Reflecting on the Future

by James R. DeLisle, PhD

Commentary

A number of pundits have claimed that we are in uncharted territory; that we are experiencing unprecedented turmoil in the economic, capital, and real estate markets. These times are indeed unusual, but not as unique as might appear to those new to the real estate industry.

Indeed, in a 1996 report I used the same “reflecting on the future” theme presented in this real estate outlook. At that time, I pointed out that “as institutional investors returned to the asset class in droves.... they brought a more disciplined approach with them, paying close attention to the underlying real estate fundamentals of the asset classa.” Although such a prognostication may be several years ahead of the current cycle, it is important that we draw on past, similar experiences to help us prepare for life after the current, evolving revolution in the real estate industry.

We are going through a revolution that will result in a leaner, meaner, cleaner, and greener real estate industry. The leaner side is based on the likelihood that many players—both professionals and companies—will opt to leave the industry over the next several years. This is particularly true for those with neither the experience nor formal training that is necessary to survive the prolonged downturn we are facing. The meaner side refers to the fact that many relationships will be strained during the correction, resulting in the termination of partnerships and advisory assignments. There will be contentious negotiations between lenders and borrowers facing maturing bullet loans or projects that are underwater with values lower than debt obligations. The cleaner side refers to the fact that many traditional institutional investors and other players will eschew risk and withdraw from value-added and other more aggressive investment strategies that supplanted core investments over the past years. Finally, the greener side refers to the industry’s increased emphasis on the bottom line rather than on normative activities that are not market based but the right thing to do. These comments are not to suggest that the movement toward sustainable real estate will be abandoned but that it will take on new meaning. Ultimately, real estate solutions that can be justified on both environmental and economic bases will become the new norm, much as they should have been all along.

Thus, we are entering a period that will be extremely challenging and painful for those adversely affected by the wealth transfer that will be a by-product of the shakeout. Over the longer term, the renewed discipline and emphasis on real estate fundamentals will be good for the industry and for those who stay in the game. These attributes will also help the industry move to a stage of evolution characterized by greater accountability and a new set of best practices. However, in order to navigate through the troubled waters ahead, it is more important than ever to keep a close eye on the economy, capital markets, and real estate fundamentals. Thus, the following reflections on the future are offered, with special attention to the embedded lessons they present.

The Economic Environment

Overview

The federal government officially declared the recession had ended in late 2009. While many welcomed the announcement, others wondered what they had missed. That is, if it is indeed all over, why weren’t market participants feeling a sense of euphoria and renewed exuberance?
The reality is that while we may technically be out of recessionary ground, many remain on the defensive. Such feelings are understandable especially as some of the government stimulus programs wind down, and the market is forced to determine its fate. It appears the economy has turned the corner and will stay on track; however, concerns have been raised about the durability of the economic recovery. It is still too early to declare victory in the battle over the fate of the economy, as some fears linger that it may slip back into a double dip recession.

The improved economic environment has not muted taxpayer outrage over excessive bonuses paid by financial firms, especially among those benefiting from bailouts. This issue is not likely to go away. Since compensation is key to retention of talent—and has played a role in how firms approached the bailouts—compensation planners will continue to search for ways to reward top talent. In some cases, this will take the form of deferred payments or more stock awards, which can help promote a greater alignment of interest among corporate leaders, investors, and other stakeholders. Although such programs will be highly visible, they may not penetrate the working ranks of the firms, leaving many dealers and traders incentivized to take risks. Regardless, as firms work their way off the government coffers, government criticism is not likely to affect major changes. In the meantime, as in the case of the Bank of America warrants under TARP that have increased in value, the government is benefiting from the early recovery. To this point, warrants have fetched some $4 billion, with gains helping offset some of the losses that were absorbed.

On the international front, the dollar lost some ground as the Federal Reserve (Fed) decided to hold rates down, signaling that it recognizes the tenuous nature of the recovery.

The federal budget deficit has continued to grow to a record $1.4 trillion. Despite the winding down of some stimulus programs, government spending has risen for unemployment benefits and has continued with bailouts for the beleaguered financial services industry. While the record level of federal expenditures will create a long-term hangover for the economy, they have helped stabilize the economy and have contributed to some of the economic improvement. However, the economic outlook is more problematic than in more typical recovery periods due to the difficulty in determining how much of the improvement is temporary and how much will carry over as the economy has to stand on its own. While near-term prospects for the economy are generally positive, the situation will remain tenuous until businesses and consumers regain their confidence and are willing to open up their purse strings.

**Economic Growth**

The initial report for real gross domestic product (GDP) growth in the 2009 third quarter was around 2.6%, a figure that many jumped on to signal the recession had finally ended. The subsequent downward revision in GDP growth surprised many on Wall Street and Main Street and was a stark reminder that the recovery will be gradual and somewhat tentative.

In general, the downward adjustments were attributable to weaker consumer spending, declines in inventories, and reductions in business fixed investment. While these revisions were disappointing, they set the stage for a stronger 2009 fourth quarter. The improvement in GDP offered positive testament to the effectiveness of the government’s various stimulus programs. Improvement on the economic front has reduced the risk that the economy may slip back into recession, although there is still some downside risk as the economy is weaned off government support.

On the international front, the United States lost some of the ground it had gained. This setback was due in part to widening of the trade deficit, which approached $100 billion in the 2009 third quarter. On the other hand, U.S. claims on foreign assets and foreign claims on U.S. assets both increased, suggesting that global capital flows are beginning to improve.

Unfortunately, net long-term capital flows to the United States tapered off. The phenomenon reflects increased competition for capital at the global level. Also, the renewed confidence in emerging markets has dampened the attraction of U.S. investments, which had become more attractive in terms of risk-adjusted returns. This renewed interest in emerging markets led to strong performance in several equity markets. While creating some short-term problems, the prospects of a global recovery bodes well for U.S. exports and may help improve the balance of trade. This was evidenced by improvement in exports at 2009 year-end, which exceeded a moderate increase in imports.

**Employment**

The record level of job losses during the recent recession elevated employment statistics to the most-scrutinized measure of the state of the economy.
Over the past several months, employment losses have continued to moderate, although the country is still facing net job losses. In terms of job openings, the figures remain disappointing. On the other hand, the pace of job separations has declined. Although modest, improvement in this barometer has provided a much-needed sense of stability for workers who have struggled to hang on during the waves of cutbacks. Government employment has been a mixed bag, with some increases in the ranks of federal workers, but losses at the state level. This situation is expected to continue to deteriorate as state revenues decline and states face even greater deficits that force cutbacks in nonessential services.

The unemployment rate has also declined. Unfortunately, the improvement was largely due to the increasing number of job hunters who have left the workforce after giving up hope of finding employment. Even those who have found jobs have faced a bittersweet reality, with many coming back online at lower-paying jobs with less benefits.

The employment outlook remains guarded with more losses expected over the near term. However, increases in several leading indicators—including temporary employment, hours worked, and factory orders—suggest that the worst may be over. Indeed, if the domestic and global economies continue to improve, we may see some actual job growth in the second half of 2010. If that occurs, it could stimulate demand, which could have a positive impact on small businesses and consumers, both of which will be key to a sustainable recovery.

Inflation and Interest Rates

On the inflation front, the situation remains relatively stable, with few signs of a short-term increase in prices. Indeed, skittish consumers have kept pressure off retail prices, especially for nonessential goods and services. The Consumer Price Index increased moderately at year-end 2009, although once food and energy are removed from the equation, inflation remained largely flat. Energy prices remain something of a wild card, with speculators placing upward pressure on prices. If the trend toward higher heating costs holds, it could strain household budgets and undercut some of the progress that has been made in firming up the economy.

Although energy prices have been under upward pressure, soft demand resulting from the global economic downturn has held down prices of other commodities. Since the economic recovery in the United States is lagging that of many other nations, domestic commodity prices might outpace the economic recovery. Import prices have also risen moderately, due in part from the weak dollar and improved economic conditions abroad. The risk of externally induced increases in costs is offset in part by excess capacity on the plant and equipment front, which will provide some cushion against unexpected inflation. Similarly, strong productivity growth has helped boost corporate profits and position companies for the future. The weak labor market has also helped corporate balance sheets and is likely to help hold inflation in check when companies begin to hire.

The Fed continues to lean towards nurturing the economy rather than worrying about a potential bout of inflation that could get out control in light of significant deficit spending and the weak dollar. Inflation-related concerns have been debated by the Federal Open Market Committee in its discussions over what to do about interest rates. Even if the Fed continues to hold rates down, the importance of global capital flows to support the U.S. economy and economic expansion depends in part on continued offshore appetites for U.S. assets.

The U.S. recovery is likely to lag the global recovery, both in timing and magnitude. Coupled with less fears of risk in emerging markets, this is likely to create some shifts in the flow of funds to the disadvantage of the United States. When coupled with greater attention on the risk side of the pricing equation, limited access to capital may forestall the recovery and make it more expensive to borrow. At the same time, small businesses are expected to remain in a defensive mode by holding down costs and debt obligations to ensure their survival until they are sure the economic recovery is sustainable.

Business Indicators

The Conference Board Leading Economic Index has continued its upward trend, rising to the highest level it has reached since the recession began. A number of other economic indicators reveal that business activity picked up toward the end of 2009. Factory orders rose, orders for capital goods and shipments were up, and
businesses moderately increased investment activity. At an aggregate level, manufacturing conditions also improved at year-end, benefiting from an increase in new orders. Inventories continued to decline, although the rate of decline tapered off. Sales activity picked up, also helping to reduce the inventory/sales ratio. Industrial production also improved toward year-end. The improvement was fairly widespread, affecting both the durable and nondurable sectors. Capacity utilization also improved moderately, although still low by historical standards.

A number of surveys of chief executive officers (CEOs) show confidence levels improved during 2009. Unfortunately, the attitude of CEOs of small businesses continues to be clouded by legitimate concerns over rising taxes, additional regulations, rising health-care costs, and continued tight credit. Thus, small business confidence levels are expected to remain guarded despite some general improvement in economic conditions. This situation offers evidence of the struggles faced by small business during the recession. It also punctuates the negative impact that tightened credit standards and reduced credit availability have had on small businesses. Given the general sense of pessimism among small business owners, it is unlikely this important sector will see employment growth.

Stock Market

The major domestic stock indices racked up strong returns in 2009, which largely reversed the losses incurred during 2008. Mutual fund performance generally mirrored that of the stock market in 2009. The bond market did not fare as well, with Treasury bonds slipping into negative territory. The improved performance of the stock market is attributable to the success of cost-cutting measures as well as the fledgling economic recovery.

Global companies are positioned to take advantage of improving demand for exports due to the combination of the weak dollar and the end of the global recession. The financial sector will be closely scrutinized as investors try to understand the risk exposure associated with existing portfolios and growing reserve requirements. Consumer goods companies and retailers will likely lag until consumer confidence rebounds. On the other hand, the technology sector has led many other sectors in anticipation of growing demand from offshore customers and the introduction of new products and operating systems. Companies’ ability to expand earnings and drive stock prices will depend on their ability to increase revenues. At the same time, investors will be looking for signs that financial markets will be able to stand on their own feet without the benefit of government intervention.

Consumer Confidence

The Conference Board Consumer Confidence Index rose moderately in December 2009, and the Expectations Index increased even more, suggesting that consumers are looking forward to better times. This improvement was attributable to an improved outlook for business conditions and an ultimate recovery in the employment market. However, the Present Situation Index slipped. This suggests that consumers are likely to stay on the sidelines until the overall economy picks up and the benefits ripple down to their level. In the University of Michigan Consumer Sentiment Index, the value also jumped up in December. While this improvement received much attention as businesses and investors looked for signs that the consumer may be returning, it is too early to tell if the corner has been turned. Interestingly, although many conditions remain weak, consumers seem to take some solace from the fact that things are not getting worse as fast as they were over the past several years.

If consumers can rekindle their optimism in the economy and their personal situations, they can be expected to help bolster the economy. However, heavy revolving credit loads, which are gradually being reduced, will force many consumers to continue to rein in their purchasing habits. Recognition of limited prospects for increases in wages is also likely to cloud consumer sentiment, with many still happy just to have a job.

It should be noted that according to a recent Conference Board survey, employee job satisfaction is at an all-time low. While there is some disagreement with these results, the poll suggests that many workers—including those frustrated with lack of raises, declining benefits, increased workloads, and fewer resources—have been hanging on to jobs due to a lack of options. In addition, some workers have been tied down by the depressed housing market and budget concerns. This situation bears some watching as the economy recovers, since a wave of employee defections could place a damper on the overall economic recovery and drive costs upward.
In spite of the soft job market, personal incomes have continued to improve modestly, although not for workers forced out of higher-paying jobs. During this period of household stress, the savings rate has remained relatively stable, suggesting that consumers are paying more attention to their future at the expense of immediate gratification from current purchases. To the extent that this holds, some of the upside potential for consumer sales might be left behind, especially as retirements loom for aging baby boomers, and government budgets and benefits remain strained.

**Retail Sales**
Retail sales account for some 70% of the U.S. economy and as such, have received significant attention from those watching the fledgling recovery. Since the crash of the housing market in mid-2006, retail sales have plummeted. Consumers have reined in their spending and cut back to more essential goods and services. In recognition of these factors, many retailers cut inventory going into the crucial holiday season. While this became something of a self-fulfilling prophecy and placed downward pressure on retail performance, it proved to be warranted in light of consumer demand. That said, retail sales continued to improve modestly at 2009 year-end. The modest improvement in retail sales was well received by pundits, especially in light of the inclement weather on the East Coast during the peak of the holiday shopping season.

Internet sales were a different story, racking up consistent improvements throughout 2009. However, Internet sales still account for less than 4% of total retail sales, although that market share is at a new record. Going forward, retail sales are expected to show moderate improvement if the employment picture begins to improve. But, there are few prospects of a consumer-led rally that could catapult the economy into an expansionary mode. Rather, consumers will do their part as long as expectations remain positive, and there are no material erosions in current conditions.

**Housing Market**
After a prolonged period of correction, the single-family housing market has begun to show some signs of improvement. The S&P/Case-Shiller Home Price Indices showed some improvement at 2009 year-end, especially compared to the figures for the prior year. However, these results are not across the board, and the sector continues to struggle on a number of fronts. Prices continued to decline at the national level even though some metro areas were able to eke out modest gains in month-to-month figures toward the end of 2009.

Pending home sales declined between October and November catching many off guard and providing a stark reminder that the housing market remains vulnerable to traditional downturns. Despite some of the optimism among homebuyers, new home sales slipped, continuing the trend that began last summer. These results would have been even more disappointing in the absence of the first-time homebuyers program. On the other hand, existing home sales continued to increase, rising to the highest levels since the market correction began. Inventories of existing homes also declined as buyers took advantage of low interest rates and stabilized prices.

Some of the increase in delinquency rates in residential mortgages can be attributed to foreclosure moratoria and the Making Home Affordable Program. These two factors combined to increase the backlog of homeowners in the delinquent category while slowing down the pace of foreclosures. Among types of mortgages, the distressed rates were highest for subprime loans of which some 30% are delinquent. This compared to the overall adjustable mortgage category for which delinquencies rose into the double digits. On the other hand, the rate of foreclosure on prime fixed-rate mortgages was relatively low on both absolute and relative bases. On a regional basis, delinquency and foreclosure rates vary dramatically, with a limited number of markets accounting for the most dramatic figures.

In terms of residential mortgage activity, applications for new purchases were down at 2009 year-end, and refinancing applications were relatively flat. Disappointing conditions in the housing market carried over to homebuilders as evidenced by a decline in builder confidence measured by the NAHB/Wells Fargo Housing Market Index (HMI). Also, extremely tight credit continued to keep construction activity in check. This situation is unlikely to change over the near term, with financial intermediaries paying close attention to consumer demand for housing and homebuilders’ balance sheets. Thus, while the housing market will be critical to sustaining the economic recovery, the industry clearly will not lead the charge.

**Real Estate Outlook**

**Market Overview**
The commercial real estate market has continued to deteriorate; indeed, the market is being flooded with
Inbox are being inundated with no-risk approaches to capitalize on the market malaise, but it is clearly too early to be bottom fishing since the bottom is not yet in sight. That is not to say there are not going to be some great opportunities in 2010, but those opportunities should be left to experienced veterans who have the wherewithal to survive the downturn and have the ability to sift through the growing glut of assets that will be coming to the market.

Although there are still some bulls who contend that the market is going to return to normal in the near term, many are waking up to the reality of the market. This is evidenced by the somber tone emanating from the prognosticators who have subdued audiences at a range of professional trade meetings. On the other hand, a number of industry spokesmen are suggesting that 2010 will present a great opportunity for buying commercial real estate in public or private arenas. While such a trend would be much welcomed, historical evidence suggests the commercial market is not likely to bottom out over the next twelve months.

Even though some investors will continue to acquire assets, the bulk of opportunistic investors and market timers are likely to stay on the sidelines for much of the 2010. It is also likely that there will be an early rally as the first real wave of distressed asset sales hits the market. After a brief flurry of activity, it is likely that the market will step back to wait for credible evidence that the bottom has been reached. Unfortunately, this activity will have an adverse impact on mark-to-market accounts, putting current owners under additional strain.

Novices and veteran players who lack the staffing, research, infrastructure, and other key resources to capitalize on the flailing industry are advised to stay on the sidelines for the near term. Although they may be missing the opportunity to benefit from the wave of wealth transfer that will be occurring in commercial real estate, they will also avoid getting drawn into the fray. This advice is consistent with our leaner forecast for the industry, in which the number of active players will decline due to defections to other industries, failures as a result of bankruptcies, or acquisitions by larger players with access to capital. Indeed, according to Real Capital Analytics, a firm that has positioned itself as a leading source of distressed asset information, the universe of active players in the U.S. market fell to around 1800, a dramatic decline from its peak in 2006. That said, a wave of new players is poised to step into the commercial real estate market.

To this point, the bulk of distressed activity that has occurred has focused on the commercial mortgage market with limited activity and direct purchases. This situation is likely to change during 2010 as more products come to market and sellers are more motivated. During this period, many are expected to take the gloves off, creating a meaner environment in which transactions rather than relationships are the focus of activity.

On a positive note, there has been an uptick in transaction volume, ranging from sales of trophy assets to sales of distressed assets. The former case is characteristic of our forecast for a cleaner industry environment in which investors are more likely to pursue lower-risk strategies than in the recent bull market. This is evidenced by the flight to quality and risk aversion of investors that has manifested itself in multiple bids for core assets with relatively low bid-ask spreads.

Another strategy being deployed by owners of trophy properties in need of short-term capital is the use of partial sales rather than outright dispositions. This approach has been a win-win transaction that provides access to much-needed capital without forcing the disposition of solid assets with upside potential. Such activity is expected to continue, although parties will pay close attention to their alignment of interest, as well as buy-sell agreements to resolve issues that are likely to arise when the market comes back or if conditions erode more than anticipated. A meaner example of this trend is the likely growth in loan-to-own or partnership agreements, with the underlying motivation being the ability to acquire solid assets from distressed owners who are unlikely to be able to satisfy contractual provisions.

Support for the prediction of a leaner, meaner, and cleaner real estate market environment emanates from several considerations. Recent institutional investor news—such as the firing of real estate managers at the California Public Employees’ Retirement Fund—suggests that institutional investors are becoming more cautious in their investments. Recent reports indicate that many institutional investors are reducing their exposure to real estate assets and are seeking more liquid investments that offer lower risk and higher returns. This trend is likely to continue throughout 2010, as institutional investors look to real estate market conditions to make informed decisions about their investments.
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System (CalPERS) who headed up failed investment schemes and the recent scandals surrounding millions of dollars that CalPERS inadvertently paid to middlemen—has fueled public outrage. Additional regulations and restrictions are likely to be implemented and may affect the broader class of institutional investors and place a restraint on real estate investment activity.

Office Market
At a national level, office market fundamentals continue to deteriorate, with national vacancy rates increasing and rents losing ground. This deterioration has been fairly widespread, affecting most markets and submarkets although the central business districts have not been hit as hard as suburban markets.

Office absorption continues to be negative in many markets, with vacancy rates moving toward the upper teens. Office tenants are still continuing to give space back, although the rate of returns has moderated along with declines in employment levels. The decline in rents has been fairly consistent, drilling back some fifteen months when the recession first hit the commercial market. The good news is the pipeline of office development has been largely shut down with developers pulling the plug on pending projects as well as a number of projects in the early stages of construction. Financing remains extremely tight and will likely continue well into next year. The deterioration in office market fundamentals, coming on the heels of increased return requirements for investors, has placed additional downward pressure on values.

On the public front, the performance of office real estate investment trusts (REITs), as benchmarked by closing stock prices, has been ahead of the private market. While the sector has lost some steam as concern over deteriorating real estate fundamentals and declining valuations has increased, office REITs have not gone into a tailspin.

In terms of leasing market dynamics, the balance of power has clearly shifted to retailers, which has hit landlords and managers of properties with maturing leases particularly hard. Indeed, in a number of markets landlords have had to renegotiate leases downward to retain tenants as they have focused on the need to insulate their rent rolls from cannibalization by competing landlords. This weakness in market fundamentals is expected to continue for some time as retailers rationalize their store holdings and consumers wait for the economy to improve.

With respect to returns on the private side of the market, the erosion in values has been fairly widespread, with regional malls and grocery-anchored community shopping centers faring the best. The decline in retail returns was ahead of other property types as the sector responded to the economic contraction and the erosion in demand. As in the case of office properties, retail REITs experienced a rebound in 2009. The most significant improvement was in regional mall REITs, with the exception of General Growth Properties (GGP), which went into bankruptcy as a result of a flawed financial engineering strategy. A positive note for the regional mall sector is that GGP is on track to exit bankruptcy court in 2010.

The rebound in closing prices for large shopping center REITs paralleled that of their regional mall counterparts, while prices of REITs focused on medium and small retail properties were relatively flat. With respect to distressed assets, the retail sector remains the most significantly affected although much of the distress can be traced to the GGP debacle. In terms of subtypes, grocery-anchored power centers and single-tenant and urban stores have performed well enough to avoid showing up on the distressed asset radar screen.

The outlook for the retail sector is guarded; the fledgling economic recovery and stabilization among retailers would suggest the worst is over. Improvement in the sector will be gradual, however, and will lag that of the overall economy as the industry deals with the significant overhang of surplus space.

Industrial/Warehouse Market
The industrial sector has experienced the same fate as other property types, with vacancy rates rising as
demand for space remains tepid. At a national level, absorption rates for industrial property were negative. With tenants continuing to give space back to landlords, positive absorption is expected to continue.

In the face of the contraction of demand, warehouse construction activity has slipped to record lows and is significantly below the peak of the market in 2007. Despite the decline in construction, industrial vacancy rates have risen into the double digits. This increase in vacancy was fairly pervasive, with the majority markets reporting higher vacancy levels. In light of deteriorating fundamentals, warehouse rents slipped although not as significantly as other property types. The industrial sector has benefited from the fact that a significant proportion of the market is locally owned and thus not subject to some of the overbuilding affecting other property sectors.

While the weak dollar and global economic recovery suggest exports may pick up with the broader economy, excess capacity in the industrial and warehouse sectors are likely to create a lag in market fundamentals. Changes in supply chain models are also likely to create some shifts in fundamentals, with some markets benefiting and others losing ground in the broader global context. With respect to investment performance, the private industrial sector has seen significant erosion in values though not nearly as pronounced as some of the other property types. Within the sector, warehouse and research and development properties have experienced significant declines, while office properties have not experienced the same levels of write-downs in values.

On the public front, industrial REITs followed the same pattern of write-downs that, with a few exceptions, were followed by a moderate recovery in 2009. With respect to distressed assets, the industrial sector has had relatively limited problems with assets at around $5 billion of industrial properties falling in that category. The near-term outlook for the industrial sector is for additional erosion, followed by gradual recovery as the economy begins to pick up speed.

**Apartment Market**

The apartment market has not escaped the plight of other property sectors. Vacancy rates have risen and are likely to remain high throughout 2010. At the same time, rental rates have slipped, and owners have been forced to increase concessions in order to attract and retain tenants. While not surprising in the context of the broader commercial real estate market, the fate of the apartment market caught many players off guard, especially those anticipating a boost from the collapse of the single-family market, which provided some respite for the multifamily sector. Unfortunately, the short-term leases of apartments allow tenants to contract quickly in the face of job losses and other budget pressures. While the economic recovery is expected to help the apartment sector when jobs pick up, prospects remain guarded for the near-term outlook.

With respect to investment performance, the apartment sector has been one of the favored property types among private institutional investors. Strong investor demand has historically allowed the sector to experience relatively high risk-adjusted returns with demand for product holding up values. The recent correction in the commercial market has spilled over to the apartment sector, with the total returns falling along with other property sectors. High-rise urban projects, which had been one of the more favored subsectors, have experienced serious write-downs. At the same time, a number of such projects appear to have gotten ahead of the demand curve and are suffering from erosion in net income. While also declining in value, garden and low-rise apartment projects have not fallen as much as other apartment categories and other commercial property types.

On the public side of the market, apartment REIT stock prices peaked along with the broader housing market. With respect to distressed assets, the apartment sector is on par with other property types, with some $30 billion of troubled assets reported at 2009 year-end.

Looking forward, the apartment market is likely to be flat during 2010, with some downside risk. However, when the economy begins to improve and new jobs are created, the sector should benefit from the elasticity in demand.

**Real Estate and Capital Markets**

**Capital Market Overview**

The commercial real estate industry continues to suffer from erosion in value and lack of debt capital, creating downward pressure on the asset class. During 2010, capital flows to real estate will be mixed, with increasing acquisitions as investors begin to move
Financial Views

Unfortunately, the prospects for continued erosion in values will likely result in negative net capital flows. In many respects, the industry is facing unprecedented wealth transfer as values decline even further. In this environment, many current owners are facing the prospects of losing significant wealth that may take years to recover. Other owners will lose assets outright due to an inability to carry debt loads or refinance maturing bullet loans. While these trends will create a number of opportunities for investors, they will not attract sufficient capital to help stabilize the industry. Indeed, the impending debt crisis associated with refinancing activity in the face of tighter underwriting will be of such a scale that additional government interventions may be required. Unfortunately, neither politicians nor taxpayers are likely to be in much of a mood to provide outright bailouts for the commercial real estate industry.

During 2010 and beyond, individual owners of commercial real estate are likely to face problems accessing debt, which will be much more severe than the lack of access to credit that small business owners have faced. Unfortunately, while small businesses were able to pull back and cut costs, many real estate investors do not have the same degree of flexibility and may not be able to maintain solvency. In this environment, the capital markets are likely to be finicky, with savvy investors and lenders picking their assets very carefully. On the other hand, the expected explosion in distressed asset dispositions may be met with a feeding frenzy that will swamp the market with potential deals. Some of these deals may never get done, while others that will get done probably should not if proper attention were paid to fundamentals.

Even though the Fed is expected to hold rates low for the foreseeable future, commercial real estate investors are likely to face even tighter underwriting standards as lenders focus more attention on existing balance sheets and mark-to-market accounting that may reveal more weaknesses than currently priced into the system. Renewed interest in the risk side of the equation is likely to place upward spreads on commercial mortgage rates that are unlikely to benefit from government subsidies. Additional upward pressure on spreads is likely to come from commercial lenders faced with rising delinquency rates. The end result will be a severe capital crunch on the debt side of the industry with no obvious solution on the horizon.

Construction Activity

During much of 2009, the month-to-month trend in construction activity was negative, with the exception of a slight uptick in April. Total private residential construction levels were somewhat mixed, with a decline in November reversing growth in October. Private nonresidential construction was relatively flat, consistent with tightened credit and weakening market fundamentals across property types. On a positive note, private spending on utilities was relatively strong in both month-to-month and year-over figures. On the other hand, commercial and office construction activity levels were down of some 40%.

Public construction activity was up on a year-to-year basis through November 2009, with the transportation sector leading the charge. Disbursements from the American Recovery and Reinvestment Act (ARRA), which includes some $787 billion in funding, should provide a boost to public construction activity and help stimulate activity over the near term. Of the $130 billion disbursed through October 2009, the vast majority was for outright grants, which should increase the multiplier effects and help states deal with budget shortfalls without creating future claims.

Looking forward, commercial construction is expected to languish through the year. While residential construction will also be tempered, an increase in permit activity suggests builders are ready to respond to a much-awaited increase in demand and stabilization in the single-family sector. Such improvement will depend on further gains in the economy, employment growth, and successful workouts of the flood of distressed assets still hanging over the sector.

Commercial Mortgage Market

Although exact figures are not available, especially with ongoing downward price adjustments, the outstanding value of commercial mortgage-backed securities (CMBS) holdings in the United States is in the range of $750 billion. In the absences of new issuances and ability to attract capital, the industry is facing tremendous pressure that continues to threaten its very existence. Indeed, with real estate fundamentals continuing to erode and borrowers coming under additional stress, delinquency rates on CMBS are continuing to increase, reaching a record 6% by 2009 year-end with more increases on the horizon.
The most troubled area has been in the large office and hotel sectors, both of which have been particularly victimized by erosion in demand. While large, multitenant offices were thought to be insulated from economic downturns, the widespread layoffs earlier in the recession hit home, with a number of tenants giving back space and others curtailing expansion plans upon which some of the speculative office in the pipeline was predicated. Going forward, delinquency rates in CMBS pools are expected to rise, with the potential to double before the commercial market begins to stabilize.

Given the plight of the CMBS industry, the public mortgage market will be out of the picture when it comes to new and maturing loans, leaving a significant void in the market. Unfortunately, the private commercial mortgage market has been suffering from many of the same pressures as its public counterparts. Indeed, there are significant questions regarding the credit quality of many bank portfolios, especially if they are marked-to-market and reflect the underlying risks and realities of the market. As such, lenders are expected to continue to tighten underwriting standards and play hardball with borrowers who are underwater and have to refinance maturing loans.

While the Federal Deposit Insurance Corporation (FDIC) is likely to expand efforts to clear out problem assets by selling those assets at a significant discount to face value, the FDIC is unlikely to have the financial wherewithal to absorb the impending volume of losses. Rather than outright sales, in some cases the government will retain partial interests in some of the pools it liquidates, helping make them more marketable and retaining some upside for taxpayers if recovery rates are higher than expected. However, before looking at upside potential, the commercial loan industry will have to come up with some answers. How to resolve the impending crisis will be a major wild card affecting the commercial real estate market and, given the depth of the problem, the broader economy and financial sectors as well.

**Private Equity Market**

The private equity market for institutional real estate is likely to undergo a revolution as the market struggles through the downside of the curve. Institutional investors will need to rethink their attitudes toward core versus noncore real estate investing. For example, for all value-added real estate funds reported in the NCREIF-Townsend Fund Indices, the annualized return through the third quarter of 2009 was -43% compared to -46% for all opportunistic funds. While open-end, commingled funds also struggled with -55% returns, the standard deviations were much lower than their riskier counterparts. For the trailing ten-year returns, core real estate funds provided the same returns as value-add funds with standard deviations, which were almost 50% lower. While returns on core funds lagged those on opportunistic funds for the ten-year period, standard deviations were around 12% compared to 22% for the riskier investments.

These poor results, on both an absolute and a risk-adjusted basis, are likely to force institutional investors to revisit their core/noncore allocations. During this stage of the cycle, we are likely to see institutional investors looking at real estate for diversification benefits and for attractive risk-adjusted returns. Under this model, investors have a preference for core assets, with a marginal appetite for riskier assets that could bolster returns without introducing significant risk. Indeed, since the mid-1990s, rather than holding a preponderance of core investments, the market share of value-add and opportunity funds in institutional real estate portfolios has grown dramatically, with core investments having a gross market cap of $80 billion compared to riskier models that commanded $244 billion in institutional real estate holdings. While this shift worked in a prolonged bull market, when the market corrected, the fallacy of the strategy was driven home with a vengeance. Indeed, in light of its weak results CalPERS has already announced such a shift.

Given that turmoil is likely to characterize the market during this adjustment period, the flight to cleaner assets will be problematic at best, especially in light of the flood of distressed assets on the market. While this will be an extremely painful process, it will ultimately lead to a healthier and more stable industry in which underlying market fundamentals supplant charisma and acumen related to raising capital and the machinations of financial engineering. Thus, 2010 will be part of a revolutionary period in which the rules of engagement for institutional players will be rewritten, with new business models emerging as well as new infrastructure to support them.

**Public Equity Market**

In some property sectors, the public market has bounced back ahead of the private market. This
situation can be attributed to a number of factors including the greater elasticity of demand and liquidity of REIT shares relative to direct ownership. While the major REIT players are sitting on stockpiles of cash through secondary offerings and have access to unsecured debt, the significant deterioration in underlying market fundamentals has forced them to delay positioning themselves for a wave of accretive investing. The delay can also be attributed to the lack of high-quality product coming online at distressed prices and the competition for attractive core assets that have come to market. To this point in the cycle, REITs have not been able to exploit the withdrawal of capital from the asset class. However, many of them have their powder dry and sufficient liquidity to be able to move when the market opens up, assuming investors do not panic with bad news surrounding market fundamentals. To this point, the recent rebound in REIT prices has held up. At the same time, yields are lower than long-term averages. While many REITs have been able to manage debt up to this point in the cycle, the shortage of capital for refinancing and acquisitions from private and public sources is likely to put a damper on the asset class that will ripple over to the public side of the market.

**Conclusion**

In this outlook report, we have highlighted two distinct but related themes. First, we predicted that the commercial real estate market is entering a revolutionary period and once the dust settles, the real estate industry will be leaner, meaner, cleaner, and greener. While we did not expand on the latter criterion (i.e., greener), we believe that prediction will hold and that the real estate industry will begin to redefine *green buildings* to incorporate market-based solutions that achieve social goals that are economically viable today and in the future.

Second, we discussed lessons that might provide a road map to navigate through the troubled waters ahead. During this transitional period, the industry will face a number of challenges, including significant transfers of wealth as the industry moves from a capital markets play to a real estate fundamentals play. While the adjustment to the new order will be painful and many may not survive, the end result will be positive with the fortunes of the real estate market more dependent on underlying market fundamentals than on the machinations and creativity of financial engineering. We are indeed entering interesting times that will change the industry.

James R. DeLisle, PhD, is the Runstad Professor of Real Estate and Director of Graduate Real Estate Studies at the University of Washington. Prior to his current assignment, DeLisle was the director of the Real Estate Research Center and the coordinator of the e-Commerce Program at Georgia State University. Before returning to academia, he was an executive vice president and head of strategic planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate where he founded the Investment Research Department and directed it for nine years. He has published widely in academic and professional journals. DeLisle received his BBA in real estate and MS in marketing research from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research.


**Contact:** T 206-616-2090; E-mail: jdelisle@u.washington.edu