Emerging Trends in Real Estate® 2009

A joint venture of:

[Logos of Urban Land Institute and PricewaterhouseCoopers]
Emerging Trends in Real Estate

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Executive Summary

The credit crisis and ensuing recession promise to drag commercial real estate markets into a difficult period marked by value losses, rising foreclosures, and reduced property revenues. In 2009, expected total real estate private equity investment returns will likely register in negative territory for the first time in nearly two decades. After an unprecedented meltdown, housing values should finally hit bottom during the year, followed by later correcting commercial sectors. Cap rates continue to increase to more historic ranges, raising yield expectations and triggering depreciation. Beginning in 2010, Emerging Trends interviewees anticipate a slow recovery, hampered by risk aversion, constrained financing sources, and a weakened economy. REIT stock portfolios, which have already suffered significant losses, will lead any rebound.

Late-in-the-game investors who heavily leveraged acquisitions at peak market prices face significant hurdles to meeting debt-service requirements as weakening tenant demand results in rising vacancies and slumping rents across most property sectors. Long-term owners, employing reasonable financing strategies, should manage their way through the downturn, suffering paper losses after significant gains over the past decade. Lender problems will extend from residential portfolios into commercial real estate loans, the consequences of shoddy underwriting as markets became overheated.

Investors need to focus on asset management and leasing strategies to hold and attract tenants, limiting declines in property cash flows. Once liquidity returns to credit markets, chastened lenders will force stringent requirements on borrowers. Investors will need to reorient acquisition strategies away from high leverage and financial engineering, and expect more moderate returns in any recovery. Cash investors will have the upper hand and excellent opportunities will appear at market lows and recapitalize struggling owners. Significant equity capital apparently waits for sellers to capitulate and owners to mark down portfolios. Optimists suggest the sidelined capital will be enough to cushion markets against a severe downturn. Siderling local partners for foreign investors, local partners for foreign investors, local partners for foreign investors.

Commercial developers confront a dismal year—financing evaporates for new construction and projects coming on line will struggle to lease up, falling short of forecasts. Emerging Trends ratings for development prospects in most cities and sectors approach record lows. At least, commercial activity remained relatively tempered throughout the upcycle, helping many markets approach supply/demand equilibrium. Already savaged, homebuilders see little hope for improvement until mortgage markets come back and the job picture brightens—not in 2009.

In a classic flight to quality, interviewees continue to favor familiar coastal global pathway cities as investment outlooks grow bleak—ratings uniformly decline for almost all markets. Among major metropolitan areas, Seattle and San Francisco take top rankings, followed by Washington, D.C., New York, and Los Angeles. Houston vaults into the top ten for the first time in more than a decade, propelled by its energy industry. Denver also scores relatively well thanks to a strengthened downtown and an improved mass transit system. Interviewees generally view secondary and tertiary cities as higher risk—they are less diversified and less integrated into key transport networks. Markets with exposure to the housing debacle—especially in Florida, southern California, and the Southwest—rose. For Chicago, cities in the Midwest weaken further—carmaker troubles don’t help.

Among property sectors, only apartments show some enduring strength—increasing numbers of young adults and people pushed out of the housing market keep rent rolls relatively healthy. Always favored, online activity in Latin America real estate concentrates in Brazil and Mexico, where growth seems well capitalized, interviewees expect capital availability to decline, curtail development and limiting transaction activity. Near-record-low office vacancies will increase as businesses grow more cautious and curtailing development and limiting transaction activity. Near-record-low office vacancies will increase as businesses grow more cautious and curtailing development and limiting transaction activity. Near-record-low office vacancies will increase as businesses grow more cautious and curtailing development and limiting transaction activity.

Emerging Trends in Real Estate® presents a consensus outlook for the future and reflects the views of more than 700 individuals who completed surveys and/or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed over 270 individuals, and survey responses were received from over 440 individuals whose company affiliations are broken down as follows:

- Private Property Company or Developer: 43.3%
- Real Estate Service Firm: 18.6%
- Institutional/Equity Investor or Investment Manager: 17.2%
- Other Entity: 7.8%
- Bank, Lender, or Securitized Lender: 4.8%
- Publicly Listed Property Company or REIT: 4.6%
- Homebuilder or Residential Land Developer: 3.7%

A list of the interview participants in this year’s study appears at the end of this report. To all who helped, the Urban Land Institute and PricewaterhouseCoopers extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.

Preface

A joint undertaking of the Urban Land Institute (ULI) and PricewaterhouseCoopers, Emerging Trends in Real Estate® is a trends and forecast publication in its 30th edition; this year, it is expanding to cover real estate markets in Latin America. It is the most highly regarded and widely read forecast report in the real estate industry. The report provides an outlook on U.S., Canadian, and Latin American real estate investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

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For 2009, U.S. commercial real estate faces its worst year since the wrenching 1991–1992 industry depression. Values will drop substantially, foreclosures and delinquency rates will increase sharply, and a limping economy will crimp property cash flows. The aftershocks of rampant “over-the-top lending” that batter the entire credit system leave property markets substantially overleveraged and vulnerable to significant depreciation. The industry’s “savings grace”—controlled development—had helped maintain reasonable equilibrium in most property sectors until recently. But a one-two punch of the continuing housing meltdown and tight credit softens demand—consumers stop shopping and employers cut jobs. “People simply don’t have the dollars to spend anymore.” Lofty energy prices, inflation, deflated stock market portfolios, and world financial turmoil contribute to a toxic brew, potentially delaying prospects for any economic rebound and further weakening outlooks for property investments. “People have been so focused on the credit crisis [that] no one noticed the economy sneaking up to knock their legs out from under them.” Real estate value losses will average 15 to 20 percent off mid-2007 peaks, and could be more severe for lesser-quality commercial properties in secondary and tertiary locations, according to interviewees.

The sudden demise of Wall Street stalwarts and mortgage giants shatters investor confidence about remedying financial market turmoil expeditiously. Although substantial vulture capital has been raised to bottom-fish for distressed properties, possibly cushioning against severe value declines, real estate businesses will continue “to starve” until debt sources resume funding owners and investors. “The debt world needs to be fixed,” says an interviewee. “A huge capital gap has been created, most debt has vanished, and all the available equity is not enough to fill the hole.” No one expects surviving financial institutions to ramp up lending once they finally stanch mammoth balance sheet bleeding, even with gargantuan government bailouts. Persistent risk aversion and new regulation could limit debt capital flows for the foreseeable future, muting transaction activity. Many owners needing to roll over mortgages in the coming years can expect to face substantial refinancing hurdles, including higher lending rates, more stringent underwriting, increased equity requirements, and recourse terms.

So the industry faces “multiple disconnects”: some owners drowning in debt as values decline, lenders without money to lend, slackening property income flows, and unprecedented avoidance of risk. “Only when property financing gets restructured will pricing reconcile so we can find a floor” and “this transition period could wipe out companies and people.” The housing markets have already been especially unforgiving to homebuilders, lenders, land speculators, and late-in-the-game buyers—not only did easy credit help send housing prices up to unsustainable levels, but developers also wildly overbuilt, compounding the current distress.

Taking all the bad news in stride, most real estate players, including homeowners, should uncomfortably ride out the storm. Expect financial and property markets to hit bottom in 2009 and flounder well into 2010, convalescing slowly absent an unanticipated economic jolt. Owners who locked in debt on a long-term basis or shied away from heavy leverage—like pension funds and real estate investment trusts (REITs)—should have the staying power and cash flows to cover obliga-
tions to lenders and stomach paper losses. "As long as you can sit with what you have you'll be fine." But those investors who overpaid and borrowed heavily, particularly in the 2005–2007 period, stand in the crosshairs, unable to meet unrealistic underwriting projections.

Some wistful Emerging Trends interviewees wonder how they ever embraced the alluring notion that secular change in the capital markets had eliminated most cyclical investment risk. In hindsight, "there was never any structural change, just a temporary surge of capital into the markets." The ensuing leverage binge and transaction fee fest morphed suddenly into a financial market debacle, now marked by industry contraction. At the very least, cap rates and return expectations will need to recalibrate to more normal, historical levels. "It's hunkering-down time," where the initial winners will be companies "[that] can out-lease and out-manage their competition." Eventually, savvy investors will be able to cash in on an inevitable recovery.

Indeed, "the market always comes back," just not in 2009.

Uncertainty and Distress

Growing Pessimism. Since summer 2006, the Emerging Trends interviewees have turned from wonderment about the staying power of ebullient pricing and skyrocketing values to growing concern over the subprime mess, and now gloomy recognition that the commercial markets will suffer through a significant correction. The downward trajectory of industry sentiment accelerated as interviewees became more anxious about the nation’s economic prospects and credit markets remained nastily gridlocked with no signs of imminent recovery. Then the rapid demise of iconic financial institutions elevated trepidation to near panic. "There’s been a lot of bravado and denial turning into hand-wringing and pain." "Everybody had been drugged by the long bull market."

"Uncertainty" over a "minefield" of issues now beyond most investors’ control grips the industry. Enduring credit chaos upends the entire global financial system. In the wake of run-amok securitization and rampant risk offloading, "no one knows who owns what or what it is worth." "Some of the smartest people I know are paralyzed," says a veteran mortgage banker. Players hope that government intervention can help restore liquidity, but realize that AIG, Wachovia, Lehman, Merrill, Freddie, Fannie, and Bear represent significant distress reaching into virtually every brand name financial enterprise. "Banks are broke and many investment banks are bust from leveraging their businesses to the max. They don’t have the money to lend."

Lender Distress. Interviewees wish that financial institutions would “take their inevitable writedowns and clear the market,” but understand that the potential severity of losses in a sudden reaccounting could undermine more companies and crater confidence in a suddenly fragile banking system. Instead, lenders grasp for government handouts and buy time—letting buyers quietly cherry-pick nonperforming loans and making allowances to many borrowers. "They extend paydown requirements and put off re-fis, delaying dropping the hammer." The $700 billion bailout and other emergency programs pave the way for institutions to move bad loans off balance sheets, eventually using auctions to speed up the process. "We can’t crash the system, but we also can’t keep prices where they’ve been." Then ugly reality sets in—taking losses, writing down values, and wiping out frothy gains from recent years. More banks and investment banks could fold, the hedge fund casualty list will grow. Continuing shockwaves emanating from the commercial market correction will erode market confidence further and discourage investing until players can be relatively certain the bloodletting is over. Only then will meaningful transaction activity resume:
- Cash and low-leverage buyers will be king;
- Surviving banks will impose strict lending guidelines, requiring more recourse and equity;
- Left-for-dead commercial mortgage–backed securities (CMBS) markets will revive, but in a more regulated form; and
- Opportunity funds will need new investment models that can’t rely on massive leverage and cap rate compression to boost returns and promotes.
No Deal. For private equity real estate owners, “It’s too late to sell.” In fact, Emerging Trends surveys register the lowest sell signal in the report’s 30-year history (see Exhibit 1-1). Survey buy ratings continue to rebound off 2006 lows (when players should have retreated) as investors hopefully expect seller capitulation to meet their increased yield expectations. Many real estate owners just focus on holding on through the “rough sledding,” comprehending that transactions are beside the point until the market takes its bitter medicine and suffers pain. “The best bet at this point is to ride out the cycle.”

Writedowns Loom. While lenders dithered and sidestepped marking down their convoluted portfolios, appraisers and private equity fund managers also avoided taking significant writedowns through most of 2008 despite the handwriting on the wall. They pointed to the lack of meaningful transactions to gauge value declines and the yawning gap between buyers’ and sellers’ expectations, reminiscent of the housing markets circa 2006. “Sellers want prices available a year ago, while buyers want prices anticipated a year from now.” Various opportunity funds have raised “a ton” of money—rumored at upwards of $300 billion—but managers don’t want to start acquiring anything before the market has finished sliding, and some commitments may not stick after the downturn. The dearth of transactions, however, stymies devaluations. Owners won’t sell at “liquidation prices” if not forced, and lenders haven’t pushed troubled borrowers for fear of exacerbating recognition of their own problems. This circle will likely only be broken when banks and special servicers ramp up foreclosures. From the trickle of transactions, interviewees suggest that pricing levels had declined at least 10 percent off 2007 highs by midyear 2008.

Rising Cap Rates. An interviewee consensus calculates that cap rates need to increase about 150 to 200 basis points on average from their recent lows to more normal 7.5 to 8.5 percent territory depending on property sector, market, and asset quality. That translates into a possible 15 to 20 percent value haircut. Trophy, 24-hour city properties should have less exposure—with their cap rates rising 50 to 75 basis points—while B and C product could see increases of 200 to 300 points. Inflation and rising interest rates pose additional downside risk. Through 2008, Fed policy makers continued to keep interest rates well below historic norms to stave off economic turmoil despite energy cost–driven inflation and blame on low rates for creating baleful asset bubbles. Over the longer term, interest rates should rise, putting more upward pressure on cap rates.
Double Whammy. Optimists had been hoping for offsets from rising property net operating incomes to help counter depreciation from rising cap rates. But the lackluster economy compromises their projections. Instead of rents rising or at least holding steady, owners resign themselves to a deteriorating leasing environment where concessions and tenant inducements proliferate. Higher energy costs and inflationary pressures ramp up operating costs, shrinking bottom lines further. Total returns cannot escape negative territory—the depth and severity of the recession will determine the extent of losses.

This downturn “looks like a long doubleheader,” bemoans an interviewee. “The first game is the credit crisis and we’re only in the middle innings. And now we have another game to play and that’s the poor economy.” “Every day that goes by without economic improvement increases the risk for real estate.”

Deteriorating Economy

While economists and politicians quibbled throughout 2008 over the definition of recession, most Emerging Trends interviewees conclude that America’s consumer-based economy has been whipsawed acutely by jobs losses, high energy costs, the housing crisis, reignited inflation, and the near collapse of credit markets. “It’s hard to remember when the economy faced so many negative factors at once.” Many people face mounds of debt (mortgage, credit card, auto, and student loans), experience no real growth in wages and grapple with higher health care costs, and cope with volatile gas pump prices and utility bills. Their homes, stock portfolios, and 401Ks, meanwhile, all have lost value, rattling psyches and creating insecurity. With the United States in a shopping slump and the credit crisis spreading, the world economy also sputters, reducing chances that American exports will be enough to provide a necessary domestic stimulus. In addition, the weak U.S. dollar, debtor nation status, and reliance on energy sources from fractious world regions undermine recovery prospects. “The big picture makes for less optimism,” says an interviewee. “The role of a mature U.S. economy is diminishing, changing the personality of investment, consumption, and development patterns.”

Higher Unemployment. The dreary jobs picture stirs particular apprehension about the country’s ability to bounce back from its current slump. Although overall U.S. employment had been healthy from 2002 to 2007, job creation and wage growth trailed other economic expansions. High-paying manufacturing jobs continued to migrate overseas, replaced by lower-wage/lesser-benefit service sector “discount store” jobs. At the margins, many white-collar companies steadily transferred more “knowledge-based” work overseas to lower-cost markets thanks to telecommunications and Internet technologies. While high-tech jobs have rebounded off 2001 lows, the important financial services industry “is a train wreck” and its prodigious Wall Street bonus machine in shambles. To make matters worse, the government sector will scale back in 2009, as state and local agencies face severe declines in tax revenues. Slashed budgets translate into reduced government hiring and layoffs as well as reductions in contracts to private firms and funding for nonprofits. For the short term, rising unemployment and additional consumer distress appear unavoidable. Interviewees, meanwhile, continue to scratch their heads about new job growth engines; most mention energy, health care, and education. Initiatives to recast the country’s increasingly obsolete infrastructure (roads, rails, transit, airports, electric grid, water/sewage systems) as well as securing greater energy independence through new technologies may key an eventual resurgence. But such programs have no chance to gain immediate traction, given various political, business, and financing roadblocks—certainly not in time to help in 2009.
Chapter 1: Forget the Quick Fix

**Fundamentals Deteriorate.** The confluence of the credit mess and weak economy set the stage for commercial real estate markets to take some hard knocks, lagging as usual behind the stock market, which has already suffered a bearish correction. As noted, problems will result from lowered demand, not overdevelopment, except in condominiums, where many markets added too much supply in the wider housing splurge. Not surprisingly, outlooks for shopping centers hit the skids in the consumer retreat. Hotel forecasts also turn somber—vacation and business travel declines. Office owners find insulation in longer-term leases, but most businesses stop expanding and many start to cut back—so vacancies will increase and rents soften. “Everyone is afraid to deploy capital and plays defense.” Warehouse markets also suffer erosion in tenant demand as fewer goods get shipped and logistics specialists study how to reduce energy costs. Only apartment markets benefit from housing distress—more people can’t afford to own and need to rent. Core urban markets with mass transportation alternatives to the car solidify their advantages over far-flung car-dependent suburban areas, and more investors and developers target infill locations for future mixed-use residential projects, especially near transit stops.

**Development Blues.** In 2009, most new development activity stops in its tracks. Unless a builder presents a bullet-proof, preleased project with construction costs locked down, lenders won’t touch large development deals. Bankers also demand that builders have large equity stakes in projects. “It’s almost impossible to find financing that isn’t prohibitively expensive.” Says an old pro: “Developers should put all planning on hold. For projects underway, they need to lower leverage, increase reserves for tenant improvements and marketing, relook every assumption, and assume the worst.” In addition to problematic demand and wary lenders, energy and construction material costs ratchet up budgets and squeeze profits further. At least labor costs abate and material costs may follow if world demand ebbs in a global slowdown. For most developers scheduled to open new buildings during the year, their timing couldn’t be much worse. At least the drop in activity after a period of relatively controlled new construction should allow commercial markets to recover more quickly once demand strengthens again. That has not been the case in most housing markets, swamped by large inventories of unsold new homes—the significant oversupply extends the downturn. Many homebuilders stuck with land tracts have little choice but to bail out at cents-on-the-dollar sales or let banks foreclose.

**Brokers Lament.** While developers struggle, brokers watch commissions vanish into the vast bid-ask chasm separating buyers and sellers. 2008 deal volumes are 20 percent of those of 2007, and 2009 may not be much better. “It’s a terrible time for transaction people” after “some incredible years.” Interviewees agree that sellers will blink first—“they need to get reality.” Underwater owners will almost certainly cave toward buyer expectations, hoping enough dollars come off the sidelines to buffer pricing in bidding for distressed assets. Unlike in recent years, cash buyers will have the advantage—leveraged buyers and financial engineers “are gone.” Opportunity funds need to reorient their formulas and expectations—returns and promotes won’t be as high without a boost from debt. Money will be made on riding markets back to recovery and releasing properties, not on cap rate compression and financing structures.

Without as much leverage in the market, any pricing increases over time will be more “moderate.” “The impact of lower debt levels and more expensive debt is lower growth assumptions.” Underwriting will be based on 12-month trailing cash flows, not dreamy forward projections. “Cash-on-cash is important again.” First-stage transactions will involve owner recapitalizations, restructurings, and programmatic ventures—“even the best of players need equity.” But no one wants to look stupid by buying too soon—select trophy properties with long rent rolls get some attention from cash-rich offshore buyers, taking advantage of the limp dollar. History shows these properties hold value better in down periods, and appreciate faster in recoveries. Everybody else waits out the logjam. “It’s
Emerging Trends in Real Estate® 2009

Private markets need to correct: While dealmakers and intermediaries have been blasted by dismal transaction volumes and REIT stocks have suffered steep losses, the private real estate markets haven’t taken their beating. Lenders must begin to reconcile and mark to market their portfolio problems and force distressed owners into becoming motivated sellers. Given the complexity and depth of banker problems, especially in rationalizing CMBS portfolios, the process will take time. And no one really knows what to expect when CMBS special servicers start foreclosing except for the prospect of widespread litigation.

Debt capital needs to flow: Government bailouts aside, wobbly lenders won’t eagerly open loan spigots again until they recapitalize and learn to navigate a more stringent regulatory landscape. The left-for-dead CMBS market also must reformulate for “normalcy” to return. Securitization structures need simplification, “getting back to basics,” so investors have greater confidence about underlying assets. Lender underwriting and due diligence will require more documentation, loan-to-values will be lower, and debt service coverage will be higher. In short, don’t expect a surge of new debt capital to float markets suddenly.

Regulators need to help restore confidence in the securities markets: Since rating agencies proved lame in evaluating offerings and B-piece buyers ultimately failed at self-regulation, the government will insert itself into overseeing mortgage securitization markets—taxpayer losses from shoring up RMBS, CMBS, and collateralized debt obligation (CDO) lenders, not to mention Freddie Mac, Fannie Mae, and AIG will be too massive for politicians to just twiddle their thumbs and wink at financial industry lobbyists. While resuscitating CMBS

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**Tenant Retention.** Keeping tenants and securing rent flows should dominate owner strategies to manage through the doldrums. “Do whatever it takes to get tenants to stay.” Landlords need to focus on keeping occupancies up rather than pushing rents—otherwise, other owners can lure tenants away by undercutting them, and finding replacements will be difficult. “In this environment, you make money or lose less by out-hustling the competition—buying occupancy and defending space.” Office owners begin to approach tenants up for renewals 18 to 24 months prior to expirations and attempt to ink one- to two-year lease extensions on “blend-and-extend” deals. Clearly, tenants have the upper hand, but many companies struggle to make decisions given the murky economy and changing real estate environment. Some stake reasonable bets that rental rates will deteriorate over the next year and believe they’ll do better if they wait out landlord entreaties.

**Looking for Recovery.** Everyone wonders how long it will take for commercial markets to recover and the industry to get back in gear. Odds increase on a more extended pause than a quick rebound. The following is what needs to happen and why nobody should hold their breath:

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**EXHIBIT 1-6**

*Index Returns: Real Estate vs. Stocks/Bonds*

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markets, any systemic overhaul promises to keep lenders and securitizers on a short leash, leading to considerably more measured debt flows.

The economy needs to improve: On the fundamentals side, falling demand for space won’t affect real estate markets severely until 2009. With prospects for a rapid economic bounce back questionable, property cash flows may diminish or at least stay under pressure well into 2010. Interviewees trash notions of V-shaped recoveries and turn more realistic: “With every day, recovery gets stretched out further.”

Housing’s condition: no better: Thanks to overdevelopment, housing tanked earlier and more severely than commercial markets, but shows no signs of recovering more quickly. For mortgage bankers, “the subprime mess was just the tip of the iceberg”—they threw caution aside across all lending categories. Now, stricter lending standards and the sickly economy sap the homebuyer market. Speculators have disappeared under pools of losses. “The few buyers out there look for the deal of the century” and many prospective purchasers can’t afford more than that. Until lenders recover and Americans feel more secure about their financial futures, homebuying stays anemic. Between the Federal Reserve and Congress, more screws will be turned on bankers to follow stricter and more conservative underwriting guidelines, eliminating rash practices and forcing buyers to put up more equity. Unfortunately, many people who refinanced in the pricing spiral learn their homes can perform more like roulette wheels than ATMs. Homeownership still offers the American dream, but recent experience will temper buyer enthusiasm and raise market caution for years to come.

Forget the quick fix.

Key Issues
The listing economy—jobs, interest rate changes, energy costs, inflation—raises greatest concern among survey respondents in an analysis of key trends. (See Exhibit 1-7.) They increasingly downplay consequences from terrorism and the Mideast wars—these geopolitical issues score lower rat-

EXHIBIT 1-7
Importance of Issues Affecting Real Estate Investment and Development in 2009

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<td>Climate change/global warming</td>
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</tbody>
</table>

1 = no importance, 2 = little importance, 3 = moderate importance, 4 = considerable importance, 5 = great importance.

Source: Emerging Trends in Real Estate 2009 survey.
ings than in previous years. But some interviewees express unease about Russia’s resurgence and America’s less imposing superpower status. Trade deficits and market imbalances get somewhat shorter shrift even though they relate to U.S. oil dependence and inflationary pressures. Construction material costs remain primary concerns for developers, but land prices and labor costs become lesser issues as prices decline and worker availability increases with fewer ongoing projects.

**Lower Profits.** Not surprisingly, real estate firm profitability forecasts turn sharply more negative from last year’s report. About 45 percent of respondents expect poor to fair results in 2008, with only 16 percent anticipating very good to excellent performance. 2009 may be marginally better, if transaction volumes increase. (See Exhibit 1-8.)

**Trending Green.** Portfolio problems, the construction stall-out, and increasing industry angst could distract from the push to reduce buildings’ carbon footprints and install green technologies. But rising utility bills get everybody’s attention. Big tenants increasingly put “green” on their priority checklists—they want good PR for occupying environmentally correct space, savings from more energy-efficient systems, and improved working environments for greater productivity and to recruit and retain younger, up-and-coming employees. Some investors still question whether green attributes translate into premium pricing. The dearth of recent deals and falling prices limit any reasonable analysis. “It’s hard to understand green values since so few have traded,” says an interviewee. “The economics haven’t been proven; it’s not a driver of rents yet.” Other owners insist that “LEED is critical.” In particular, developers of Class A office buildings realize that LEED certification has become a competitive baseline to lure tenants out of nongreen existing space. In higher-growth development-friendly markets, developers take risks by not spending an additional 3 to 5 percent on project costs for green technologies. LEED also extends its application to multifamily projects where renters have become more global-warming conscious, “especially the Generation Y set.” If the market doesn’t fully embrace green for now, local governments may force the issue. Major cities around the country begin to pressure real estate owners to reduce energy consumption, water use, waste disposal, and outdoor watering. State and local governments also provide tax abatements and other incentives to encourage green practices. “Developers are just not thinking if they don’t go green.”

**Retrofitting Options.** Some owners and managers tackle retrofitting existing space to reduce energy costs and tamp down operating expenses. “The biggest energy control is people—turning out lights, putting down blinds in summer, opening them in winter, and turning faucets off.” Simple, relatively inexpensive changes (“as little as $1.50 per square foot”)—low-flow toilets, energy-saver lightbulbs, low-water landscaping, waste recycling—can result in significant savings. But existing properties will have a tall order competing against new space—installing under-floor air systems and window technologies won’t pencil out. Big-box retailers, shopping center owners, and warehouse investors consider the benefits of placing solar panels on large roof prints, particularly in sun-drenched regions where significant HVAC bills can be reduced.
Chapter 1: Forget the Quick Fix

Investment

**Be Patient and Husband Cash**
Until sellers relent, investors should sit tight. “[Amass] as much capital as possible and wait” for prices that clear the market. Opportunities will surface at significant discounts to peak pricing and patience will be rewarded. “Investments made in 2009 could result in substantial future returns.”

**Buy Discounted Loans**
Lenders will be offloading more loans at increasing discounts once the pressure builds to resolve damaged balance sheets. Buyers need to focus on underlying collateral, watching for wide disparities in asset quality and resiliency. They also must carefully scrutinize loan positions in the capital stack—mezzanine and lower tranches of senior debt “may have no value.”

**Recap Distressed Borrowers**
Some overleveraged owners will look to lifelines from new capital sources rather than face defaults. Investors will be in the driver’s seat—they can get better deal structure, more guarantees, principal paydowns, and bigger spreads. Invest in maturity defaults, construction loans/bridge loans, or take mezzanine positions and equity stakes. “You can get equity returns for debt risk.”

**Hold Core**
Investors really have no choice—selling as vultures circle makes no sense. Well-leased properties with manageable roll-over exposure will take paper losses after scoring years of outsized paper gains. Owners should step up tenant relations and leasing programs to maintain occupancies and cash flows.

**Buy Public REITs**
These stocks have taken a major licking, already factoring in much of the expected declines in private markets. They may experience more downside when negative headlines increase about rising commercial defaults and foreclosures, but will lead any market recovery. Many larger companies are well capitalized with manageable debt loads and should navigate ensuing turbulence as fundamentals falter—lowered share prices make their dividends look more attractive again.

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**EXHIBIT 1-9**
Real Estate Business Activity Prospects in 2009

<table>
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<tr>
<th></th>
<th>1</th>
<th>5</th>
<th>9</th>
</tr>
</thead>
<tbody>
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<td>Investment</td>
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<td>Real Estate Services</td>
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<td>Financing as a Lender</td>
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<tr>
<td>Commercial/Multifamily Development</td>
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<td></td>
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<tr>
<td>Homebuilding/Residential Land Development</td>
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</table>

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on U.S. respondents only.

“Investments made in 2009 could result in substantial future returns.”
Focus on Global Pathway Markets
The favored 24-hour coastal cities—D.C., San Francisco, New York, L.A., Boston, and Seattle—will hold value better and bounce back more quickly. Core players and offshore investors gravitate to these elite business and cultural centers linked directly to Asia and Europe commercial capitals. Hot-growth Texas markets—Houston and Dallas—show temporary strength as long as oil prices stay high.

Staff Up Asset Managers, Leasing Pros, Workout Specialists
“It’s time to work your asset base the best you can and realize you can’t stop losing some value. Do the best you can to lose less. Separate good assets from bad. It’s property triage time. Put workout specialists on the bad assets and protect as much value as you can in disposing of them. Put the best asset managers and leasing people on good properties to improve cash flows and enhance future value.”

Development
Retrench
Financing is limited, tenants are scarce, vacancies increase, and construction costs remain high.

Reorient to Mixed Use and Infill
Energy prices and road congestion accelerate the move back into metropolitan-area interiors as more people crave greater convenience in their lives. They want to live closer to work and shopping without the hassle of car dependence. Higher-density residential projects with retail components will gain favor in the next round of building. Apartment and townhouse living looks more attractive, especially to singles and empty nesters—high utility bills, gasoline expenses, car payments, and rising property taxes make suburban-edge McMansion lifestyles decidedly less economical.

Plan More Transit-Oriented Development
Metropolitan areas nationwide realize they need to build or expand mass transportation systems in order to overcome road congestion, which strangles economic growth and increases carbon footprints. Increasingly, people want to drive less and seek subway, commuter railroad, or light-rail alternatives. Developers can’t miss securing project sites near rail stops and train stations.
“It’s time to work your **asset base** the best you can and realize you can’t stop losing some value. Do the best you can to **lose less.**”

**Go Green**
If you think oil and electricity costs will plummet and global warming issues will disappear, then sidestepping the additional costs for installing green technologies may make sense. Remember how market interest in energy efficiency subsided quickly after the late-1970s oil price crisis faded? But today developers roll the dice and buck current tenant demand, if they redline green technologies. Cutting energy expenses should be a priority in controlling rising operating expenses. Available government subsidies and rebates can reduce costs.

**Property Sectors**

**Buy or Hold Multifamily**
Apartment investments get a boost from a host of significant trends: increasing numbers of young adults who leave their parents’ homes, more aging baby boomers looking to downsize from suburban lifestyles, and stiffer mortgage costs/requirements that make homeownership too expensive for some prospective buyers. Increasing renter demand helps blunt ongoing recessionary impacts and ensures solid cash flow increases when the economy improves.

**Buy or Hold Industrial**
Despite near-term softness in availability rates, coastal gateways and primary international airport hubs will consolidate their positions as prime warehouse markets operating along global pathways. Watch for distressed owners and pick off bargains in top markets.

**Hold Office**
Long-term leases can bridge the downturn.

**Hold Hotels**
Occupancies decline and room rates suffer—it’s no time to sell.

**Buy Residential Building Lots**
The market collapse mauls homebuilders—increasingly, they capitulate and give up inventoried land tracts in bankruptcies and foreclosures. Prices are cents on the dollar from market peaks. But investors must be prepared to hold for a while.

**Purchase Distressed Condos**
At the right prices, these projects can be transformed into profitable rentals. Properties in urban areas near transit hubs make the best bets. Once markets recover, units can be converted back for sales.

**Pray for Retail**
Mall owners hope consumers haven’t collectively shopped till they dropped. Neighborhood centers with stronger grocery anchors and chain drugstores should fare best: people still need to eat and purchase more Advil for all their headaches.
All that anonymous “other-people’s-money” that had flooded unbound into U.S. real estate suddenly vanished by fall 2007. In a Bay of Fundi moment, markets went from inundated in capital to drastically undersupplied, especially for precious debt (see Exhibit 2-1). It took the subprime wake-up call to convince bond investors that they had little or no idea about the collateral in their mortgage-backed securities, and suddenly everyone realized the property markets had been overplayed. The credit crisis might have been manageable had profligate lending been confined to subprime, but the bingeing had extended across all residential and commercial real estate as well as corporate markets, triggering a global financial maelstrom.

Low interest rates, lax regulation, untested financial instruments, and garden-variety greed conspired to upend the property markets even though construction lenders were mindful to control developer borrowings and keep commercial building in relative check. The blame can be spread around: Wall Street bankers pushed the envelope on bond structures, rating agencies “didn’t know what they were doing,” and bond investors forgot the basic principle of caveat emptor. Lenders’ profits inflated due to increased volumes and offloading loans into securities, seemingly reducing their balance sheet risk. Borrowers kept bidding up prices on anything with a foundation, flipping their acquisitions as soon as possible to the next leveraged buyer. “Swampland in Florida found its way into AAA securities.” All the intermediaries—bankers, lenders, rating agencies, appraisers, lawyers, and brokers—took their cut of fees at every transaction and government regulators were asleep at the switch. “Should anyone be surprised at what happened?”

Where’s the Money?

Make No Assumptions. For 2009, the multibillion-dollar questions become: When will money return to the suddenly strangled real estate markets, and who will be investing and at what levels? As markets deleverage and correct, the length and severity of the repricing process will influence the resumption and intensity of capital flows. No one should make assumptions too readily, especially after Wall Street’s near-death experience. After the 1998 Russian credit crisis, the

**EXHIBIT 2-1**

Real Estate Capital Market Balance Forecast for 2009

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<tr>
<th>Equity Real Estate Capital Market</th>
<th>Debt Real Estate Capital Market</th>
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<tr>
<td>37.9% Moderately Undersupplied</td>
<td>58.1% Substantially Undersupplied</td>
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<tr>
<td>13.1% Substantially Undersupplied</td>
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<td>16.0% In Balance</td>
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<tr>
<td></td>
<td>1.0% Substantially Oversupplied</td>
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Source: Emerging Trends in Real Estate 2009 survey.

Note: Based on U.S. respondents only.
industry learned that CMBS markets linked to global capital flows will not guarantee liquidity for real estate and that investment diversification cannot offset systemic risk. But in 2008, the lesson was reinforced with a corollary: capital flows can shut down for extended periods with dire consequences. The interviewee consensus nevertheless presumes that equity real estate investors will hold firm on commitments and step up investments once markets stabilize, primed by the opportunity to buy at market bottom. They are much less sanguine about lenders and CMBS markets resurfing quickly.

No doubt, equity capital will be more restrained without debt capital to stoke returns. Lower-leverage investors—REITs especially—may be active, but opportunity funds will need to revise strategies, using more cash. If losses are worse than expected and demand for space sinks during an extended recession, always-nervous pension plan sponsors may revise allocation targets downward and pull back. In any event, the stock market likely will recover before real estate—could investors get on that bandwagon and downsize property portfolios for a while? Also, no one expects core portfolios to score upper-teen annualized performance again anytime soon. A reversion to the mean indicates that the timing may be right to sidestep real estate in the near term, even after a correction. A research leader anticipates “a reduction in real estate allocations and modest 5 percent real returns.” Will investors really be satisfied with bondlike returns after this recent round of seesaw performance?

It’s quite possible that real estate’s recent heady run of outperformance may have solidified its asset diversification credentials and place in institutional portfolios no matter what transpires in coming months. The weak dollar also should continue to encourage foreign investors to buy properties. But the industry shouldn’t blindly count on a restored wellspring to jump-start transactions and development. Interviewees may be engaging in wishful thinking by ranking prospects for U.S. private real estate investments ahead of all other asset classes in 2009 (see Exhibit 2-2) or they may be simply wondering, “Where else can I place my money?” Whatever the rationales, everyone should be clear: capital markets’ dynamics have changed dramatically.

**Less Capital.** Not surprisingly in light of the credit cataclysm, respondents appear certain that capital availability for both debt and equity will be constrained in 2009 and investment will be “rather muted.” (See Exhibit 2-3.) In fact, overall capital availability ratings (on a one-to-nine scale) are the lowest in the survey’s history. Only opportunity funds and mezzanine lenders will have more money to invest than in 2008, according to the surveys. Significantly, expectations sink for financing from commercial banks and CMBS. Many previously active private syndicates and tax exchange buyers without leverage leave the scene.

**Sideline Equity.** Interviewees in particular wonder what will happen to the guesstimated $300 billion supposedly raised by various opportunity funds and investment banks at the peak of investment frenzy and in the wake of record performance. Pie-in-the-sky optimists hope that “hordes of capital,” “looking for a home,” will lead to a rapid recovery, even “to the point of overcorrection in the opposite direction.” More likely, some
investors may pull back commitments in the wake of financial market earthquakes, and other interviewees counter that equity flows alone cannot turn the market in any case. “Real estate is a debt-driven business and we need debt.” The sidelined equity capital operates off promotes, which require leverage for the managers to make money. “Without debt to juice returns, they have more limited motivation.” Buying core assets at discounts doesn’t fit the current opportunity model and targeting land lots means extending investment horizons beyond current terms. Clients, meanwhile, want their dollars invested. “We’re muddling through another 12 months without debt,” says an adviser. The “clock is ticking on investment periods and managers are caught between making bad deals and losing commitments.”

Reviving CMBS. As noted in last year’s report, securitization of debt helped “Wall Streetize” real estate over the past 15 years, funneling huge flows of diverse capital from around the world into U.S. property markets. Emerging from the RTC rescue of savings and loans in the early 1990s, CMBS reoriented and energized real estate financing, and interviewees agree that reviving securitized markets will be essential for restoring liquidity and speeding any real estate market recovery. But the credit crash effectively demolished CMBS markets and clobbered Wall Street wizards—the survivors now cope with their own massive portfolio losses, bad trading bets, and deflated stock prices. Punished and downsized, the “CMBS industry is like deer caught in the headlights, directionless with no idea where to go to find the catalyst to get back in business.” Securitized offerings in 2008 were a small fraction of previous years (see Exhibit 2-4), mirroring the collapse of overall debt markets.

Before CMBS bond buyers’ appetite for new investments returns, they will need to make sense of their existing holdings—a jumble of tranches with questionable collateral caught in declining markets. For starters, banks and special servicers must identify problem loans and markets need to clear before bond buyers have any chance to regain their bearings. Then the industry must ensure transparency in underlying collateral and restore confidence in bond ratings. Rating agencies proved ill-equipped to assess offerings or understand complicated structures. Rich fees paid to them by issuers added an untenable conflict of interest. Investors
also had bought off on B-piece buyers’ ability to scrutinize offerings and kick out bad loans. The cartel, however, lost control in the proliferation of offerings and “house-of-cards” investment banker structures. Most interviewees now reluctantly accept that government regulators need to get involved to rebuild credibility. “Everything is on the table.”

Back to Basics. For all the spin about public market transparency, CMBS blurred into murky investment bets as structures morphed into sliced and diced tranches of mortgages combined together in diverse pools, which were leveraged and hedged in complex swaps. Some investors wondered whether Albert Einstein could figure out how these collateralized debt obligation (CDO) bonds worked, but Wall Street slapped on a yield and the rating agencies obliged with their stamps of approval. That was enough for many bond buyers who had no idea whether their investments were backed by a suburban housing tract outside Tulsa or a downtown San Francisco office building. “The industry forgot about real estate underwriting, there was no differentiation between asset quality, and assumptions were juiced aggressively.” “You can never get cream from underlying junk.” Interviewees suggest that CMBS needs to backtrack closer to its original structures—smaller portfolios, A/B tranches, better asset/liability matching, and reasonable loan-to-values (65 to 70 percent). “Buyers will come back when spreads decline, and it may take two to three years for spreads to tighten.” Ultimately, the health of real estate fundamentals will also be crucial in reattracting investors.

Repairing the CMBS machine and rebuilding investor confidence won’t be easy.

Dropping the Hammer

Rising Defaults and Delinquencies. While housing default and foreclosure rates have skyrocketed to levels not experienced since the Great Depression, commercial delinquencies have remained stubbornly low even as market fundamentals ebb. (See Exhibit 2-5.) In these dicey markets, lenders and servicers make allowances on covenants and grant extensions as long as borrowers remain current. But reserves begin to run out and many owners who bought or refinanced in 2005–2007 may now be underwater. “We will also start to see more maturity defaults and borrowers won’t be able to get the dollars they need.” For 2009, expect commercial foreclosure rates to increase as lenders bite the bullet on workouts and special servicers become more active. Defaults and delinquencies will not approach levels seen in the early 1990s, but could rise to 3 percent to 4 percent of outstanding loans. “Analysts, regulators, and new management will increase pressure on bankers to clear up their portfolios.” Headhunters report that banks have started to hire workout teams “in earnest.” Scarred veterans of the early-1990s lender meltdown recall that bankers “took it easy” until faced with increasing volumes of problems and distress. “A civil workout process will get more hard-edged as distress increases—we haven’t gotten into survival mode when people start to rip into each other. Courtesies will drop when fundamentals start to slip.” Restraining default and delinquency rates will depend heavily on tenant demand buttressing property cash flows. “Everything depends on the economy.”

Litigation Nightmare. For years, industry players have speculated about what happens when CMBS special servicers confront widespread defaults and workouts. Will they peremptorily follow loan documents and foreclose on borrowers or negotiate allowances like local bankers used to do with favored clients? And among bondholders, which tranches will receive proceeds and who gets cut out? In many cases, CMBS tranching and packaging has distorted “investments beyond recognition.” Ensuing complications could create
Private Investors

Opportunity Funds. Opportunity funds sit on boatloads of commitments and gnash teeth over their inability to do deals while markets teeter. “They want huge discounts.” Some managers, who moved prematurely on residential land tracts, already count losses. Funds continue to raise dollars, but “not as much as hoped” and fractured debt markets force reduced performance expectations. “They won’t be able to get the returns promised to clients.” Existing highly leveraged portfolios face “markdowns” on legacy transactions and refinancing challenges as hopes fade that markets can avert value declines. Vintage funds investing over the past six years have enough early gains to show strong overall annualized returns despite recent stinkers—“maybe not in the mid 30s, but in the 20s,” says a portfolio manager. Now, interviewees wonder whether all the committed capital “will show up when it’s time to pull the trigger.” And some fund managers leave the scene entirely in the Wall Street bloodletting.

Hedge Funds. Some hedge funds jump to fill the lending gap by extending short-term, high-interest-rate bridge loans to tide over borrowers in dire refinancing straits. They also look to buy discounted mortgage and CMBS portfolios. Real estate specialists continue to carp that hedge fund managers lack real estate experience and “pay too much” on deals. “They’re fixed-income guys not looking at underlying collateral. They haven’t learned.” Time will tell. Active in the 2005–2007 investing frenzy, hedge funds may be exposed to increasing portfolio problems as markets correct.

Syndicators, High-Net-Worth Investors, 1031 Investors. While many leveraged investor syndicates make themselves scarce, some core-oriented funds continue “to pay up for quality.” Managers sold out at market highs and have capital to reinvest. “They’re not getting great deals, but they are

Discipline Returns. Crisis reflexively spawns discipline in real estate markets to the point that many recently reckless lenders are now afraid to underwrite mortgages unless transaction structures eliminate most risk. They require significant borrower equity, recourse, secure property cash flows, and low tenant rollover exposure. No one wants to touch larger $100 million loans, even in syndications. Securitization had been agnostic to location and property type—terms, requirements, loan-to-values were homogenized. Now, commercial banks differentiate again—apartments and Class A office in 24-hour cities gain special favor, but other sectors and properties in secondary and tertiary markets face much more difficult financing hurdles. “They’re pulling in their horns, reserving funds for premier clients and trophy properties.” Interviewees expect stringent standards to stay in place until lenders’ balance sheets improve and real estate markets exit the danger zone (see Exhibit 2-6). Gradually, as people start to resume making money, guidelines will loosen “and in ten years it will be reckless and undisciplined again.”

“The industry forgot about real estate underwriting, there was no differentiation between asset quality, and assumptions were juiced aggressively.”

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on U.S. respondents only.

### Exhibit 2-6
**Underwriting Standards Forecast for the United States**

- Standards Will Become More Stringent: 69.1%
- Standards Will Remain the Same: 18.2%
- Standards Will Become Less Stringent: 12.7%

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on U.S. respondents only.
U.S. Capital Sources

EXHIBIT 2-7

Sources: Roulac Global Places, from various sources, including American Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserves, FannieMae.com, IREI, NAREIT, PricewaterhouseCoopers, and Real Capital Analytics.

Note: Excludes corporate, nonprofit, and government equity real estate holdings, as well as single-family and owner-occupied residences.

* 2008 figures are as of second quarter, or in some cases projected through second quarter.
Chapter 2: Real Estate Capital Flows

EXHIBIT 2-8
U.S. Real Estate Capital Sources 2008

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<td>Public Debt</td>
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<td>Life Insurance Companies</td>
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<td>REIT Unsecured Debt</td>
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<td>Pension Funds</td>
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<tr>
<td>REITs (Equity &amp; Hybrid)</td>
<td>$390.0 B</td>
</tr>
<tr>
<td>Public Untraded Funds</td>
<td>$40.7 B</td>
</tr>
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</table>

U.S. Real Estate Capital: $4,757.6 B
Equity Capital: $1,159.0 B
Debt Capital: $3,598.7 B

Sources: Roulac Global Places, from various sources, including American Council of Life Insurers, CMSA/Trepp Database, Commercial Mortgage Alert, Federal Reserves, FannieMar.com, IREI, NAREIT, PricewaterhouseCoopers, and Real Capital Analytics.

Note: Excludes corporate, nonprofit, and government equity real estate holdings, as well as single-family and owner-occupied residences.

* 2008 figures are as of second quarter, or in some cases projected through second quarter.
Emerging Trends in Real Estate® 2009

dividends. Recent net sellers, REITs have focused operations teams on strengthening rent rolls in anticipation of trouble, and “moderate” leverage levels should help them “ride out any problems” without cash flow issues. Expect REITs to be active early buyers when markets stabilize—“they have lines of credit to take advantage of any opportunities.”

Pension Funds

Pension funds “should have been queuing up to get out of core open-end funds two years ago” when returns were eye-popping in the mid-to-high teens. “Now they will be taking losses in mark-to-market funds.” Many enamored plan sponsors had raised real estate allocation targets to 5 to 10 percent in their asset models, and focused new investments “up the risk spectrum” in value-add and opportunity funds. But stepped-up real estate investments and stock market declines combine to resurface the dreaded “denominator effect,” pushing many plans over their allocation targets and “shutting them down” for making more commitments. Belatedly, lines form to exit funds. “Raising money is like pushing a rock up a very steep hill,” says a frustrated adviser. “Plan sponsors engage in long-term strategies and allocations, but tend to miss on short-term tactics.” Investment managers struggle to attract interest from existing clients in new closed-end funds—“they want their money back from existing funds before they reinvest.” Advisers may confront more bad news. If markets deteriorate, as expected, most plan sponsors will keep checkbooks closed—“they don’t invest in tough times.” Public pension interviewees consider reducing the number of managers and funds to facilitate oversight for budget-stretched staffs. The winnowing process favors top performers with “big footprints” in managing funds across the risk-return spectrum as well as private/public and global markets. When markets settle down, plan sponsors “will miss the best opportunities. They never make the first move,” says a manager.

REITs

Public REITs already suffered through price declines in the stock market tumble as “shareholders anticipated lower NAVs” (net asset values). But these stocks could take another hit if too many bad headlines surface about commercial market travail. Investors can count on a REIT market recovery well before private markets turn around. “2009 could be a good time to buy.” Many companies appear well positioned—“they can benefit from a flight to quality” and investors like their ample dividends. Recent net sellers, REITs have focused operations teams on strengthening rent rolls in anticipation of trouble, and “moderate” leverage levels should help them “ride out any problems” without cash flow issues. Expect REITs to be active early buyers when markets stabilize—“they have lines of credit to take advantage of any opportunities.”

Foreign Investors

Reminiscent of the Japanese two decades ago, Middle East players trophy-hunt for prime buildings in major 24-hour cities. In a market environment where capital turns tentative, they have become “one of the few dependable sources for writing checks.” Hardly monolithic, these investors include sovereign wealth funds, pension funds, wealthy individuals, and networks of high-net-worth investors who can pay in cash from all their oil earnings. “There’s a phenomenal amount of capital at their disposal” and “most don’t mark-to-market, so they can take the long view.” Capital preservationists tend to
concentrate their attention in the United States, but opportunity investors scour the world and have been investing in Brazil, Russia, India, and China. Survey respondents anticipate that Middle East investors will keep spending in 2009, but some interviewees suggest they will become increasingly careful. “Their pace is unsustainable.”

European investors back off as their economies slow down. Notably, the recently active Irish have retreated. The Germans, meanwhile, continue to wait out any market turbulence—they got nervous early about the level of cap rate compression and high pricing in the core properties they tend to covet. Australians may “have gotten over their skis” in a splurge of purchasing at or near market peaks, taking advantage of the weak American dollar. Canadian pension funds want to expand U.S. holdings, but won’t hurry into declining markets. Neither will Japanese and Chinese investors who were primed to increase investments too.

Banks and Insurers

The depth of the housing crisis and credit market disruption undermines bank lending and threatens to torpedo more institutions. Banks simply cannot afford to lend much money before they resolve existing portfolio problems, and their financial positions continue to erode despite capital infusions and federal government interventions. More regional banks could fail from troubled homebuilder loans and money center institutions may require additional backstops. Any deterioration in commercial real estate markets will amplify balance sheet damage. At best, 2009 offers a chance for banks to stabilize, but lending will continue to be severely constrained. “They will charge a lot to take on any risk.”

Over the past decade, more conservative life insurers had been shunted aside by CMBS conduits and the commercial banks—they secured a niche making long-term permanent loans to high-credit owners. “Now they are the new sheriffs in town,” cherry-picking the very best lending opportunities. “It’s revenge of the nerds.” Says an insurance executive: “We can be selective and focused, receiving comfortable spreads.” They concentrate on the office and warehouse sectors, generally steering clear of retail and hotels. Fannie’s and Freddie’s dominance in apartments has kept them out of multifamily. But insurers will “not be saviors” and have no reason to increase allocations. Slowing insurance policy and annuity sales limit their ability to expand real estate lending. Insurer mortgage portfolios won’t be free of problems, either—“some borrowers will have trouble refinancing and need more equity.”
Emerging Trends in Real Estate® 2009

### Mezzanine Debt

Opportunity and hedge funds circle distressed owners, offering borrowers enticing short-term debt infusions to buy them time. Through high-interest-rate, loan-to-own structures, they masquerade as mezzanine leverage. But some recapitalizations can reap “excellent risk-adjusted returns” for lenders taking mezzanine positions, if they carefully underwrite their investments. “Not everyone knows what they’re doing—there’s a lot of dumb money running from subprime debt to high-yielding mezz deals.” Traditional mezzanine bankers, who invest in the 75 to 85 percent part of the capital stack, need to focus on existing portfolios, “spending lots of time on asset management rather than new deals.” The collapse of securitization markets limits their financing sources and forces up borrowing rates to get necessary yields. Many of these traditional mezzanine lenders have been forced to exit the market, at least temporarily.

### CMBS

“It took 20 years to create the securitization markets and a couple of months to blow them up.” Most interviewees concede it may take “several years” for markets to reinvent and resuscitate, “and we won’t have liquidity until then.” Deteriorating real estate fundamentals could increase the challenge and delay a resolution: “No one wants to catch a falling knife.” With the temporary exit of conduit lenders, small owners in B and C markets have few borrowing options when they need to refinance.

Interviewees stress that “there was nothing wrong with the [CMBS] concept, if only loans had been properly underwritten and structured.” B-piece buyers “made a lot of money and most of their loans are still paying off—they will reenter the market quickly with resumed discipline.” Other fixed-income investors may require some level of government oversight before they get comfortable again since “no one trusts the rating agencies.” “Euro investors are gone and the pension funds have headed for the hills.” A conduit executive suggests that future CMBS lending will be fixed rate, not floating, and focused on smaller $5 million to $10 million loans in more secondary markets. “Instead of securitizing $200 billion–plus a year, we should be doing about $70 billion.” Some interviewees even predict that CDOs can make a comeback, but that may be too much for anyone to stomach. Older vintage, properly underwritten CMBS can still find a market, “but are hard to buy.” Newer vintage “stuff” is abundantly available (for obvious reasons).

### U.S. Buyers and Sellers: Net Capital Flows by Source and Property Sector

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<tr>
<th></th>
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<tbody>
<tr>
<td><strong>Billions</strong></td>
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<tr>
<td><strong>Apartment</strong></td>
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<td><strong>Industrial</strong></td>
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</table>

#### Exhibit 2-12

**U.S. Buyers and Sellers: Net Capital Flows by Source and Property Sector**

The table shows net capital flows by source and property sector from second-quarter 2007 through second-quarter 2008. The flows are categorized into different segments: Condo Converter, Cross-border, Fund, Institutional, Private In-State, Private Out-of-State, REIT Public Company, Syndicator, User/Other, and Unknown. The source for this data is Real Capital Analytics.
“Not everyone knows what they’re doing—there’s a lot of dumb money running from subprime debt to high-yielding mezz deals.”
Familiar U.S. global pathway cities, which have become investor favorites and global business magnets, reinforce their premier standings in the looming market correction. Interviewees expect these 24-hour coastal centers to hold value better and recover more quickly from any downturn, and predict that investors and lenders will retreat from secondary and tertiary markets. Investment ratings decline markedly from last year for most cities in the survey—“no markets will outperform.” Prospects dim especially for smaller cities and places dependent on for-sale housing to spur growth. “The major markets provide shelter” and “long-term returns.” “They offer enhanced urban environments, which remain attractive for the quality of life experience. Any bumps in the road can be managed.”

West Coast gateways Seattle and San Francisco reclaim top rankings from New York, which stumbles over Wall Street’s breakdown. Washington, D.C., and Los Angeles hold their own, but southern California’s large suburban satellite markets—Riverside and Orange County—tank in mortgage and housing misery. So does San Diego, but not as dramatically. Ironically, the investment prospects for long-forlorn Texas markets strengthen, spurred by the nation’s flourishing energy industry, which has its headquarters there. But cities in another fast-growing state, Florida, falter, with their housing markets in utter disarray. Hot-growth desert cities—Phoenix and Las Vegas—get “blown out,” while Midwest factory towns lose even more ground—only Chicago manages to rate fair prospects in an enduring regionwide decline.

Back to the Cores

**Infill’s Desirability.** High gas prices and utility bills, meanwhile, accelerate people’s already shifting attitudes about where they want to live. Increasingly, they seek greater convenience by locating closer to urban cores and infill locations—not only because of mounting suburban congestion on aging, inadequate road systems, but also because the cost equation is changing in favor of less car-dependent lifestyles. Time is money, and steadily lengthening commutes in most major metropolitan areas have tested drivers’ patience for more than a decade. Many suburban families living in pedestrian-unfriendly communities need as many as three or four cars so that mom, dad, and the kids can get to divergent locations without any mass transit alternatives. Gasoline that costs over $3.50 a gallon piles on top of multiple car payments, routine maintenance costs, repair bills, and insurance premiums. People start to realize they may save by living closer to work and stores in higher-density infill locations—they can get rid of a car or two to pay for more expensive housing, and gain convenience. If electricity and heating bills continue to surge, high-ceilinged McMansions in outlying subdivisions will become even more burdensome on pocketbooks. Smaller houses or apartment-style living suddenly looks more attractive and economical to more people. As noted in previous reports, many empty nester baby boomers and their young adult progeny favor more urban lifestyles and move back in from the suburbs.

San Francisco, California.
EXHIBIT 3-1
U.S. Markets to Watch: Commercial/Multifamily Investment

Source: Emerging Trends in Real Estate 2009 survey.

EXHIBIT 3-2
U.S. Markets to Watch: Commercial/Multifamily Development

Source: Emerging Trends in Real Estate 2009 survey.
Emerging Trends in Real Estate® 2009

Chapter 3: Markets to Watch

24-hour environment and the center city once again surpasses upstart suburban commercial nodes as the metropolitan area’s predominant office location. Is it any coincidence that Denver consistently has cracked the survey’s top ten rankings over the past four years?

Atlanta Takes Action. Atlanta hasn’t visited the Emerging Trends top ten since 1997—in 1996, the city actually topped the survey in a pre-Olympics growth spurt. But this vast Southeast metro takes action to overcome the liabilities of breakneck suburban expansion, which left its downtown for dead and precipitates horrendous traffic congestion outside the perimeter. “Hope for the future lies in greater density.” Rescuing downtown and re-creating an urban center extending to Midtown and uptown Buckhead now takes precedence. High-rise residential streetscapes emerge, attracting younger workers.

Overcoming Car Dependence.
The 24-hour stalwarts—New York, Boston, Chicago, San Francisco, and Washington, D.C.—all benefit from efficient hub-and-spoke mass transit systems that may include interconnected networks of subways, commuter rail, buses, and ferries. Fast-growing Sunbelt cities had pooh-poohed mass transit in their rapid expansions, enabled by interstate highway building during the 1960s and 1970s. Virtually no one contemplated the consequences of car dependence until populations began to overwhelm road capacities. Now, escalating driving costs exacerbate concerns about the economic viability of unrestrained horizontal development and weak urban centers in the midst of these suburban agglomerations. Government leaders and local planners have joined forces with chamber of commerce interests and real estate players to confront challenges posed by expected future growth. They realize that distended sprawl development no longer provides a model to sustain metropolitan area prosperity.

Denver’s Lead. Cities like Denver and more recently Atlanta start to make amends. Beginning more than a decade ago, Denver focused on reinvigorating its sleepy 9-to-5 downtown by redeveloping its LoDo warehouse area into an attractive commercial, entertainment, and residential district anchored by sports stadiums. Backed by the state of Colorado, the municipality began building an extensive light-rail and commuter-rail system leading from key suburbs into the urban center. Major avenues were transformed into pedestrian malls, served by shuttle buses linked to train stations. Transit-oriented development caught on along suburban stops and the old Stapleton Airport was redeveloped into a new urbanist community. Residential development now begins to expand in and around downtown, creating a more 24-hour environment and the center city once again surpasses upstart suburban commercial nodes as the metropolitan area’s predominant office location. Is it any coincidence that Denver consistently has cracked the survey’s top ten rankings over the past four years?

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EXHIBIT 3-4  
**Leading U.S./Canadian Cities**

<table>
<thead>
<tr>
<th>Investment Prospects</th>
<th>Development Prospects</th>
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<tbody>
<tr>
<td>Good</td>
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</tr>
<tr>
<td>Modestly Good</td>
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<tr>
<td>Fair</td>
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<td>Modestly Poor</td>
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<tr>
<td>Poor</td>
<td>Poor</td>
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<tr>
<td>Very Poor</td>
<td>Very Poor</td>
</tr>
</tbody>
</table>

Legend:
- Good
- Modestly Good
- Fair
- Modestly Poor
- Poor
- Very Poor
who favor walkable neighborhoods and intown living. A “LoDo-ish” cultural and entertainment district springs up around downtown’s Olympic Park. Developers cluster new mixed-use projects near subway stops while the city secures property rights for a circumferential green recreational “beltline” and considers solutions involving light rail, shuttles, and buses to connect more districts inside the perimeter to its increasingly popular but limited subway system. All the disparate activity and ideas head Atlanta in the direction of a more viable urban landscape with 24-hour neighborhoods and amenities to accommodate expected population growth. But in true Atlanta fashion, developers’ eagerness has led to significant overbuilding—many condo units go begging for now.

The Vertical Wave. Other once moribund city centers also begin to rejuvenate in the midst of new high-rise residential construction. Downtown Los Angeles steadily builds more apartments and condominiums, ditto uptown Dallas, Houston (downtown and the Galleria), and even downtown Brooklyn, St. Louis, and Milwaukee. Suburban office nodes also follow the model, inserting high-rise residential, service retail, and restaurants into office districts and around regional malls. “Urban centers will be the driving force in the future.” “There’s a return to the cores where people can find a combination of entertainment, shopping, culture, and action.” “People want life and they find it more now in urban environments.”

The Suburban Advantage. Suburbs will continue to retain their edge among many families looking for better school districts and child-friendly environments. But the mortgage crisis, high car-related costs, and increasing property taxes roil the suburban idyll. “People are making incredible sacrifices to bring up their kids.” In past decades, various federal grants helped subsidize extensions for roads and sewers, enabling subdivision growth and suburban expansion. That’s over. Shortfalls in the Highway Trust Fund (a result of not raising gasoline taxes) deplete federal coffers. Responsibility for improving and maintaining infrastructure transfers to local governments, which often must raise tax bills to fill potholes or add turning lanes. Many homeowners struggle with these unanticipated tax hikes in addition to higher mortgage payments.

Crime and Water. The difficult economy, falling real estate values, and fewer property transactions hit cities and suburbs alike in their wallets. Declining tax revenues naturally lead to reduced services. Gains in the attractiveness of 24-hour cities could be squandered if cutbacks in police, fire, and sanitation result in less safe and appealing environments. Nothing would undermine 24-hour dynamics more quickly than rising crime rates.

Water issues increasingly plague many hot-growth Sunbelt regions. A recent drought spotlights Atlanta’s insufficient reservoir system. Declining levels along the Colorado River threaten expanding cities throughout the Southwest, including Las Vegas and Phoenix, and southern California could face another Chinatown moment. These areas will be unable to accommodate future population growth without solving their water needs through increased conservation and finding new sources.
Emerging Trends in Real Estate® 2009

Chapter 3: Markets to Watch

Major Market Review

So-called smile investing remains in fashion. For 2009, interviewees like the familiar coastal favorites—Seattle, San Francisco, and Los Angeles along the Pacific; and New York, Boston, and Washington, D.C., to the east. These gateways can prosper in the evolving global marketplace and “they pose less risk” in a downturn. Likewise, the “three key metros in the middle of the country”—Chicago, Dallas, and Atlanta—benefit from their large international airports, which also feed into global commerce. Cities off the global pathways will continue to be disadvantaged. Ratings fall across all regions except Texas, where energy industry kingpins Houston and Dallas register upicks. Southeast and Southwest markets, which had crested on a homebuilding wave, take some hard falls. Survey sentiment declines to record lows for many Rustbelt and heartland cities, shunted off the economic growth track.

Seattle. This Northwest magnet for brainpower industries grows into one of America’s important gateways and job incubators. “It’s a city of great creation, new ideas, and new businesses.” More than just Microsoft and Boeing, Seattle boasts a diversified group of corporate giants and cutting-edge companies. But this sturdy market braces for some buffeting. Sub–10 percent downtown office vacancies will rise—3.5 million square feet (325,160 sq m) of new supply plus more tepid job growth equals flattening rental rates and more concessions. Owners scramble to find tenants as Washington Mutual collapses and Starbucks downsizes. Bellevue thrives in an office building splurge filled mostly by Microsoft. This satellite office market remains vulnerable to any future layoffs by the software giant. Arealwide housing demand drops and prices slip, staying well above national averages. Outer suburbs suffer greater pricing erosion—a lack of mass transportation and high gasoline costs affect perimeter areas. Condo builders suffer agitation; sales and presales “fall dramatically.” But interviewees rate the market a strong buy for apartments—rents move up, vacancies head down, and new projects are limited. Low retail vacancies buffer shopping centers in any consumer pullback—“owners may come down with sniffles, but no pneumonia.” Surveys rank the area’s Puget Sound ports as the nation’s number-one buy among industrial markets.
San Francisco. The City by the Bay never strays far from the top of the survey, featuring a Pacific gateway with barriers to entry and quality of life, comparing favorably to any other 24-hour market. An expected drop in prices and values won’t be “nearly as bad” as during the 2000–2001 tech wreck, when office and apartment developers overshot. “No construction glut exists this time.” Expect the well-diversified local economy to outperform the national average, helping all property sectors. The city actually ranks first for development and homebuilding (despite scoring mediocre marks), and rates as the leading “buy” market for apartments and office. The city’s transcendent waterside setting helps lure travelers and sustain hotels, while its ports tap into Asian trade. Lofty housing prices fall, but foreclosure distress should remain relatively restrained, especially compared with that seen in some overbuilt southern California markets. Silicon Valley’s “energy and enthusiasm return,” impelled by resurgent high tech. Some interviewees warn that software companies won’t be immune to the recessionary downdraft. “That’s a disaster waiting to happen.”

Washington, D.C. The ultimate hold market when the economy struggles, the nation’s capital always cashes in from federal spending—those taps never stop gushing—and the area overflows with brainpower jobs linked to government, lobbying, defense, tech, biotech, and education. Downtown office vacancy should stay below 10 percent and apartments “lease up no matter what.” But builders may have overstepped north of Massachusetts Avenue and around the new baseball park. Infill suburbs like Bethesda, Alexandria, and Arlington look solid, but office vacancies soar in northern Virginia from a recent building spree. “Look for see-throughs along
Chapter 3: Markets to Watch

New York. Wall Street’s implosion threatens near-term prospects for the country’s principal global pathway city—“a daisy chain” of lost investment jobs leads to cuts in accounting, law firms, advertising, car dealers, co-op brokerages, and restaurants. Puny year-end 2008 bonuses for surviving traders and bankers promise to chill the market further. “But no one should count us out.” Office vacancies ramp up as a host of financial giants leaves the scene. Rents drop from stratospheric to “comfortably high levels,” although concessions increase and nervous landlords approach tenants about reupping to forestall increasing rollover risk beginning in 2010. Owners and inves-

tors take some heart from the absence of speculative development (too many barriers to entry), but anticipate that companies will hold out for better deals as more sublease space comes on the market. Skeptics question plans for massive office building at Ground Zero after the unprecedented financial industry failures and more development is planned over the Hudson rail yards—who will fill the space? Hotels should not count on foreign tourists, if offshore economies decline further. The city’s recent hotel squeeze could turn into a bulge—about 50 new projects are planned or underway. The retail frenzy ends, but the city’s concentration of wealth keeps Madison Avenue boutiques in business. Co-op and condo markets finally weaken—developers worry about flagging buyer demand. City services retrench—tax revenues decline off reduced property transaction volumes as well as lowered incomes. The area’s aging mass transit systems won’t get needed funding for upgrades and expansion. Not surprisingly, suburban markets catch a nasty cold, too.

The tollway” as you head out toward Reston and Herndon. The office market in Rockville, Maryland, also softens. Condo and housing prices reverse more steeply than national declines, following a heady run of increases about double the national average. Emerging Trends respondents love area retail potential—sustained employment and wages should help keep people in stores. The area’s Achilles’ heel remains growing congestion in poorly planned suburbs, especially in northern Virginia. The region desperately needs to expand its Metro mass transit system and relieve crowded roads to facilitate future growth. Any transit-oriented development hits “grand slams.”

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**EXHIBIT 3-8**

U.S. Hotel Buy/Hold/Sell Recommendations by Metropolitan Area

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<th>Metropolitan Area</th>
<th>Buy</th>
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<tr>
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<td>33.8</td>
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<td>6.6</td>
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*Source: Emerging Trends in Real Estate 2009 survey.*
Los Angeles. Holding up the best in housing-ravaged southern California, L.A. benefits from a well-diversified economy and dense infill environment with higher barriers to entry than in nearby suburban markets like Orange County and the Inland Empire. An office building wave could weaken the market into 2010 after a falloff in demand—the financial services crash hurts prime west Los Angeles in particular. Downtown continues to benefit from condominium and apartment projects, which help nurture a more 24-hour environment amid hulking office towers, but Pasadena, Glendale, and west L.A. commercial centers still retain an upper hand closer to premier family-friendly executive neighborhoods. Driving to downtown gets more challenging every year and gas prices increase commuting angst. Overall, multifamily has legs: “It’s almost impossible to lose money on apartment investments, if you have a five- to ten-year investment horizon.” Hotels benefit from the city’s global pathway location. But housing woes devastate homebuilders in previously high-flying San Bernardino and Riverside, where foreclosures spiral and home values drop like rocks. The once white-hot Inland Empire industrial market cools temporarily—as nationwide consumer contraction hits warehouse demand near the nation’s largest port, L.A./Long Beach. “Big-box warehouse developers pushed too far,” “building to the horizon.” Upscale Orange County—“ground zero for the mortgage collapse”—gets nailed by its exposure to home lenders, some of which go belly up. Absorbing shadow office space “could take three to four years.” The O.C. housing picture looks even worse—prices dive. Weak household credit dampens shopping center outlooks throughout southern California.

Houston. “Stays hot as long as energy stays hot.” The U.S. capital for “Big Oil” vaults into the Emerging Trends top ten for the first time since 1995, just as the rest of the country swoons over record-high fuel and utility prices. “It’s back to the late 1970s,” when this market boomed during an energy crisis. “For all the talk about becoming more diversified,” Houston needed the oil surge to allow demand for space to catch up with its propensity for rampant development. Interviewees legitimately can point to additional market strengths: the Johnson Space Center, world-class medical facilities, a burgeoning Gulf port, and trade with Mexico. The population keeps expanding due to the high-octane job engine and reasonable cost of living.

EXHIBIT 3-9
U.S. Retail Property Buy/Hold/Sell Recommendations by Metropolitan Area

<table>
<thead>
<tr>
<th>Metropolitan Area</th>
<th>Buy</th>
<th>Hold</th>
<th>Sell</th>
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<tbody>
<tr>
<td>Washington, D.C.</td>
<td>40.0</td>
<td>51.8</td>
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<td>Seattle</td>
<td>39.1</td>
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<td>New York</td>
<td>34.9</td>
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<td>Houston</td>
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<td>62.3</td>
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<tr>
<td>Atlanta</td>
<td>7.5</td>
<td>61.3</td>
<td>31.1</td>
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Source: Emerging Trends in Real Estate 2009 survey.
sis on expanding mass transit alternatives and buttressing Denver’s downtown core as the regional hub should pay future dividends. Some transit-oriented mixed-use residential development along suburban rail stops gets ahead of itself, but will outperform eventually.

Dallas. "Texas creates jobs" and Dallas, like Houston, gains ground in the Emerging Trends rankings, comparing favorably to most other hot-growth markets, which don’t get the same boost from energy-related businesses. AT&T’s move from San Antonio underscores the importance of Dallas/Fort Worth International Airport, which secures the city along the cross-country global pathway. But let’s not get too carried away—office vacancies remain stuck around 20 percent and even higher in the perpetually struggling downtown. Local developers, who chronically overbuild, may have met their match in the financing morass—the dearth of construction lenders should finally slow down construction activity. Living styles trend more vertical: the Metroplex "no longer just builds

Boston. Beantown hangs in there despite steadily losing financial jobs to company mergers and acquisitions, bank takeovers, and now Fidelity moving operations to cheaper space in Rhode Island. The good news is plenty of investment and money management jobs remain; health care, biotech, and education help pick up some of the slack, and the area’s top-ranked colleges and universities provide exceptional talent to seed the workforce. Limited commercial development in the site-constrained Financial District and Back Bay neighborhoods helps keep office space “tight,” but new harborside hotels threaten to “hurt older product.” Suburban markets never fully bounced back from early-decade tech-wreck reversals—they look more vulnerable. Values will “back up”—housing has already taken a drubbing after steep gains.

Emerging Trends in Real Estate® 2009
Emerging Trends in Real Estate® 2009

Planos. High-rise and mid-rise apartments spring up around commercial nodes. “Suddenly we like urban cores more in Texas.” Apartment owners do well and developers keep building—lower-income demographics provide more renters. Like everywhere else, homebuilders stagger, but single-family value declines have been relatively moderate since prices never rose too sharply. Significantly, the state and local governments take concerted steps to integrate and expand Metroplex mass transit in the face of road congestion and gasoline sticker shock.

Chicago. “Looks like New York, behaves more like Atlanta.” Buildings “pop up too easily” and office rents show little to “no rent growth” in this 24-hour Midwest titan. “It’s not one of my favorites,” says a locally based investment manager. “I know too much.” Low-teen office vacancies are bound to increase as the “uneven” economy goes sideways and new construction is completed, luring tenants out of older buildings. West Loop stays the best submarket—near commuter trains.

Oversupplied condos weaken—“nothing sells”—upwards of a quarter of buyers had been speculators. Many “mom and pop” investors have trouble keeping up with mortgage payments—“there’s a lot of shadow renting.” Apartments “do well” nevertheless—younger workers want to stay near the bright lights and action. Exurban housing values sink. The closer homeowners live to the city core, the better they feel about their property nest eggs. O’Hare Airport and the city’s central breadbasket location keep industrials in the global pathway mix. “Chicago’s not slow and not fast, nice and steady—it’s got good demographics, transportation, workforce, and infrastructure.” The 2016 Olympics bid contributes “positive buzz.”

San Diego. The deflating housing market torpedoes enthusiasm—what went way up now heads way down. Investors avoid panic mode—this southern California bastion for almost-ideal weather is a solid hold market, destined to rebound over time. “San Diego has been hit hard by subprime and housing, but not as bad
as the O.C.—flat days ahead temper great long-range prospects.” Office property flipping had “gotten out of hand” to unsustainable levels—last buyers suffer, and vacancies jump into the mid-teens as employment stagnates. Homeowner fallout—weakening consumer appetites and lowering credit quality—unsets a historically superior shopping center market. Hotels and the convention center would do better if the city had a bigger airport, taking more nonstop flights from the East Coast and international points. LAX and the Los Angeles/Long Beach port fix the global pathway 110 miles (176 km) to the city’s north.

**Atlanta.** 2009 promises “tough times” as an overbuilding hangover and slipping demand roil investors. The regional economy depends on high growth, but lacks energy and high-tech engines that currently help sustain other markets. It’s no time to buy in any of the property sectors. Office developers “play a game of chicken” in Buckhead, where “a bloodbath is coming.” About 2.5 million square feet (232,257 sq m) of spec construction is underway in a market that traditionally absorbs less than 500,000 square feet (46,451 sq m) annually. The “goofy” activity “defies description.” Condo and apartment builders also trap themselves in Atlanta-style irrational exuberance—constructing new projects well ahead of demand. What do you know—industrial markets suffer from oversupply, too. This market exemplifies the “move back in” as many baby boomers seek to escape from driving headaches outside the perimeter. “As soon as my 15-year-old is out of the house, we’re moving out of East Cobb to a condo penthouse in Midtown.” Besides trying to reduce traffic snarls, leaders struggle over how to increase reservoir capacity and find additional drinking water sources. New roads, more mass transit, and needed water/sewer infrastructure all translate into higher future taxes. “Ultimately, a more cosmopolitan Atlanta means a more expensive lifestyle.” “The reason for relocating here will no longer be a more relaxed, cheaper quality of life.”

**Philadelphia.** Consistently off interviewees’ radar screens, Philadelphia retains favorable 24-hour attributes—cultural/historic attractions, decent intown neighborhoods, medical facilities, universities, and commuter-rail lines. But the city has never replaced enough lost manufacturing jobs and inner-city areas have been slow to gentrify. As a result, Philly ranks at or near the bottom of all sector buy/sell ratings. A Northeast high-speed rail corridor would help lift Philadelphia’s prospects, turning the market into a more convenient low-cost alternative to its higher-octane Northeast neighbors—New York and D.C.

**Miami.** “All of Florida seems to be dropping into the ocean economically.” No doubt the luster is gone—housing values plummet in oversupply and foreclosures, insurance costs skyrocket, hurricane phobia increases, and a state revenue gap foreshadows tax hikes. “The condo-apartment market is so bad, even vultures won’t go there” and
30 percent–plus house-price declines pound homebuilders while speculators “get massacred.” By comparison, the office sector rates a solid hold and industrial properties near the supply-constrained airport always sustain strong demand. Hotels have peaked after a strong run—there’s less reason for everyone to party along South Beach.

Phoenix. This “dynamic” high-growth hot bed will need to rise again from the ashes after residential and apartment developers went overboard in the desert. “Office is on its butt,” too. “Everybody piled into the market and gets beat up.” Prices drop dramatically, “but now may be the time to invest when the market is flat on its back” and banks turn off construction lending. Population growth will continue and businesses like the lower-cost environment. In a place where volatility is the name of the game, opportunity investors with cash should start to circle. In the meantime, locals need to temper sprawl, deal with water issues, and fund mass transit. Suburban agglomeration problems begin to surface in spades.
Smaller Market Prospects

The ongoing flight to quality steers investors away from smaller markets, sitting off global pathways with less diversified economies. “They can’t get growth.” Recent airline flight cutbacks by carriers spotlight their second- and third-tier status, making business travel more difficult and expensive. Investors fear that any major employer downsizing can knock out market prospects. And exit options become limited as capital reflexively withdraws. In general, the consensus view is that many of these markets will suffer greater value declines and recover more slowly.

Austin scores well in the Texas upsurge—state government and the University of Texas plus a swell of high-tech businesses make for a good story. “It’s a shining star . . . relatively.” But developers “need to slow down; too much multifamily construction is underway.” The center city transforms skyward with more mid- and high-rise residences. Nearby San Antonio also benefits from the Lone Star halo effect. Raleigh/Durham and Charlotte continue to grow—the Carolinas provide a low-cost alternative to the Northeast and Florida with a pleasant Goldilocks climate. But Charlotte “shivers in its boots” over Wachovia’s demise. “That market depends on two banks and a power company.” Portland prospers in Seattle’s shadow, but increasingly plays second fiddle. Honolulu needs to worry that Asian travel doesn’t slip. Domestic business already dips due to rising airline rates and consumer belt-tightening. For now, Salt Lake City draws fewer Californians moving east to its cheaper cost of living. Nashville benefits from an expanding entertainment industry around its country music empire. Many stars and their fans buy residences—“high-end apartments are a best bet.” In the Midwest, Minneapolis and St. Paul manage to hold their own, relying on a diversified economy not wedded to manufacturing. Tampa, Orlando, and Jacksonville suffer in the Florida downturn. Excess condos and homebuilding mire these markets, but Orlando still gets a boost from foreign tourism thanks to Disney (as long as the dollar stays weak) and Jacksonville’s expanding port is a prime asset. Retail is “overheated” statewide. “There may be opportunity in the repricing.” California’s state government presence buoys Sacramento, but a questionable levee system raises concerns in the event of an earthquake. Las Vegas “craps out,” building way too much of everything. Casino owners overplayed their hands. Automaker-ravaged cities in the Rustbelt can’t get investor traction. New Orleans dodged another hurricane, but can’t attract back major businesses lost to Houston, Atlanta, and Dallas over the past quarter century.
For 2009, Emerging Trends interviewees expect declining performance among property sectors, operating in a problematic economy and coping with slackening demand. “Owners will try to keep occupancies as high as possible through concessions and free rent periods.” Some sectors will be considerably weaker than others. Already dismal housing prospects worsen and bottom out at record survey lows, while investment outlooks for retail sink to discomfiting "modestly poor" levels. Hotels slide into the “fair to poor” range, office dips to “fair,” and industrial warehouse registers somewhat better “fair to modestly good” marks. Interviewees forecast the best investment performance for apartments—they sustain a “modestly good” rating. (See Exhibit 4-1.) Development prospects are worse than investment prospects, and development will be extremely limited in all sectors, except apartments and maybe industrial, which manage fair prospects for new projects.

- Apartments and distribution/warehouse continue to hopscotch for top ranking. In 2009, apartments reclaim the number-one position. Demographics (more young adults) and the housing market collapse boost the number of renters, keeping apartment occupancies high and firming up rates. High-end apartments may face softening in markets, with failed condo projects morphing into rentals.
- Industrial remains an investor favorite for its steady cash flows, but the consumer downturn could mean lowered inventories and less shipping activity. R&D industrial holds up—high-tech companies outperform the overall economy.
- Downtown office should weather any leasing falloff better than suburban markets. Investors gravitate to higher-quality core product in major business centers over office parks and...
Retail had a great run, but it’s over. Consumers tap out on credit as unemployment numbers rise. The housing mess shakes confidence and gas prices sap in-store spending. Fortress malls and neighborhood shopping centers in high-income infill areas remain solid investments, but B- and C-quality product suffers.

Everybody waits for housing prices to stabilize and mortgage bankers to normalize lending. Interviewees anticipate another difficult year marked by more foreclosures and distressed sales, which help to clear the market and work down homebuilder inventories. Lenders may take a long time to revive and no one expects a sudden rebound in values.

Top Buys/Holds/Sells. Not surprisingly, the surveys score moderate-income apartments, warehouses, and downtown office as best buys and holds among the property sectors—these sectors retain their value better and throw off steadier cash flows. Retail had a great run, but it’s over. Consumers tap out on credit as unemployment numbers rise. The housing mess shakes confidence and gas prices sap in-store spending. Fortress malls and neighborhood shopping centers in high-income infill areas remain solid investments, but B- and C-quality product suffers.

Volatile hotels react to economic pressures, which can quickly reduce occupancies and room rates in recessionary environments. More companies penny-pinching travel budgets and vacationers stay closer to home or don’t go at all. Full-service hotels in major markets will outperform limited-service brands in suburban areas and along interstate cloverleaves.
Emerging Trends in Real Estate® 2009

Chapter 4: Property Types in Perspective

for warehouse/industrial to 73 basis points for limited-service hotels. (See Exhibit 4-3.) “We’re seeing a return to more historic levels.” Following a pattern, retail centers and hotels show the sharpest increases, industrials and apartments the lowest. Survey cap rates, which registered in the 5 to 7.5 percent range in 2007, advance into a 6 to 9 percent band for 2009. Expected unleveraged IRRs uniformly rise above 10 percent, with all sectors showing increases over last year’s report.

**Development Skid.** Straitjacketed by parsimonious lenders and hamstrung by falling demand as well as stubbornly high material costs, developers resign themselves to a disconcertingly quiet 2009. Construction financing for major projects is virtually impossible to obtain, homebuilding is redlined, and retail makes lenders especially nervous. Only rental apartment and some warehouse projects have much chance to register profits worth the risk, according to surveys. The firm lid on construction raises hopes that markets can recover more quickly and pent up demand will generate a round of sustained development activity after 2010.

**Apartments**

**Strengths**

Over time, apartments solidify their position as the best risk-adjusted core real estate investments. Demand from the burgeoning Generation Y/young adult population kicks into gear just as housing woes push defaulting homeowners into rentals and tougher mortgage underwriting prevents some renters from buying homes. “Owning doesn’t look like a reasonable option for many people.” As folks marry later in life, they stay in apartments longer, too. More empty nesters and retirees, meanwhile, give up suburban homes for easier upkeep and the convenience of apartment living in infill areas. “Apartments are a bright spot.” No wonder institutional investors never tire of buying these properties—“you almost always have an exit strategy.”

**Weaknesses**

Landlords can’t give away multifamily units in Florida, Phoenix, and Las Vegas, where builders went into overdrive and vacant condos convert into rentals, softening high-income apartments in particular. The shaky economy and rising unemployment numbers lead to lower tenant quality in weaker markets, affecting rent levels and net operating incomes. High energy and utility bills raise operating expenses, squeezing bottom lines. “You need a better economy to really move rents.” If the job picture deteriorates fur-

**Best Bets**

Everybody likes value-add plays, rehabbing older product into workforce housing where demand is strong. Possible government subsidies can provide a bonus. “You put $5,000 to $10,000 into each unit and can convert B-/C+ product into B/B+ and sell to core investors at a premium.”

Owners need to focus on hiring the “right” managers who can enhance leasing activity and retain tenants.

**Exhibit 4-4**

**U.S. Moderate-Income Apartments**

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<td>Expected Unleveraged IRR During Holding Period</td>
<td>10.1%</td>
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**Exhibit 4-5**

**U.S. High-Income Apartments**

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<td>Expected Unleveraged IRR During Holding Period</td>
<td>9.9%</td>
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Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on U.S. respondents only.
Begin to target overbuilt hot-growth markets for bargains—failed projects can rebound quickly when demand revives.

**Avoid**

Upscale apartments in “overbaked” condo markets remain vulnerable to failed projects converting into rentals and increasing supply. It’s no time to consider new projects where developers went on a bender. Think twice about investments in properties located in totally car-dependent areas away from commercial centers.

**Development**

Residential projects near mass transit stops can be no-brainers. Focus on infill areas in suburban markets with traffic problems. Mixed-use construction in urbanizing suburban nodes almost always includes residential components to help create more attractive 24-hour environments and feeds demand for retail. In high-cost 24-hour cities, local governments will continue to force affordable housing requirements on developers in return for approvals on more profitable office and condo projects.

**Outlook**

In the face of adverse economic metrics, apartment values should hold up, “but don’t expect increases.” Investors should not complain—treading water with multifamily beats being submerged in other sectors. At least cash flows can
offset anticipated cap rate advances. As the population edges back to infill markets and suburban metros evolve into more vertical environments, apartment demand and development will only intensify.

Industrial

Strengths
Institutional investors’ appetite never subsides for big-box warehouse properties located near leading gateway ports and primary international airports. Solid core-style investments, they produce steady cash flows and avoid sharp pricing swings. Values get cushioned in downturns: “Everyone wants to buy, but there is not much to go around.” Short construction lead times keep markets from getting too overbuilt—developers can pull back more easily when tenant demand diminishes. That’s good—since demand drivers wane in 2009.

Weaknesses
Slumping consumer buying leads to declining import traffic, slowing warehouse activity. Vacancies begin to rise especially at the Pacific seaports, geared to Asian manufacturers that pump cheap goods into U.S. markets. Stepped-up U.S. exports don’t make up the difference. Markets tied to homebuilding also show softness—homebuilders stop buying construction materials and fewer new homeowners mean reduced overall spending to fill houses with stuff. “Slowing orders for products push inventories down.” High gasoline prices force shippers to reconsider logistics and shipping routes, using more trains and fewer trucks. “Everyone is on hold.” Port bottlenecks along the West Coast bring potential new competition from Mexico, which will require more advanced rail infrastructure to ship goods into the United States. Portfolio investors struggle to build holdings through multiple acquisitions of smaller, disparate properties—“transaction costs mount.”

Best Bets
Despite dipping short-term prospects attributable to the economic slowdown, premier coastal markets will continue to shoulder ever-increasing import/export activity in the burgeoning global marketplace. Growth constraints on supply will challenge L.A./Long Beach, San Francisco, and Seattle to keep up with anticipated future demand from Asian shippers. The New York/New Jersey area faces similar capacity issues on the East Coast, creating opportunities for Charleston, Savannah, Jacksonville, and Houston. But these ports need deep-enough harbors to handle new oversized container ships.

Avoid
Investors should take care placing early wagers on potential shipping hubs in Texas markets and places like Kansas City, Memphis, and Columbus. Indeed, some of these markets could transform into major distribution centers over time. New intermodal transport corridors will become a 21st-century necessity, replacing or enhancing the interstate system and aging rail lines. But the federal government needs to join forces with states, shippers, and railroads to plan these next-generation networks for maintaining national competitiveness. Although costly infrastructure revamping won’t happen immediately, any changes will determine winner and loser markets.
Emerging Trends in Real Estate® 2009

Development
Builders need to back off. Rising vacancies, high construction costs, and limited financing take a toll on near-term plans. “Everything shuts down” for now.

Outlook
No other real estate sector faces the potential for greater adjustment and transformation of its markets. Investors need to monitor how high fuel prices shift shipping patterns and change warehousing priorities. Texas markets could benefit if more Asian goods move through Mexico. Likewise, heartland markets will become more strategic for intermodal transport, if shippers rely less on gas-guzzling trucks and more on railroads for cross-country runs. The widening of the Panama Canal will make Gulf and East Coast ports more accessible to Asian manufacturers in coming years, reducing pressure on West Coast ports. But the sheer volume of increased trade anticipated in the ever-globalizing economy ensures growing need for new types of distribution facilities and steadily increasing demand at the major gateways. At some point, the country will be forced to address its increasingly inadequate infrastructure and figure out more efficient transport systems.

Research & Development
Volatile cousins to warehouse and distribution facilities, R&D properties look like a safe harbor. They probably can skate through the current economic turmoil without significant downside as long as overall global demand holds up for tech-related products and services. In this cycle, R&D could be insulated from problems more concentrated in housing and financial sectors. Most high-tech, software, and biotech businesses had strengthened after overextending and crashing in
the 2000–2001 tech wreck. These properties rate strong holds from interviewees, with sizable buy sentiment also evidenced. High tech helps Seattle and San Francisco area markets, including San Jose, rank at the top of investor surveys.

Office

Strengths
Long leases protect office owners after markets crest and limited development activity, especially in most downtown markets, should help buffer against any serious investor dislocation. “We can weather this storm.” The credit crunch keeps planned projects from breaking ground—“when recovery comes, rents may recover quickly.” During the recent upcycle, most businesses tempered leasing requirements—they didn’t anticipate growing into extra space—and hired conservatively, maintaining lean staffs and squeezing down space per capita to its limits (about 180 square feet/16.7 square meters). “No one has been looking for bigger offices

and younger workers like collaborative, open-space environments.” As a result, interviewees expect more measured layoffs and less sublease vacancy than during previous market bottoms. Energy and high-tech markets could even sustain modest growth tracks.

Weaknesses
Leasing slows, leading to more concessions and possible rent erosion, especially in markets with concentrations of financial and investment firms. “It’s turning into a tenants’ market.” Development activity and fewer barriers to entry leave some suburban-oriented metropolitan areas more vulnerable to higher vacancies and tenant hopping. Phoenix, Orange County, Buckhead, outlying northern Virginia, and Las Vegas head off the cliff. Higher utility and fuel costs shave net operating incomes as rents flatten. Long-term demand trends point to slower growth. Companies continue to focus relentlessly on expense reductions, outsourcing more work overseas and to consultants, who don’t receive costly benefits or need cubicles. Technology lets them work from home.
Emerging Trends in Real Estate® 2009

Best Bets

Landlords must court tenants aggressively to sustain occupancies through the downturn—"it may make sense to trade concessions for better credit." Larger tenants need to consider limiting how much space they put back on the market for subleasing. If they give up too much space in 24-hour central business districts (CBDs), they may lose control of contiguous blocks, which can limit their growth options in a recovery. You’ve read this old chestnut before—higher-quality properties in 24-hour markets will hold value better and rebound more quickly.

Avoid

Secondary and tertiary cities prepare for steeper value losses in a capital flight to quality. The entire market quakes when a big employer downsizes. "They always turn out to be more volatile."

Development

Construction lenders remained relatively disciplined throughout the recent cycle—institutional memories from the late 1980s kept projects in check. Now, the severe credit rollback applies a coup de grâce—most developers might as well take the year off and those with projects coming on line need to brace for leaner bottom lines.
Emerging Trends in Real Estate® 2009

Chapter 4: Property Types in Perspective

Outlook
Owners can’t escape value corrections and flattening rents. They hope the economy improves enough to steady demand and limit exposure to future rollover risk. Trophy hunters who bagged dearly priced acquisitions in 2006–2007 take more lumps in high-profile flameouts. Top markets shouldn’t stray too far from equilibrium, allowing rents to jump-start after companies begin hiring again in 2010 or 2011.

Hotels

Strengths
Major coastal cities should continue to attract offshore euro and yen visitors who flock along global pathways to these U.S. destinations as long as the weak dollar makes them bargains. New York, Los Angeles, Orlando, and San Francisco should “stay in the game” while other markets struggle. But anxiety increases even in the top lodging markets—interviewees question the durability of the foreign tourist blitz when international economies may be following the U.S. slide. Upscale luxury segments and mid-scale hotels without food and beverage historically perform better in souring demand scenarios. Occupancies decline off record highs and RevPAR growth finally flattens after a healthy four-year “boomlet.” Industry pros reluctantly accept the reality of their business—a lousy economy impacts hotels earlier and harder than most other property sectors, but hotels can rebound more quickly too since room rates adjust on a nightly basis.

Weaknesses
Domestic travel turns south—CFOs tell their bean counters to slash travel and convention budgets, consumers curtail spending and eliminate vacations, and airlines reduce flights outside prime business markets, including those to many leisure destinations. The airline cutbacks hit secondary and tertiary cities disproportionately hard—now fewer people will travel to them. Even Las Vegas and popular Florida markets prepare for a chill. Suburban limited-service product typically gets overbuilt in upswings—the past few years have been no different. New supply comes on line just as demand falls off. Interstate cloverleaf hotels and motels see occupancies decline as drivers limit travel to save on gasoline costs. Rising cap rates mean lowering values when cash flows can’t keep up. “We’re at an inflection point.”

Best Bets
The big hotel companies will start offering enticements to keep more rooms filled—bonus nights, free meals, and complimentary massages at the spa. For investment and development opportunities, they go overseas to expanding markets in the Middle East and Asia. In the United States, investors have little choice but to hold onto hotel assets. Buying opportunities will emerge from bad development timing—specifically
Emerging Trends in Real Estate® 2009

involving distressed owners who can’t service debt on newly opened properties in markets walloped by airline/driver fuel cost fallout. You play the odds that oil prices moderate and travelers eventually regain their footing.

Avoid

Until the market shakes out, most markets and lodging segments don’t offer any upside. All you can say about Las Vegas is “ouch.”

Development

Forget about it!

Outlook

The lodging sector presents a “real mixed bag”—New York and Los Angeles full-service hotels could sustain occupancies and revenues. Airport hub business centers will generally fare much better than connector cities, while some more “off-the-beaten track” metropolitan areas and suburban markets could “face bloodbaths.” The length of the economic trough will determine whether average industry benchmarks show little to no growth or serious declines.
Retail

Strengths
Monopolistic fortress malls, owned mostly by REITs, and high-income-area neighborhood shopping centers should weather the ongoing consumer retreat better than other retail segments. Interviewees remain relatively positive about urban retail in the prime 24-hour markets.

Weaknesses
Shopping centers turn “high risk.” Inflation and energy costs eat into retail sales, while the unsettling jobs picture and housing woes unnerve most shoppers. Retailers “land on their backsides” in “a long-overdue correction” after REITs were “pressured by shareholders to show growth,” and other developers “built some unnecessary projects.” “It’s a disaster waiting to happen: too much square footage and consumers don’t have their pocketbooks.” Interviewees see “more retailer bankruptcies on the horizon.” Some chains would have failed sooner had they not been propped up by easy financing (sound familiar?). Now they go dark in the bad economy. After a decade-plus boom, “the retail bone yard fills up again.” The “Darwinian environment” means retailers will once again concentrate stores in the top centers, leaving some B and C malls behind—half empty and teetering.

Failing mom-and-pop stores will hurt some neighborhood centers and leisure/power centers face a big-box liquidation shakeout. “You need anchor tenants with strong credit to offer any comfort.” Interviewees wonder, “Do all these drugstores in strip centers make sense? We said the same thing about Starbucks and look what happened.” More and more people are buying discounted drugstore items at the big wholesale clubs.

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| Expected Capitalization Rate, December 2009 | 7.6% |
| Expected Unleveraged IRR During Holding Period | 10.3% |

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<tr>
<td>Investment Prospects</td>
<td>Modestly Poor</td>
<td>3.89</td>
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<tr>
<td>Development Prospects</td>
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</table>

| Expected Capitalization Rate, December 2009 | 6.8% |
| Expected Unleveraged IRR During Holding Period | 9.7% |

<table>
<thead>
<tr>
<th>Buy</th>
<th>Hold</th>
<th>Sell</th>
</tr>
</thead>
<tbody>
<tr>
<td>29.8%</td>
<td>50.0%</td>
<td>20.3%</td>
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</tbody>
</table>

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on U.S. respondents only.

<table>
<thead>
<tr>
<th>2009</th>
<th>Prospects</th>
<th>Rating</th>
<th>Ranking</th>
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</thead>
<tbody>
<tr>
<td>Investment Prospects</td>
<td>Modestly Poor</td>
<td>4.06</td>
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<tr>
<td>Development Prospects</td>
<td>Modestly Poor</td>
<td>3.50</td>
<td>10th</td>
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</table>

| Expected Capitalization Rate, December 2009 | 7.6% |
| Expected Unleveraged IRR During Holding Period | 10.3% |

<table>
<thead>
<tr>
<th>Buy</th>
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<tbody>
<tr>
<td>11.4%</td>
<td>53.1%</td>
<td>35.6%</td>
</tr>
</tbody>
</table>

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on U.S. respondents only.
Best Bets
Buy or hold mall REIT stocks—these companies marshal leverage over retailers to keep stores in their portfolios, dominated by fortress malls. They may suffer further hits, but most damage has been factored into share prices. Consumers crave bargains—outlet centers and discount clubs, and big boxes hold their own. Well-located strip centers, anchored by top supermarket chains, will continue to draw necessity shoppers.

Avoid
Lifestyle centers’ original concept concentrated projects in upscale neighborhoods near fortress malls. But recent development in lower-income areas at suburban edges “gets slammed.” Expect the return of “ghost malls”—older B-minus and C regional shopping centers wither into potential land plays for mixed-use developments.

Development
Not happening! REITs shed land they targeted for new projects. Second ring road shopping centers, fearing third ring road development, don’t need to worry anymore—“they won’t be leapfrogged.” Some older “underutilized and under-exploited” centers in prime infill areas could make future enhancement plays. We underscore “future.” Over time, residential/retail/office mixed-use concepts will expand into infill areas, providing more 24-hour-style convenience.
“In previous generations, people bought homes to live in and didn’t look at them as wealth generators. That changed recently and people overreached. Homebuying was oversold as a path to financial freedom.”

**Outlook**
Shopping center owners brace for value losses and declining operating incomes. Replacing lost tenants will prove difficult as retailers retrench. Until job growth resumes and gasoline costs moderate, consumers’ enthusiasm lags. Higher interest rates and lower housing values present further hurdles. Overleveraged Americans also need to rein in credit card and mortgage debt as well as lingering student and auto loans before they can feel comfortable about mall sprees. Retail stays down for a while.

**Housing**

**Strengths**
Despite the most significant declines in housing prices since the Great Depression, most long-term homeowners, who mortgaged rationally, should retain significant value gains from many years of steady appreciation. “In previous generations, people bought homes to live in and didn’t look at them as wealth generators. That changed recently and people overreached. Homebuying was oversold as a path to financial freedom” and speculators using easy leverage bid up the market. Finally, a price bottom approaches—probably by late 2009—as foreclosures and fire sales increase, and homebuilder inventories slowly sell off at significant discounts. “The worst is over.”

**Weaknesses**
Devastation visits land developers, who lose all equity on their building lots and may be personally liable on gobs of leverage—some borrowed upwards of 95 percent. Now “people who bought land as values dropped are sorry they did”—prices continue to fall. Homebuyers and sellers won’t have a meeting of the minds until distressed assets move through the system. Problems extend well beyond subprime to all pricing segments—affluent buyers overreached on jumbo mortgages, too. “We need to move back to pricing levels from 2003–2004 before a floor establishes.” While sticker prices nose-dive into more palatable ranges, home-
Emerging Trends in Real Estate® 2009

Development

Ha. Ha.

Outlook

As markets stabilize, attitudes about homebuilding, homebuying, and home lending will undergo a radical back-to-the-future readjustment. People learn that there is more to owning a home than just debt service—"you have all sorts of other expenses and need ample reserves." And the idea that home values have nowhere to go but up has evaporated. Reality sets in that the American dream can easily turn into a nightmare. For all the political rhetoric, some people "can’t afford to be homeowners and shouldn’t be." Surviving homebuilders will refocus on infill concepts—denser communities with mixed uses and town center elements. Chastened lenders, prodded by regulators, realize they need to reinforce underwriting standards and scrutinize buyers’ credit at the expense of loan volumes. The country figures out again that too much of a good thing—low-cost leverage—can be disastrous. Expect a slow, lurching recovery.

Niche Markets

Interest in niche and mixed-use sectors dissipates—investors have "too many problems to look under rocks for yields. You don’t hear boo about them." Interviewees complain about

Best Bets

Homes closer to prime commercial cores will outperform. "People realize they don’t need 3,000 square feet [278 sq m] and four cars anymore." At some point, those high-end Miami condos overlooking the Atlantic will be good buys. "In 1975, we had 30,000 unsold units in south Florida, the same in 1988, and now again." Ocean views always find a market.

Avoid

Outer-ring suburbs and exurban areas will register greater losses as market demand shifts toward infill neighborhoods. McMansion subdivisions in the sticks take a double whammy—rising heating/cooling bills for these expansive homes work against sellers already struggling to overcome resistance to car commuting expenses.

buying may become more difficult for the average purchaser. Shellacked mortgage lenders won’t back off higher equity requirements and stricter covenants. Rising interest rates promise higher mortgage rates. "We’ve got to have more jobs and wage gains and I don’t see that in 2009." "Every sale is a struggle—even in New York City." Indeed, the worst may be over, "but there is more pain to come."

EXHIBIT 4-32

U.S. Single-Family Building Permits

EXHIBIT 4-33

The S&P/Case-Shiller Home Price Index

Source: U.S. Census Bureau, Moody’s Economy.com.
* Forecast.

Source: Standard & Poor’s.
* Data as of June 30, 2008.
the inability “to deploy much money” in these generally “thin” market segments. “It’s too hard to price uncertainty and there is not enough volume to make it worth the time and resources.” Niche appeal fades from several years ago when core investors shut out of primary food group sectors by pricing spirals sought better value in alternative categories, primarily medical office, student housing, and self-storage. Returns have been spotty (better for medical office and self-storage)—“cap rates increase more quickly than for the major property sectors.” “Numbers haven’t panned out for deals.”

Survey respondents continue to tout the student housing, medical office, and seniors’ housing markets as demographic plays. (See Exhibit 4-34.) Infrastructure also shows promise—the United States requires significant investment to upgrade roads, mass transit, water-sewage systems, and electric grids. Growing demand for workforce housing keeps tax credit apartments strong. Mixed-use development and planned community concepts short-circuit in the housing market morass and credit meltdown.

**Student Housing.** A pure demographic bet—the Generation Y cohort crowds into college campuses, which have trouble squeezing everyone into residence halls.

**Medical Office.** An equally large baby boomer cohort ages into more sickness and infirmity. “The older you get, the more time you spend visiting doctors and hospitals.”

**Infrastructure.** The United States spends about $140 billion annually on roads and mass transit, but the government estimates that necessary projects require upwards of $240 billion to keep the nation competitively moving people and goods. Private investors could fill some of the enormous gap if more state and local governments could get comfortable with financing arrangements and imposing more and higher user fees on drivers.

**Tax Credit Housing.** Severe shortages of reasonable rental housing hobble many cities that price out lower-income workers. Fannie and Freddie subsidies had supported new projects, but will funding continue when the government decides how to reconstitute these failed entities?

**Seniors’ Housing.** The numbers remain compelling—a graying population will increase demand significantly for various forms of adult communities—over-55 subdivisions and apartment residences, assisted living communities, and nursing homes.

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**EXHIBIT 4-34**

**Prospects for Niche and Multiuse Property Types in 2009**

<table>
<thead>
<tr>
<th>Property Type</th>
<th>Investment Prospects</th>
<th>Development Prospects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Student Housing</td>
<td>6.09</td>
<td>5.66</td>
</tr>
<tr>
<td>Medical Office</td>
<td>5.84</td>
<td>5.52</td>
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<tr>
<td>Infrastructure</td>
<td>5.68</td>
<td>5.57</td>
</tr>
<tr>
<td>Seniors/Elderly Housing</td>
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<td>5.51</td>
</tr>
<tr>
<td>Urban Mixed-Use Properties</td>
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<td>5.59</td>
</tr>
<tr>
<td>Apartment</td>
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</tr>
<tr>
<td>Rental: Tax Credit</td>
<td>5.29</td>
<td>4.93</td>
</tr>
<tr>
<td>Mixed-Use Town Centers</td>
<td>5.06</td>
<td>4.09</td>
</tr>
<tr>
<td>Self-Storage Facilities</td>
<td>5.09</td>
<td>4.31</td>
</tr>
<tr>
<td>New Urbanist Communities</td>
<td>4.86</td>
<td>3.83</td>
</tr>
<tr>
<td>Lifestyle/Entertainment Retail</td>
<td>4.54</td>
<td>3.83</td>
</tr>
<tr>
<td>Resort Hotels</td>
<td>4.00</td>
<td>3.45</td>
</tr>
<tr>
<td>Master-Planned Communities</td>
<td>4.00</td>
<td>3.94</td>
</tr>
<tr>
<td>Master-Planned Resorts</td>
<td>3.94</td>
<td>3.53</td>
</tr>
</tbody>
</table>

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on U.S. respondents only.

**Urban Mixed Use.** People want convenience and head back in the direction of urban cores. The hot-growth Sunbelt suburban agglomerations, meanwhile, start to encourage increased densification in infill areas to enable future growth. Mixed-use projects sit in the sweet spot, but financing will be hard to attract in the short term.

**Self-Storage.** Upended housing markets force more dispossessed and downsizing homeowners to squirrel away all those sofas and bar stools that didn’t get bought in yard sales or go to relatives.

**Master-Planned Communities, New Urbanist, Resorts.** Anything involving development and housing has limited appeal.
Less volatile Canadian real estate markets cannot avoid shockwaves emanating from “the big elephant in the room” next door. The U.S. credit morass, the weak U.S. dollar, falling U.S. demand for Canadian products, and the “stuck in a rut” U.S. economy have helped undermine reasonably robust momentum and soften solid supply/demand fundamentals. Interviewees turn more cautious, uncertain, and pessimistic—“brace yourself for mediocrity” in 2009. “Expect a tough slog, but not as bad as in the United States.” Respondents worry in particular about a deep or lengthy U.S. recession broadening any market downturn in Canada, but anticipate more of a “slowdown,” “not a disaster.” “We know we are not an island and are vulnerable.”

Canada’s split-personality economy—“the West versus the East”—faces headwinds, particularly in Ontario and Quebec, which falter somewhat from declines in manufacturing precipitated by a combination of the poor U.S. economy and strong Canadian dollar—U.S. buyers slow imports and industrial markets suffer from automakers’ distress. Western energy markets led by Calgary and Edmonton have experienced rapid growth thanks to skyrocketing oil and natural gas prices, “but may be getting ahead of themselves” as the world economic slowdown affects energy pricing. The “strong resource sector helps us dodge a bullet” and consumers haven’t overleveraged, but “overall the 2009 economic outlook is not that good.”

Investment Prospects

Underwriting Nerve. While U.S. lenders lost their discipline, Canadian banks and government regulators maintained conservative underwriting standards—pricing in housing and commercial markets avoided frothy levels. “We never got overextended with 80 to 90 percent leverage here” or adopted “exotic” loan structures. Canada’s Big Five office markets—Toronto, Montreal, Calgary, Edmonton, and Vancouver—all boast healthy single-digit vacancies, and other sectors track near equilibrium. “Our transaction markets stay relatively controlled—they lack the deal-making intensity you see in the States.” Institutional-quality core real estate concentrates in the portfolios of a handful of major pension funds that don’t engage in buying and flipping. Values don’t escalate as much—“we can get frustrated when we see big gains across the border in boom times, but we are much more comfortable in tough times.” Development also has been restrained except in hot-growth energy boom towns—Calgary and Edmonton—where markets show signs of overheating. “It’s night and day between today and the early 1990s during the last critical downturn, when risky large-scale office buildings were constructed without preleasing.”

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Emerging Trends in Real Estate® 2009

**Rates are returning to a more normal range above 7 percent to attract capital and with rents holding steady, some value erosion will occur, with B/C feeling it more.**

**More Caution.** Transaction volumes fell off in 2008 from the active 2005–2007 period when prices escalated, because of stepped-up deal making by leveraged buyers aping their U.S. counterparts. Canadian lenders have become more cautious in reaction to U.S. credit problems, pushing most
sales “unless they can get yesterday’s prices.” In 2009, interviewees expect the all-cash crowd to find opportunities among increased numbers of motivated sellers—typically, undercapitalized owners and smaller REITs struggling in the more difficult borrowing environment.

Development Drop. Development activity should slacken noticeably in 2009. Higher financing costs plus expensive materials and a tight market for construction workers ratchet up project budgets to “risky” levels while demand for space debt-dependent investors out of the markets. “Banks don’t want to increase their exposure to real estate right now” and limit lending through exposure caps, pricing, and covenants. Favored borrowers can wangle 65 to 70 loan-to-values, but spreads and costs increase, and bankers want recourse. A majority of survey respondents forecast that debt markets will be substantially or moderately undersupplied in 2009, while equity markets will be in better balance (see Exhibit 5-4).

Less Capital. Capital availability will decline from all sources except private property companies, according to surveys. (See Exhibit 5-5.) In addition to more stingy commercial banks, the demise of CMBS markets crimps debt flows. The big pension funds hold onto their premier domestic assets and shift attention for new investments outside Canada “to find more pop.” REITs “continue to languish,” especially smaller-cap stocks that have trouble raising capital. “Some could be toast,” vulnerable to takeovers and consolidations into bigger companies. “When real estate comes back in favor, the larger-cap REITs will rebound,” “but not for a while.” Foreigners encounter a difficult investment climate—high transfer taxes and government regulations create hurdles. Middle Eastern players, flush with money to burn, will be the most active among offshore sources (see Exhibit 5-6), while the weak U.S. dollar leaves Americans without their traditional currency advantage. In general, cash buyers wait for better deals and are happy that the smaller, leveraged buyers are gone. Owners, meanwhile, back off

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**EXHIBIT 5-4**

Real Estate Capital Market Balance Forecast for 2009

<table>
<thead>
<tr>
<th>Equity Real Estate Capital Market</th>
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</thead>
<tbody>
<tr>
<td>Substantially Undersupplied 17.9%</td>
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<tr>
<td>Moderately Undersupplied 46.4%</td>
</tr>
<tr>
<td>In Balance 39.3%</td>
</tr>
<tr>
<td>Substantially Oversupplied 10.7%</td>
</tr>
<tr>
<td>Moderately Oversupplied 3.6%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debt Real Estate Capital Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Substantially Undersupplied 17.9%</td>
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<td>Moderately Undersupplied 46.4%</td>
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<tr>
<td>In Balance 39.3%</td>
</tr>
<tr>
<td>Substantially Oversupplied 10.7%</td>
</tr>
<tr>
<td>Moderately Oversupplied 3.6%</td>
</tr>
</tbody>
</table>

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on Canadian respondents only.

**EXHIBIT 5-5**

Change in Availability of Capital for Real Estate in 2009

<table>
<thead>
<tr>
<th>Equity Capital from</th>
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</thead>
<tbody>
<tr>
<td>All Sources</td>
</tr>
<tr>
<td>Private Property Companies</td>
</tr>
<tr>
<td>Government-Sponsored Enterprises</td>
</tr>
<tr>
<td>Syndicators/TICs/1031 Exchange Investors</td>
</tr>
<tr>
<td>Publicly Listed Property Companies/REITs</td>
</tr>
<tr>
<td>Private Equity/Opportunity/Hedge Funds</td>
</tr>
<tr>
<td>Institutional Investors/Pension Funds</td>
</tr>
<tr>
<td>Mezzanine Lenders</td>
</tr>
<tr>
<td>All Sources</td>
</tr>
<tr>
<td>Securitized Lenders/CMBS</td>
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</table>

<table>
<thead>
<tr>
<th>Very Large Decline</th>
<th>Stay the Same</th>
<th>Very Large Increase</th>
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<tr>
<td>4.03</td>
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<tr>
<td>4.71</td>
<td>4.71</td>
<td>4.71</td>
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<td>4.36</td>
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<td>4.30</td>
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<tr>
<td>4.14</td>
<td>2.92</td>
<td>2.92</td>
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</table>

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on Canadian respondents only.
Markets to Watch

Although Canada is one of the world’s least densely populated countries, Canadians concentrate in a handful of major metropolitan areas. Toronto, Montreal, and Vancouver in particular feature strong 24-hour cores and globally cosmopolitan environments, while Calgary grows into a prominent urban center. Other major cities also evolve along the more traditional core/suburban ring model, avoiding distended suburban agglomeration configurations. Formidable gasoline taxes have always made driving more expensive than in the United States, but recent fuel price hikes reinforce the benefits of infill lifestyles, including access to mass transportation. In particular, Toronto boasts one of the highest percentages of apartment living in North America, accentuated by a recent wave of condominium construction in and around the vibrant downtown astride Lake Ontario. “We will continue to see more movement by people and businesses back into the cores because of suburban congestion and higher gasoline expenses.” “Any office or residential near subway stops is bound to benefit.” Outer suburbs suffer, and secondary and tertiary markets lose favor.
Prospects for Canadian metros cool across all regions in 2009—ratings decline geographically moving from west to east. (See Exhibit 5-8.) Vancouver leapfrogs to the survey pinnacle over Calgary and Edmonton, last year’s top choices. Not surprisingly, Toronto dominates in the East, followed by Ottawa, Montreal, and Halifax in the Maritimes.

**Calgary.** Canada’s hot-growth juggernaut peaks after torrid value gains in the midst of a development spree. Either “it’s time to take a healthy step back” or else “days of reckoning are coming.” Developers now build 7 million square feet (650,321 sq m) of new office space in a market with a total of 38 million square feet (3.5 million sq m)—“that’s a lot!” Housing demand subsides as homes get “too pricey” in “an avalanche of supply.” Investors take comfort in “the ton of wealth” generated by Alberta’s energy industry, but the market definitely turns higher risk.

**Edmonton.** Not long ago, office rents had been in the single digits, now they approach $50. This metropolitan area hits the jackpot from squeezing dollars out of tar sands—oil companies expand like crazy. But values “look too high.” Interviewees predict: “Here comes a dip.” Like Houston, Edmonton is a pure energy wager.

**Toronto.** Canada’s “ultimate bellwether” and premier 24-hour city, Toronto concentrates the nation’s corporate headquarters and manufacturing industries. “If you’re doing business in Canada, you need to be based here unless you’re in energy.” Weakness in the financial and manufacturing sectors dampens enthusiasm. New office, mostly preleased, will add about 5 percent to the city’s inventory and may increase vacancies to the high single digits. B and C owners “should worry.” Condo sales soften after a building blitz of high-rise residences and developers wisely postpone some projects. “It’s not Miami, but the for-sale ads go on and on in the newspapers.” Housing values become more vulnerable further away from the core. Apartments and industrial remain solid plays. Over time, investors score in this global gateway.

**Ottawa.** Buffered by its wellspring of federal jobs, this government town offers slow growth and stability. Local investors can take greater comfort when the economy slumps.

**Montreal.** Downtown office vacancies recently declined to mid-single digits, surprising some interviewees. “It’s doing amazingly well.” High tech, regional corporate headquarters,
Emerging Trends in Real Estate® 2009

Property Sectors

Interviewees predict weakening supply/demand scenarios across most property sectors—industrial and apartments have “modestly good” prospects. Other categories—office, housing, retail, and hotels—trend toward “fair” outlooks (see Exhibit 5-9). Performance flattens for A-quality properties after solid value and income gains in recent years, but returns could slump for B and C assets. “A dichotomy develops in pricing.” Prime downtown office buildings and fortress malls essentially won’t trade—institutional owners will husband strong income flows from dependable rent rolls in these cash machines. Some deterioration in pricing will appear in lower-quality real estate as cap rates increase and tenant demand...
Apartments. “Buy in any city.” Multifamily demand links more to demographics—immigrant flows, aging baby boomers, and younger adults—than to the economy. All these cohorts grow and all want to live in and around urban cores. Vacancy rates never edge much above the 2 to 3 percent range. “It’s the most stable asset class.” The recent condo boom drives up land prices and makes apartment development less profitable. Although some failed condo projects may be converted into apartments, any problems in for-sale housing should help overall apartment demand. Oil prices also push people back into cities and apartment living for greater convenience closer to work. Renters moving from houses find another benefit: cheaper apartment heating bills.

Industrial. High costs to build new warehouse space in Ontario, the nation’s manufacturing heartland, keep supply tight. Expensive land around Toronto stymies developer activity. Most interviewees anticipate that diminished demand will push up vacancies marginally, “but not more than a few cracks appear.” If the economy slows more than expected and exports into the United States don’t bounce back, the warehouse picture may look less rosy.
Office. Vacancy rates in the mid- to low-single digits have “never been lower,” but will edge up in most markets. Toronto gets choppy with new projects delivering and Calgary will need to absorb substantial space. Slowing job growth could hurt demand and rent growth stops or backs up in some markets. Suburban areas will be more exposed to a falloff in demand than downtown cores.

Housing. Prices crest and drop slightly overall. “Don’t expect anywhere near a free fall, but bidding wars are over.” Again, suburban areas will experience more deterioration than neighborhoods closer to city centers, where values should hold steady. Western markets do better than eastern ones, except for softness in the overbuilt Calgary and
Emerging Trends in Real Estate® 2009

Chapter 5: Emerging Trends in Canada

Edmonton metropolitan areas. Homebuilding slows down—“the bloom is off.” Banks get cautious and “put the kibosh on 40-year mortgages.” Borrowers go through more hoops, and many potential buyers head to the sidelines. Condos face lower sales volumes with speculators out of the market. A weakening jobs scenario means more trouble.

Retail. Any new development focuses mostly on urban infill and Costco/Wal-Mart superstores. Lifestyle centers never got going here—outdoors concepts don’t work as well in wintry climes—and new regional mall development is nil. Power centers “beat the pants off” smaller Class C malls. Consumer spending trails off in central and eastern provinces where rent growth weakens. Tenants stop expanding until economic uncertainty clears. Future development opportunities will focus on mixed-use concepts around existing regional malls and intown retailing.

Hotels. “Flat at best.” Cities have too many rooms unless conventions come to town. “Toronto could use more upscale product, but land is too expensive to build, and it’s hard to increase rates.” Motels and resorts get short-changed by the strong Canadian dollar—U.S. vacationers stay home, and more Canadians go to the States. Bankers begin to steer clear, and buyers “have trouble getting credit.” Some borrowers face pressure.

Best Bets
- Buy or hold apartments.
- Hold onto center city investments.
- Conserve cash for emerging opportunities.
- Live in Vancouver.

EXHIBIT 5-20
Canadian Hotel

<table>
<thead>
<tr>
<th>2009</th>
<th>Prospects</th>
<th>Rating</th>
<th>Ranking</th>
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</thead>
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<tr>
<td>Investment Prospects</td>
<td>Fair</td>
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<td>5th</td>
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<tr>
<td>Development Prospects</td>
<td>Modestly Poor</td>
<td>4.20</td>
<td>5th</td>
</tr>
<tr>
<td>Expected Capitalization Rate, December 2009</td>
<td>8.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected Unleveraged IRR During Holding Period</td>
<td>8.9%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Buy 18.2% Hold 45.6% Sell 38.2%

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on Canadian respondents only.

EXHIBIT 5-21
Canadian Hotel Property Buy/Hold/Sell Recommendations by Metropolitan Area

<table>
<thead>
<tr>
<th>Metropolitan Area</th>
<th>Buy</th>
<th>Hold</th>
<th>Sell</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vancouver</td>
<td>28.1%</td>
<td>46.9%</td>
<td>25.0%</td>
</tr>
<tr>
<td>Calgary</td>
<td>25.0%</td>
<td>52.8%</td>
<td>22.2%</td>
</tr>
<tr>
<td>Toronto</td>
<td>17.2%</td>
<td>55.2%</td>
<td>27.6%</td>
</tr>
<tr>
<td>Montreal</td>
<td>3.7%</td>
<td>55.6%</td>
<td>40.7%</td>
</tr>
</tbody>
</table>

0% 20% 40% 60% 80% 100%

Source: Emerging Trends in Real Estate 2009 survey.
Note: Based on Canadian respondents only.
Emerging Trends in Latin America

“What made Latin America unsafe for investment has mitigated.”

This year’s Emerging Trends makes an initial foray into evaluating Latin American markets—sounding out interviewees for their opinions and analysis. Next year, the report plans to undertake regional surveys to expand its property markets’ coverage of this important and growing economic region.

Over the past two decades, Americans and Europeans have ventured repeatedly into Latin America looking for opportunities and analyzing how to gain footholds in underserved real estate markets with large populations and increasing pockets of wealth. Investors’ and developers’ tentative initiatives typically foundered in confronting a potpourri of daunting challenges. For starters, they were repeatedly discouraged by precarious economies rocked by explosive inflation, high interest rates, debt-laden governments, and pervasive poverty. Political instability, corruption, lack of transparency, and various regulatory hurdles hampered transacting business. In addition, finding reliable local partners proved difficult.

**Growth and Opportunity.** Although impediments remain, the property investment landscape in Latin America appears somewhat more inviting and stable: high commodity prices energize regional economies; Brazil and Peru gain investment-grade credit ratings, joining Mexico and Chile; new credit policies power growth in consumer spending and homebuying; expanding retail activity increases demand for industrial space; and manufacturers (automakers and aerospace) build factories and create more jobs, taking advantage of cheap labor. Major office markets—São Paulo, Mexico City, Buenos Aires—lack Class A space, have extremely high occupancies, and experience solid rent growth from increasing demand. So once again, relatively low prices and high yields lure back offshore real estate players, who start investing selectively in certain markets and property sectors. “What made Latin America unsafe for investment has mitigated—we don’t face as much economic volatility or currency problems,” says an interviewee.

### EXHIBIT 6-1
**Latin America General Indicators**

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<tr>
<th>Country</th>
<th>Unemployment</th>
<th>Inflation</th>
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<tbody>
<tr>
<td>Argentina</td>
<td>9.2%</td>
<td>8.5%</td>
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<tr>
<td>Brazil</td>
<td>9.3%</td>
<td>4.5%</td>
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<tr>
<td>Chile</td>
<td>7.8%</td>
<td>7.8%</td>
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<tr>
<td>Colombia</td>
<td>11.1%</td>
<td>5.0%</td>
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<tr>
<td>Costa Rica</td>
<td>5.5%</td>
<td>10.8%</td>
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<tr>
<td>Ecuador</td>
<td>7.5%</td>
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<tr>
<td>Mexico</td>
<td>3.7%</td>
<td>3.5%</td>
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<tr>
<td>Panama</td>
<td>7.2%</td>
<td>4.2%</td>
</tr>
<tr>
<td>Peru</td>
<td>8.0%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Uruguay</td>
<td>9.2%</td>
<td>8.5%</td>
</tr>
<tr>
<td>Venezuela</td>
<td>7.2%</td>
<td>22.5%</td>
</tr>
</tbody>
</table>

Source: Cushman & Wakefield.
Emerging Trends in Real Estate® 2009

Source of about 30 percent of its GDP) and Mexico City (“for its sheer size”). Rio de Janeiro, Buenos Aires, and Monterrey (Mexico’s base for factories serving the United States) receive considerably less attention. “Overall, a big cultural divide remains” and the economies are opaque—“you need to be prepared to work back channels.” Don’t even think about doing business in these countries without local partners. “It’s still difficult to get concrete information, everything is based on personal relationships, and all business is conducted face to face.” And don’t kid yourself, Mexico can be dangerous—drug lords and violence are not going away. “You need bodyguards if you go to certain places.”

Brazil Ascendant. Brazil may have “finally arrived—we’ve been waiting for decades.” Interviewees express “cautious optimism” about improving government oversight, strong commodities, and excellent growth rates. Inflation rates have been tamed from a stratospheric 2,500 percent in 1990 to about 5 percent today and the economy avoids energy cost spirals by producing flex fuels from its vast interior biomass. The nation’s currency, the real—once a basket case—recently has increased in value against both the U.S. dollar and euro. Now, an investment-grade credit rating lowers the nation’s borrowing costs and advances a more credit-based economy. The increased availability of financing enables development, which had been hamstrung by the lack of capital across all property sectors for the past quarter century. For developers, opportunity potentially abounds:

- By some estimates, the country needs 8 million new housing units to meet pent-up demand.
- Only 400 shopping centers exist in a nation of nearly 200 million.
- Neither Rio de Janeiro nor São Paulo has any Class A office space.
- Warehouse space is limited and obsolete.

Caution Required. For now, the investment focus remains prudently narrow and relatively limited, belying increased enthusiasm. Interviewees tap five top cities for investment consideration led by São Paulo (Brazil’s business capital and source of about 30 percent of its GDP) and Mexico City (“for its shear size”). Rio de Janeiro, Buenos Aires, and Monterrey (Mexico’s base for factories serving the United States) receive considerably less attention. “Overall, a big cultural divide remains” and the economies are opaque—“you need to be prepared to work back channels.” Don’t even think about doing business in these countries without local partners. “It’s still difficult to get concrete information, everything is based on personal relationships, and all business is conducted face to face.” And don’t kid yourself, Mexico can be dangerous—drug lords and violence are not going away. “You need bodyguards if you go to certain places.”

**EXHIBIT 6-2**

<table>
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<tr>
<th>Latin America Economic Growth</th>
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<tbody>
<tr>
<td>Percentage Real GDP Growth</td>
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<tr>
<td>South America and Mexico</td>
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<td>Peru</td>
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<td>Venezuela</td>
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<tr>
<td>Mexico</td>
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</table>

Source: World Bank (annual percent change).

* Projections.
Emerging Trends in Latin America

Investors in the near term as American consumers tighten belts. The country’s petroleum industry, a mainstay of recent growth, also sets off alarms—reserves fall dramatically in its offshore oil fields. But higher labor costs in China and other Asian manufacturing centers shift more work back to Mexico, closer to American export markets. European manufacturers also see advantages from producing goods in Mexico bound for the United States, including reduced shipping costs (higher oil prices make shorter routes less expensive).

**Too Late?** Some interviewees warn that Latin American emerging markets “could hit speed bumps or potholes.” An adviser notes: “The cat is already out of the bag” in both Brazil and Mexico as a rush of investors has bid up pricing. Early players will do better than 2009 entrants. Returns were in the high 20s; they now fall into the high teens, with enduring capital market and political risk part of the investment equation. Newfound credit appetites in these countries can set the stage for future problems. How borrowers manage paying down loans bears watching, considering these countries’ pervasive high interest rates and proclivity for economic instability and reversals. The stalwart United States serves as an example of what can happen when too many loans suddenly go bad in an unsustainable pricing environment.

**Mexico’s Appetites.** Mexico “needs everything” to satisfy demand from its expanding middle class and, like in Brazil, consumer credit takes hold, fueling shopping fervor. International retailers, including American discounters, enter the market—more than $6 billion in various mall projects are underway. Shopping center investors must realize that relatively few local markets can realistically accommodate traditional center formats—most people in Mexico and Latin America don’t own cars and malls need to be pedestrian accessible. That’s one reason why investors should focus on Mexico City, which has modern infrastructure and more drivers. The government also focuses major infrastructure overhauls (including mass transit) in and around the nation’s capital, providing greater opportunities for developers. Homebuilding—particularly low- and middle-income developments in suburban rings—also gets a boost from the increased availability of mortgage financing. Mexico’s economic dependence on exports to the United States worries investors in the near term as American consumers tighten belts. The country’s petroleum industry, a mainstay of recent growth, also sets off alarms—reserves fall dramatically in its offshore oil fields. But higher labor costs in China and other Asian manufacturing centers shift more work back to Mexico, closer to American export markets. European manufacturers also see advantages from producing goods in Mexico bound for the United States, including reduced shipping costs (higher oil prices make shorter routes less expensive).

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Interviewees

Ackerman & Co.
Kris Miller

Ackman-Ziff Real Estate Group LLC
Gerald Cohen
Patrick Hanlon
Arti Hart
Jason Krane
Adam Steinberg
Simon Ziff

AEW Capital Management
Michael J. Acton
Marc L. Davidson
Robert J. Plumb

AGN Realty Partners LLC
Gregory N. Senkevich

Allied Properties Real Estate Investment Trust
Michael Reid Emory

AM Connell Associates, LLC
Alice Connell

Arizona Real Estate Center
Jay G. Butler

Aspac Developments Ltd.
Gary Wong

Aviva Capital Management
Edward M. Casal

Babcock & Brown Residential
Philip Payne

Barclays Capital
P. Sheridan Schechner

Barrett American
Michael D. "Mick" Patton

bclMC Hospitality Group
(Formerly CHIP Hotels REIT)
Edward Pitoniak

Berkshire Income Realty, Inc.
David C. Quade

BioMed Realty Trust, Inc.
Kent Griffin
Greg Lubustikin
Matthew McDevitt

BlackRock
Jay Alexander
Cathy Bernstein
John Chang
Keaton Edwards
Craig Estrem
William Finelli
Shelton Getter
Ted Koros
Mike Krier

Shawana McGee
Larry Mohr
Kevin Scherer
Elysia Tse
Michael Yurinich
Barry Ziering
Ron Zuazk

Boston Properties, Inc.
Michael LaBelle

Buzz McCoy Associates, Inc.
Bowen H. "Buzz" McCoy

Caisse de Dépôt et Placement du Québec
Fernand Perreault

Calloway Real Estate Investment Trust
Simon Nyilassy

Canadian Apartment Properties Real Estate Investment Trust
Thomas Schwartz

Capmark Finance
John Cannon

Capright Property Advisors, LLC
Jay Marling

CB Richard Ellis, Inc.
Dan Callihan
Raymond Wong

CB Richard Ellis, Inc.
Tyler Anderson
E.M. Blake Hutcheson
Mindy Korth

CenterPoint Properties Trust
Paul Fisher

Champion Partners, Ltd.
Jeff Swope

Chartwell Seniors Housing Real Estate Investment Trust
Stephen A. Suske

Chase
Mark Snow

Churchill Commercial Capital
Cindy Hammond

Citigroup Property Investors
Lawrence Ellman

Colliers International
Ross Moore

Colony Capital, LLC
Richard B. Saltzman

Column Financial, Inc.
Kieran Quinn

Commercial Mortgage Alert
Donna Knipp

Commercial Mortgage Securitization Association
Dorothy Cunningham

Continuum Partners
Mark Falcone

Cornerstone Real Estate Advisors LLC
Graham J. Bond
Tony Pierson
David J. Reilly

Cousins
Tad Liethread

Crown Realty Partners
Michael A. Pittman

Cushman & Wakefield
James Carpenter
Mark Detmer
Bruce Ficke

Cushman & Wakefield of Arizona
Steven R. Gragg

Cushman & Wakefield Sonnenblick-Goldman
Mark Gordon
Steven Kohn
Thomas MacManus

DCT Industrial
Phil Hawkins

Deloitte
Dorothy L. Alpert

DeRito Partners Development Inc.
Andy Kroot

Donahue Schriber
Lawrence P. Casey
Patrick S. Donahue

DTZ Rockwood
Craig Callaway
Matthew Jordan
Alex Ray
Jason Spicer
Brian Waldman

Dundee Real Estate Investment Trust and Dundee Realty Corporation
Michael Cooper

Eastdil Secured
Christopher Casey

Emigrant Savings Bank
Patricia Goldstein

Empire Communities
Paul Golini, Jr.
Andrew Guizzetti
Daniel Guizzetti
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<td>Richmond McCoy</td>
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Vestar Development Company
Lee Hanley

Vornado Realty Trust
Michael D. Fascitelli

Warnick & Company
Bob Hayward

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- Exploring issues of urbanization, conservation, regeneration, land use, capital formation, and sustainable development;
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- Sharing knowledge through education, applied research, publishing, and electronic media; and
- Sustaining a diverse global network of local practice and advisory efforts that address current and future challenges.

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Executive Vice President, Global Information Group

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Asia Pacific Real Estate Tax Leader  
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Asia Pacific Investment Management and Real Estate Leader  
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United States Real Estate Tax Leader  
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United States Real Estate Business Advisory Services Leader  
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What are the best bets for investment and development in 2009? Based on personal interviews with and surveys from more than 700 of the most influential leaders in the real estate industry, this forecast will give you the heads-up on where to invest, what to develop, which markets are hot, and trends in capital flows that will affect real estate. A joint undertaking of PricewaterhouseCoopers and the Urban Land Institute, this 30th edition of Emerging Trends is the forecast you can count on for no-nonsense, expert advice.

Highlights

- Tells you what to expect and where the best opportunities are.
- Elaborates on trends in the capital markets, including sources and flows of equity and debt capital.
- Advises you on those metropolitan areas that offer the most potential.
- Indicates which property sectors offer opportunities and which ones you should avoid.
- Provides rankings and assessments of a variety of specialty property types.
- Reports about how the economy and concerns about credit issues are affecting real estate.
- Describes the impact of social and political trends on real estate.
- Explains how locational preferences are changing.