Some Light at the End of the Tunnel Seen by Leading Real Estate Investors

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In spite of the pervasive feeling that commercial real estate is in dire straits today, a recent meeting of top executives in the real estate capital markets revealed there may indeed be some light at the end of the tunnel. While job growth remains dismal and real estate fundamentals are bad and getting worse, we have seen recent signs of an economic rebound, and the real estate capital markets have loosened up in recent months.

Survey data from the participants at the ULI McCoy Symposium on Real Estate Finance, held on December 14, 2009, in New York, present a mixed but generally improving outlook for a variety of key indicators. In general, for 2010 these observers expect a healthy 3 percent gross domestic product (GDP) growth rate, a persistent 10 percent unemployment rate, positive job growth of 1 million jobs, modest growth in housing starts reaching 675,000 units annually, increasing bond rates, modest growth in property transactions, real estate investment trust (REIT) total returns of 10 percent, negative returns of -5 percent in the NCREIF index, growing REIT issuance, and office vacancies climbing higher to 18 percent. A summary of their responses appears below.

ULI McCoy Symposium Participant Expectations for Key Economic and Real Estate Indicators			
	2008 Total or Year-End	**2009 YTD or Current**	**2010 Year-End or Full-Year Expectations—Median**
Economy			
GDP Growth†	0.4%	-3.20%	3%
Unemployment	7.2%	10.0%	10.0%
Jobs Change (nillions)	-3.1	-4.1	1.0
Housing Starts (thousands)	905	458	675
Debt			
5-Year T-Bond	1.55%	2.19%	2.55%
Baa Corporate Bond Rate	8.07%	6.34%	6.50%
TED Spread	135 bps	23 bps	40 bps
Net Real Estate Lending (billions)**	$112.6	-$39.8	-$25.0
Real Estate			
Transaction Volume (billions)	$133.6	$37.9	$75.0

REIT Total Return	-37.7%	21.4%	10.0%
NCREIF Total Return	-3.3%	-15.1%	-5.0%
REIT Equity Issuance (billions)	$16.8	$26.7	$37.0
Office Vacancy Rate	14.4%	16.6%	18.0%

† Defined as 1Q - 3Q 2009 GDP / 1Q - 3Q 2008 GDP.
** Net commercial mortgage lending through 3Q for 2008 and 2009.
Sources: Federal Reserve, Economy.com, RCA, NCREIF, Bloomberg, SNL Financial, NAREIT, CBRE Econometric Advisors.
Note: Data as of December 10, 2009; expectations as of December 14, 2009. Expectation medians are based on surveys completed by 14 leading real estate capital markets executives at the ULI McCoy Symposium on Real Estate Finance on December 14, 2009, in New York.

Economy and Capital Markets Slowly Moving in the Right Direction, Finally

Most economists believe that the economy bottomed between February and July of 2009, but job growth is certainly lagging and the volume of job losses is staggering. Notes one executive, "We have never had less than 12 percent job growth in any ten-year period, but job growth has been ZERO over the past decade, the first time in history." However, according to one participant, "We should start to see positive job growth by March or April of 2010."

The question remains whether we will see a robust, average, or weak recovery, and participants had varying views on this, with the general consensus falling around 3 percent growth in GDP. "I see little chance for a double-dip recession, but no robust recovery either. There is no opportunity for further monetary stimulus, so we have what we have from the Fed. While credit markets have loosened up considerably for corporations and REITs, there are still large segments of the economy and small business that cannot get credit." With the job losses we have seen, even a robust recovery of 3.5 percent or more would take three years or more to re-create the jobs that have been lost since 2008.

Inflation is certainly a concern going forward. "We have no historical basis for predicting inflation in the current environment, but the bias is certainly toward higher inflation." The federal deficit is also a major concern. The fiscal imbalances are outside Fed control, and will likely lead to inflation, higher taxes, and higher interest rates, and with higher interest rates this deficit problem will balloon further. Higher rates could also create further threats for real estate and housing. Noted one participant, "There are around 10 million homeowners who are at risk of losing their homes and probably only 7 million have much hope of avoiding foreclosure." LIBOR will rise and this will affect those who are today benefiting from the existing low rates.

A lot of population growth assumptions are also in question. Many have assumed that population growth will continue as in the past, but there is reason to believe it may not, as immigration has declined and reverse immigration is actually happening in some areas,

e.g., many Brazilian immigrants are moving back to Brazil, where the economy is better. This is especially important for the multifamily property sector, which may see much less absorption from these demographic sectors. Immigration is not driving markets in places like Phoenix and Florida as it has in the past.

Financial/Regulatory Policy Mostly Successful, Some Issues Loom

Numerous financial policies—ranging from low interest rates to bank regulation to TALF to new accounting rules—are currently in play. The TALF program, intended to bolster and restart the commercial mortgage–backed securities (CMBS) market, has been slow to take hold but has ultimately been successful in the restarting of the CMBS market in recent months. TALF helped tighten spreads and launch a recent CMBS issuance from DDR. "It helped a lot, but most new deals have and will bypass TALF and its red tape. It helped reopen the market, but it is now largely dead as a source of capital. The government should be pleased, however, as the program did its job with minimal government investment."

The Public Private Investment Program (PPIP), a sister program targeted to assist banks with their bad real estate loans, is yet to be tested but should kick in when bank loans finally start to break loose from bank books in 2010.

In general, bank regulators are buying time for banks, allowing them to "extend and pretend," and we are evolving away from credit crisis issues. Banks have been able to recapitalize even as they face continuing loan problems. Bankers at the table supported this policy, noting that this would allow them to carry these assets forward and hopefully reduce their losses as markets recover. Notes one banker, "It does not make sense to force the banks to write down the debt if they do not choose to." Notes another banker, "The GGP bankruptcy resulted in forced loan writedowns that were excessive, and the value of this debt has since risen."

Private equity players and others were not so sure about the wisdom of this bank regulation policy, pointing out that a similar policy was used in Japan some years ago, contributing to what has been called the "lost decade" for the Japanese economy.

Other issues of importance: the carried-interest issue has been put off for another year; tax cut expirations are an issue for the near future; there will be pressure for higher taxes in 2010; treatment of foreign investors via FIRPTA is a problem in terms of attracting foreign capital to U.S. real estate; and new accounting rules now preclude off-balance-sheet treatment of qualified Special Purpose Entities, and these entities must get consolidated onto the balance sheet of the company that owns the first loss piece, potentially affecting banks, mortgage REITs, and other investors.

Debt Capital Loosening

Debt markets have loosened up most visibly on the corporate side, where corporate loans have been generally available for viable companies. Many REITs have been able to raise

debt capital and execute new lines of credit, the result in part of their ability to access and raise capital in the equity markets.

On the CMBS side, the market has reopened with the recent DDR deal and other subsequent deals. But it is still unclear how and to what degree the CMBS market comes back further. There remains a dispute among existing investors about who controls the pools of nonperforming loans in existing portfolios, the AAA- or B-piece owners. This needs to be worked out. It is unlikely we will see any significant comeback of the CMBS market in 2010, but at least it is no longer dead.

Another positive sign in this sector, notes one observer, is that GGP has been able to renegotiate their loans, demonstrating that workouts are doable. However, notes another executive, "The court decisions related to the GGP deal will lead us to change our underwriting standards in the future to protect against highly unfavorable outcomes that came out of those decisions."

In addition, several new mortgage REITs have been launched in recent months, although the window for raising such capital seems to have closed. These entities will be interesting to watch, and there were concerns expressed about whether they are attractive investments. Noted one observer: "Why are mortgage REITs allowed to present themselves as unleveraged investment vehicles when in fact they use 95 percent leverage?" Mortgage REITs have different investors than equity REITs, and according to one observer, "They are a better deal for issuers than investors."

While credit markets have also loosened in the banking and insurance sectors, "banks are still not doing any net lending," in part the result of a lack of demand and few reasonable opportunities. In a market with declining fundamentals and excessive debt on existing investments, underwriting is necessarily more conservative, which is taking many deals off the table.

For existing loan problems, lenders are choosing to kick the can down the road. There will be some bad debt that will come to the market, but not that much. Extend, extend, extend is the policy that has been adopted and endorsed by regulators. Notes one banker, "If the operator is doing a good job of managing the property and is making the loan payments, we will not foreclose. We will extend 18 to 24 months and may extend again for a similar length of time on commercial properties." As a result of these bank policies, distressed debt funds have not been able to find much to buy.

Most life companies have not been selling bad loans into the secondary market because prices are too low. Most of their loans were conservatively underwritten and are ten-year loans, allowing them to wait out the market for now. Noted one life company executive, "Roughly one-third of our loan portfolio we would not refinance because of LTV ratios, but only half of our portfolio is coming due in the next five years." In general, life companies are finding the current lending environment very attractive. Notes one executive, "One year ago, we were out of the market and building liquidity. As things move back toward normal, we see very attractive relative value for loan spreads for

quality loans. It is hard to make lending mistakes today. It is a great time to be lending." However, there is an excess supply of mortgage debt available—albeit with stiff underwriting requirements—given current levels of demand. "We will jump on any deal that looks good. The problem is that there aren't many deals that look good." Club deals have come back for larger loans.

One economist noted that the real estate industry has seen repeated failures over the decades where 70 percent or more debt was used, and this suggests that perhaps the only really prudent level of debt financing for real estate is closer to 50 percent or 55 percent. However, even today there is a substantial amount of debt capital available at 65 to 70 percent loan-to-value ratios—on marked-down valuations—but not a lot of takers for such debt.

Equity Investors/Owners Still Mending, Waiting

"We will ultimately see a trillion-dollar loss to commercial real estate on a $4 trillion base," noted one observer. Investors are clearly licking their wounds, but there is also equity on the sidelines waiting to make new investments. While it is easy to be pessimistic about commercial real estate today, one positive factor, notes one investor, is that "unlike in past recessions, investors are viewing real estate as a legitimate asset class that they want to stay with. The bad news is all the conditions that are now being placed on these real estate investments."

A fair amount of equity capital is waiting on the side for properties to come to market, but thus far these properties have not presented themselves in any quantity. Capital is ahead of fundamentals and there are a lot of equity funds with lots of capital and no investments yet.

In terms of what investors will see in 2010, lower-quality assets are likely to break loose from smaller banks or the FDIC or others and become available for sale, but these are not much in demand currently. Many of these assets have high vacancies, require additional investments, or are not in desirable locations. "There are lots of hotel deals and condos and development deals that are currently in the market, but these are not the preferred investment opportunities for many of the buyers."

The limited number of higher-quality core assets that have come to market recently have often attracted many bidders and relatively high prices. "Appetite for high-quality core assets is strong," notes one investor, and pension funds and other investors from all over the world are still interested in paying attractive prices for these prime assets. However, not many prime assets are coming to market.

Thus, a chasm is developing between high-quality assets with high investor demand and competitive pricing, and low-quality assets with low investor demand and weak pricing. Most owners of high-quality assets are choosing to hold for now, unwilling to sell these assets in the current market unless they need to raise capital and/or they can command a

reasonable price. “High-quality assets are trading today when/if they come to market. There is not much flow, but these are big and expensive assets.”

Pension funds are now looking to put money back into the market as their equity stock market holdings have improved. “In 2008 they did nothing, and in 2009 they did a little more than nothing.” In many cases, they are being outbid for the core assets they seek. One investor notes, “We have looked at deals on behalf of pension funds and either were outbid or passed on the pricing. Fundamentals will not improve until 2012–2014, so you can’t price in much upside.”

Private equity funds have money to buy assets, but they often do not see much that is available at attractive prices. Notes one investor, “For what we do, we do not see much opportunity currently. Institutional money is available to invest, but not much is flowing due to lack of deals.” Assets are overleveraged and must go through a process of deleveraging and repricing before they come to market, and this process is taking longer than many investors thought.

Notes another private equity investor, “We have seen a shift from buying on cap rates to buying on replacement costs. We are putting capital into restructurings. We have a new $200 million fund to invest and have made no investments for over a year. There is a lot of money that has been raised—sitting in funds and being charged fees—that has not been invested for one or more years. Fee holidays will be required soon for many of these funds.”

Public real estate equity markets have been quite active of late. Notes one REIT executive, “We have been able to raise capital three times in the public markets in the past year. It has been surprising how the public capital markets have opened up in recent months.” There is also growing interest in REIT initial public offerings (IPOs) now that public markets have been reopened for new REIT stock issuance. Notes one observer, “There are probably 12 to 15 IPO deals in the works. They will need to compete against existing mature companies, and it remains to be seen how these new companies will fare.”

Another investment manager in the REIT space notes, “There is a shortage of public vehicles in the hotel and industrial sector, but not elsewhere.” He also notes, “Blind pool REITs will be hard to get done. It is important to have structure, governance, and management. Existing REITs could raise much more equity if there were opportunities to buy assets. Currently there is no shortage of capital, there is a shortage of acquisition opportunities.”

Moving abroad, investors see Asia in a recovery phase, but Japan as trailing. Prices in Asia are better than expected and some investors are using this situation to become net sellers to raise capital. China, Hong Kong, and Singapore are doing well. India is also interesting as land prices are down, but it is an all-equity market with big infrastructure problems. Western Europe is in a similar situation to the United States, and there is little impetus there for banks to sell loans.

In general, notes one investor, “Domestic capital feels more comfortable at home for the time being; part of managing risk is staying home now.” But the United States is viewed as being cheap on a relative basis, with upside potential, so this could change. Global funds are not dead but are not very active either.