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The Impending Revolution in Real Estate: The New Rules of Engagement

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This is a presentation to the Burns Society sponsored by the Franklin L. Burns School of Real Estate and Construction Management made by Jim DeLisle, the 2010 designated Burns Visiting Scholar and the Runstad Professor of Real Estate and Director of Graduate Real Estate Studies at the University of Washington. The thirty minute presentation draws on a brief discussion of the economy, capital and real estate markets. Based on this background, we explore the fundamental questions of “Where We Are”, “How We Got Here,” and “Where We’re Going.” As noted in the title, the underlying premise is that we are undergoing a revolution in real estate practice and education; one that will be characterized as a return to fundamentals. The final topic highlights the 10 trends that will occur as a result of this “revolution,” as well as the impacts they will have on the industry as well as the academic community as it struggles to rise to the challenge. For a more detailed discussion of the macroeconomic environment, capital markets, and real estate fundamentals, please refer to the presentation made at the Burns Coffee on April 18, 2010.

Presentation Overview

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- I: Where We Are
- II: How We Got Here
- III: Where We’re Going

Hyperlinked Table of Contents to Presentation

- Overview 1
 - The Three Major Attributes of Real Estate 1
- Part I: Economic Environment for Real Estate 1
 - Economic Outlook..... 1
 - Economic Snapshot 2
 - Business Indicators..... 2
 - The Global Recovery..... 3
- Part I B: Where We’re at in the Capital Markets 4
 - Capital Market Overview 4
 - Trends in Capital Flows 5
 - Commercial Real Estate Performance..... 5
- Part I C: Where We’re at on Fundamentals..... 7
 - Spatial Fundamentals Overview..... 7
 - National Commercial Market Conditions 7
 - Trends in Cap Rates and Transactions 8
 - Troubled Assets..... 9
 - Denver Transaction Volume and Pricing 9
 - Two-Tiered Pricing System..... 10
- Part II: How we Got Here..... 10
 - Overview 10
 - The Three-C’s of Our Disconnect 11
 - Institutional Real Estate Turbulence 11
 - Disconnection of Capital and Spatial Markets 13
 - Commoditized Pricing: Market Compression 13
 - Commoditized Pricing: Property Type Compression..... 14
 - Mission Drift: Core to Opportunistic Strategies..... 14
- Part III: Where We’re Going..... 15
 - Overview: Themes of our Times..... 15
 - Trend 1: Spatial and Capital Market Reconnect..... 16
 - Trend 2: Distressed Asset Turbulence..... 16
 - T3: Distressed Asset Spillover 17

T4: Foreign Capital Flows to Real Estate	18
T5: Changing of the Guard.....	19
T6: Asset/Fund Transfers & Shifting Preferences.....	19
T7: Relationship Shifts.....	20
T8: Increasing Government Intervention	21
T9: Renewed Search for Next CMBS Sector.....	21
T10: More Time for Reflecting on the Revolution	22

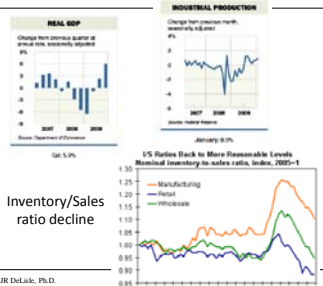
Economic Snapshot

The economic snapshot contains a number of positive indicators, although not all are pointing up. Real GDP was strong at year-end, although the rate has flattened out a bit and is expected to be in the 2-3% range during 2010. The inventory buildup in 2009 has been burned off which might create added stimulus to production. Interest rates remain low by historical standards, with the Fed pledging to hold them down as long as possible. The employment front remains a problem, with no signs of a quick turnaround. The plight of the unemployed benefited from extension of the emergency funding for longer term benefits although this issue will continue to resurface in the face of tempered job growth and a soft labor market. Inflation has not been a major concern although there are some signs that prices may start rising, especially with the impact of the weak dollar on imports and a strengthening global economy which the US is likely to lag.

Economic Snapshot

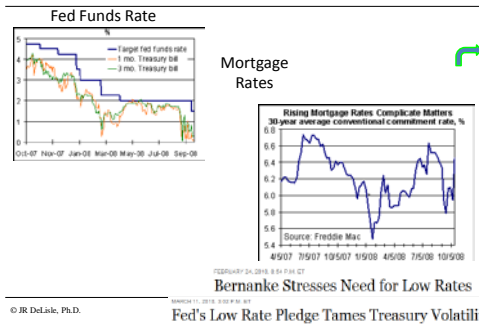
Economic Indicators

Economic Indicators: Showing Improvement



Interest Rates

Interest Rates, Mortgage Rates & Spreads



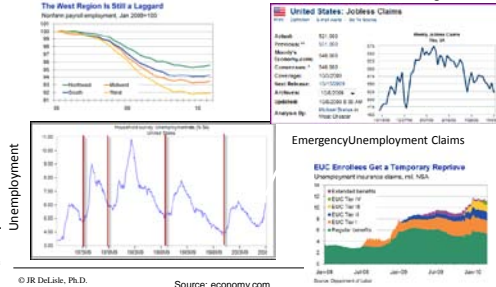
Inflation & Prices

Employment & Unemployment

Good News in 2010: Employment Losses Slowing

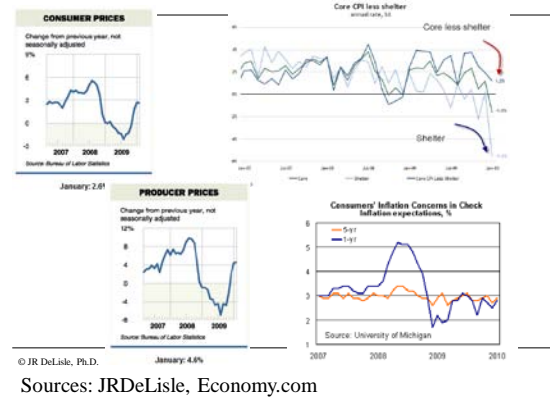
Moderate Net Employment Gains

Jobless Claims Slowing?



Inflation and Prices

Seasonably Adjusted CPI



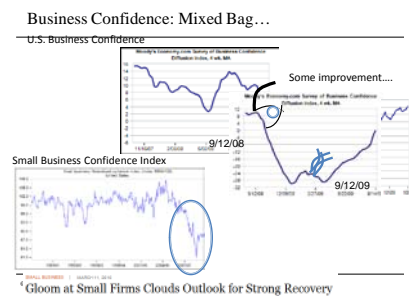
Business Indicators

The recent recession and the slow, somewhat uncertain recovery, has created significant angst among business leaders and consumers. The recent improvement in economic indicators has led to improved business confidence levels overall, although small business confidence remains clouded keeping small business owners on the defensive. Consumer confidence levels have trended upward moderately although the weak employment picture and concerns about the troubled housing market and the broader economy has

made for a choppy ride with confidence levels slipping moderately in April. This pattern is expected to continue until employment and earnings prospects improve. A number of observers have argued that the housing crisis is behind us and that the market has bottomed out. While declining house prices have indeed tapered off, rising to vacancy rates in the prospects for even more foreclosures hangs over the sector. The withdrawal of government support in the form of purchases of mortgage-backed securities as well as expiration of the temporary housing tax credit programs will put additional downward risk on the housing sector.

Business Indicators

Business Confidence

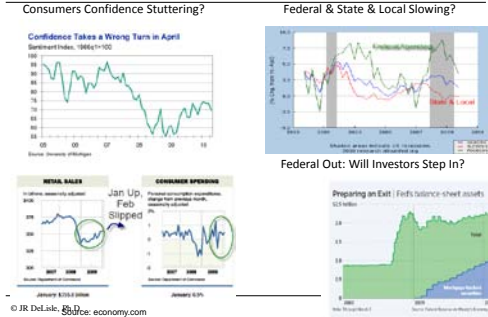


Stock Market



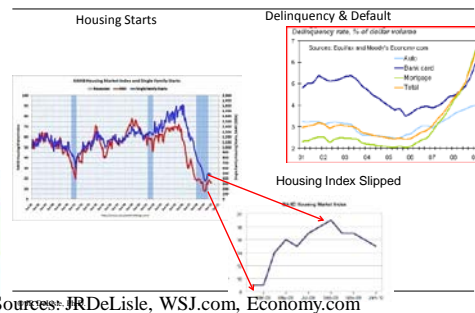
Consumer Confidence & Retail Sales

Consumers Back in the Game? Government Out?



Housing Market Indicators

Housing Market Indicators: Transition?

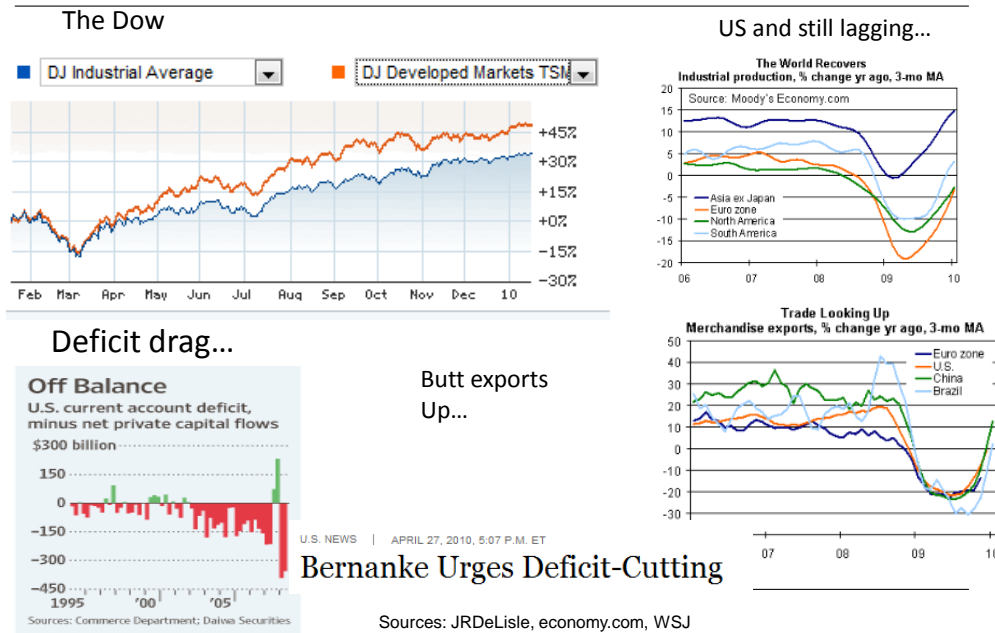


The Global Recovery

The improvement in the US stock market has received widespread attention and is welcomed news to many observers. While the recovery in the stock market has been positive, it is important to note that it lags its global counterparts. Indeed, the recovery in North America in terms of industrial production trails the exuberant growth in Asia and South America and is on par with more tempered recovery in the euro zone.

On a positive note, exports have turned up and are ahead of the euro zone, although still lagging Asia and other emerging markets. The deficit remains a concern, especially with exports languishing in spite of the cheap dollar and our dependence on foreign purchases of US securities.

US vs. Global Economies



Part I B: Where We're at in the Capital Markets

Capital Market Overview

As with the broader economy, real estate capital markets are at a critical stage of the cycle. While much has been said about the significant pool of capital that has been raised to take advantage of the troubled real estate market, the reality

is much that capital continues to sit on the sidelines. Since any of the stewards of the capital are new players and new organizations, there is much uncertainty surrounding the "rules of engagement" they will embrace when they make their move on the real estate market. In the meantime, cap rates continue to rise moving toward their historical averages which continues

Part I-B: Where We're At in Capital Markets

Capital Market Flash

- Tentative, waiting to pounce, new players & rules
- Rising Cap rates, declining values de-capitalizing
- Challenges re-levering; credit crunch for asset class

to downward pressure on values creating further de-capitalization real estate market. The industry will face significant challenges re-capitalizing the market especially with the credit crunch hanging over the asset class. Looking at both the economic and capital markets, there are a number of danger signals for commercial real estate. For the first time in years, capital flows may actually decline as assets are repriced and owners forced to come up with more equity at higher yields that are commensurate with the attendant risk. The prospects of a deep and prolonged recession create significant downside risk that has yet been priced into the market.

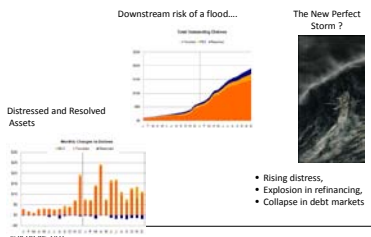
Trends in Capital Flows

The real estate capital markets are in the middle of significant turmoil which may turn into a tsunami of unprecedented proportions. Distress assets continue to build at a dramatic pace, while workouts have lagged. The CMBS industry has collapsed and continues in that moribund state although some deals are being done. Life insurance companies have stepped up lending activity but nowhere near the volume needed to recapitalize the impending surge in refinancing activity. In the face of this turmoil, capital deployment (vs. build-up) will be down for 2010 and into 2011 before the rookies get into the game. Unfortunately, “rookie” mistakes will be costly and may exacerbate and already difficult position.

A Snapshot on Capital Market Indicators

Capital Market Clouds: Distressed

Capital Market Clouds: Distressed Assets



CMBS on it's Knees

CMBS Delinquency Rates by Property Type



Capital Flows Slipping: Sideline Game

Trends in Capital Flows

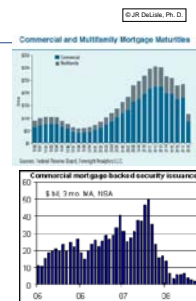


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Impending Mortgage Crisis

Commercial Mortgage Capital

- Tightened Credit
 - DCRs: pressure on income
 - LVs: Reduced; equity risk exposures
 - Risk Rebirth: recourse debt
- Outlook
 - Impending Crisis
 - Flight to quality
 - Tighter; increased equity and recourse
 - Meaner; more aggressive foreclosures
- Opportunities
 - Selective, lower risk, seasoned assets
 - Creative financing: convertible debt



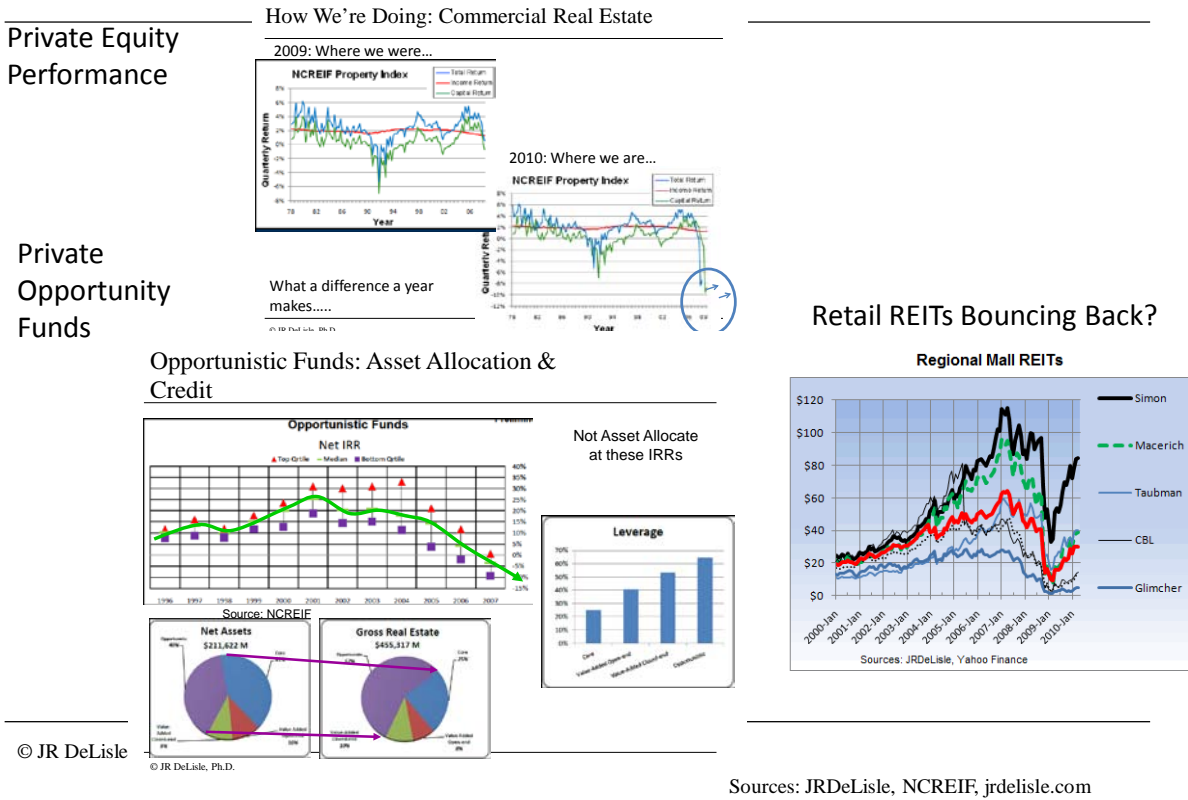
Sources: JRDeLisle, WSJ.com, RCAnalytics, com, Economy.com

Commercial Real Estate Performance

The private commercial real estate market –as measured by the NCREIF Open-end, Commingled Equity Fund Index– has plummeted since its peak in 2008, falling some 38% in value. The speed and depth of this decline is unprecedented, exceeding that of the latter 80s and early 90s which lead to the previous

“revolution” in commercial real estate which led to securitization of the debt (CMBS) and equity (REIT) sectors. In addition to the classic NCREIF Index which is largely core, private opportunity and value-add funds have had a very difficult time, falling even more dramatically in value. As noted in the graph, the speed of the collapse in commercial values was unprecedented. Since we are facing a tempered economic recovery, it is likely the recovery will be choppy as it was in the early 90s and prolonged, dragging on for 5-6 years.

Commercial Real Estate Performance



Interestingly, REITs have bounced back in 2009, with the momentum carrying share prices upward for more than six months. The growing spread between the private and public markets is interesting and bears watching. In some respects, it suggests that optimism is growing and that investors believe the market has turned the corner. On the other hand, it may suggest that disconnect between the spatial and capital markets continues, and that the “revolution” which would bind them forever has yet to sink in. The reality is likely a combination of the two, with investors noting that REITs are well positioned to take advantage of distressed asset sales as they did in the 90s. On the other hand, their performance has been dragged down somewhat by the deterioration in spatial fundamentals which has forced them to shore up their own portfolios and focus effort on asset management, tenant retention and cash solvency.

Part I C: Where We're at on Fundamentals

Spatial Fundamentals Overview

In looking at the snapshot of the spatial market --supply and demand for real estate-- the bottom line echoes that of the broader economy and capital markets. That is, there is some additional downside risk associated with a combination of a slowing economy, tighter credit, a renewed interest in risk, and weakening fundamentals.

That situation should prevail over the near-intermediate term, with commercial real estate lagging the broader economic recovery which is well into 2011 at best. These will be interesting and challenging times with some opportunities for those willing and able to take advantage of the market malaise and lack of capital.

National Commercial Market Conditions

The commercial real estate market fundamentals are deteriorating across-the-board with rising vacancy rates and falling rents dominating the news. On the other hand, development activity has plummeted with the exception of projects in the pipeline. In some markets, developers have been forced to abandon projects during construction while in others they have filled in holes in anticipation of a long hiatus. This situation is expected to continue with further erosion in market fundamentals limited additions to supply.

That situation should prevail over the near-intermediate term, with commercial real estate lagging the broader economic recovery which is well into 2011 at best. These will be interesting and challenging times with some opportunities for those willing and able to take advantage of the market malaise and lack of capital.

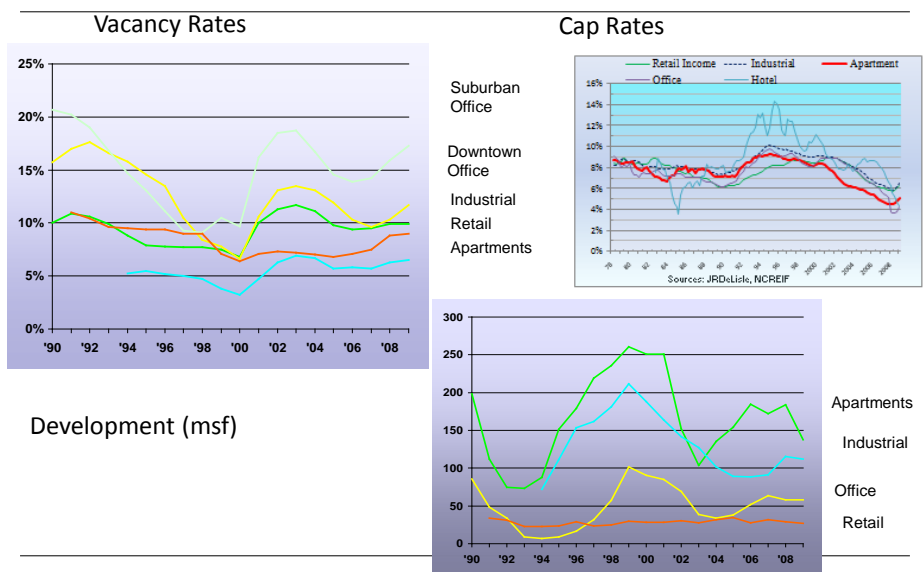
Part I-C: Where We're (Fundamentals) At

Spatial Market Flash

- Still weakening, negative absorption; more downside risk
- Vacancy rates pushing records, rents declining
- Negative absorption, lagged recovery

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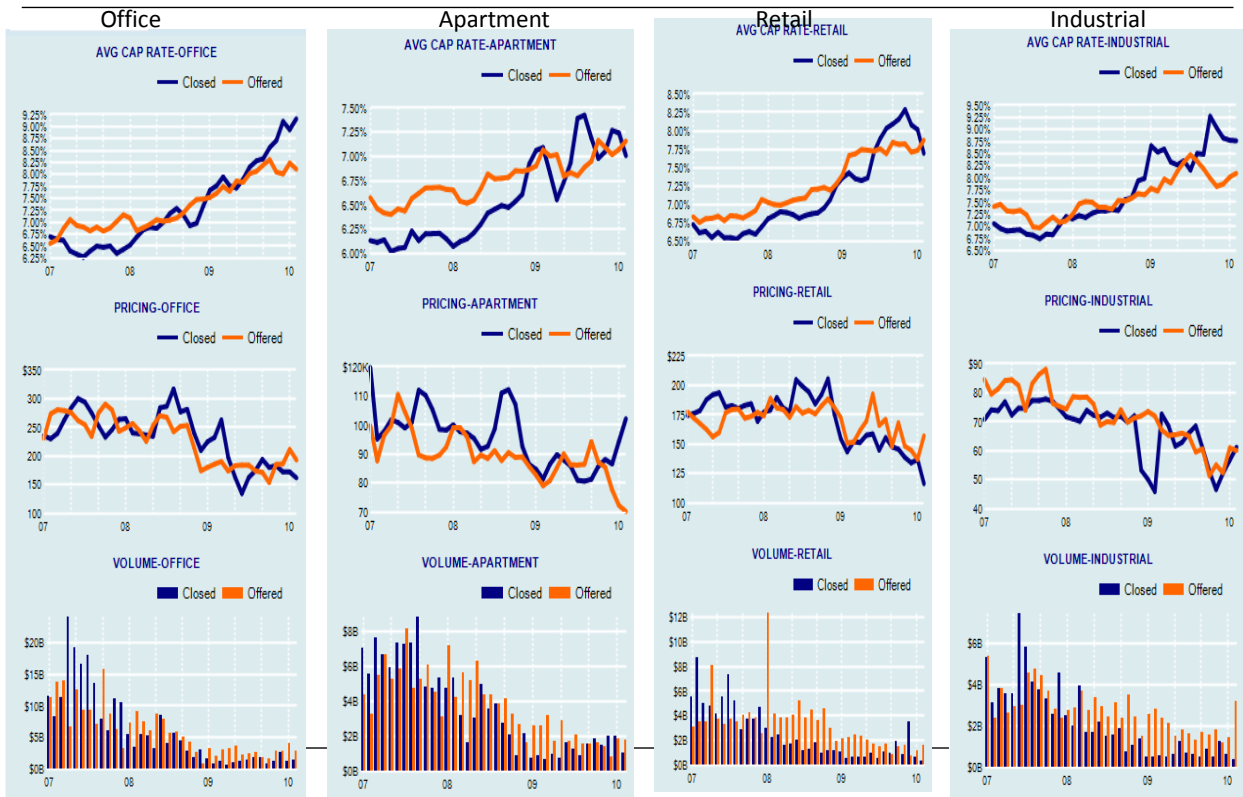
National Commercial Market Trends



Trends in Cap Rates and Transactions

The deterioration in real estate fundamentals across the major food groups, has led to a consistent increase in cap rates for closed transactions. The flight to quality and competitive atmosphere surrounding the good projects have come to market have led to a convergence between bid and ask spreads. This situation is likely to change on the flood of distressed assets of the market and attention shifts to risks inherent in such investments. The pricing of assets that have sold has also trended downward, although not as much as cap rates have risen. This anomaly has been due to the higher quality of assets that have actually closed as well as a limited transaction volume in the face of significant capital chasing scarce deals.

Trends in Cap Rates, Pricing and Transactions

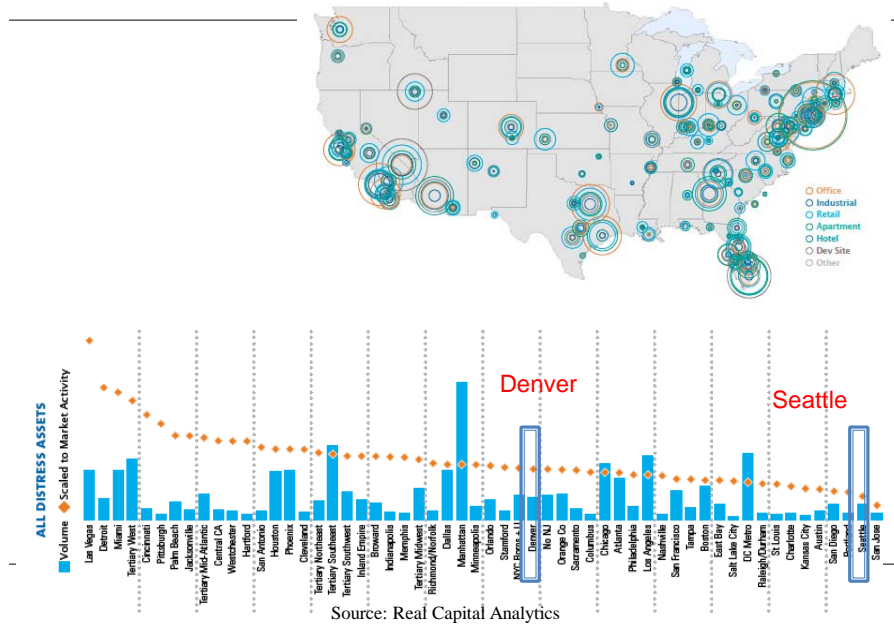


Source: Real Capital Analytics

Troubled Assets

The troubled asset radar map generated by Real Capital Analytics indicates the widespread nature of distress in the commercial real estate market. As noted, few major markets have escaped the downturn which has affected almost all property sectors. Denver and Seattle have both experienced an increase in distressed assets with more on the horizon. While creating much consternation for troubled owners, the level of distress in these markets is relatively low especially on a scaled to market basis.

Troubled Asset Radar: US, Denver & Seattle



Denver Transaction Volume and Pricing

Denver Transaction Volume

	Office Market Data				Closed Transactions				Offered Properties			
	In USD mil.; Oct '09 thru Feb '10				\$ Vol	# Props	Avg PPU	Cap Rate	\$ Vol	# Props	Avg PPU	Cap Rate
Office	Southwest											
	Austin	\$95	3	\$174		\$52	5	\$119				
	Dallas	\$201	15	\$84		\$510	20	\$136	7.35%			
	Denver	\$141	8	\$148	8.55%	\$229	11	\$157	8.72%			
	Houston	\$542	10	\$204		\$133	13	\$103	8.79%			
	Phoenix	\$70	9	\$116	10.50%	\$235	20	\$188	9.40%			
Apartment	San Antonio					\$66	7	\$104	9.46%			
	Tertiary Southwest	\$136	20	\$98	8.80%	\$211	20	\$112	7.60%			
	Total	\$1,185	65	\$158	9.28%	\$1,436	96	\$136	8.58%			
	Denver	\$194	7	\$104,076	6.60%	\$13	1	\$43,333				
	Houston	\$409	25	\$60,950	9.00%	\$536	39	\$42,244	8.28%			
	Phoenix	\$360	24	\$69,053	7.09%	\$325	22	\$50,859	6.31%			
Retail	San Antonio	\$113	7	\$71,994		\$60	6	\$36,357	6.58%			
	Tertiary Southwest	\$126	10	\$53,057	8.09%	\$321	36	\$40,737	8.63%			
	Total	\$1,531	95	\$70,508	7.27%	\$1,668	142	\$43,343	7.86%			
	Denver	\$168	8	\$147		\$188	9	\$287	7.69%			
	Houston	\$151	8	\$30	9.46%	\$187	23	\$80	8.00%			
	Phoenix	\$180	15	\$143	9.44%	\$173	16	\$276	8.53%			
Industrial	San Antonio	\$17	1			\$68	9	\$137	7.79%			
	Tertiary Southwest	\$119	9	\$98		\$174	23	\$128	8.29%			
	Total	\$854	50	\$100	9.45%	\$1,080	101	\$128	8.23%			
	Denver	\$98	11	\$67	9.46%	\$94	11	\$64	8.29%			
	Houston	\$38	4	\$67	9.40%	\$83	10	\$82	7.96%			
	Phoenix	\$145	12	\$50	8.75%	\$196	21	\$88	8.36%			
Southwest												
San Antonio	\$20	1			\$84	4	\$42	9.07%				
Tertiary Southwest	\$58	5	\$33		\$184	22	\$42	8.97%				
Total	\$425	40	\$51	9.15%	\$913	88	\$59	8.85%				

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Source: Real Capital Analytics

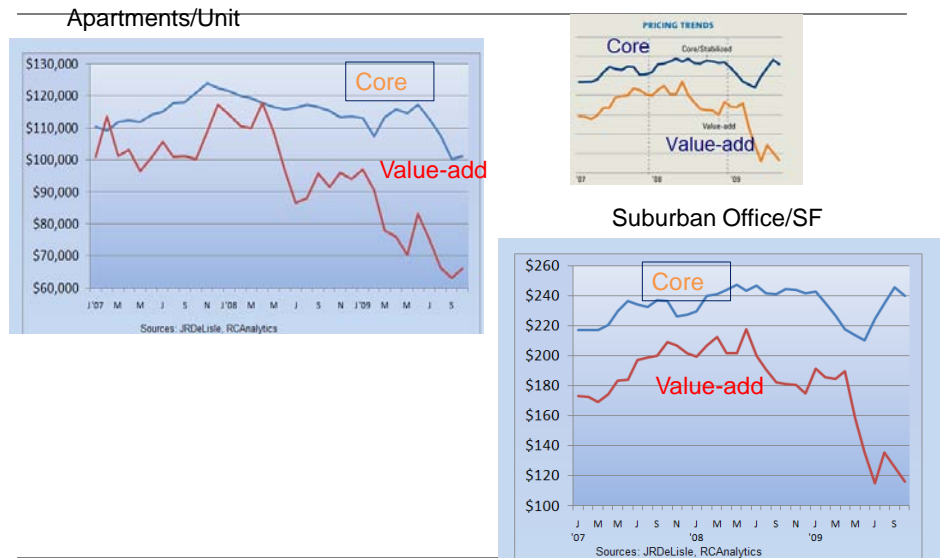
average of 6.6%. Eight retail properties were sold for total hundred 68 million followed by 11 industrial properties and \$98 million and 9.46% cap rate.

Although transaction time is down across-the-board, Denver and other major markets in the southwest have seen some sales activity. in the four months through February 2000 1040 1 million of the 229 million in office properties placed on the market sold an average 8.55% cap rate. The volume was higher with apartments which traded an

Two-Tiered Pricing System

Although transaction levels have been relatively low, the transactions that have occurred reveal the emergence of a two-tiered pricing system in which core assets (e.g., proven assets, fully leased, solid cash flows) are trading at a much higher value than distressed assets. This situation is likely to hold, although the glut of distressed assets that will hit the market is likely to create some convergence as buyers find it difficult to identify core assets from the impending flood of listings.

Emergence of Two-Tiered Pricing System



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Source: Real Capital Analytics

Part II: How we Got Here

Overview

Looking at both the economic and capital markets, there are a number of danger signals for commercial real estate. For the first time in years, capital flows may actually decline as assets are repriced and owners forced to come up with more equity at higher yields that are commensurate with the attendant risk. The prospects of a deep and prolonged recession create significant downside risk that has yet been priced into the market. To get a better handle on the future, it is useful to spend some time exploring the dramatic if not traumatic events that got us to where we are today.

Part II: How We Got Here?

2010 Capital Market

- Tentative, waiting to pounce, new players & rules
- Rising Cap rates, declining values de-capitalizing
- Challenges re-levering; credit crunch for asset class

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The Three-C's of Our Disconnect


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The Three-C's of our Disconnect)

- Credit Crisis
 - Easy Credit
 - Cheap Credit
 - Plentiful Credit

- Crisis of Confidence
 - Consumer Confidence
 - Corporate Confidence

- Crisis of Collateral
 - Value attributable to delinking spatial market/cap
 - Values correction as “marked to market”
 - Re-pricing of Risk



We are facing an unprecedented confluence of seemingly independent, but related events. The problems began to surface in the residential credit markets. Once attention was drawn on festering problems in the residential market, some began to worry about whether this was a symptom of a broader problem. Those who began to explore how widespread the credit practices were in other sectors, realized that we had created a house of

cards. As attention turned to the broader economy, the credit crisis quickly turned into a crisis of confidence. The crisis of confidence was contagious, rippling across the consumer and corporate spectrum forcing many players to revisit expenditure patterns. Once confidence levels were eroded, the market faced the double-whammy of tightening or evaporating credit. This quickly translated to erosion in collateral values, leading to a self-fulfilling prophecy which became a black hole that started the implosion.

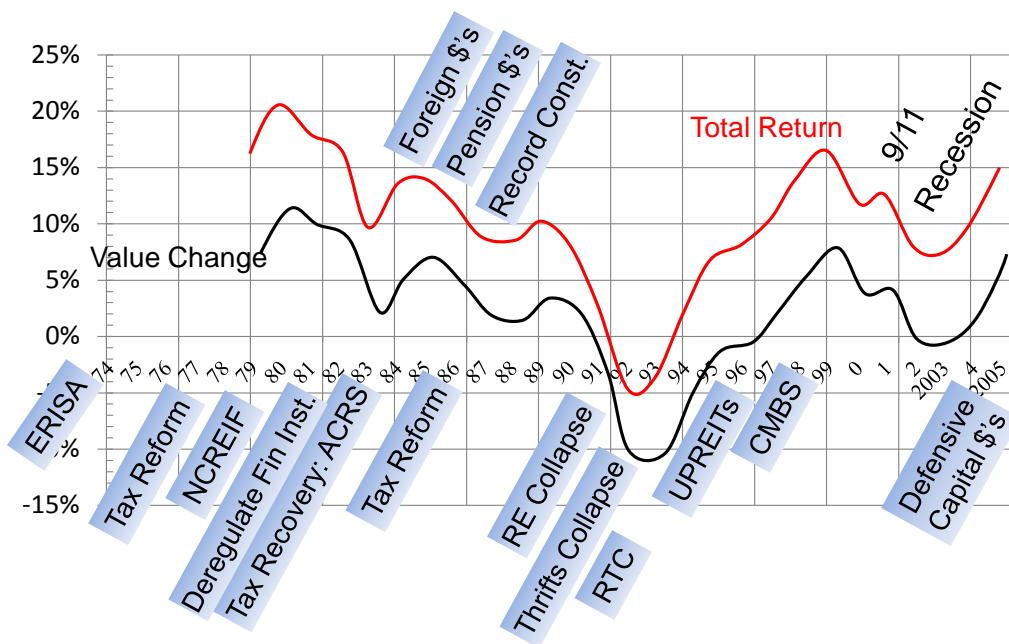
Institutional Real Estate Turbulence

In order to understand the impending crisis facing the commercial real estate industry is useful to take a historical look in to see if we can extract the lessons learned from the past. The seeds for institutional real estate investment were planted with the passage of ERISA in 1974. The most significant impact of the legislation was to raise the prudent man criterion to prudent expert criterion. Under the prudent man criterion, institutional investors to avoid real estate as a risk management tool based on its inherent complexity. However, under the prudent expert criterion, if real estate was an asset class, institutional investors and asset allocators were required to commit resources to achieve diversification. By 1978, institutional capital flows to real estate were still limited, due in large part to the absence of the return is series of asset allocators could use to understand how real estate with other asset classes. To address that need the real estate units of the major life insurance companies including Prudential, Aetna, Cigna and Equitable created the National Council of Real Estate Investment Fiduciaries (NCREIF). The objective of NCREIF was to create a time series for real estate returns that asset allocators could use along with stocks, bonds and other asset classes in making asset allocation decisions.

In 1981, financial institutions were deregulated and allowed to create development subsidiaries. In 1982 the Economic Tax Recovery Act (ERTA) creating double declining depreciation was passed. This attracted more capital for syndicators, who doubled up with foreign investors and pension funds to create a surge of capital to real estate. This created a disconnect between the spatial and capital markets. This led to overbuilding which ultimately led to the collapse of latter 80s. Other than disposing of troubled assets, the real estate market shut down. When the commercial real estate market collapsed, the RTC was created to work off that debt financial institutions. In 1994 faced with the prospect of filing bankruptcy, Taubman decided to file an IPO and convert to a REIT and was quickly joined by a spate of other owner/developers including Simon, DeBartolo, General Growth and a number of smaller players. Around the same time, while the RTC was wrapping up its business, Wall Street investment banks and others sought to convert the temporary securitization of commercial real estate to an ongoing activity. During the mid-to latter 90s REITs grew from under a \$10 billion industry to over \$200 billion, while CMBS volume rose from nothing to a similar market cap.

Institutional RE Investment Tubulence

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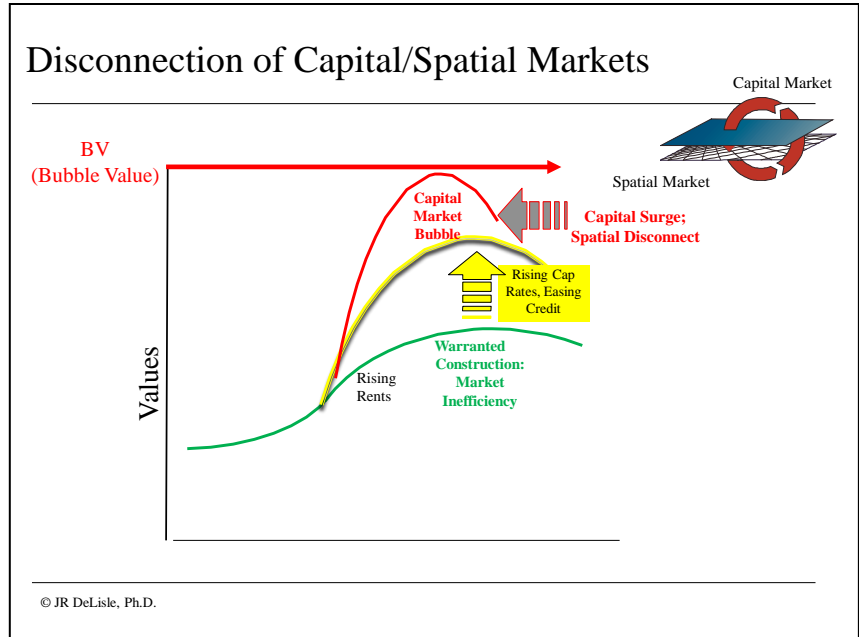


Our success in recapitalizing the real estate market was quickly adopted across the globe, setting the stage for the worldwide collapse of credit and real estate markets that is now occurring. In 2001, the 9/11 tragedy attracted investors to real assets are real estate --and other real assets-- were seen as defensive investments. Benefiting from an improving economy and the government's support of homeownership for all and complete trust in self-control by financial institutions, the housing market went on a bull run characterized by easy credit. Thus, both the commercial and residential markets became disconnected from the fundamentals (i.e., Wall Street vs. Main Street or Capital Markets vs. Spatial Markets). This disconnect led to the recent collapse since easy created permeated all asset classes and became an accepted mode of operation. Unfortunately, the problems in the commercial market have yet to be recognized with attention

being focused on the residential market and the broader credit markets. The disconnect that occurred on the commercial side that has yet to receive attention suggests hard times ahead.

Disconnection of Capital and Spatial Markets

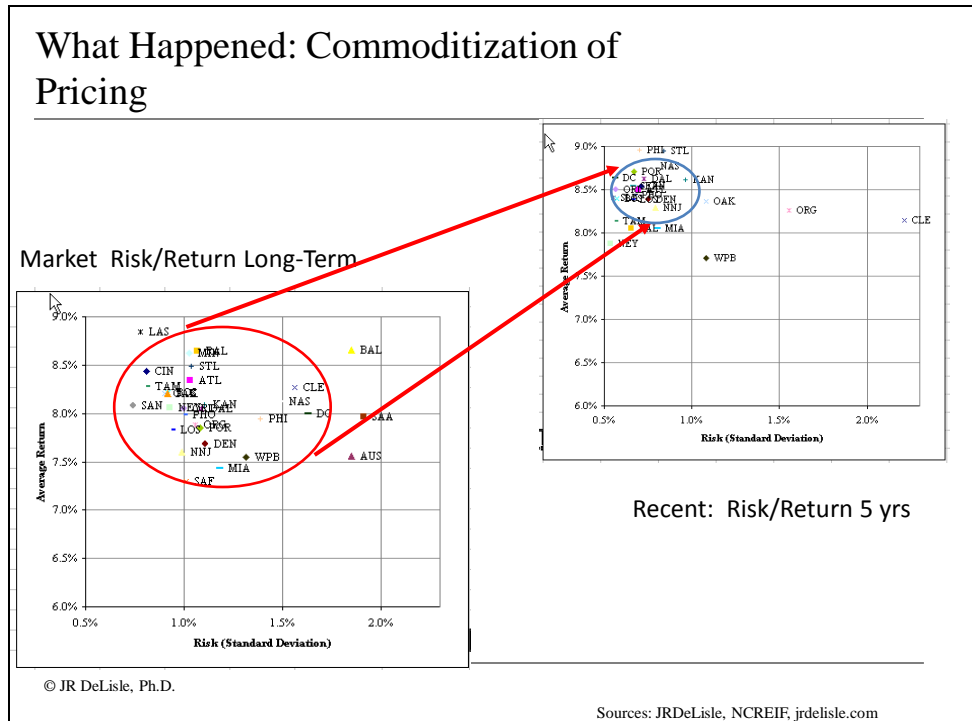
The real estate asset class is inherently cyclical, with periods of over and under building. This can be attributed to the lags in production, capital intensive nature, and typically large size of transactions. As such, developers tend to over-react to market conditions and lead to periods of overbuilding. On the other side of the cycle, after developers pull back, market conditions tighten up and drive rents up and vacancies down. The result is improved returns which depending on conditions



in the broader macroeconomic environment and performance of real estate relative to other asset classes can lead to a capital market surge. This situation was exacerbated by the absence of an appreciation of the importance of underlying real estate market fundamentals, with investors and lenders either ignoring the risk component or managing it by transferring it to other parties. This led to the peak of the commercial market in 2008 in which properties were traded at, and appraised at, bubble prices.

Commoditized Pricing: Market Compression

One of the “buy-products” of the disconnect between spatial and capital markets was the trend toward commoditized pricing. This term refers to the fact that investors --and indirect capital providers-- failed to price risk associated with property types and markets. As such, prices converged from historical levels. This is illustrated by comparing the long-term risk/return plots by



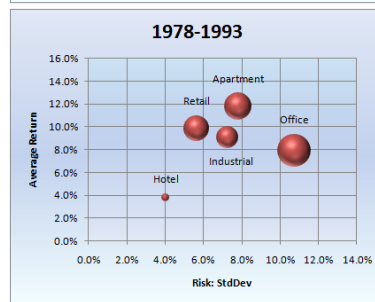
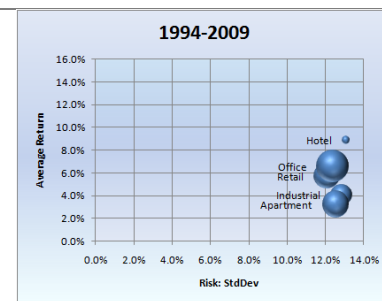
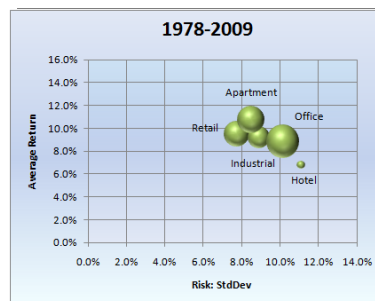
market with the more recent risk/return plots stemming back some 5 years. As noted, markets were drawn into a narrow band due in large part to surplus capital flows. Going forward, returns are expected to diverge or move to longer terms levels along with the attendant risk. Respondents to the survey were somewhat divided on the question of whether commoditized pricing is behind us, with a slight majority believing that fundamentals would once again prevail as investors focused on the risk side of the equation. If this occurs -- as I believe it will-- 2nd and 3rd tier markets with limited exit strategies will fact particular challenges, as will weaker product which in the recent past benefited from the rising tide of values. On the other hand, there will be opportunities for those who can pick and time markets --which is possible in real estate-- as well as those with an understanding of fundamentals and the ability to “Create value.”

Commoditized Pricing: Property Type Compression

As in the case of markets, the institutional real estate markets experienced significant commoditization across property types over the past decade. This is reflected in the shifts in the risk/return positioning of the office, retail, industrial, apartment and hotel sectors noted in this slide. Over the long term from 1978-2009, retail properties exhibited

the lowest risk (i.e., standard deviation), while hotels had the greatest. In the 15 year period from 1978-1993, hotels had the lowest risk, while office properties had the highest. Finally, during the past 15 years, property types converged around the same risk level, which was elevated from the initial period and exceeded the highest level experienced by office properties. Going forward, risk and return are expected to diverge, returning to longer term levels which will add more uncertainty to the asset class.

Institutional Property Type Commoditization



Type	1978-09		1978-93		1994-09		3Q 2009 Mkt Cap *
	Average	Std Dev	Average	Std Dev	Average	Std Dev	
Retail	9.5%	7.8%	9.8%	5.6%	12.1%	5.7%	\$ 54.13
Industrial	9.2%	8.9%	9.1%	7.3%	12.8%	4.1%	\$ 37.09
Apartment	10.7%	8.5%	11.8%	7.8%	12.5%	3.2%	\$ 59.10
Office	8.8%	10.2%	7.9%	10.7%	12.4%	6.6%	\$ 88.75
Hotel	6.8%	11.1%	3.8%	4.0%	13.1%	8.9%	\$ 4.76
Total							\$ 243.82

Sources: JRDeLisle, NCREIF * Market Cap in \$billions as of 3Q 2009

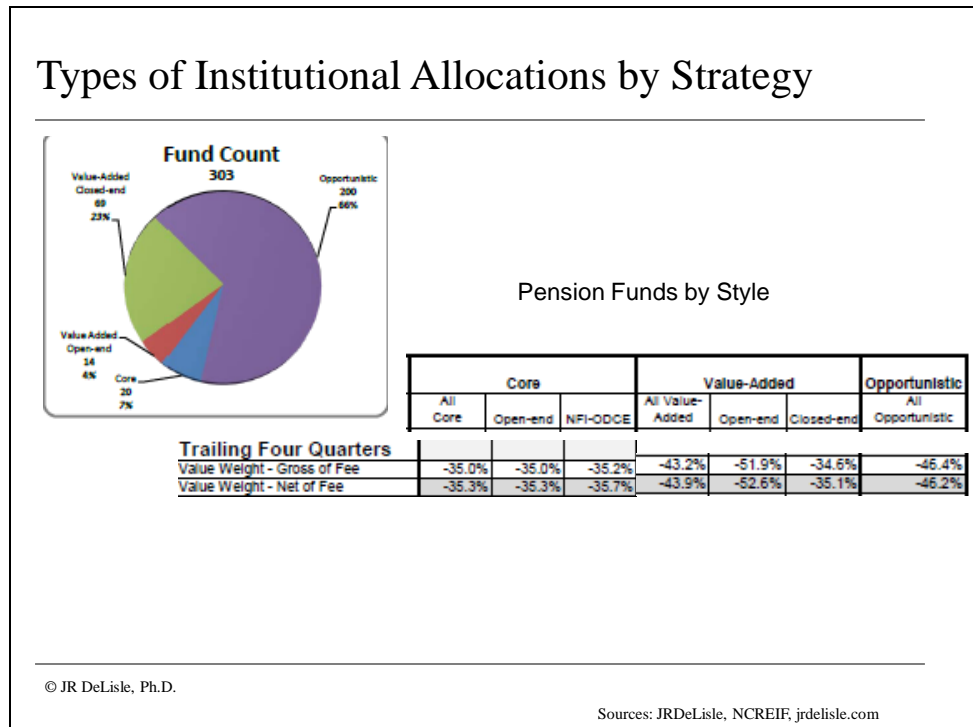
Bullet sizes reflect Market Cap

Sources: JRDeLisle.com, NCREIF

Mission Drift: Core to Opportunistic Strategies

During the 1980s, institutional investors favored core investments with little appetite for value-add or opportunistic investments. Indeed, those terms weren’t even coined until the mid-90s when advisors tried to differentiate themselves –all at the same time– and expanded their product lines to include higher return investments that could compete with Wall Street vulture funds which dominated the market in its early recovery phases. Over the past 10 years, this pattern was completely reversed, with value-add and opportunistic funds comprising over 90% of strategies for investors in the NCREIF universe. The collapse of the commercial market and the disappointing performance of higher risk funds has caused a reversal of fortunes, as punctuated by CALPERs which announced it is shifting back to a more traditional strategy after

racking up significant losses. Other pension funds are expected to continue this trend setting the stage for significant increase in asset takeovers and upward price pressure on “core” assets.



Part III: Where We’re Going

Overview: Themes of our Times

In this environment, many real estate professionals are faced with the prospects of laughing or crying. To lighten up the scene a bit, it’s useful to look at a couple of themes. The first is the play on the “Cash is King Theme.” While cash is important, in this stage of the cycle investors who are not wary are likely to be able to make \$10 million profits through no-brainer investing. While I don’t agree with late night television programs that it’s as easy as it sounds, it can be done assuming you start with \$20 million!!! With the impending flood of distressed assets and the surge of new, naïve players, the ability to close deals will be of paramount concern. Similarly, “caution” and realism will rule while curmudgeons like me will

Part III: Where We’re Going as signaled by the “Themes of our Times” © JR DeLisle, Ph. D.

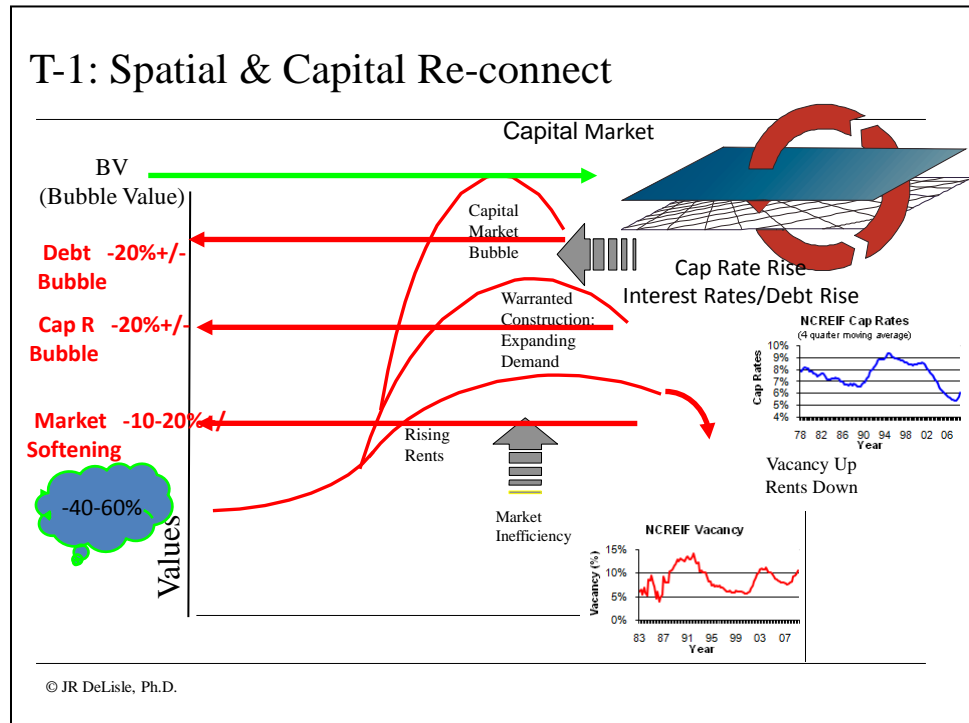
- **The C-Theme:**
 - C ??? is King....
 - Closing is King, or
 - Caution is King, or
 - Curmudgeons are King
- **The M-Theme:**
 - Show me the M ???
 - Show me the Manager, or
 - Show me the Management Plan, or
 - Show me the Manger (i.e., Divine Intervention)

spin tales and document lessons learned, both before and after they hit home.

The M-theme is a play on the Jerry Maguire theme, “Show me the Money.” Again, it points to the importance of fundamentals and the ability to develop and implement solid management plans that are spearheaded by experienced asset and property managers who are empowered to act. Absent that, it’s back to the manger and hope for “divine intervention” which I don’t see on the horizon....

Trend 1: Spatial and Capital Market Reconnect

As noted earlier, the unprecedented convergence of cyclical forces – exacerbated by easy, cheap, plentiful credit and a lack of focus on risk-- converged to create bubble pricing. Once the bubble burst and it became clear that values were unsustainable, values collapsed as capital



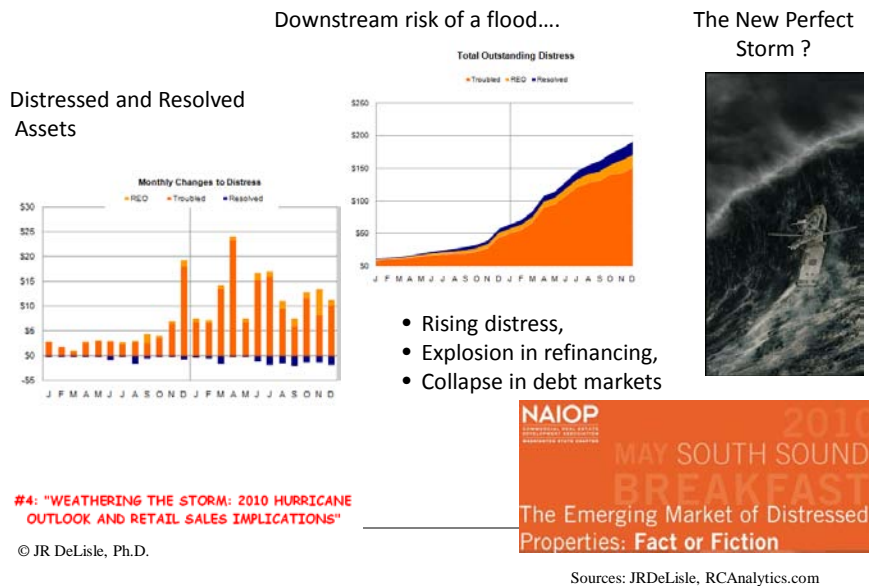
pulled back, cap rates rose and market conditions deteriorated. Drawing on my experiences in the 90s and what I have seen in terms of the spatial/capital divide, I believe institutional property in mark-to-market accounts may lose 40-60% of value before the cycle begins to turn. If so, we’re slightly more than half way there which suggests we are in for more difficult times ahead. Even then, the market will not get back to the bubble pricing, with recovery pushing some 80% of the old peak when the market fully recovers. Even then, pricing and values gains will depend on underlying market fundamentals, with emphasis on risk/return ratios and a general aversion to risk.

Trend 2: Distressed Asset Turbulence

While transaction volume in the commercial real estate market has been relatively slow, the surge in distressed assets suggests that situation will change over the next 12-15 months. When these assets hit the market and begin to clear, the market will be flooded with a tidal wave of potential deals. In terms of scale, as of April 2010, the pent-up supply of distressed assets approached \$300 billion. This figure understates the potential scope of the impending crisis. For example, it does not include performing mortgages in bank portfolios that are in danger of falling into distress as market conditions deteriorate. It also fails to recognize the downward pressure on values as the market tries to absorb distressed assets when they ultimately come to market. At some point, holders of distressed assets and special servicers will be forced to try to unload them,

regardless of underlying fundamentals. Unless there is some type of intervention, which doesn't appear likely, the situation will be reminiscent of a perfect storm.

T2: Distressed Asset Turbulence

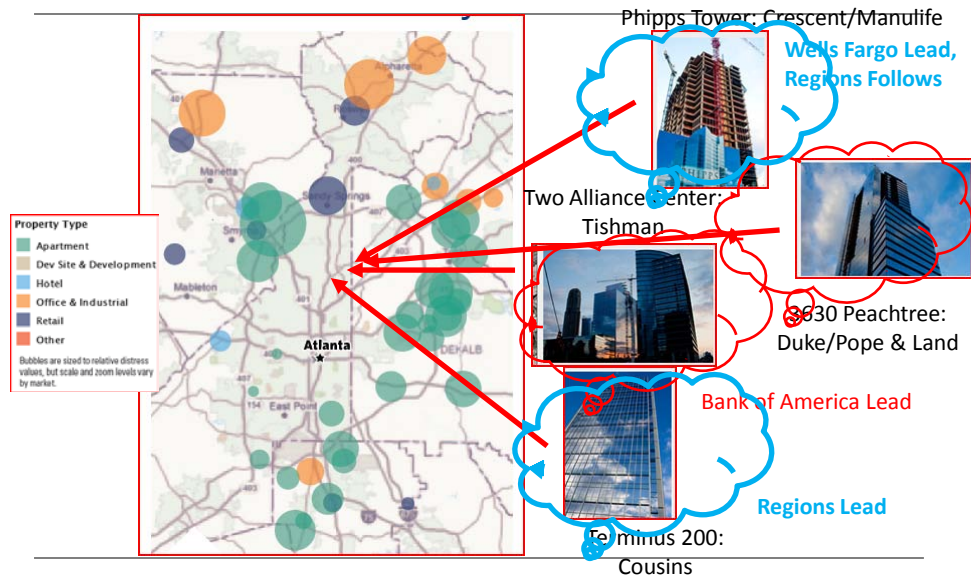


T3: Distressed Asset Spillover

Some owners of commercial real estate and some recent buyers who have been swooping up stronger assets take solace in the fact that their assets are performing well and have good fundamentals. While such assets will serve them well in the long run, it is important to recognize that the potential disposition of distressed assets at bargain

basement prices may create some spillover effects that drag down values of strong assets. For example, distressed buyers who are able to acquire assets for 40%-60% of “value,” will likely try to lure tenants to their buildings using their lower cost basis as a floor which would allow them to undercut rents. Even if owners can keep tenants in

T-3: Distressed Asset Spillover: Why it Matters



© JR DeLisle, Ph.D.

Sources: RCA, WSJ 4/21/2009

place, net market rents are likely to experience additional downward pressure, creating a further drag on appraised values. These effects will be especially pronounced in mark-to-market accounts which will be forced to document the extent of unrealized losses in their holdings. While this situation will tend to cure with the market, the interim effects will create additional turmoil in the already stressed market.

The potential for these spillover effects can be highlighted by exploring the distribution of “currently distressed” and “potentially distressed” assets in the Atlanta market. These troubled spots were then superimposed on a map indicating the imminent delivery of four major speculative buildings in Buckhead, one of the leading submarkets in Atlanta.

The slide also notes the “doubling down” of some of the major banks who have assumed significant risk exposures in concentrated areas. To the extent that distressed buyers are willing to discount rents to capture tenants, grab landlords should be on notice and paying much more attention to their existing tenants. Indeed some owners are renegotiate leases to try to extend the terms in return for a reduction in rents. The strategy may become more widespread but may also be delayed as tenants are developing a better understanding of the condition in Outlook for the commercial market.

T4: Foreign Capital Flows to Real Estate

The influx of foreign capital has been critical to the economy as declines in real estate values made such investments attractive, both in absolute and relative terms as the US lags the world in its recovery. While

foreign capital flows will be an important part of the re-capitalization, they will not help avoid the additional downturn on the horizon. That said, competition for managing foreign capital flows will be heated, making it difficult for potential investors to sift and winnow among the “compelling” stories that will be put together. Unfortunately, low barriers to entry in advising individual offshore investors will cloud the picture, placing capital in the hands of some who will lack the market connections, real estate acumen and experience necessary to target and then ultimately manage complex assets, many of which will need to be repositioned to create enduring value.

T-4: Foreign Capital Flows to US: 1Q 2010



Top Property Types

	Total Props	Total Volume (in mil)
Strip	847	\$18,613.5
Warehouse	785	\$8,486.5
Mall & Other	560	\$14,686
Garden	509	\$10,830.3
Office - Sub	498	\$17,782.5
Office - CBD	320	\$54,159.5
Limited Service	238	\$2,052.2
Full-Service	111	\$8,597.4
Mid/Highrise	103	\$3,685.8
Flex	100	\$2,317.4
Other	80	\$8,978.9
Total	4,151	\$150,189.9

Strategies for Winning Chinese Real Estate Investors:

What Developers, Owners, Fund Managers, and Professionals Need to Know

May 10 – 11, 2010, at Harvard Graduate School of Design

China Investment Corp Invests \$800 million in Morgan Stanley Real Estate Fund

Jin Jiang Hotels JV to Acquire Interstate Hotels and Resorts--\$307 Million Deal

China State Construction Corporation to Invest \$99 Million in Baha Mar Resorts; China Exim Bank in Negotiations to Provide \$1.9 Billion Construction Loan

Tax changes in US planned to ease financial burden on foreign commercial property investors

News - Latest
Written by Ray Clancy
Wednesday, 28 April 2010 12:00

The new bill also would treat the sale of stocks by foreigners of a REIT that is less than half foreign owned as a stock sale and not subject to US taxes.

The Real Estate Roundtable, an industry trade group, said it hopes the changes would lure about \$100 billion sitting on the sidelines back into the US commercial property market.

Sources: JRDeLisle, WSJ.com, RCAnalytics.com

T5: Changing of the Guard

One of the more difficult challenges for recent players in the market will be a changing of the guard. That is, the role of some of the more successful players over the past 5-10 years will likely change, with some stepping up their game and others reducing or leaving the playing field. For example, after a difficult 2008, REITs have been doing fairly well with a number of larger REITs raising some \$12 billion of capital in the first half of the year. The ability to raise capital for the otherwise distressed asset class is reminiscent of the mid-90s when REIT market cap surged from sub-\$10 billion to some \$200 billion. Offshore investors will also likely be active

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Last updated: April 28, 2010 09:51am

Caruso JV to Invest \$750M in Retail, Mixed

- REITs
 - Have reversed downward spiral
 - Significant new capital raised through Sept 2009
 - Low Dividends suggest accretive opportunities
- Global Investors
 - Western European
 - Middle East
 - Asia/Australia
- Domestic Funds
 - Positive denominator
 - Core vs. Opportunity Funds
 - New Value-Plus Funds

Dipping Back Into Real Estate
Pension funds and other big investors are opening the funding spigot to real estate private-equity again, but are focusing on less risky 'core' deals. Capital flows to real estate strategies:

Category	2009 Actual	2010 Projected
Private Equity (Valued-Added)	\$6.0 billion	\$6.0
Private Equity (Opportunistic)	6.0	7.0
Private Equity (Core/Core-Plus)	2.8	12.5
Other	3.2	8.8

Sources: Institutional Real Estate; Kingsley Associates

WSJ, April 27 2010

players in the US real estate market when it begins to move, although the US real estate recovery is expected to lag other developed nations. Finally, a number of existing and new domestic funds will be established over the near term as sponsors try to take advantage of the market malaise and the strong talent who could implement successful investment programs on the street. A number of sources have suggested that well over \$200 billion of equity capital has been assembled to acquire commercial real estate at distressed prices. While much of this capital remains on the sidelines, it is interesting to note the general sources of capital that are lined up.

T6: Asset/Fund Transfers & Shifting Preferences

The private institutional real estate market has lost some 38% of value as reflected in the NCREIF Commingled Open-end Index. The numbers have been even more pronounced for the Value-Add and Opportunity Funds tracked by NCREIF and Townsend. Thus, the “risk” side of such investment strategies becoming painfully clear although few investors focused on that side of the equation. Another source of funds –separate accounts– which are dedicated funds and ventures managed by advisors on behalf of pension funds and other institutional investors, have gone unnoticed. The exception is CALPERs which has taken center stage in firing managers and reallocating assets as a result of disappointing performance and prospects for even more losses. This is reminiscent of what happened during the early 90s when pension funds turned “meaner” and put the blame on advisors who they felt should have been able to avoid such losses. Going forward, we will see institutional investors try to correct these mistakes without dumping otherwise good assets by selling partial interests (e.g., Harvard, Stanford) or hiring new managers to take over existing

assets. At the other end of the spectrum, new funds will find sourcing assets that generate high double digit returns promised in prospectuses extremely difficult, especially if they are not willing to roll the dice and get ahead of the market. Some will refund money while others will turn to more exotic investments, including emerging markets where it will be difficult to monitor risk and determine if investment returns are commensurate with risk. That is what happened in the 90s and a trend that helped lead to the

globalization of the asset class. In this environment, balance and discipline rather than chasing deals will rule the day or at least buy some time to live another which, for many, may be a realistic goal.

T7: Relationship Shifts

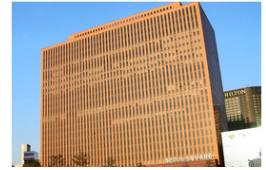
The recent turmoil in the commercial real estate market and the promise of more to come will test relationships among various players. This will create a difficult environment in which to conduct business, a trend that will continue for several years while the industry deals with the aftermath of the excesses of the recent past. Some

relationships will be severed, while others will be re-affirmed. Investors will be looking for new advisors and consultants, changing captains as a way of navigating through the troubled waters. In addition to changing partners, the nature of contracts will change as investors seek to protect themselves through even greater alignment of interest using co-investment, subordinated fees and look-backs to ensure advisors and managers stay focused on the bottom line.

T6: Asset/Fund Transfers & Shifting Preferences

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- Voluntary
 - Reassignment of Assets (e.g., CALPERS)
 - Partial Sales of Core (e.g., Harvard, Stanford)
- Investment Preferences
 - Search for Value/Clean
 - Eschew risk
 - Fewer products/structures
- Opportunity Funds
 - Some refunding of money due to inability to place
 - Mission Drift: shifting strategies to place money



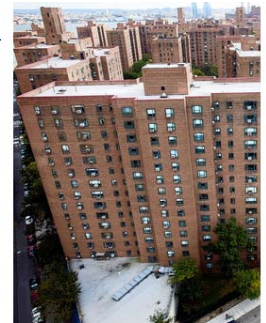
Evan Ramstad/The Wall Street Journal

Seoul Square: Office tower in South Korea
Private-Equity Sponsor: Morgan Stanley
Investors include: Montana Board of Investments
\$1 Billion Deal
Status: Morgan Stanley projects its fund will lose its \$350 million equity stake

T7: Relationship Shifts

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- The “Meaner” Phase
 - Hard line on workouts
 - Rising lawsuits on failed ventures
 - Increase in contentious negotiations
 - Surge in arbitration activity
- Relationship Changes
 - Rising matchmaking activity
 - Prenuptial alignment of interest
 - Co-investment
 - Incentive fee structures
- Relationship Bonding
 - Re-affirmation of working relationships
 - Opportunity for vertical expansion; more with fewer



Brian Harkin for The Wall Street Journal

Stuyvesant Town and Peter Cooper Village: 56-building, 11,000-unit apartment complex in New York City
Private-Equity Sponsor: Partnership between Tishman Speyer and BlackRock
Investors Include: California Public Employees’ Retirement System and California State Teachers’ Retirement System
\$5.4 Billion Deal
Status: Property being given back to lenders; total equity loss of \$1 billion

T8: Increasing Government Intervention

The political fall-out from the bailouts and stimulus programs the government introduced to help the economy through the recent recession and avoid the collapse of the financial system will hang over the country for a number of years. Indeed, outrage is likely to grow even stronger as taxpayers are forced to begin to repay the debt that has been racked up. The outrage over the Goldman scandal is symptomatic of more to come and argues that future

bailouts will be highly unlikely until we are on the brink of, or just over, disaster. Thus, the commercial market will be on its own until things hit the breaking point which may well come with the surge of refinancing due to hit over the next three years and the ultimate flood of distressed assets pent up in the queue. The government is likely to look for additional revenue as in the case of the bill to repeal the carried interest treatment which has subsidized general partner compensation. The potential for such “wipeouts” should be closely monitored, especially since lobbying by interest groups is likely to be less effective due to public scrutiny and outrage. Challenging times indeed!

T8: Increasing Government Targeted Intervention

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- Goldman
 - SEC’s civil fraud suit
 - Foreign regulators question dealings
 - Domestic and Foreign Affairs
 - Domestic
 - The SEC is gathering evidence of fraud inv
 - Goldman clients may sue if they bought securities Goldman expected to lose value
 - Shareholders may bring class-action lawsuits over deals that drove stocks down
 - Congress may use Goldman case to argue oversight rules should be strengthened
 - Global
 - Britain Prime Minister Brown accused Goldman of “moral bankruptcy”
 - Germany wants compensation for IKB bank
- Carried Interest Change
 - Current: Profit % of fund, JV or LP to GP is Capital Gain taxed at 15%
 - Proposed: Treat compensation as ordinary income; a three-fold increase



Source: AP April 20, 2010

T9: Renewed Search for Next CMBS Sector

While the CMBS industry remains on its knees and delinquency rates rise even more, the search will be on for some “new” version of securitized debt to fill the \$300 billion hole it left. This is especially true in light of the impending surge in refinance activity

T9: Renewed Search for CMBS Resurrection

(e.g., Special Servicer Split Deal Structure)

THE WALL STREET JOURNAL

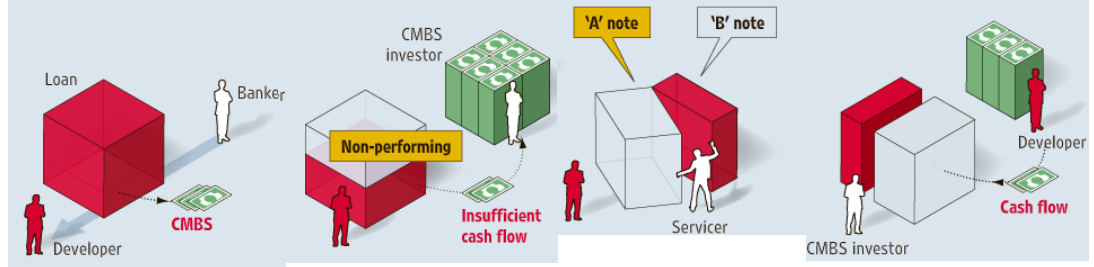
Debt Relief | How CMBS servicers split bad loans to allow borrowers to keep their properties

A bank makes a commercial mortgage to a developer, then sells the loan as commercial-mortgage-backed securities, or CMBS. The cash flow generated by this property slowly repays investors in the CMBS deal.

If the cash flow declines, the loan becomes delinquent and the “special servicer,” who represents CMBS investors, has to choose between modifying the loan terms and foreclosing on the property.

The servicer splits the loan into an ‘A’ note and a ‘B’ note. The property’s cash flow is only enough to cover debt service on the ‘A’ note, while the ‘B’ note becomes a “hope” note and get no payment for the loan’s term.

The hope is that upon maturity of the loan, if there are any proceeds left after the ‘A’ note is paid off, some of the remaining dollars would be used to pay down the ‘B’ note.



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and the continued pace of downgrades. While the ultimate form of such initiatives is an unknown, financial engineers and Wall Street types will be at work creating new products and tranches that may appeal to investors. Regardless of the form these activities take, it is likely that the asset class and investments will be bifurcated or partitioned, breaking them into two or more categories with varying levels of risk. Unfortunately, it will prove impossible to financial engineer out of a bubble, suggesting that losses will have to be realized before the asset class can move forward and reverse its freefall. These developments will bear close monitoring as a leading indicator of when capital flows may begin to turn around.

T10: More Time for Reflecting on the Revolution

In the current stage of the real estate cycle, many difficult decisions will have to be made. Some lucky decision-makers will be focused on expanding wealth, while others will be focused on damage control and survival. However, while the market has already sustained significant losses and experienced tremendous wealth transfer, the current revolution argues that wealth expansion cannot be taken for granted by buying good assets alone. Value must be captured and retained,

which will depend on the ability to apply solid fundamentals and critical thinking. During this period, being connected to the rapidly changing markets and having solid on-going relationships will be more important than ever. To help, I will try to stay on top of the unfolding scene and, where possible, try to get ahead of the curve. I offer my personal website <http://jrdelisle.com> with more features to come including an AskDrD interactive element. My full text articles on Financial Views dating back 10 years are also available in the Market Watch section. Good luck and thanks for the opportunity to share my thoughts and to stay connected. For many it will indeed be a good time to go back to school and pursue formal real estate studies; a revolutionary concept for many. However, it is clear the next wave of industry leaders will need to master fundamentals to help guide us through the current crisis and help avoid the next.

T-10: Time for Reflecting on the Future.....

© JR DeLisle, Ph. D.

- So, we'll be "Leaner, meaner, cleaner and greener"
- Reflecting on the Future...
 - Experience, critical thinking and survival instincts will rule...
 - If you don't have that, there's always school...



<http://jrdelisle.com>