Commercial Real Estate Outlook 2012: A Positive State of Mind?

CoreNet Global: Seattle
James R. DeLisle, Ph.D.
January 17, 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 and Career Plans

#### Careers: Past & Future

<table>
<thead>
<tr>
<th>Role</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Management</td>
<td></td>
</tr>
<tr>
<td>Asset Management</td>
<td></td>
</tr>
<tr>
<td>Service Provider</td>
<td></td>
</tr>
<tr>
<td>Corporate Real Estate</td>
<td></td>
</tr>
<tr>
<td>Consultant</td>
<td></td>
</tr>
<tr>
<td>Developer</td>
<td></td>
</tr>
<tr>
<td>Investor</td>
<td></td>
</tr>
<tr>
<td>Broker</td>
<td></td>
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<tr>
<td>Lender</td>
<td></td>
</tr>
</tbody>
</table>

![Career-related buzzwords](image-url)
Professional Roles and Career Plans

How many years of experience?

<table>
<thead>
<tr>
<th>Experience Level</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>Percentage</td>
<td>7.1%</td>
<td>5.4%</td>
<td>3.6%</td>
<td>10.7%</td>
<td>10.7%</td>
<td>16.1%</td>
<td>25.0%</td>
<td>16.1%</td>
<td>1.8%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

How many more years of work?

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</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>7.3%</td>
<td>12.7%</td>
<td>18.2%</td>
<td>25.5%</td>
<td>16.4%</td>
<td>12.7%</td>
<td>3.6%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

How have recent events changed your retirement plans?

<table>
<thead>
<tr>
<th>Time Frame</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>3.6% (2)</td>
<td>0.0% (0)</td>
<td>0.0% (0)</td>
<td>50.9% (28)</td>
<td>7.3% (4)</td>
<td>27.3% (15)</td>
<td>10.9% (6)</td>
</tr>
</tbody>
</table>
How retirement plans changed due to economic events?
## Part I: Economic Environment for Real Estate

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

- Corp Profits Increasing
- Credit Market Rebound
- Low Interest Rates Continue
- Slow Econ Recovery
- Retail Sales Increasing
- GDP Surge 2012
- Emp Losses Will Stop
- Inflation Not a Concern
- No Double Dip

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How Important to Economic Recovery?

- Offshore Capital
- Create Hiring Incentives
- Fix Europe Debt Crisis
- Settle "Occupy Mvmt"
- Rising Consumer Conf.
- Resolve Budget Issues
- Strong Job Growth
- Improved Credit Access
- Low Interest Rates
- End Political Rancor

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Other Factors Important to Sustainable Recovery
Recession Risk, Labor & Production

Recession Risk

Good news....

Labor Supply vs. Demand: Unemployment and Openings

Chart 1. Labor Supply vs. Labor Demand
U.S. Seasonally Adjusted Data

Source: The Conference Board
Inflation & Interest Rates

**Core Inflation is Receding**
Core consumer prices, % change annualized

**Another Solid Quarter for Business Investment**
Computers and peripheral equipment, annualized % change

**Total Compensation**
% change

**Retail Sales**
% change

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Housing Trends

Next Generation of Homeowners Are Freaked Out

Home Builder Confidence Rises Four Points in October

Benchmark Revision Shifts Home Sales Down

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Consumer Confidence, TINR & Politics

There Is No Reality

Source: Gallup.com
Business Confidence & Manufacturing Output

Sales vs. Credit is driving confidence for small business
New Research: Informational Disintermediation

Twittering

Positive Feelings  Negative Feelings

Twitter's Global Moods

Blogging

Negative state of mind

FDIC Proposes Bank 'Stress Tests'
U.S. banks with more than $10 billion in assets would have to perform their own tests of whether they have enough cushion to withstand losses under an FDIC proposal.

Source: Science, Cornell University; Images – ScienceWri
The Global Scene

GDP Slips from 9.5 to 9.1%....

China Gets Growth Help From Domestic Demand

Euro Earns Skeptics

How many dollars one euro buys

FRIDAY: Down 1.37 cents

Global Outlook: 5 Years (Gallup)

Cosmic Convergence? China Growth and U.S. Unemployment Rates Coincide
Biggest Risks to Economy

Risks in 2011

- Political instability
- Economic crisis in Europe
- Unemployment in countries
- Credit issues
- Confidence in financial markets
- Global economic downturn
- Policies and budget concerns
- Inflation and price increases

Risks in 2012

- Housing market collapse
- Contagion from Europe
- Unemployment and job loss
- Political uncertainty
- Economic populism
- Housing price deflation
- Interest rate policy
- Budget deficits and debt

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# 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>

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How We’re Doing: Commercial Real Estate

3Quarter 2011

Current Qtr Estimate

- Income: 1.29%
- Appreciation: 2.28%

1.29% * 4 = 5.16%

Aggregate Return:
- Total, Gross: 3.58%

Annual Returns

<table>
<thead>
<tr>
<th>Income</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>

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US Transaction Momentum

QUARTERLY US PROPERTY SALES

YOY CHANGE

Search by Style

2011 YEAR-TO-DATE SEARCH SUMMARY

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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

Loan Payoffs at Maturity

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

Downgrades of BofA, Wells Fargo and Citigroup Leave CRE in Limbo

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

<table>
<thead>
<tr>
<th>2010 Spatial Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Still weakening, negative absorption; more downside risk</td>
</tr>
<tr>
<td>Vacancy rates pushing records, rents declining</td>
</tr>
<tr>
<td>Negative absorption, lagged recovery</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2011 Spatial Market</th>
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<tbody>
<tr>
<td>Still weak, limited absorption; more downside risk</td>
</tr>
<tr>
<td>Vacancy rates peaking, rents stabilizing but low</td>
</tr>
<tr>
<td>Absorption flat, recovery lagging tenants nagging</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2012 Spatial Market</th>
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</thead>
<tbody>
<tr>
<td>Spotty correction, plateau in connection, deferred resurrection</td>
</tr>
<tr>
<td>Vacancy peaking, rents creaking</td>
</tr>
<tr>
<td>Modest absorption, tenant reflection, landlord perplexion</td>
</tr>
</tbody>
</table>
## Cap Rates

### Now

<table>
<thead>
<tr>
<th></th>
<th>Under 5%</th>
<th>5%</th>
<th>5.5%</th>
<th>6%</th>
<th>6.5%</th>
<th>7%</th>
<th>7.5%</th>
<th>8%</th>
<th>8.5%</th>
<th>9%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top-tier, Trophy Assets</td>
<td>22.2% (6)</td>
<td>14.8% (4)</td>
<td>25.9% (7)</td>
<td>7.4% (2)</td>
<td>7.4% (2)</td>
<td>0.0% (0)</td>
<td>3.7% (1)</td>
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<td>7.4% (2)</td>
</tr>
<tr>
<td>Core Institutional Grade Assets</td>
<td>3.7% (1)</td>
<td>11.1% (3)</td>
<td>18.5% (5)</td>
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### 12 Months Out

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### 3 Years Out

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<tr>
<th></th>
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<th>6%</th>
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<td>3.7% (1)</td>
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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

Strongly Disagree Disagree Neither Agree Strongly Agree
How Real Were These Opportunities in Seattle in 2011?

- Takeover Distressed Equity: Extremely Low
- Vulture Investing: Low
- Repositioning Projects: Neither
- Selective Buying w/ Local Insight: High
- Taking Over Stalled Projects: Extremely High
- Help Borrowers with Workouts: High
- Asset Management Takeovers: Neither
- Buying Portfolios of Distressed Assets: Low
- Rent Reduction via Lease: Low
- Distressed Asset at 30-40% of Value: Extremely Low
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

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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 pricing
  – Lenders able to lend on non-core assets
  – Energy monitoring, regulation

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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