Seattle Commercial Real Estate Update: Spring Forward, Fall Back?

CRE Chapter Meeting: Seattle
James R. DeLisle, Ph.D.
April 11, 2012
Overview

- Respondent Profile
- Market Timing

- Part I: Economic Outlook
- Part II: Capital Market Overview
- Part III: Real Estate Market Outlook
- Part IV: Challenges, Issues and Opportunities
What Do You Want Me To Talk About?
Professional Roles

Careers: Past & Future

1. Which of the following best describes your role with respect to the real estate market?

<table>
<thead>
<tr>
<th>Role</th>
<th>Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appraiser</td>
<td></td>
</tr>
<tr>
<td>Consultant</td>
<td></td>
</tr>
<tr>
<td>Asset Manager</td>
<td></td>
</tr>
<tr>
<td>Service Provider</td>
<td></td>
</tr>
<tr>
<td>Corporate Real Estate Manager</td>
<td></td>
</tr>
<tr>
<td>Developer</td>
<td></td>
</tr>
<tr>
<td>Investor</td>
<td></td>
</tr>
<tr>
<td>Broker</td>
<td></td>
</tr>
</tbody>
</table>

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## Professional Roles and Career Plans

### How many years of experience?

<table>
<thead>
<tr>
<th>Experience</th>
<th>Under 5 years</th>
<th>5-7 years</th>
<th>8-10 years</th>
<th>11-15 years</th>
<th>16-20 years</th>
<th>20-25 years</th>
<th>26-30 years</th>
<th>31-35 years</th>
<th>36-40 years</th>
<th>Over 40 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>8.3%</td>
<td>30.0%</td>
<td>25.0%</td>
<td>8.3%</td>
<td>8.3%</td>
</tr>
</tbody>
</table>

### How many more years of work?

<table>
<thead>
<tr>
<th>Experience</th>
<th>Under 5 years</th>
<th>5-7 years</th>
<th>8-10 years</th>
<th>11-15 years</th>
<th>16-20 years</th>
<th>20-25 years</th>
<th>26-30 years</th>
<th>31-35 years</th>
<th>36-40 years</th>
<th>Over 40 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>0.0%</td>
<td>41.7%</td>
<td>8.3%</td>
<td>25.0%</td>
<td>16.7%</td>
<td>8.3%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

### How have recent events changed your retirement plans?

<table>
<thead>
<tr>
<th>Change</th>
<th>-10 years</th>
<th>-5 years</th>
<th>-2 years</th>
<th>No change</th>
<th>+2 years</th>
<th>+5 years</th>
<th>+10 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>75.0% (9)</td>
<td>0.0% (0)</td>
<td>8.3% (1)</td>
<td>8.3% (1)</td>
<td>0.0% (0)</td>
</tr>
</tbody>
</table>

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How retirement plans changed due to economic events?
## Part I: Economic Environment for Real Estate

<table>
<thead>
<tr>
<th>Year</th>
<th>Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010 Outlook</td>
<td>Recession over; slow recovery; some downside risk</td>
</tr>
<tr>
<td></td>
<td>Big businesses okay, Small struggling, stock market up</td>
</tr>
<tr>
<td></td>
<td>Consumers guarded; CEOs hopeful</td>
</tr>
<tr>
<td>2011 Outlook</td>
<td>Recession really over? slow recovery; some downside risk</td>
</tr>
<tr>
<td></td>
<td>Big business bragging profits up; small business lagging…..</td>
</tr>
<tr>
<td></td>
<td>Consumers wanna do it; CEOs hopeful</td>
</tr>
<tr>
<td>2012 Outlook</td>
<td>Limited Double-dip. Slow recovery at best; downside risk</td>
</tr>
<tr>
<td></td>
<td>Big business balance sheets okay; small business stabilizing..</td>
</tr>
<tr>
<td></td>
<td>Consumers and CEOs defensive but willing… some improvement…</td>
</tr>
</tbody>
</table>
# Market Timing: Economy and RE Markets

## Economy

<table>
<thead>
<tr>
<th></th>
<th>It already has</th>
<th>2nd Quarter 2012</th>
<th>3rd Quarter 2012</th>
<th>4th Quarter 2012</th>
<th>1st Quarter 2013</th>
<th>2nd Quarter 2013</th>
<th>3rd Quarter 2013</th>
<th>4th Quarter 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>National Market</strong></td>
<td>60.0% (6)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>10.0% (1)</td>
<td>20.0% (2)</td>
<td>0.0% (0)</td>
<td>10.0% (1)</td>
<td>0.0% (0)</td>
</tr>
<tr>
<td><strong>Seattle Market</strong></td>
<td>87.5% (7)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>12.5% (1)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
</tr>
</tbody>
</table>

## Housing

<table>
<thead>
<tr>
<th></th>
<th>It already has</th>
<th>2nd Quarter 2012</th>
<th>3rd Quarter 2012</th>
<th>4th Quarter 2012</th>
<th>1st Quarter 2013</th>
<th>2nd Quarter 2013</th>
<th>3rd Quarter 2013</th>
<th>4th Quarter 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>National Market</strong></td>
<td>10.0% (1)</td>
<td>0.0% (0)</td>
<td>50.0% (5)</td>
<td>0.0% (0)</td>
<td>20.0% (2)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>10.0% (1)</td>
</tr>
<tr>
<td><strong>Seattle Market</strong></td>
<td>62.5% (5)</td>
<td>0.0% (0)</td>
<td>12.5% (1)</td>
<td>12.5% (1)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
</tr>
</tbody>
</table>

## Commercial Real Estate

<table>
<thead>
<tr>
<th></th>
<th>It already has</th>
<th>2nd Quarter 2012</th>
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<th>3rd Quarter 2013</th>
<th>4th Quarter 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>National Market</strong></td>
<td>60.0% (6)</td>
<td>0.0% (0)</td>
<td>10.0% (1)</td>
<td>10.0% (1)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>10.0% (1)</td>
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<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>12.5% (1)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
</tr>
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Economic Outlook: Agree/Disagree

- The economy is recovering and we will avoid a double dip.
- Inflation will not be a concern over the next 2 years.
- Employment gains will accelerate in early 2012.
- GDP growth will surge in 2012.
- Retail sales will continue to increase.
- The economic recovery will be very gradual.
- Interest rates will remain low.
- The credit markets will return to normal in the next 6 months.
- Corporate profits will continue increasing next year.
Biggest Risks to National Economic Recovery?
How Important to Sustainable Economic Recovery?
## Part II: Real Estate Capital Markets

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Tentative, waiting to pounce, new players &amp; rules</td>
<td>• Patient pouncers, old rules, core rules</td>
<td>• Top-end frenzy, core investor apprehension</td>
</tr>
<tr>
<td>• Rising Cap rates, declining values de-capitalizing</td>
<td>• Cap rate halos; values unknown...</td>
<td>• Cap rate compression, spread investment</td>
</tr>
<tr>
<td>• Challenges re-levering; credit crunch for asset class</td>
<td>• Re-levering at top only; credit crunch for rest</td>
<td>• Window opening, headwinds closing, distress unrest</td>
</tr>
</tbody>
</table>
How We’re Doing: Commercial Real Estate

3Quarter 2011

Current Qtr Estimate

- **Income**: 1.29%
- **Appreciation**: 2.28%

**Total, Gross**: 3.58%

1.29% * 4 = 5.16%

Annual Returns

<table>
<thead>
<tr>
<th></th>
<th>1 Year</th>
<th>3 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>5.7%</td>
<td>6.0%</td>
</tr>
<tr>
<td>Appreciation</td>
<td>12.1%</td>
<td>-11.8%</td>
</tr>
<tr>
<td>Total, Gross</td>
<td>18.3%</td>
<td>-6.4%</td>
</tr>
</tbody>
</table>

REITs, Don't Fail Me Now

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US Transaction Momentum

QUARTERLY US PROPERTY SALES

YOC CHANGE

Search by Style

YOC CHANGE IN US PROPERTY SALES
Office, Apartment, Retail, Industrial, Hotel and Dev Sites
BY MONTH

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Long-term Commercial Transaction Trends

Institutional Allocation by Vehicle

Global: Cross-Border

Private: Market Timers
Commercial Loan Maturities: CMBS Land & Payoffs

CMBS Delinquencies

CMBS Issuances

Projected Commercial Mortgage Loan Maturities

CMBS Sales to Reach $30 Billion in 2012 on Refi Needs, JPMorgan

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CoreNet Global Risk Concerns for 2012

- Rising Loan Defaults
- Declining Rents
- Oversupply of Space
- Rising Interest Rates
- Lack of Credit
- Rising Unemployment
- Rising Vacancy
- Stagnant Demand
- Supply of Mortgage Debt
- Lack of Job Growth

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Other Risks to Real Estate Market
Part III: Spatial Market Fundamentals

2010 Spatial Market
- Still weakening, negative absorption; more downside risk
- Vacancy rates pushing records, rents declining
- Negative absorption, lagged recovery

2011 Spatial Market
- Still weak, limited absorption; more downside risk
- Vacancy rates peaking, rents stabilizing but low
- Absorption flat, recovery lagging tenants nagging

2012 Spatial Market
- Spotty correction, plateau in connection, deferred resurrection
- Vacancy peaking, rents creaking
- Modest absorption, tenant reflection, landlord perplexion
## Cap Rates: Current and 12 Months

### Now

|                         | 5%    | 5.5%  | 6%    | 6.5%  | 7%    | 7.5%  | 8%    | 8.5%  | 9%    | 9.5%  | 10%   | 10.5% | 11%   | 11.5% | 12% or More |
|-------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|----------|
| Top-tier, Trophy Assets | 40.0% | 40.0% | 0.0%  | 0.0%  | 10.0% | 10.0% | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 0.0%    |
| Core Institutional Grade Assets | 0.0% (0) | 0.0% (0) | 40.0% (3) | 20.0% (2) | 20.0% (2) | 20.0% (2) | 10.0% (1) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) |
| Distressed              |       |       |       |       |       |       |       |       |       |       |       |       |       |       |
| Top-tier, Trophy Assets | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 11.1% | 11.1% | 22.2% | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 0.0%  | 11.1% |
| 12 mon                  |       |       |       |       |       |       |       |       |       |       |       |       |       |       |
| Core Institutional Grade Assets | 10.0% (1) | 40.0% (4) | 20.0% (2) | 10.0% (1) | 10.0% (1) | 10.0% (1) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) |
| Distressed/Troubled Assets | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 11.1% (1) | 11.1% (1) | 22.2% (2) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 0.0% (0) | 11.1% (1) | 0.0% (0) | 0.0% (0) |

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# Cap Rates in 3 Years

## Now

<table>
<thead>
<tr>
<th></th>
<th>3 years from now</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Under 5%</td>
</tr>
<tr>
<td>Top-tier, Trophy Assets</td>
<td>10.0% (1)</td>
</tr>
<tr>
<td>Core Institutional Grade Assets</td>
<td>0.0% (0)</td>
</tr>
<tr>
<td>Distressed/Troubled Assets</td>
<td>0.0% (0)</td>
</tr>
</tbody>
</table>
Other Factors Affecting Seattle Outlook
Significance of Risks to Seattle in 2012

- Market Freeze w/ Surge Distressed
- Failed National Recovery
- Unreasonable Tenant Demands
- Pressure for Bank Risk Reduction
- Buyers Sitting on Fence
- Deterioration in S/D Fundamentals
- Failed Housing Recovery
- Increase in Strategic Foreclosures
- Lack of Debt for Maturing Bullets
- Failure to Replace CMBS

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Biggest Risk Facing Seattle in 2012

2011 Surprise

Potential in 2012
Agree/Disagree on Seattle Market in 2012

- Consumer Conf. Lead Retail Boom
- Banks Aggressive on Troubled
- CMBS Will Be Back!
- Negative Talk is Hype
- Commercial Values Down 15%+
- Increasing Transaction Volume
- Good Properties Easy Credit Access
- Dramatic Inc. RE Capital Flows
- Distressed Asset Flood Mkt
- Investors Down Food Chain

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How Real Were These Opportunities in Seattle in 2011?

- Takeover Distressed Equity
- Vulture Investing
- Repositioning Projects
- Selective Buying w/ Local Insight
- Taking Over Stalled Projects
- Help Borrowers with Workouts
- Asset Management Takeovers
- Buying Portfolios of Distressed Assets
- Rent Reduction via Lease...
- Distressed Asset at 30-40% of Value

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What Are the Biggest Opportunities in Seattle?

• Value Creation
  – Conversion/rehab of buildings to LEED and new leasing opportunities
  – Timing of office properties with the idea of a value added play
  – Sale-lease back
  – Locking in low debt
  – Back fill and subsequent sale
  – Buying distressed properties

• Demand
  – Continued growth in the intellectual development/trade business segment
  – Formation or evolution of another technology company

• Development
  – Redevelopment of the waterfront after the tunnel is built
  – Transportation related project
  – Office development.
  – Core class A properties
  – Mixed use development
How Will Industry Change Over 3-5 Years?

- Not a Lot
  - Not much
  - Stay about the same.
  - Not a whole lot

- Development
  - More BTS than in the past, less spec development
  - More buildings moving to LEED status

- Demand
  - Shorter lease terms, less space
  - Significant changes: hotelling and telecommuting
  - Higher demand for office product, beyond MSFT and Amazon
  - Quality properties will remain in demand

- Players
  - Fewer players, developers brokers
  - Fewer people working in it
  - Too many mouths to feed
  - Fewer local, niche players
What is Biggest Change Coming to Seattle?

• Changing Fundamentals
  – Multifamily oversupply; lack of supply in the office sector
  – Continuing drag on the market of residential
  – More consolidation, fewer players, tough on small developer

• Economy
  – Rediscovery of domestic production capabilities and competitiveness
  – Significant changes in US economic drivers; intellectual development/trade,

• Demand
  – Non-traditional office environments (hotelling and telecommuting and clicks and bricks retail)
  – Shrinking demand; improved occupancy management
  – Corporations shedding real estate. “r

• Transactions/Values
  – Buyers and sellers agreeing on price
  – Lenders able to lend on non-core assets
  – Energy monitoring, regulation
Biggest Corporate Real Estate Challenges?

- **Operations**
  - Remaining profitable with reduced revenue streams
  - Managing portfolios in the face of rapidly changing business models
  - Rising costs of construction
  - Fending off competition, new CREs

- **Future Planning**
  - Planning for growth as the need for formalized office space decreases.....
  - Uncertainty, markets will shift
  - Stay and refurbish or upgrade to a distressed location
  - Internal clients, demonstrating their value add
  - Understanding the market forces to see opportunities

- **Portfolios**
  - Off loading underutilized space
  - Maintaining existing portfolios
  - How to determine value
What Advice to Young Professionals?
Presentation Summary

• Part I: Economic Outlook
• Part II: Real Estate Capital Markets
• Part III: Real Estate Market Fundamentals
• Part IV: Challenges, Issues & Opportunities