occurs it will be particularly difficult for the chronically unemployed, who have been out of work for awhile, to find jobs; these workers may need to wait for the second wave of job openings.

### **Inflation and Interest Rates**

One of the much-needed good news items for the economy is the fact that inflation remains in check. Indeed, earlier in the year some thought the economy would enter a period of deflation that could have a devastating ripple effect on the economy. While prices are likely to continue to contract in some sectors, especially discretionary and durable goods, inflation rates should remain modest and in line with economic conditions. Energy prices will continue to be a wild card, with tempered demand taking some of the pressure off prices. However, the burn off in petroleum inventory levels may be a precursor to a return to higher prices, especially at the gas pump as consumers turn to summer vacations to try to find some solace from the dire economic environment.

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Over the longer term, the open-checkbook approach to stimulus and intervention is likely to place upward pressure on inflation. While this remains an issue, its importance has been dwarfed by the dire state of the economy, and the continued threat of collapse of the financial industry has all but forestalled such concerns.

Interest rates remain at historical lows as the Federal Reserve tries to stimulate economic activity. Despite lower rates, the major challenge faced by many potential borrowers is access to credit. This situation is likely to continue as lenders struggle with their balance sheets and underwriting standards remain tight. To help stabilize this sector and increase capital flows, Treasury Secretary Geithner outlined the Financial Stability Plan (FSP), which was introduced as a comprehensive strategy to restore stability to the nation's financial system. The FSP has several key goals that would help increase access to credit: to restore confidence in the strength of U.S. financial institution, to restart markets critical to financing American households and businesses, and to address housing market problems and the foreclosure crisis.

While these and other efforts to infuse capital into the financial system have been welcomed, many potential beneficiaries of such efforts are still waiting to see the results. This situation has carried into the residential market, especially with respect to jumbo loans—which have suffered from a severe shortage of capital as lenders have no ready take-out in the form of Fannie Mae purchases for loans exceeding conforming limits. Recently, there has been some relief for this segment of the market as portfolio lenders appear to realize that the risk of such loans can be offset with higher rates without the wide spreads that had been required. This should provide greater access to loans for this segment of the market of sales and refinancing, although underwriting standards are likely to remain rigorous.

While capital flows will remain a problem over the near term, interest rates are likely to remain low. However, the yield curve has steepened, with access

to longer-term, fixed-rate capital remaining problematic.

Going forward, interest and mortgage rates are likely to remain low, although access will be a problem for some. Confidence will be a problem for others, as they struggle to make major financial decisions in the face of uncertain property values and concern over the broader economy.

### **Business Indicators**

As might be expected, business indicators remain generally weak, with pressure on bottom lines and corporate profits dominating the news. Business confidence levels remain weak, suggesting that companies will stay in a defensive mode, seeking to hold market share and weather the economic downturn.

While some companies are hoping to maintain operations at current levels, many are responding to the difficult times by cutting back on employment, plant capacity, and business investments. This situation has been pervasive, with a few sectors taking more aggressive actions. Indeed, the Federal Reserve's Beige Book reports widespread layoffs, temporary factory shutdowns, and hiring freezes across most Federal Reserve districts. The report also suggests additional reductions in workforces and hours, painting a bleak picture that could reverse the gains that have been made and further weaken the U.S. economy in the second half of 2009.

The manufacturing sector is generally weak, with new orders coming in at disappointing levels. Indeed, industrial and manufacturing production fell over 20% in the 2009 first quarter, racking up the greatest declines in over thirty years. As a result of these declines, companies are operating at capacity utilization levels far below averages. Placing further capacity in the distribution system was the contraction in inventory levels, which cut across manufacturing, wholesaling, and retailing sectors. Going into the second half of the year, prospects are for much the same, with most companies holding back to wait out the bottom of the cycle.

### **Stock Market**

Over the past several months, the domestic stock market has been volatile, with several periods of expansion as investors absorbed any bits of good news they could find. The stock market is likely to experience some bouncing around as investors

find the strength to ignore some of the relentless string of bad news and search for indicators that the economy may be poised for a period of stabilization or recovery.

This situation has not been confined to the United States, as evidenced by the fact that emerging market stocks experienced a sharp upturn after the decision by the Group of 20 nations to pump resources into the IMF to help stabilize struggling economies. This suggests investors across the globe are getting to the stage where they are willing to take on risk and may be willing to make bets on sectors and companies that appear to be positioned to rebound when the global economy picks up. Whether this trend continues, and is actually an indicator of a potential turnaround in the global market, remains to be seen. Even if it fizzles, it suggests that investors will be ready to make their move when the global market does turn the corner, and that risk aversion may give way as investors seek to make up for lost ground. However, the situation bears close watching as the U.S. market is ahead of the global economy, which depends on a resurgence of global demand for its recovery rather than a surge in opportunistic wave of capital.

In this environment, companies are expected to remain defensive and to make difficult decisions that ensure they survive the downturn and are competitively positioned to move when the market begins to recover.

### **Consumer Confidence and Retail Sales**

The dismal state of the economy continues to weigh heavily on consumers. Despite the desire to believe that things are different and that the Obama Administration will be able to turn things around, consumer confidence remains at tepid levels. This situation is understandable in light of the string of layoffs and cutbacks that have focused consumer attention on the job market as the leading indicator for the broader economy. Many consumers have been forced take a hard look at their budgets and to look for ways of saving money. At the same time, retirement accounts have shrunk, and a growing number of companies have cut back on matching funds. In this environment, consumers have paid little attention to some of the positive elements associated with the slowdown, including lower prices for some goods and services.

Despite talk of improved access to credit and lower interest rates in general, the credit card compa-

nies have failed to rein in rates, with some announcing unilateral increases on new and existing balances. Such increases merely add salt to the wounds and place additional households at risk since consumer credit is at record levels. Until the job market begins to firm up and the benefits of the open-checkbook approach to the crisis begin to show up on Main Street, consumers are likely to remain cynical and concerned about their current and future prospects. This situation is unlikely to change over the near term as consumers take a wait-and-see approach.

### **Retail Sales**

Retail sales levels are understandably disappointing given the angst among consumers and the seemingly endless array of new issues and challenges for the economy. As signaled by the lack of consumer confidence and poor expectations, retail sales are likely to continue to languish with consumers opting to stay on the sidelines.

When consumers do venture into stores, they have a no-nonsense attitude, paying attention to the bottom line. In addition to concentrating expenditures on current needs, many consumers are trading down, looking for high-value, low-cost items that can help stretch their budgets. This emphasis on price points has caused additional concern for retailers as high-ticket, high-margin items remain on shelves. The extent of discipline among consumers has been evident in the lack of activity in the face of the conversion to digital broadcast. While the delayed implementation bought some time for households with obsolescent equipment, the actual implementation has not created a surge in purchases of new televisions, especially among marginal households struggling to make ends meet.

Going forward, retail sales are expected to remain flat to negative, with some price deflation exacerbating problems for retailers. Tightening of consumer credit and increased interest rates will also worsen the situation. Weak consumer sales will continue to plague retailers at both ends of the price spectrum, as low- and moderate-income consumers struggle to survive and higher-income consumers focus on the future challenges they may face if the housing and stock markets do not rebound. In this environment, many retailers are expected to contract inventory levels, make additional cutbacks in labor costs, tighten return policies, and close underperforming outlets in an effort to remain solvent. The

## “A new wave of consolidations is expected in the housing sector.”

industry will face major challenges in the fall, especially as it struggles to shift consumers' expectations away from deep-discount sales and price deflation, both of which have become firmly engrained in consumer psyches.

### **Housing Market**

In spite of scandals over excessive executive compensation and concerns over the growing ranks of distressed industries (e.g., insurance), the housing market continues to remain in the spotlight and the focal point of stimulus programs. To this point, the efforts to first stabilize and then stimulate the lagging housing market have met limited success.

Foremost among the major challenges in the moribund housing market are efforts to forestall the major increase in foreclosure activity that is looming on the horizon. In early March, the Treasury released information and guidelines on the Homeowner Affordability and Stability Plan, which could offer assistance to as many as nine million homeowners who are making a good-faith effort to stay current on their mortgage payments. Briefly, the plan would support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac, and provide some five million homeowners new access to refinancing. Additionally, the initiative would offer reduced monthly payments for some four million at-risk homeowners. Unfortunately, these efforts are likely to be thwarted in part by the increase in foreclosure rates, which jumped almost 50% in March as lenders lifted temporary moratoriums and decided it was time to press into action to avoid additional losses.

While some borrowers have been able to take advantage of opportunities to replace variable rate loans with more affordable, fixed-rate obligations, legions of others are too far behind or too underwater to avail themselves of such programs.

Although much attention has been focused on existing homeowners, efforts are also being extended to encourage first-time homebuyers. In particular, a new \$8,000 tax credit has replaced the initial \$7,500 program that had so many strings that buyers found them less than compelling. The program is too na-

scient to determine if it will attract significant pools of applicants to sow the seeds of a recovery. However, the early evidence suggests that potential buyers are likely to remain skeptical of such programs until there are signs that the economy, the housing market, and their paychecks have stabilized and are moving into a sustainable period of expansion.

In the current environment, housing indicators remain negative, with housing starts continuing to disappoint and few signs that the housing market is turning the corner. Through March 2009, housing starts came in at a dismal 510,000 annualized units, a 50% decline over the prior year and a reversal of the slight uptick in February, which some pointed to as a signal homebuilders were ready to start venturing back into the fray. However, it should be noted that these figures included the multifamily segment, which has been under greater pressure than the single-family market, which has remained relatively flat.

A new wave of consolidations is expected in the housing sector as local players band together to try to hang on until construction activity resumes. This follows a wave of acquisitions of local homebuilders by some larger regional players seeking to expand and diversify their holdings. While such acquisitions might occur on a one-off basis, this activity has been forestalled by the industry collapse, which has forced many larger players to focus on survival rather than growth. There are some exceptions to this rule, as typified in the announcement by Pulte Homes, Inc. that it plans to acquire Centex Corp. in a \$3.1 billion deal that would involve assumption of \$1.8 billion in Centex debt and \$1.3 billion in an all-stock transaction. If completed, the combined entity would become the nation's largest home builder, surpassing current top-seller D.R. Horton, Inc. Presumably, the combined operation would be able to achieve greater economies of scale and create a broader product line in terms of concepts, price points, and markets that would be able to survive the prolonged market trough and then flourish as the single-family sector ultimately rebounds.

### **Real Estate Market Overview**

As 2009 unfolded and the economy eroded even further, it became clear that the commercial real estate market would not escape the fallout from declining demand. As expected, the commercial industry has

begun experiencing increases in vacancy rates in the face of employee layoffs, tenant bankruptcies, store closings, and overall contraction.

Initially, negative effects were felt by weaker assets, which were vulnerable to a cyclical downturn. More recently, the erosion in performance has spilled over to strong real estate assets due to the deterioration in market fundamentals. Some owners, who had been insulated from such downward pressures, have begun to experience self-inflicted erosion in performance that is a consequence of defensive strategies they have taken to retain tenants in troubled industries and to incentivize other tenants to extend leases.

Further erosion is expected during the second half of 2009 as a surge of distressed assets hit the streets. Due to the lower cost basis, the new owners/purchasers of distressed assets will be able to offer even lower rents as part of their efforts to cannibalize tenants from existing space. To the extent this occurs, and demand remains flat or continues to decline, the performance of commercial investments may lag the levels implied by current occupancy, asking rents, and other metrics relied on in more normal times to track market fundamentals.

Until the economy begins to firm up and transaction volumes return to healthier levels, the industry will experience a period of greater volatility, with landlords and tenants struggling to figure out how to best operate in uncertain times.

### **Office Market**

By the start of the second quarter, the office market had begun to experience an increased rate of contraction. Vacancy rates increased significantly, moving from the low teens to the mid-teens. In the face of continued contraction in demand and a rising level of tenant put-backs, vacancy rates are likely to move into the upper teens. At the same time, the contraction in rents is likely to continue, with many markets recognizing that the built-in pro forma assumptions at the peak of the cycle were overly optimistic.

Overall, office absorption rates are negative, with additional downward revisions on the horizon as companies shed surplus space. Although some markets and submarkets may be able to hold occupancy levels up due to local market fundamentals, generally there will be downward pressure on rents across the board. The extent to which this pressure affects the performance of individual holdings will

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depend on a number of factors including rent rolls, tenant mix, submarket conditions, and individual asset positioning.

As with other property types, near-term transaction levels for offices are likely to remain tepid, as the bid-ask gap between sellers and buyers remains wide and prospects for the sector remain uncertain. Interestingly, some financial institutions are seeking to liquidate office properties and lease them back to access cash and boost capital. While the banks that use this approach will be committed to future rent payments, the operating leases can be kept off balance sheets, and the commitment of a strong anchor tenant should bolster values over properties facing erosion in rent rolls and quality of tenants. Some companies who own their own headquarters and other assets are expected to apply similar approaches to access capital. In the short term such trends will be good for investors in the market; however, such deals do not address the larger problem of excess supply.

Office investors holding solid assets are expected to hang on to these assets during the downturn. However, many such assets are being held by distressed investors facing the need to sell or refinance over the near term. This suggests that there may be an increase in solid assets on the market. In the meantime, it will remain a tenants' market with downward pressure on rents. Due to the difficult financial market, landlords pressed for capital may be more generous with tenant renewals, while relocating tenants may be offered more aggressive lease terms in return for lower tenant improvement allowances.

Office construction levels are expected to remain in check, with a number of projects in the pipeline being deferred or abandoned as developers struggle for debt and equity capital. This is especially true for speculative projects, although a number of preleased projects are also expected to stumble as financing dries up and underwriting standards are tightened even further.

## Retail Market

The retail market has been racked by a number of adverse factors, beginning with the contraction in retail sales and culminating in the bankruptcy and closings of a number of key tenants.

Weakness in the retail sector has been widespread, affecting the full spectrum of the market—ranging in size from mom-and-pop stores squeezed out by declining sales and tightened credit, to larger players who depended on aggressive sales and expansion to support the bottom line. Similarly, retailers from upscale boutiques to discounters are under pressure. More cutbacks and layoffs within the sector are likely, as companies cut costs to try to withstand what is likely to be a prolonged downturn and a lagged recovery.

During 2009, the level of store closings is expected to continue to increase, especially among regional and local players faced with tight credit, sticky expenses, and tepid sales. Given this rather dire outlook, it should be noted that some stores have benefited from the tight times, including secondhand stores, thrift shops, and off-price outlets that appeal to the legions of consumers seeking value-oriented goods. Going into the second half of the year, it will be interesting to see how retailers try to lure customers back to the registers, especially those who have become programmed to seek out deep discounts and expect continued price deflation. Unfortunately, upward pressure on staples and other necessities make the prospects extremely challenging for discretionary goods.

Retail real estate returns have suffered as vacancy rates rise. Landlords have been forced to triage tenants, assessing tenants' ability to survive before determining how to approach them in terms of lease renewals, concessions, and other discretionary decisions. While some tenants are holding up well in spite of disappointing retail sales, such insulation is the exception. As might be expected, retail construction levels have been dramatically curtailed, especially for innovative projects (e.g., mixed-use, lifestyle) that may have gotten ahead of demographics, as well as for niche projects that depend on a shift in market demand or revitalization (e.g., infill projects, brownfield redevelopments).

Developers and retailers who had catered to the expanding housing market will be forced to stay on the sidelines for the foreseeable future. Investors are likely to face the prospects of rising cap rates as the

market disdains all things retail, while net operating income levels face downward pressure. Transaction volumes will remain tepid, with a significant bid-ask spread. While some sellers will be forced to go to the market with product, those who can hang on will sense the sector is likely to lag other commercial property types in terms of renewed investor demand. The sales that occur are likely to be somewhat distressed, with an impending surge in such transactions threatening more downside risk.

## Industrial/Warehouse Market

The industrial market has been facing the same fate as most other property sectors, with the weakness in the manufacturing sector spilling over to the demand for manufacturing space. Declines in capacity utilization—especially among some of the troubled manufacturing sectors—suggest the asset class is likely to lag the economic turnaround. Indeed, capacity utilization has slipped to 75%, a significant decline from a year ago and a cyclical low point with more downside risk.

In this environment, capital expenditures and construction levels are likely to stay suppressed until the economy begins to improve in a sustainable manner. The global recession has placed downward pressure on both imports and exports, softening the market fundamentals for warehouse and distribution facilities. As such, vacancy rates have risen with additional deterioration on the horizon. At a national level, vacancy rates have moved into the lower double digits, with more increases likely as the global economy struggles and job losses in the manufacturing sector continue to worsen.

Some areas have been harder hit, especially those tied to the automobile industry and others dependent on heavy industry. Given the uncertainty of these sectors, ancillary suppliers and related manufacturers have been on the defensive. Indeed, the industrial sector is facing prospects for significant contraction—depending on whether the core industries can survive and if so, at what cost. In some markets, owners are voluntarily lowering rents to hold tenants, as well as going to short-term leases to retain tenants and give them the option to put back space. On a positive note, shipping costs have declined, with the potential for more softening.

Going forward, the fate of the global economy will be key for the industrial market, with the likelihood of more offshore production taking some of the

upside potential out of the recovery. Supply chains are expected to undergo even more scrutiny, causing further shifts in the relative advantage of various locations and distribution centers. In this environment, transaction levels are expected to be moderate, with the sector avoiding some of the volatility of other property types that have been more affected by the delinking between capital flows and underlying real estate fundamentals. However, there is more downside risk to rents and values as industrial properties are repriced along with other property sectors.

### **Apartment Market**

To some investors, the apartment market was supposed to serve as the reciprocal of the single-family market, with the former benefiting from contraction in the latter. This counter-cyclical nature may be true in more normal times; however, when the single-family market boom was artificially extended by easy credit and lax underwriting it left both sectors struggling from an overhang of space.

For the apartment market, this overhang involved a gradual upward creep in price points, led by condo conversions and costs for land and materials. At the other end, the gap between affordable housing and market-rate housing continued to expand, leaving the market somewhat bifurcated with imbalances at the bottom and middle end. The collapse of the ownership market reversed the trend toward condo conversions and, more importantly, the balance between supply and demand. This created an additional surge in rental space at the top end of the market as condo converters “re-apartmented” projects.

The end result has been a more complex apartment market, in which overall vacancy rates and rental levels are difficult to interpret. Some sectors that have been able to target consumers with effective demand are doing better than others. However, the weakness at the top of the market has created some softening at the upper-moderate end of the market as owners have been forced to cut rents to fill up buildings and meet underwriting standards.

In terms of market fundamentals, the apartment market has not escaped the fate of other property types, with vacancy rates rising to a three-year high. In the face of excess capacity, rents have declined somewhat unexpectedly. Due to the rather rapid turn of events, additional apartment stock is still coming on line in some markets and submarkets,

“The apartment market has not escaped the fate of other property types.”

leading to further erosion in fundamentals. Although the pipeline for new apartment projects has been dramatically curtailed, the industry faces a wave of new supply as proposed condos in the pipeline are being increasingly converted to rentals before completion.

The good news is multifamily starts are down as the market adjusts to further erosion in fundamentals as economic contraction and job losses constrain demand. In terms of transactions, sales levels have dramatically contracted, with sales that have taken place moving to the smaller end of the deal spectrum. Cap rates have risen, with the bid-ask spread widening as owners try to hold on. However, prices per unit have been coming down, a trend that is expected to accelerate as distressed products move into the pipeline and owners are forced to move product. In this environment, values should face further downward pressure with the situation likely to be more volatile than normal.

### **Real Estate and Capital Markets** **Real Estate Capital Markets**

During the first quarter of 2009, the real estate capital market all but came to a standstill as investors waited to see how things would play out. While some private and off-market deals are still getting done, for all practical purposes the brokered transactions upon which the industry depends have been put in abeyance.

In normal cyclical downturns, the market would slow down as players struggled with the bid-ask spread—with sellers dealing with the reality of a market past its inflexion point and buyers waiting until values bottomed out. In the current situation, the problem is more complicated since there is so much doubt as to what the appropriate bottom should be, and whether cap rates—which are moving toward 8%—are fair or should increase to the long-term averages that push the 10% level. The decline of some 12% in the fourth quarter of 2008, as reflected in the NCREIF Open-End Diversified Core Index, and declines in other indicators might suggest that the industry has come a long way toward a natural

## “More commercial assets are likely to fall into trouble beginning in 2010.”

bottom. However, this outlook is likely to be too optimistic, with several factors arguing that the bottom is nowhere in sight.

The assertion that further declines in commercial real estate performance are likely, with significant value losses, is based on several considerations. First, although some of the more progressive institutional players may have aggressively marked properties to market, such declines in value were based on transactional evidence. This is important since some argue that institutional values lag the market due to an appraisal smoothing process that prolongs adjustments that occur on both the upside and downside of a cycle. To some extent, the erosion in net operating income associated with a softening economy, and a moderate rise in yield requirements, might have supported such adjustments as the industry shifted toward a defensive stance. However, research into market conditions does not support the cumulative decline in value that has occurred in the NCREIF Index over the past two quarters, suggesting something more is going on behind the scenes. Since this scenario has not likely fully played out, other owners are going to find themselves pressured to catch up with recognition of unrealized losses as they did in the early 1990s.

Second, the transaction market has not yet seen the flood of distressed sales that are building up in the queue. Indeed, commercial transaction levels were abysmal during the first quarter, a situation similar to the early phases of the downturn in the early 1990s. This situation should change over the next six to nine months as reluctant owners (e.g., financial institutions with REO, and overleveraged owners) or agents (e.g., special servicers, workout specialists) are forced to liquidate real estate holdings. Given the sheer mass of such assets queued up for sale, it is likely that owners will have to make significant price concessions to move product. While the timing of this surge is uncertain, signs suggest that a wave of distressed assets is likely to hit during the second half of 2009.

Another part of the rationale behind the negative forecast is that many more commercial assets

are likely to fall into trouble beginning in 2010 as the first wave of short-term financings begin to roll over. Since these owners are motivated to sell, prices are likely to fall even more than normal, creating comparable sales that are likely to have a significant downward drag on values of nondistressed commercial property. Once this wave of distressed assets hits the market, sellers who have been holding on may move out of the denial stage (in which they believed that the price changes were temporary) and adopt lower list prices to help liquidate assets. When such transactions occur, mark-to-market values will be under added pressure to reflect the reality of the market. Indeed, given the disparity between current cap rates (which have moderately increased) and long-term averages, the overall value declines over the next six months should exceed recent levels. If the experience of the 1990s is any indication, the end result will be value losses that are much more dramatic than the 30% or so that has already been reflected in the NCREIF Index. Even more troubling is the fact that most commercial real estate is not held in mark-to-market accounts that have been subjected to periodic appraisals, suggesting the industry may be in for a major shock as the truth about current values gets factored into the broader market.

### **Construction Activity**

Given the economic environment, contracting demand, and tight credit, the contraction in the construction market is both understandable and welcomed. Although land and construction costs are declining, the absence of activity means that fewer players are in a position to enjoy such benefits.

Those projects that are currently under construction or in advanced stages of predevelopment are unlikely to benefit from any decline in costs. More troubling, some of those projects were underwritten, bid upon, and priced under entirely different assumptions than are likely to be applied to the next wave of construction. As such, new product hitting the market at the end of this wave may have a cost basis that is unrealistic compared to the current market as well as future product, which will be underwritten with more realistic assumptions and underlying cost structures. Also of concern is the renewed interest in green buildings and sustainability, which may make some of the current generation of new product functionally obsolescent as the market pauses and the new LEED 2009 standard supplants

the standard under which these buildings have been constructed.

Over the near term, residential and commercial construction levels are expected to be moderate, with no private property sectors taking a lead position. Due to tightened credit and pressure on bottom lines, renovation and rehab work is also likely to be constrained. While the public side of the market had been seen as a fallback position, the dire condition of most state and local budgets suggests otherwise. Indeed, many public projects that were in the pipeline have been placed on hold, while others are facing significant budget cutbacks. Thus, on the public side, construction activity levels will depend on how much economic support can be carved out of the stimulus packages to support infrastructure and public construction. While the initial wave of such funds is likely to go to shovel-ready projects that can have an immediate impact, such projects have not been prioritized with an eye toward the economic multiplier effects they may encompass. It is likely that the second wave of projects that benefit from stimulus funds will have a higher payback in terms of enduring economic stimulus. However, many public/private infrastructure projects that were on the drawing board, both here and abroad, are likely to be shelved without targeted financial support.

### **Private Equity Market**

Over the past six months, the private equity market has undergone a significant wave of contraction, with many players moving to the sidelines as concern over the expanding recession and rising cap rates hanging over the industry. This situation is understandable in light of the near-term record losses reported in the NCREIF Property Index for the 2008 fourth quarter. Although these losses trailed those reported for many higher-risk opportunity funds, they were somewhat surprising since many thought core assets would be able to avoid a major downturn.

When the preliminary 2009 first quarter numbers were reported, the quarterly value losses accelerated even more, bringing value losses over the past two quarters to a staggering 50% of value for mark-to-market assets. While some welcome the price correction, many private investors expect more losses as cap rates are still below historical levels and economic contraction is eroding net incomes.

Going forward, the private equity market is expected to languish, with owners who are not facing

refinancing pressure holding on to existing assets, and buyers waiting for sellers to reduce asking prices to reflect current market conditions. Despite rising interest from domestic and foreign investors seeking to take advantage of distressed sales, the level of transactions is likely to remain tepid over the near term. Cap rates are expected to increase even further as investors seek higher returns than have been available over the past several years, with further value losses on the horizon.

This slowdown is likely to place additional downward pressure on holders of distressed assets, setting the stage for a spurt in activity when the market does kick in. However, this increase in transactions will drag through the second half of 2009 and into next year unless some unexpected catalyst sets the ball in motion. In the meantime, the private market will be held in abeyance, making it difficult to accurately value assets and adding to the uncertainty that is keeping many players out of the action.

### **Public Equity Market**

The public REIT market is under pressures similar to those in the private market. However, greater transparency and liquidity have contributed to a more volatile experience for REIT shareholders, as investors have reacted quickly to signals of the impending erosion in real estate market fundamentals.

Through the end of the first quarter, the FTSE NAREIT Equity REIT Index came in at a disappointing -32% return, although dividend yields were relatively high at 9%. The negative returns were fairly widespread and surprisingly comparable with few exceptions. The good news for the industry is that REITs have been able to raise much-needed capital through new equity offerings. The list of companies that have been able to raise equity is representative of the larger industry, including such names as AMB Property, Kimco Realty, Simon Property, Corporate Office Properties, and Alexandria Real Estate Equities. Although these offerings have been at prices that are not as attractive as in the past and will be dilutive, they offer some hope that companies will be able to access sufficient capital to carry them through the challenges ahead.

The biggest news on the REIT front is the recent Chapter 11 bankruptcy filing by General Growth Properties, Inc. (GGP), the second largest mall operator in the United States with some 200 regional

## “The CMBS industry has evaporated.”

shopping centers. In addition to its sheer size, the bankruptcy is unusual in its complexity, which involves a web of cross-collateralized properties, many of which are operating well in spite of the economic downturn and tepid retail sales. The plight of GGP has been in the news for some time, with problems stemming from its buying spree and reliance on short-term debt rather than retail fundamentals. The company delayed the inevitable as long as it could, but the patience of creditors wore thin as the commercial real estate market deteriorated, with retail properties leading the downward spiral. While it is too soon to determine what impact the filing will have on the broader industry, it is likely that some top-tier malls will be placed on the market to raise capital and help the reorganized company emerge from bankruptcy. Despite the high quality of assets held by GGP that could be placed on the market, the capital intensive nature of regional malls and the need for experienced management makes the list of potential buyers rather narrow. This caveat is especially important as many of GGP's fellow mall REITs are struggling with their own challenges related to financing, tenant bankruptcies, store closings, rising cap rates, and sagging share prices.

While the GGP story will remain the big news for REITs during much of the year, its plight is not isolated, with other REITs scheduled to face refinancing challenges as short-term debt rolls. Investors are likely to pay close attention to underlying real estate conditions as well as to the ability of individual REITs to navigate through the troubled waters.

### **Commercial Mortgage Market**

In many respects, the commercial mortgage market echoes the equity side of the market, with the exception of the public side. Unlike public equities, the CMBS market is in almost complete shutdown in terms of new activity. For all practical purposes, the CMBS industry has evaporated from the scene, although attention remains focused on rising delinquency rates and an impending surge of refinancing. Rating agencies continue to pay close attention to the erosion in real estate fundamentals, with downgrades dominating the scene. This situation is

likely to continue in the near term while the industry struggles to find solutions and to address the lack of demand for new product.

Given the important role CMBS have come to play in the capitalization of the commercial real estate, it is likely the industry will be in for a wave of reforms and changes. It must transform itself to deal with pent-up problems in its own portfolios, as well as to help lead the commercial industry out of the doldrums as it did in the 1990s when it was created. However, at this point it is unclear as to how a CMBS-like industry will reemerge, which is creating much angst among borrowers and investors holding securitized paper with no clear exit strategy in mind.

On the private side of the mortgage market, activity has slowed considerably, with lenders that have cash in the driver's seat. While the private debt market has not shut down as much as the equity side, borrowers are finding it more challenging to finance properties than before. Lenders that have capital to deploy are tightening up underwriting standards, requiring more equity investment, and looking for recourse debt.

The continued erosion of real estate fundamentals, rising cap rates, and repricing of commercial investments will make lenders even more conservative going forward. Solid investments held by borrowers with impeccable track records and strong balance sheets are likely to find financing, but there are no obvious sources of capital on the private—or public—side of the market to meet the demand for refinancing that is likely to explode over the next several years. Similarly, when the first real wave of distressed commercial assets hits the street, buyers will be hard-pressed to find third-party financing and will rely heavily on seller financing, outright equity, and structured financing, which includes equity-like provisions that will give lenders some opportunity to participate in the recovery of the market. However, until the market begins to think about recovery, it will remain in a defensive mode with further erosion of collateral values and a shortage of mortgage debt.

### **Conclusion**

Over the past six months, the commercial real estate industry has entered a downward spiral. The seeds for this contraction can be traced to the same excesses that fueled the residential market collapse,

including access to easy and cheap credit. While the residential market struggles for a turnaround, the commercial market is somewhat behind and its downward trend may drag on for some time.

Despite the efforts of the Obama Administration and various government agencies to stimulate the economy, much of the efforts have been cannibalized by the need to forestall a complete meltdown of the credit markets and financial industry. Other industries have entered the fray; they are also in need of handouts and are on the bubble. Thus, rather than posturing for a turnaround in the economy, a more reasonable metric is to prevent further erosion and find a bottom.

In the current environment, companies are continuing to cut back on employment, close surplus facilities, thin inventories, and freeze business investment. This contraction has started to ripple over to the commercial market, placing downward pressure on rents and raising vacancy rates. These forces are rather widespread, affecting most property types and markets. At the same time, investors are paying more attention to risk, driving cap rates up and values down.

To this point, institutional investors have begun to do their part by acknowledging the changes and writing down assets in mark-to-market accounts. In terms of transactions, the equity market has all but shut down, with sellers hanging on to unrealistic expectations and buyers waiting for the other shoe to drop. The bid-ask spread has started to narrow, although this convergence may be delayed as erosion in values begins to accelerate. Buyers remain focused on the distressed assets that are building up in the queue.

Capital is also building up, ready to jump into the fray, but there are few signs of the explosion in transactions that many are hoping to exploit. That is, much of the capital that has been raised is in the hands of market timers, who depend on a lack of competition to allow them to scoop up out-of-

favor asset classes and benefit from a curing of the situation rather than from an understanding of the underlying fundamentals. Although commercial values have declined, the industry is nowhere near the level of distress that will allow such no-brainer strategies to be successful. Also waiting in the wings is opportunistic money that has been raised by real estate professionals who have the acumen and infrastructure to exploit a market correction once there are better signs that the market has bottomed out. Thus, the near-term outlook for the industry is guarded, with more downside risk than upside potential. Many observers will be better served by recalling history and prior bust-boom periods than the rhetoric that will undoubtedly occur as players posture for the next phase of the current cycle.

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