Commercial Real Estate Outlook 2013: It’s Déjà Vu All Over Again

CoreNet Global: Seattle
James R. DeLisle, Ph.D.
February 19, 2013
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?

2012 Topics

2013 Topical Potpourri
Professional Roles and Career Plans

Other Industry Roles

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

Answered: 90  Skipped: 9

- Property Management: 6
- Asset Management: 3
- Service Provider: 24
- Corporate Real Estate: 22
- Consultant: 14
- Developer: 4
- Investor: 1
- Broker: 14
- Lender: 7
- Student: 3

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Experience in Real Estate: Past and Future

Number of Years in RE to Date

- 20 + years

Number of More Years in RE to Date

- 15 + years

Change in Retirement Due to Recession

- 30% plus postponed retirement
# Part I: Economic Environment for Real Estate

<table>
<thead>
<tr>
<th>2010 Outlook</th>
<th>2011 Outlook</th>
<th>2012 Outlook</th>
<th>2013 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>
<td>Potential slip; slow at best; political unrest</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>
<td>Big business profits soaring; small business hanging</td>
</tr>
<tr>
<td>Consumers guarded; CEOs hopeful</td>
<td>Consumers wanna do it; CEOs hopeful</td>
<td>Consumer and CEOs defensive but willing… improvement…</td>
<td>Consumers and CEO hangover; cliff deferred not preferred…</td>
</tr>
</tbody>
</table>

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Market Timing: National vs. Seattle

Economy
- National 67%
- Seattle 83%

Housing Market
- National 60%
- Seattle 87%

Office Market
- National 53%
- Seattle 71%

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Economic Outlook: Agree/Disagree

- **Economy**
  - Recovery
  - Gradual

- **Inflation**
  - No Concern
  - Rates Low

- **Employment**
  - Accelerate
  - Credit Markets

- **GDP**
  - Surge
  - Normal

- **Retail**
  - Rebound
  - Strong

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Comparisons Among CoreNet Categories

**GDP Growth Surge**

Q1: Service Provider
Q1: Corporate Real Estate
Q1: Broker

**Corporate Profits Up**

Q1: Service Provider
Q1: Corporate Real Estate
Q1: Broker
Employment and Wages

Employment Growth

Source: Labor Department

Minimum-Wage Maneuvering Begins

In the first state of the Union, President Barack Obama pushed to raise the Federal minimum wage to $9 an hour, reviving a dormant debate. Photo: Getty Images.

Salary and Wage Increase Restrictions

July 1, 2011 - June 30, 2013

CONTENTS

UNDERSTAND

Salary/Wage Increase Restrictions and Exemptions

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Source: The Conference Board
Inflation & Interest Rates

Bernanke reiterates commitment to record easing

“Federal Reserve Chairman Ben Bernanke said the U.S. economy is far from operating at full strength and reiterated his commitment to record easing.

"With unemployment at almost 8 percent, we are still far from the fully healthy and vibrant conditions that we would like to see," Bernanke said today at a meeting in Moscow of his counterparts from the Group of 20. "The United States is using domestic policy tools to advance domestic objectives."

Import Price Index: 5 years
Housing Trends

Graphs showing housing trends including housing starts, S&P/Case-Shiller® Home Price Indexes, existing home sales, and new single-family houses sold.

Mortgage Debt Relief Act Extended

Graph showing lower rates draw few home buyers.
Gridlock, TINR, Politics & Small Business Confidence,

T I N R

House Vote 30 - Approves Three-Month Debt Limit Extension

<table>
<thead>
<tr>
<th>Yes</th>
<th>285</th>
<th>86 Democrats</th>
<th>199 Republicans</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>144</td>
<td>111 Democrats</td>
<td>33</td>
</tr>
<tr>
<td>Present</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Didn't vote</td>
<td>3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Result: Passed by a margin of 70 votes
Date of Vote: January 23, 2013

Source: Moody’s Analytics

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Consumer Confidence & Consumption

**Different Surveys, Different Trajectories**

Consumer confidence, trough=100, 2012

- Conference Board
- University of Michigan
- Rasmussen
- Bloomberg

Sources: Bloomberg, The Conference Board, U. of Michigan, Rasmussen, Moody’s Analytics

**Consumers More Optimistic About the Present**

Consumer confidence, present conditions, trough=100

**Headlines & Headwinds**

**Longer Term Perspective**

MOODY’S ANALYTICS
Economic & Consumer Credit Analytics

**401(k) breaches undermining retirement security for millions**

By Michael A. Fletcher, Published: January 14 | Updated: Tuesday, January 15, 6:34 AM

MOODY’S ANALYTICS
Economic & Consumer Credit Analytics

**Retailers Fear Payroll Tax Will Cut Consumer Spending**

http://online.wsj.com/article/SB10001424127887323949404578311811573482182.html?mod
Leading Indicators: déjà vu all over again?
Market Reactions: Investors & Consumers

Stock Mutual Fund Flows: 4Q12

Follow the Money
Quarterly flow of investor cash by fund type, in billions*

- $55.7 U.S. stocks
- $7.8 Intl. stocks
- $68.0 Bonds

*Estimated Source: Investment Co. Institute

Consumers: Wait & See

Retail Sales % change

Consumption to Remain Restrained

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Dismal.com; WSJ.online
The Global Scene

Earnings in Europe and the U.S.
U.S. corporations have largely skirted major damage from the European financial crisis, but they will likely face more trouble ahead. Compare the total revenue with revenue generated in Europe in the fourth quarter for 39 companies with significant sales in Europe, and the change in revenues.

There's a Feeling of Instability Bubbling Up
There's a back to the future feel about the global economy right now. The only question is back to what future? The obvious answer considering the events of the past week is the 1970s. There are plenty of echoes in the world today of the currency instability, rising inflation, rising unemployment and political uncertainty that marked that troubled decade.

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Importance of Factors to Sustainable Recovery

Politics Aside    Low Interest Rates    Improve Access to Credit    Strong Job Growth    Resolve Debt Ceiling

Aside            Rates             to Credit             Growth          Ceiling

Consumer        Resolve Cost    Global       Increase     Attract Offshore
Confidence      v. Revenue     Economy Up   H-1B Visas       Capital

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Factors Critical to Recovery and 2013 Risks to Outlook

Risks in 2013
### Part II: Real Estate Capital Markets

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Tentative, waiting, new players &amp; rules</td>
<td>• Patient pouncers, old rules, core rules</td>
<td>• Top-end frenzy, core investor apprehension</td>
<td>• Top-end frenetic, core fanatic</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>
<td>• Cap rate regression, acquisition aggression</td>
</tr>
<tr>
<td>• Challenges re-leveraging; 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>
<td>• Winds are blowing, deal junkies are crowing, déjà vu again...</td>
</tr>
</tbody>
</table>

© JR DeLisle, Ph.D.
## How We’re Doing: National Private Real Estate

<table>
<thead>
<tr>
<th>NCREIF Property Index</th>
<th>Market Value ($ Millions)</th>
<th>Number of Properties</th>
<th>4th Quarter 2012 Returns</th>
<th>3rd Quarter 2012 Returns</th>
<th>1 Year Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Index</td>
<td>319,951.4</td>
<td>7,270</td>
<td>Total</td>
<td>2.54</td>
<td>2.34</td>
</tr>
<tr>
<td></td>
<td>100.0%</td>
<td></td>
<td>Income</td>
<td>1.41</td>
<td>1.42</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Appreciation</td>
<td>1.13</td>
<td>0.92</td>
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</tbody>
</table>

### Property Type Subindexes

<table>
<thead>
<tr>
<th></th>
<th>Market Value ($ Millions)</th>
<th>Number of Properties</th>
<th>4th Quarter 2012 Returns</th>
<th>3rd Quarter 2012 Returns</th>
<th>1 Year Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apartment</td>
<td>80,570.8</td>
<td>1,514</td>
<td>Total</td>
<td>2.81</td>
<td>2.43</td>
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<tr>
<td></td>
<td>25.2%</td>
<td></td>
<td>Income</td>
<td>1.31</td>
<td>1.31</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Appreciation</td>
<td>1.49</td>
<td>1.11</td>
</tr>
<tr>
<td>Hotel</td>
<td>8,274.0</td>
<td>243</td>
<td>Total</td>
<td>2.24</td>
<td>2.14</td>
</tr>
<tr>
<td></td>
<td>2.6%</td>
<td></td>
<td>Income</td>
<td>1.82</td>
<td>1.86</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Appreciation</td>
<td>0.41</td>
<td>0.28</td>
</tr>
<tr>
<td>Industrial</td>
<td>45,321.8</td>
<td>2,974</td>
<td>Total</td>
<td>2.37</td>
<td>2.32</td>
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<tr>
<td></td>
<td>14.2%</td>
<td></td>
<td>Income</td>
<td>1.49</td>
<td>1.51</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Appreciation</td>
<td>0.88</td>
<td>0.81</td>
</tr>
<tr>
<td>Office</td>
<td>112,724.6</td>
<td>1,426</td>
<td>Total</td>
<td>2.17</td>
<td>2.32</td>
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<tr>
<td></td>
<td>35.2%</td>
<td></td>
<td>Income</td>
<td>1.35</td>
<td>1.38</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Appreciation</td>
<td>0.82</td>
<td>0.94</td>
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<tr>
<td>Retail</td>
<td>73,060.2</td>
<td>1,113</td>
<td>Total</td>
<td>2.97</td>
<td>2.31</td>
</tr>
<tr>
<td></td>
<td>22.8%</td>
<td></td>
<td>Income</td>
<td>1.52</td>
<td>1.50</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Appreciation</td>
<td>1.45</td>
<td>0.82</td>
</tr>
</tbody>
</table>
NCREIF NPI Returns & RCA Transaction Volume

Year in Review

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National Cap Rates by Ptype & Volume

Source: RCAnalytics

Transaction Volume

Source: RCAnalytics
Commercial Loan Maturities & Default Trends

Maturity Outcomes by Number of Loans

Source: Fitch

CMBS Loan Delinquencies by Property Type: 2004—Present
7.91% as of January 2013

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

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Still weakening, negative absorption; more downside risk</td>
<td>Still weak, limited absorption; more downside risk</td>
<td>Spotty correction, plateau in connection, deferred resurrection</td>
<td>Moderate improvement, users content, producers lament</td>
</tr>
<tr>
<td>Vacancy rates pushing records, rents declining</td>
<td>Vacancy rates peaking, rents stabilizing but low</td>
<td>Vacancy peaking, rents creaking</td>
<td>Vacancy slipping, rents holding</td>
</tr>
<tr>
<td>Negative absorption, lagged recovery</td>
<td>Absorption flat, recovery lagging tenants nagging</td>
<td>Modest absorption, tenant reflection, landlord perplexion</td>
<td>Some uptake, tenant reflection, developer conviction</td>
</tr>
</tbody>
</table>
Seattle: NCREIF Investments 4Q2012

<table>
<thead>
<tr>
<th>Props</th>
<th>Years</th>
<th>Market Value ($ millions)</th>
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</thead>
<tbody>
<tr>
<td>WA - Seattle</td>
<td>269</td>
<td>27.75</td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WA - Seattle</td>
<td>51</td>
<td>11.75</td>
</tr>
<tr>
<td>Apartment</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WA - Seattle</td>
<td>24</td>
<td>7.50</td>
</tr>
<tr>
<td>Apartment-Garden</td>
<td></td>
<td></td>
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<tr>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Props</th>
<th>Years</th>
<th>Market Value ($ millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>WA - Seattle</td>
<td>115</td>
<td>23.75</td>
</tr>
<tr>
<td>Industrial</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WA - Seattle</td>
<td>98</td>
<td>14.50</td>
</tr>
<tr>
<td>Industrial-Warehouse</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WA - Seattle</td>
<td>70</td>
<td>13.00</td>
</tr>
<tr>
<td>Office</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WA - Seattle</td>
<td>32</td>
<td>5.25</td>
</tr>
<tr>
<td>Office-CBD</td>
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<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WA - Seattle</td>
<td>38</td>
<td>8.50</td>
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<tr>
<td>Office-Suburban</td>
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<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WA - Seattle</td>
<td>30</td>
<td>4.50</td>
</tr>
<tr>
<td>Retail</td>
<td></td>
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<tr>
<td></td>
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<td></td>
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</tbody>
</table>

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# Seattle Transaction Volume and Pricing

<table>
<thead>
<tr>
<th>Market</th>
<th>Volume (in $mil)</th>
<th>Cap Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>NYC Metro</td>
<td>41,637</td>
<td>5.86%</td>
</tr>
<tr>
<td>LA Metro</td>
<td>26,559</td>
<td>6.27%</td>
</tr>
<tr>
<td>SF Metro</td>
<td>21,858</td>
<td>5.78%</td>
</tr>
<tr>
<td>DC Metro</td>
<td>19,202</td>
<td>6.24%</td>
</tr>
<tr>
<td>Chicago</td>
<td>11,359</td>
<td>7.00%</td>
</tr>
<tr>
<td>Seattle</td>
<td>10,334</td>
<td>5.71%</td>
</tr>
<tr>
<td>Houston</td>
<td>8,749</td>
<td>7.38%</td>
</tr>
<tr>
<td>Dallas</td>
<td>8,137</td>
<td>7.29%</td>
</tr>
<tr>
<td>So Fla</td>
<td>8,133</td>
<td>6.94%</td>
</tr>
<tr>
<td>Boston</td>
<td>7,771</td>
<td>6.98%</td>
</tr>
<tr>
<td>Atlanta</td>
<td>6,934</td>
<td>7.09%</td>
</tr>
<tr>
<td>Phoenix</td>
<td>6,155</td>
<td>5.99%</td>
</tr>
<tr>
<td>Denver</td>
<td>5,773</td>
<td>6.79%</td>
</tr>
<tr>
<td>San Diego</td>
<td>4,853</td>
<td>6.45%</td>
</tr>
<tr>
<td>Austin</td>
<td>4,214</td>
<td>6.83%</td>
</tr>
</tbody>
</table>

Investors Pour (poor?) more $’s into Seattle
Seattle Transactions and Distressed Assets

Transactions 2012

Top 100 Distressed 2012
Seattle Cap Rates: 2013, 2014 and 2016

Mode <5% = 28%  
Mode 5.5% = 25%  
Mode 9% = 19%

Mode 5.5% = 25%  
Mode 6% = 23%  
Mode 8.5-9% = 27%

Mode 6% = 38%  
Mode 6-6.5% = 46%  
Mode 8.5-9% = 31%
Seattle Market Outlook: Agree/Disagree

- Investors: Poor in $’s
- Core Prices: Surge
- Office Vac.: Declining
- Comm’l Mtgs: Easy Access
- Transactions: Accelerate

- Investors will poor significantly...
- Prices for core assets will...
- Office vacancy rates will conti...
- Commercial mortgages will be ea...
- Transaction levels will accelerate...

- Developers: New Office
- Multi-family: Taper Off
- Local Emp: Above US
- Housing: Rebound
- I-90 Tolling: Successful

- Seattle developers will begin...
- Multi-family construction activity w...
- Local employment increases...
- The housing market will rebound wi...
- The movement to add tolling to...

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Seattle’s Biggest 2012 Surprises and 2013 Concerns

2013 Concerns

Biggest 2012 Surprises

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Significance of Risks to Seattle Economy in 2013

- Overbuilding of the apartment...
- A shortage of large blocks of...
- Continued increases in violent...
- A failed recovery in the housing...
- A withdrawal of outside capital a...

Lack of Affordable Housing vs. Top End

- Q1: Service Provider
- Q1: Corporate Real Estate
- Q1: Broker

Shortage of Big Blocks of Office

- Q1: Service Provider
- Q1: Corporate Real Estate
- Q1: Broker

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Top Issues and Risks in Seattle Real Estate Market

- Lack of significant job growth
- Difficulty accessing mortgage...
- Stagnant business conditions
- Rising office rents
- Rising unemployment

- Lack of access to credit for...
- Rising interest rates
- Traffic gridlock worsened...
- Withdrawal of outside capital
- Lost momentum in the housing...
How Will Industry Change Over 3-5 Years?

• Development
  – Possible spec development
  – LEED becoming ubiquitous

• Demand
  – Shorter lease terms, less space
  – Significant changes: flex and short term needs
  – Technology driving
  – Quality properties will remain in demand

• Players
  – Fewer large players working in it
  – Fewer local, niche players
Green Building Movement: CoreNet 2008-2013

Tenants Pay  Mkt. Green  More $’s
Mkt. Green  Research  Support $’s
More $’s  w/o Reg/Inc  OK Green $’s
w/o Reg/Inc  Support $’s  On Own

Bottom Line Pressure
not Stop Green

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What Are the Greatest Opportunities in Seattle?

• Value Creation
  – Distressed real estate; true value-add
  – Existing property Upgrades
  – Buying below top
  – Back fill and subsequent sale
  – Buying distressed properties

• Demand
  – Continued growth in the intellectual business segment
  – Beyond Amazon: emergence of new technology companies
  – Affordable housing; too much top end

• Development
  – Waterfront
  – Transportation related projects
  – SoDo
  – Core Seattle/Bellevue Class A

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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 for less than core assets
  – Lenders able to lend on non-core assets
  – Energy monitoring, regulation
Biggest Corporate Real Estate Challenges?

- **Operations**
  - Cutting costs while satisfying demand
  - Maintaining competitive advantage
  - Increase spending in spite of bottom line pressure

- **Future Planning**
  - Forecasting corporate needs
  - Making bets in the face of uncertainty
  - Earning respect, internal clients & management
  - Rightsizing in face of downsizing pressure

- **Portfolios**
  - Gauging portfolio level demand
  - Maintaining strategic focus under pressure, uncertainty
  - Measuring value-add, attribution
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

Knowledge Business: Creation and Transfer

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